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Key Currency Views

- We see the USD index (vs. developed markets) at an inflection point after an upward 8-year cycle, reflecting its expensive valuation (on PPP for instance), the reduction of US cyclical outperformance, the start of a Fed easing cycle and elevated policy risks (with attacks on central bank independence, trade policy uncertainties, debt ceiling risks resurfacing) against the backdrop of wide US twin deficits.

- With a global slowdown unfolding, JPY is attractive as a safe haven as it is cheap vs. USD and likely to be supported by nominal and interest rate differentials vs. USD given very limited room for action for the BoJ or success in lifting inflation expectations. With structural BoP support and cheap valuation, we see some upside risks too for EUR vs. USD since the impact of ECB restarting QE should be limited as foreign investors’ holding of EGBs are now lower than when QE initially launched and rate differentials are supportive.

- The next few weeks may provide a window for cyclical currencies to benefit before a broad global slowdown reduces the case for positive differentiation. NOK has room to benefit vs. EUR ahead of Norges Bank’s likely rate hike on Sep 19th given market underpricing but any rally is unlikely to be sustained given most of the macro upside for Norway is behind us and the currency in line with its short-term drivers. SEK should be underpinned vs. EUR by a strong BoP position and a remaining tightening bias by Riskbank before the interest rate outlook is likely downgraded in September in our view to reflect the impact of global developments. A negative basic balance (BoP) is likely to make CAD sensitive to the erosion of cyclical outperformance vs. US, risks of delays in USMCA ratification and the impact from weaker US demand, especially as CAD is now fairly valued vs. USD on our metrics.

- The structural factors for a bearish case for GBP vs. EUR - a fragile BoP position, rising risks of no deal EU exit and/or early general elections - are now reinforced by the cyclical downturn in our view.

- The negative impact on EMFX from the slowdown in major economies is mitigated by the search for yield amid falling global yields. While the growth channel should ultimately prevail, there is a case in the near term selective attraction of EM in our view. Resilience of growth is uneven across EM as is the speed of monetary policy response. A managed gradual CNY depreciation should add to downward pressures on regional currencies such as KRW, SGD but keep broad EM systemic risks at bay. Central Europe stands out given solid domestic demand. PLN should be a steady performer vs. EUR due to BoP strength and a bias to hike by NBP to slowly develop even if not before well into 2020. We see slight CZK outperformance vs. EUR as CNB is set to resist rate cuts in view of above potential growth.

- Across EM high yielders the outlook for INR is supported by positive chain effects between lower yields, debt dynamics and growth that can run further in the current global environment and given India’s much reduced current account deficit. Twin surpluses in Russia and a gradual easing cycle attracting foreign inflows into the local bond market make a positive case for RUB. We have turned from positive to neutral on MXN amid downward revisions to growth in Mexico, rising external risks (e.g. ratification of USMCA by US Congress) and deterioration in the sovereign balance sheet (due to the Pemex crisis). In contrast, we see ZAR as vulnerable to global growth slowdown given its reliance on portfolio flows and the rising sovereign risk in view of the impact from Eskom crisis and slow growth. TRY prospects are entirely dependent on carry remaining in view of the sanction risk from the US and a precarious external liquidity position.
USD Outlook

- The impact from tariffs has spilled over from the external sector to the domestic economy, with business investment being hit and hiring slowing down across sectors. We look for GDP growth in Q3 2019 to slow down to around 1% QoQ annualised, down from over 3% in Q1.

- The diminishing fiscal stimulus in H2 2019 and the late stages of the cycle apparent in corporate credit leverage and consumer confidence underpin the downshift growth, which has only been reinforced by heightened trade tensions. Combined with too low actual and expected inflation vs. target, external risks to the outlook (eg. trade policy, geopolitics, Brexit) and the greater need to be preemptive close to the zero lower bound, below-potential growth solidifies the outlook for Fed easing. We look for a 25bp interest rate cut in July, followed by another 25bp cut in Sep while the Fed is likely to end earlier-than-scheduled its balance sheet tapering.

- Risk to our view: US-China trade/tech agreement, bi-partisan support for infrastructure programme in US Congress.

- The upward USD cycle that started in 2011 is likely to have run its course and we look for the USD index (vs. DM) to weaken over Q3 as its interest rate support falls further amid Fed easing at a time when US cyclical outperformance is declining and PPP valuation of the USD is expensive on our metrics.

- On the flow side, USD support has already eroded. Net foreign equity inflows are negative and close to -0.7% of GDP over the past 12 months while net foreign bond inflows remain sizeable but partly boosted by US repatriation flows and more likely to be currency hedged.

- Policy risks include additional trade tensions (with China, Mexico, Japan or the EU), a dysfunctional political system as debt ceiling debate unfolds (although both parties have moved away from austerity), continued attacks on Fed’s independence and heightened verbal intervention on the USD by President Trump.
EUR Outlook

• Following a likely stabilisation of real GDP growth in Q2, we think downside risks may increase in the H2 as business uncertainty weighs on capital investment and the trade environment has weakened. Domestic demand and services have been resilient so far, but overall, we think real GDP growth in 2019 will dip below the long-term average (1.4% YoY).

• In Germany, forward-looking surveys point to growth tracking sideways at 0.1-0.2% QoQ in Q2. The outlook for the manufacturing sector remains concerning given its sensitivity to Asian demand, the auto sector, and the threat of US protectionism. A change in leadership of the SPD in their party-conference in Dec brings risk of a coalition collapse, which may dampen already low expectation for a fiscal response to current growth weakness.

• In Italy, we see downside risk to growth should talks between Italy and the EC on the 2020 budget breakdown and tighten lending conditions. The government needs to present a credible budget plan, with weak growth giving limited fiscal space, and as the EC has advised Italy be placed on an Excessive Deficit Procedure with an expectation that the budget deficit will reach 3.5% of GDP by 2020.

• We think the ECB will become more dovish given downside risks to growth, lower market and survey-based inflation expectations. They may change rate guidance in July to include an easing bias, and deliver a 10bp rate cut by Sep. We doubt rate cuts will impact EUR vs. the USD since a 75% probability of 2x10bp rate cuts by year-end is priced, and we see scope for a sharper decline in US yields relatively. A new QE programme has also become more likely. Discussion seems to be underway for a higher “issuer limit” than the current 33%. That said, the transmission of QE into a lower EUR has been weakened as foreigners have been selling EGBs since 2015, and now hold 20% less than when QE started in 2015. Our base case is ECB policy will have limited impact on EUR in Q3. We therefore see upside risk to EUR from the Euro area’s large and stable current account surplus, an improving rate differential for EUR vs. the USD, and the cheap valuation of the EUR in PPP terms.
JPY Outlook

- JPY is one of the cheapest G10 currency vs. USD on our metrics, which reinforces its attraction as a hedge in the face of global growth risks.

- The BoJ has little ammunition left, as it holds more than 50% of the JGB market and buying more ETFs would have limited macro impact. We look for a change in the forward guidance at the July BoJ meeting. We look for a delay in forward-rate guidance on July 30th while the BoJ will likely resist rate cuts in Q3, given the negative side-effects for the banks and provided JPY appreciation remains gradual.

- We expect US bond yields to fall more than JGB yields over the next few months, as the Fed embarks on an easing cycle starting on Jul 31st in our scenario and as despite some flexibility around YCC (yield curve control), JGB yields are floored at around -20/-25bps in our view. On real rate differentials, the Fed is likely to be more successful in reaching inflation expectations than the BoJ in our view, also pointing to a decline in USD/JPY. The sensitivity of USD/JPY to 10-year rate differentials has been rising so far this year.

- With the global economic slowdown at play this is traditionally something that acts a catalyst for Japanese repatriation flows. This should be all the more the case as domestic growth momentum is weak too in Japan. Even ahead of the October consumption tax hike household spending has remained lacklustre. In addition, we expect the investment outlook to deteriorate in view of less buoyant corporate profits and remaining trade uncertainties.

- In addition, historically low hedge ratios of a number of Japanese institutional investors on their US assets are likely to be raised. Both trends should support JPY vs. USD in our view.

- Risk to our view: US-China broad trade/tech agreement in Q3, quicker and more decisive BoJ easing than our base case (which is for a change in the forward-rate guidance change only on Jul 30th).

Sources: Macrobond. Data as of June 2019

Portfolio equity flow repatriation by Japanese investors usually takes place when global manufacturing cycle turns down

GBP TWI likely to be around 12% weaker on a yearly basis if FDI inward flows are reduced sharply after Brexit

Sources: Macrobond. Data as of January 2019
GBP Outlook

• Both Brexit uncertainties (higher risks of a ‘no deal’ Brexit on Oct 31st with a new Conservative PM) and domestic political risks (risk of early general election) are likely to dampen business investment in H2 2019 in our view after it contracted over the past quarters.

• Leading indicators are pointing to a deterioration in the labour market, which is set to hit household spending given the low savings ratio. The recent fall in housing prices in addition create a negative wealth effect. In turn, we see the weakening in activity spilling over from the manufacturing sector, where Brexit has so far had the biggest impact (e.g. car sector), to services.

• The downshift in growth below potential is bound to keep interest rate expectations for cuts rather than hikes in our view.

• While our base case scenario remains for a negotiated exit from the EU (with a free trade agreement to be negotiated with the EU) likely at a later date than Oct 31st, the risk scenario of a ‘no deal’ exit has yet to be priced in EUR/GBP in our view. EUR/GBP is only slightly expensive to interest rate differentials and also roughly in line with other relative cyclical dynamics. Hence it fails to reflect the risk of a systemic shock that could drive GBP 20% to 30% lower on a trade-weighted basis in our view (e.g. EUR/GBP spiking well above parity). The view on EUR/GBP partly reflects that on EUR/USD (upward risks) as GBP already shows a large discount vs. USD on interest rate differentials and more fundamental valuation measures such as PPP.

• The financing of UK current account deficit (above 4% of GDP in 2018, a record 5.6% in Q1 2019) primarily relies on portfolio flows, which makes GBP vulnerable to a deterioration in sentiment. In addition, FDI inflows to the UK have declined since the EU referendum and net FDI turned negative in Q1. Increased risks of a no deal Brexit or of an early election before end-2019 leading to a market-unfriendly outcome would deal a blow to GBP given unstable external financing.
AUD Outlook

• Growth has fallen below trend. Downside risks from the global outlook lie ahead, likely to require a combination of monetary easing, fiscal stimulus and AUD-trade-weighted depreciation. With NAIRU now estimated by the RBA at roughly 4.5% but surveys pointing to a further grind higher in the unemployment rate, additional monetary easing is needed to move the policy stance to an accommodative one. We look for an additional 50bp cumulative cut by the end of 2019.

• For inflation to converge to target, contribution from fiscal policy would be helpful and/or trade-weighted AUD depreciation welcome. Broad USD weakness and a bottom in 10-year spread offer some support to AUD/USD. A trigger would be additional deterioration in global growth/China’s economy, which we expect in Q3 2019. With CNY the biggest weight in AUD trade-weighted index, our view for CNY gradual depreciation and AUD TWI appreciation unhelpful as inflation undershoots target, AUD/USD renewed decline will likely triggered by a repricing of RBA terminal rate, negative Chinese economic surprises and a reduction in short-market positioning.

CAD Outlook

• Domestic demand has firmed, with resilient labour market dynamics and stronger household spending. However, intensification of downside risks for global trade and increased likelihood of a delayed ratification of USMCA by the US, we see rising external headwinds to growth.

• We believe the BoC will remain on the side lines, with a readiness to cut interest rates. Support for CAD from a higher interest rate differential with the US is likely behind us in our view. Based on our short-term fair value metrics combining relative economic surprises, rate differentials and oil prices, USD/CAD is now fairly valued. The debt service ratio of the private sector has increased to high levels, in contrast with the US. The BoP position is likely to be a headwind to CAD. As foreign portfolio inflows have declined sharply, the basic balance deficit has widened, making CAD vulnerable to negative headline news on USMCA ratification or global trade prospects.
SEK Outlook

- Economic data has strongly surprised on the upside, including Q1 GDP growth, but forward-looking indicators point to slowdown ahead. Global trade slowdown is likely to take its toll on the economy in H2 2019 in our view.

- Although inflation has recently been in line with Riksbank’s forecasts, underlying pressures are unlikely to accelerate over the coming months. Labour shortages appear to have peaked according to surveys and wage inflation is set to remain moderate in our view. We expect the Riksbank to signal a pause in its tightening cycle. While its interest rate path points to a hike around the turn of the year, we believe this prospect will be delayed to well into 2020 at the Sep 5th meeting. The impact on SEK vs. EUR should however be minimal as the market is already pricing roughly unchanged interest rates over the next couple of quarters.

- An improved BoP position, a large undervaluation of SEK on a trade-weighted basis and roughly neutral expectations for interest rates by markets should keep SEK supported vs. EUR.

NOK Outlook

- Cyclical outperformance of Norway stands out. Business surveys point to growth accelerating above potential over the next couple of quarters, thereby keeping the labour market potential buoyant, raising further the positive output gap and keeping underlying inflationary pressures above target.

- Although housing price gains have slowed down, household debt remains very high and keeping financial stability risks in check is a key priority for Norges Bank. we look for another 25bp hike on Sep 19th 2019. While they forecast close to 2 additional hikes by beginning 2020, the output gap is expected to roughly halve by 2021, which suggests policy interest rates may peak by Sep 2019 at 1.5% in our view. Based on short-term financial metrics, EUR/NOK is now close to fairly valued as its equilibrium rate has moved higher. In turn, any repricing of the Sep 19th Norges Bank meeting should likely be seen as the high for NOK vs. EUR in our view.
CNY Outlook

- The escalation of trade tensions implies a big downshift in China’s GDP growth from H1 to H2 2019. OECD estimates show the impact from the rise in US tariffs to 25% on USD 200 bn of imports to 0.7% an if this were to be extended to the rest of US imports the total impact would amount to 1.2% drag on China’s GDP growth over 2 years. China still has policy levers to cushion this external shock. The authorities will likely continue to favour additional fiscal stimulus over monetary easing to support the economy given the structural issue of credit leverage and potentially destabilising impact on residents’ outflows from much easier domestic liquidity.

- Past monetary and liquidity easing has started to filter through to credit but after a rebound in activity and credit in Q1, Apr-May data showed signs of relapse. Policy transmission is hampered by high credit leverage. After the surge in Q1, the pace of local government debt issuance has run out of steam, despite an easing of regulations, which has constrained the rebound in public infrastructure investment.

- Risk to our view of managed CNY depreciation: in an adverse global environment the number and severity of Chinese credit events (eg. banks, local governments) could rise and require monetary policy to be loosened more aggressively. With a protracted period of tensions on trade and technology lying ahead and its drag on China’s growth, the case for a weaker CNY, already rooted in BoP deterioration (with the current account surplus having eroded and a deficit set to be registered over the next few years) and CNY overvaluation on a trade-weighted basis.

- CNY basket should weaken (by around 5% a year) in our view, given the cyclical downturn and the need to ease broad monetary conditions. Depreciation vs. USD is likely to remain contained and managed. Capital controls are tighter than in 2015-16, our proxy of capital outflows is much lower and fiscal stimulus is being favoured compared to excessive increases in liquidity. Nevertheless a further decline of nominal growth could exacerbate corporate credit stress and require bigger liquidity injections from authorities, adding to CNY risks.
Asia Outlook

• **KRW**: External headwinds to growth have built up, reflected in a record high inventories/shipment ratio, weak industrial momentum, a collapse in semiconductor exports and a deterioration in business surveys. With our view for CNY depreciation in H2, downside pressures on KRW should build up. Fiscal support is likely to diminish in H2, as the supplementary budget package has yet to be passed in Parliament. With consumer confidence below long-term average and household debt service high, private consumption is weak, dampening inflation pressures. This paves the way for BoK easing likely to start on Jul 18th. With China-US trade tensions disrupting regional supply chains, Korean firms have tended to relocate out of China rather than bringing back onshore direct investment, given rising labour costs.

• **INR**: Weak rural demand and the non-bank financial institution crisis are squeezing credit. In turn demand-side pressures and inflation expectations have abated, allowing for monetary easing. We look for 2 additional cuts (August and Q4). We expect the budget to preserve the commitment to medium-term fiscal consolidation but also keep a focus on supporting growth. INR should also be supported by a narrower current account deficit and resilient FDI. We see RBI’s cut as reviving foreign inflows to the bond market but equity flows may have overpriced the political good news. Indeed we do not share the euphoria post-elections: until Modi’s BJP gets the majority at the upper house, progress on labour market or land reforms is unlikely.

• **SGD**: After GDP growth slowed down sharply in Q1, business surveys show little signs of recovery. Exports and manufacturing production are expected to remain weak in H2. Spillover from external weakness to the labour market is already happening, with deterioration in the ratio of unfilled vacancies to unemployed. We believe the chances of MAS easing at its October meeting on the back of growth concerns have increased (above 50%). Domestic costs have stayed relatively high, with core inflation still within MAS forecasts for 2019 (near 1.5% YoY). Unit labour costs have been resilient but slower growth and job creation should have a disinflationary impact. The SGD basket, currently close to the upper end of the band, is too strong in our view, given the risk of slope reduction by MAS in Oct.
• **RUB:** We think RUB will benefit from strong current account and fiscal surpluses, that are both supported by oil trade revenues and a persistently cheap valuation of RUB to oil. Growth remains challenged with activity trackers suggesting real GDP growth was tracking near-0% YoY as of June. We think weak consumer demand and below target inflation will lead the CBR to cut the policy rate to the bottom of the neutral range (~6%) at a pace of 1x25bp cut per quarter. A monetary easing cycle amid an unchanged sanction environment could lead to more inflows into Russia’s local sovereign bond market, a trend that has persisted since Jan, and added support for RUB. The main challenge to RUB in Q3 is seasonal trade balance weakness in July and August.

• **PLN:** The domestic backdrop remains strong with real GDP growth in Q1 at 4.7% YoY, and likely to stay supported in Q2 and Q3 from a fiscal boost and low unemployment. Such policies have helped give the ruling Law and Justice Party’s (PiS) a 22%-pt. lead over the opposition in opinion polls, suggesting they are well positioned to expand their parliamentary majority in elections in November. This is likely to take inflation above the central bank’s 2.5% target and the market may price a small risk of rate hikes should inflation persistently overshoot their target. However, our base case is for the NBP to keep rates on hold through 2020, therefore the yield differential between PLN and EUR may widen on the back of possible ECB rate cuts. PLN will likely be supported by a cheap valuation and a strong balance of payment position. As such we see PLN as a CEE outperformer.

• **TRY:** We move to a neutral outlook on TRY given the combination of lower US yields, a potential bottoming in Turkish growth and the passing of elections. We are not yet constructive on TRY given large negative tail-risks. Turkey is set to acquire the Russian S-400 defence system and US congress may bypass Trump with sanctions via the ‘CAASTA’. This could impact financial flows into Turkey and with a low private sector-rollover ratio and no let-up in the dollarization trend of local deposits, may add to downside pressure on FX reserves. The CBT is also likely to begin an easing cycle in July, though we expect TRY will be less sensitive to measured rate cuts of around 100bp per quarter.
CEEMEA Outlook

- ZAR: ZAR faces the twin risks of a widening current account deficit and further portfolio outflow, amid a deteriorating growth outlook. Weakening of terms of trade and weak Chinese demand may keep the current account deficit wide in spite of a weak outlook for imports. South Africa also faces deteriorating debt dynamics from weaker growth and rising fiscal expenditure on Eskom. In Q2 there were several days in which foreigners substantially sold local equities and bonds, which may reoccur in Q3 given the uncertain external backdrop. We think the SARB may start an easing cycle as soon as Jul 18th, with a 25bp policy rate cut, in reaction to falling core inflation. This should lower ZAR carry, which, at around 7% on 3m-implied yields, does not compensate for the above BoP risks, in our view. We are bearish on ZAR for Q3.

- CZK: Growth has weakened with business sentiment and the manufacturing PMI starting to turn lower and reflect weakness in German industry. Consumer sentiment has fallen and the CNB now sees wage growth and core inflation moderating through the 2H. This, along with potential rate cuts from the ECB, argues for a prolonged pause in the CNB’s hiking cycle; we think the policy rate will remain on hold through 2020 vs. market pricing of near 50bp of cuts. Current and financial accounts are both near zero, which may explain why CZK implied-volatility is the lowest in the G20. We think CZK may make modest gains vs. the EUR.

Latin America Outlook

- MXN: Banxico’s survey shows GDP growth expectations are down from 1.8% and 1.9% in 2019 and 2020 to 1.3% and 1.2% only. The tariff threat from Trump, policy uncertainty under AMLO and tight fiscal policy have weighed on activity. Banxico is under pressure to ease in view of a dovish Fed stance and historically high real rates, but will likely resist still in Q3 in our view given elevated inflation expectations. The burden from Pemex support for the budget (with Pemex set to be downgraded to high yield) and persistently slow growth could lead credit agencies to cut the sovereign rating again. With Democrats unlikely to speed up the process in the US Congress, the ratification of the USMCA deal could be delayed to 2020, an election year. Such a timing would hit further business in Mexico.