Too Early to Call the Comeback

Currency | What’s Changed
---|---
USD | Look for the dollar to hold onto some strength until covid fears dissipate
CAD | Expect loonie weakness to continue, given current risk attitude and record-low oil prices
EUR | The lack of a pan-European response to the crisis will continue to weigh on euro sentiment
GBP | Easing risk negativity and a rebound later this year should see sterling pick up strength
JPY | Expect JPY to strengthen as global demand recovers further out

Commodity FX | Risk sentiment will be the major driver of price action for the AUD and NZD
LATAM FX | The risks associated with the lack of fiscal room to battle virus increases risks for regional economies should see the currencies weaken in the near-term
FX Asia | Look for ongoing stability in the Chinese currency, which has acted as somewhat of an anchor for the other regional currencies, to continue

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<th>Currency Outlook</th>
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Key Indicators- Latest Data Point

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CAD

Avery Shenfeld | Taylor Rochwerg

**Weakness Still Lies Ahead**

Q2 20: 1.45 | Q4 20: 1.40 (USDCAD)

The shift to a risk-on environment saw the greenback give back some ground, and thus the C$ strengthen relative to the levels seen in mid-March. But we’re still wary of the rally in equities, since, barring the availability of a mass-produced wonder drug that allows a quick end to the pandemic, the long path to restore activity to where we were in February implies a large hit to both 2020 and 2021 earnings.

While that disappointment might not produce much of a general flight to the USD, with global oil prices having gone negative and still sitting at weak levels, despite a deal being reached to cut production and prop up prices, we expect the Canadian dollar to return to its recent trough, with dollar-Canada at 1.45 by mid-year.

Longer-term, while we look for see modest strengthening in the loonie next year as the market looks ahead to better levels of global activity in 2022, assuming that we are seeing progress towards a vaccine, we still anticipate the need for a weaker C$ further out. That key ingredient will be necessary to see the rotation away from consumption and housing and towards exports, which should see USD/CAD push higher to 1.41 by the end of 2021.

USD

Avery Shenfeld | Taylor Rochwerg

**Safe Haven Bid Still in Play**

Q2 20: 99.4 | Q4 20: 96.6 (DXY)

Following a heightened bid in the flight to safety, the greenback has given back some ground that it picked up in late March. While US equity markets jumped on news of returns to work and drug trials underway, we’re wary of the potentially pre-emptive risk-on moves. In addition to the struggle to test enough of its citizens for covid-19, it’s likely that only a very partial return to normal activity will be tolerable without triggering a reacceleration of cases. The dollar is starting from stronger levels, reflecting a flight to safety value, but we expect the currency to slowly give back some of that strength when we expect economies to begin to recover alongside progress on the virus frontier.

Looking beyond the coronavirus, we still see the USD to be in an overvalued position in terms of the country’s current account balance. As such, we’re maintaining our medium-to longer-term view, wherein the greenback should weaken against many other major currencies come next year.

Jeremy Stretch | Bipan Rai

**EUR Holding Up Despite a Lacking Pan-European Response**

Q2 20: 1.11 | Q4 20: 1.14 (EURUSD)

The unwinding of the USD liquidity squeeze helped mitigate short-term EUR headwinds. The reversal of the funding crunch coincided with speculative investors paring back modest EUR shorts. In early April, the market swung towards the largest long EUR speculative skew in two years. Despite significant net inflows, market concerns about the lack of a coordinated pan-European COVID response has limited EUR impetus.

While euro sentiment remains compromised by the lack of political coherence, we’ve seen the ECB taking action by expanding its balance sheet. However, that move has been dwarfed by the additional supply of USD currently being injected into the market, which remains supportive for the EUR/USD pair.

Despite the lack of a pan-European response to the crisis, we regard the easing in German fiscal conditions as significant. Germany’s easing of the so-called ‘Blackzero’ policy - injecting €156bn into the economy - should result in a significant fiscal multiplier effect.

The widening in UST-Bund spreads, by roughly 100bps since the beginning of the year, has effectively reduced the Greenback’s allure. With previous US growth and spread-based advantages being pared back, we expect positive fund flows, due to the perpetuation of the eurozone current account surplus, to point towards modestly benefitting the euro - despite elevated political strains.

JPY

Jeremy Stretch | Bipan Rai

**Positive on JPY Strength**

Q2 20: 105 | Q4 20: 103 (USDJPY)

There’s been a drastic reduction in realized volatility in USD/JPY over the past month. Indeed, March trading was initially characterized by traditional risk-off downside for the pair, with levels breaking below the 102 handle. That was quickly reversed when the USD ‘squeeze’ took over, as there was a general shortage of USD funding available. So, where are we now? Things have stabilized to a degree, with pre-COVID ranges continuing to hold, and the vol curve has gone from being inverted to flat. Sentiment towards owning JPY has moderated, as the ratio of similar delta out of the money JPY calls to puts (against the USD) have also been reduced.

Still, there are compelling reasons to like the downside in USD/JPY. First, risk should remain relatively somewhat on the defensive, as global demand struggles to recover in the coming quarters. Second, spread compression has reduced the appeal of using the JPY as a funder - especially against
the USD. Over time, Japan’s net external surplus implies that the JPY needs to strengthen, which should lead to USD/JPY testing the 100 mark in the coming quarters.

Jeremy Stretch  |  Bipan Rai

UK Economy Coming Under Pressure
Q2 20: 1.25 | Q4 20: 1.29 (GBPUSD)

The BoE lowered interest rates to the effective lower bound of 0.10%, while simultaneously increasing QE by £200bn. These measures combined equate to roughly 225bps of easing. We’re also seeing the Bank allowing for an aggressive expansion of the government’s overdraft, with the BoE increasing the amount of funds being made available for lending. That has allowed for the government to access funds quickly - without a recourse to the bond market.

Beyond monetary expansion, the UK fiscal deficit will likely exceed 10% of GDP - breaching post-GFC highs. This is worth noting, because the deterioration in government finances was a key factor in Fitch’s downgrading of the UK’s credit rating by a notch, to AA-. The government’s aggressive policy responses, including covering 80% of salaries of furloughed workers, will weigh upon government finances. The cost of those measures could be three times of what was initially assumed, as unemployment could rise by two million workers. Despite response efforts, the UK economy could witness a decline of approximately 15% q/q in Q2.

The UK should experience a modest rebound Q3, thereby easing risk negativity. In addition to the fact that the UK could see an extension in the Brexit implementation period, that should encourage a modest GBP/USD uptrend into 2021.

Jeremy Stretch  |  Bipan Rai

CHF: Strength as Problematic
Q2 20: 1.05 | Q4 20: 1.08 (EURCHF)

Movement in the CHF has primarily been a reflection of risk tone and movements in the EUR. With respect to the latter, there’s still a lack of solidarity when it comes to measures addressing the crisis, and that premium is starting to see increases in the EUR. This has resulted in renewed downside for EUR/CHF, with the pair hitting lows of 1.0508 - levels not seen since 2015. We believe that CHF strength can continue, should lockdowns in European countries get prolonged, or if a second wave hits EZ economies. CHF strength continues to pose a problem for the SNB, and currency intervention is the risk to watch for going forward - especially given the size of Switzerland’s external surplus.

Jeremy Stretch  |  Bipan Rai

Riksbank Turns to their Balance Sheet
Q2 20: 11.00 | Q4 20: 10.60 (EURSEK)

The Riksbank still appears to view monetary stimulus as no quick-fix. However, with CPIF having slipped to a five-year low of 0.6% in March and inflation expectations retreating by 0.4% to 1.0%, this suggests that pressure on the CB to further ease policy will remain. Given falling utility prices against sizeable base effects, the April CPIF reading could slip into deflationary territory for the first time.

Having already struggled to exit negative rates, we expect the central bank to continue utilizing their balance sheet as opposed to lowering rates, such as by increasing asset purchases and liquidity injections. Should inflationary pressures show no signs of life into H2, expect the pressure on the Riksbank to act aggressively to persist.

The aggressive uptick in the correlation between EUR/SEK and the VIX index, which has more than doubled in the last nine months, underlining the cyclically correlated nature of the currency. Should global response measures help alleviate trade negativity into H2, that implies that the pair should ease back towards 10.40 over the next year.

Commodity FX
Jeremy Stretch  |  Bipan Rai

NOK Continuing to Show Signs of Struggling
Q2 20: 11.35 | Q4 20: 11.00 (EURNOK)

The inverse correlation between Brent crude and EUR/NOK has diminished from early March highs of 0.77, the metric remains near 0.6 - well above the long-term average. The elevated correlation underscores that, should oil prices remain low, the NOK could struggle to find domestic-based impetus.

The Norges Bank responded to shifting growth dynamics by cutting rates from 1.50% to an all-time low of 0.25%. In addition, in line with global central banks, the government increased its spending by USD $9.5bn. This additional expenditure appears to be funded by the divestment of assets held by the sovereign wealth fund. As a result, the unwinding of around USD $13bn of assets - necessitating the translation back into NOK - helps explain the retreating of EUR/NOK from a brief flirtation above 13. An recalibration in oil prices, driven by a rebound in global demand, should encourage EUR/NOK back towards 2019 levels come next year.
AUD Making a Comeback
Q2 20: 0.62 | Q4 20: 0.59 (AUDUSD)

With China relaxing the social distancing measures that were implemented during COVID, USD funding pressures abating, and global risk sentiment rebounding, the AUD has exhibited a strong beta. Indeed, AUD/USD has appreciated over 14% from lows seen in mid-March. In response to COVID, the RBA cut rates to 0.25%, and introduced YCC in order to keep the cost of borrowing low. We do not foresee any further cuts from the Bank, which will limit downside moves in the currency. For now, expect risk sentiment to be the major driver of price action. We expect AUD/USD prices to stabilize as the market awaits coronavirus updates on a go-forward basis.

NZD Benefitting from Risk Rebound
Q2 20: 0.57 | Q1 20: 0.58 (NZDUSD)

Like the AUD, the NZD has been a beneficiary of the risk rebound that we’ve been experiencing since late March, with the currency appreciating by roughly 8% from its lows. With interest rates at 0.25%, RBNZ is likely finished easing, putting a floor under the currency. We suspect that risk sentiment moving forward will be key in guiding NZD/USD movements, which suggests that the pair should stabilize - at the very least as COVID cases in the developed world plateau.

ZAR: A Downgraded Reality
Q2 20: 19.00 | Q4 20: 17.95 (USDZAR)

The ZAR has been the major laggard year-to-date, depreciating by almost 25%. Over the last month, USD/ZAR breached 18.0 for the first time, temporarily reaching 19.0. While the recent USD funding squeeze seen in Q1 may have amplified ZAR headwinds, domestic considerations have also weighed heavily upon the currency. The combination of the loss of its investment grade credit rating (forcing its removal from the FTSE WGBI Bond Index), and the CB’s aggressive monetary easing (cutting rates by 200bps to an all-time low of 4.25%), explains the reasons for 1m USD/ZAR vol remaining well above 20% over the last month.

The fear of South Africa formally losing its last investment grade rating has long stalked the country. The reality of the ratings move by Moody’s will see a significant net selling of domestic bonds when the index rebalances later this month. However, private sector investors have at least partially pre-empted the move, as revealed by flow data that indicates heavy selling over recent weeks. As such, we look for the ZAR to remain on the defensive.

South Africa’s fiscal backdrop also remains a source of concern, as an elevated cyclically-adjusted deficit as a share of GDP suggests that the government could be unable to shield the economy from repercussions of the coronavirus pandemic. As a result, ZAR headwinds will likely persist until global demand dynamics improve and risk tendencies ease.

LATAM FX

MXN: Public Policy Uncertainty Increasing Fiscal Risks
Q2 20: 22.0 | Q4 20: 22.0 (USDMXN)

Mexican assets have gained some ground since our last publication. General optimism stemming from the “flattening of the curve” in Italy and Spain gave some momentum to risk assets across the globe, and further fiscal stimulus and liquidity measures in advanced economies have also contributed to this improvement. However, the combination of warnings of an oil inventory surge, a decline in demand for crude oil this year, and Fitch’s downgrading of the country’s credit outlook to BBB-, has put the brakes on the positive sentiment surrounding Mexican assets more recently. Moreover, local business sentiment about the lack of economic policy responses has prompted speculation about the potential departure of the incumbent Minister of Finance.

We expect MXN volatility to remain high, given the steep deterioration in growth prospects for this year, ongoing political risks, and a likely acceleration in the monetary policy easing cycle. While we expect the MXN to regain ground towards the end of Q2 alongside a stabilization of the virus outbreak globally, we suggest waiting for better entry points (25-25.5) before dipping into short USD/MXN positions.

BRL: Fiscal Adjustment on Hold
Q2 20: 5.00 | Q4 20: 4.80 (USDBRL)

The situation in Brazil is particularly fragile, as a quick deceleration in growth is putting the brakes on the fiscal adjustment process, which will likely cause a deviation from the spending cap. Moreover, as economic data deteriorates, support for further fiscal reforms could lose strength, thereby increasing structural risks going forward.

Moreover, we expect USD/BRL volatility to remain elevated, as there is continued speculation of the dismissal of Brazil’s Minister of Health, which is effectively working...
to counteract the recently renewed risk-on sentiment. With regards to USD/BRL, we expect some consolidation in the 5.20-5.25 range, as positive external news creates a favourable environment for risk assets. Nevertheless, we remain cautious about jumping early onto the BRL bandwagon, as the COVID-19 situation remains fluid within the country, and internal issues surrounding the handling of the pandemic within the government increase.

Luis Hurtado

**COP: Oil Shock Brings Fiscal credibility to the Front Page**

Q2 20: 3800 | Q4 20: 3600 (USDCOP)

While Colombia was expected to be the star of Latin America this year, the situation has quickly changed. Oil exports represent 40% of total merchandise exports, or around 4.9% of GDP, and FDI into the oil sector represent approximately 20% of total FDI. A double negative hit via the current account and FDI.

Moreover, the drop in oil prices and growth effectively diverted the economy away from its fiscal targets this year, and reignited concerns of a downgrade in the country’s credit rating to junk. Fitch matched S&P’s downgrade, and set the country’s credit rating to BBB-(negative outlook). The according statement highlighted that the predictability and credibility of the medium-term fiscal policy have deteriorated. We mentioned this late last year, as we didn’t see room for further fiscal adjustment during the remainder of the Duque Administration. Moreover, even prior to the COVID-19 outbreak and oil shocks, Colombia was set to use one-off revenue sources to comply with its fiscal target in 2020. As a result, look for limited COP upside in the near-term.

Luis Hurtado

**CLP: Fiscal and Liquidity Measures Take the Lead**

Q2 20: 850 | Q4 20: 830 (USDCOP)

Improvement in global sentiment and in copper prices could rapidly push the CLP to the 800-820 range - in line with our forecast prior to the onset of the COVID-19 outbreak. Nevertheless, there are likely to be questions surrounding Chile’s recovery should investment remain low, given the political uncertainty that will likely persist until after the presidential elections and until the ratification of the new constitution, which is scheduled for somewhere between late 2021 and early 2022.

In terms of monetary policy, in its latest rate announcement, the BCCh cut the overnight rate by 50bps, in line with market expectations. The statement was considerably dovish with respect to the economic growth outlook, and dismissed inflationary pressures from the depreciation of the peso. However, it appears that the CB will focus on liquidity measures going forward, as fiscal actions (4.7% of GDP) take the lead. In our view, this is neutral for the CLP, with the market focusing on the magnitude of the deterioration of the economic outlook and the duration of the COVID-19 impacts on the local economy.

Asia FX

Patrick Bennett

**USD/Asia**

Q2 20: 7.10 | Q4 20: 6.95 (USDCNY)

With a number of major economies still in lockdown, Asian economies that are leveraged to external trade and to global demand more generally will exhibit higher vulnerability than others. Specifically, South Korea, via its trade linkages to China and to global consumer demand, has come under pressure at various points in time. Those economies that were already exposed through deficits in trade, current, or fiscal accounts, are now underperforming, especially India and Indonesia.

Looking at China, being the first exposed to the virus and now looking to be amongst earliest to return to work, economic data is starting to show the depths of the contraction in activity that took place. Q1 GDP contracted by 6.8% y/y, industrial production declined by 8.4% in that period, and retail sales by -19% y/y. Trade data held up better than expected, with exports contracting by 6.6% y/y in March, and imports sitting just 0.9% weaker y/y. The better than expected results have also been the case in other economies, but potentially have not yet accounted for the fact that trade takes longer to plan and execute. Should inventories simply be piling up, weaker trade numbers could lie ahead.

In order to sustain domestic activity, we expect China to again turn to infrastructure building, which we saw in post-2009. We don’t expect this to be a full-fledged repeat, but we again look for a relatively import-oriented repeat. We will continue to track raw industrial commodity shipments, as to-date they have remained firm. External surpluses could be reduced in this approach, but a stable currency should remain an important element.

There’s been notable strength in China’s intra-regional trade, as China’s trade with ASEAN expanded 6.1% in Q1, accounting for 15% of total trade. Imports and exports to EU decreased by 10%, to the US by 18%, and trade with Japan also declined by 8%. We anticipate that intra-regional trade in Asia can continue to hold up better than that with the rest of the world, and as such, we look for some outperformance of select Asian currencies. We
continue to recommend selling any strength in EUR/CNH, initially targeting a move to 7.60. We also recommend CNH/KRW longs ahead of support at 170.
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