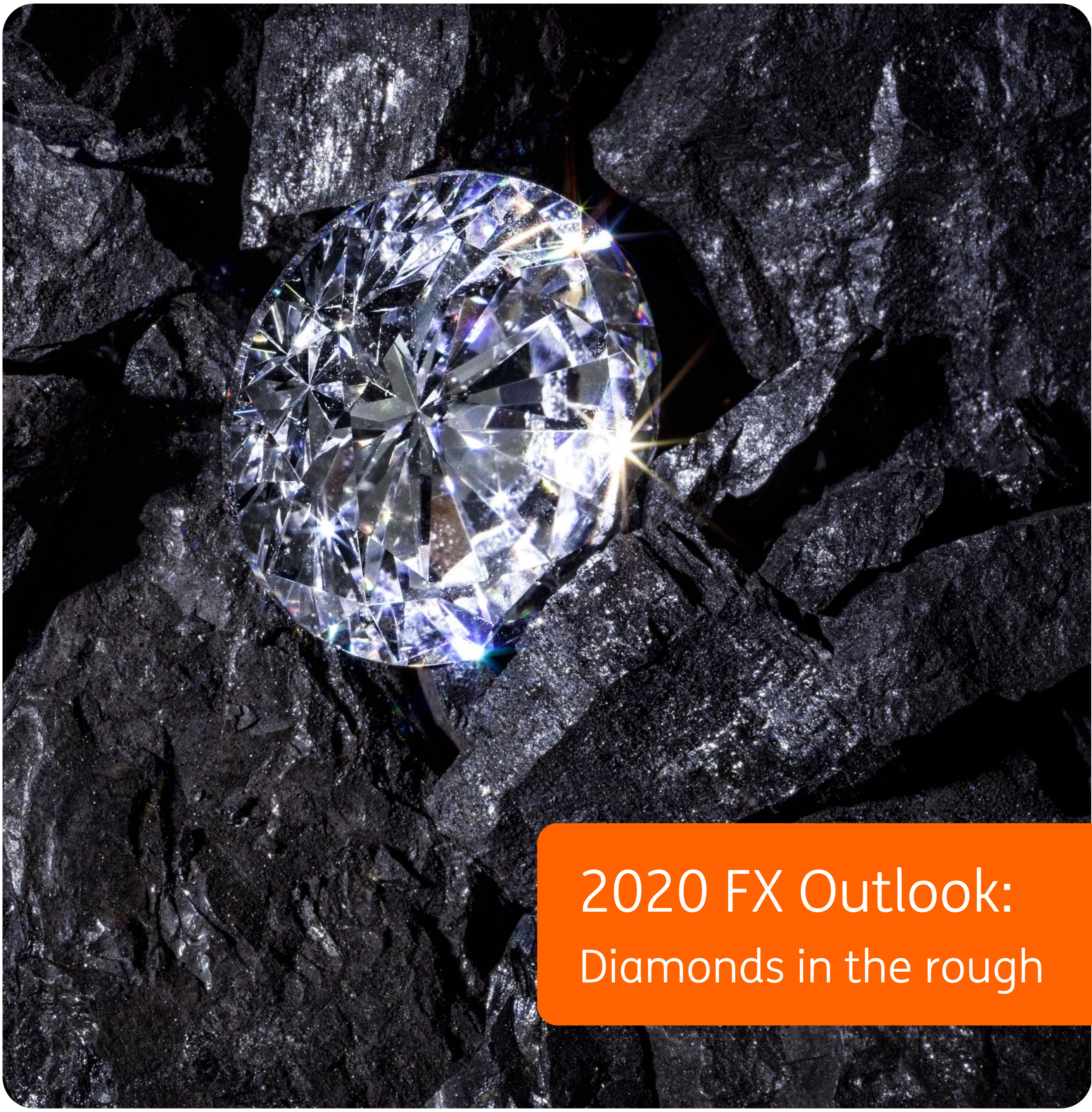
Economic & Financial Analysis

27 November 2019

Please note that this is the non-investment research version of 2020 FX Outlook and does not include the investment strategies contained in the Global Markets Research version of this report



2020 FX Outlook:
Diamonds in the rough

FX Strategy Team

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Executive summary

- **Diamonds in the rough? *definition*: *'something with hidden characteristics and future potential'*. In an FX market priced for secular stagnation, we think the call for 2020 is to identify those undervalued currencies able to hold their own against the dollar – but which are also backed by both yield and growth.**
- **Screening for these characteristics we find that commodity currencies should perform well in 2020. In the G10 space, we like the currencies of Norway, Canada and New Zealand. In the EM space, BRL may offer one of the best stories in 2020.**
- **What of the dollar? Unlike many others, we don't see a clean dollar bear trend in 2020. Continued money printing from G3 central banks mean relatively subdued ranges for G3 currencies, with the EUR emerging as the funding currency of choice.**

Key views

Second-guessing the mutually acceptable deal scenarios for Presidents Trump and Xi has proved a near impossible task in 2019. And overlaying a 2020 FX outlook on a single baseline scenario looks dangerous. Instead we are taking the view that: (1) world trade volumes are unlikely to fall as sharply as they have over the past two years; and (2) some segments of the FX universe are already priced for a view of secular stagnation.

Developments in core markets will also define the 2020 outlook. G3 economies look set to slow further, G3 central bank balance sheets could grow by as much as US$1tr and core bond yields will remain subdued. Renewed liquidity should keep volatility low.

Outperforming in this environment should be those undervalued currencies, with yield, that can deliver total returns against the dollar. Relative economic strength should help too. In the G10 space, this favours NOK, CAD and NZD as well.

In this publication we make the case for a different kind of dollar decline. One played out against selective commodity currencies and high yielders, rather than a broad-based drop. There are no clear signs of the de-dollarization trend hitting escape velocity yet, but we have an article on whether Central Bank Digital Currencies (CBDC) can play a role in the huge cross-border remittance market. This could reduce dollar demand.

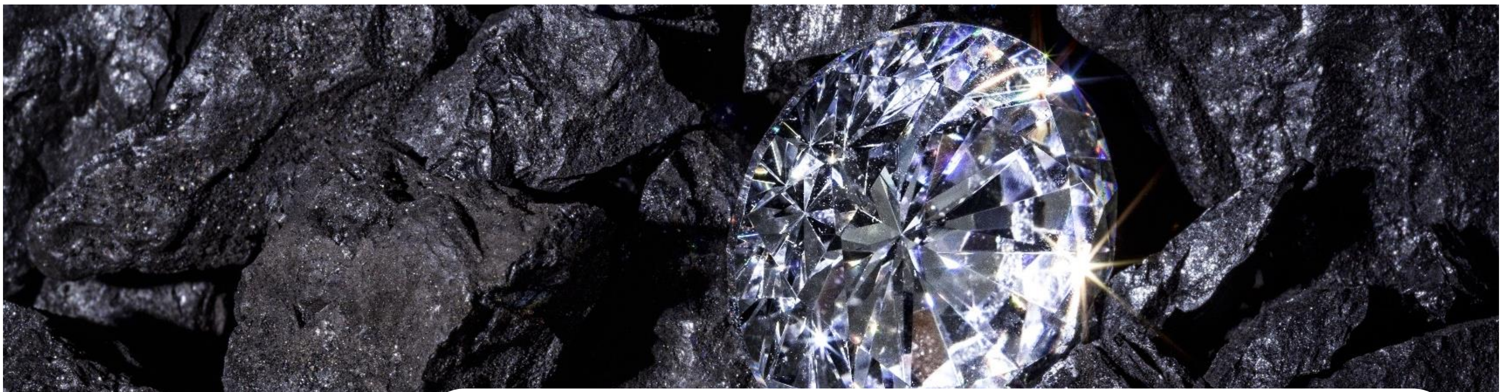
We also present a dollar scenario analysis around US Presidential elections in November.

Subdued growth in Europe suggests investors will have to work hard for returns here. We are edging our EUR/USD forecast lower (1.13 by end-2020) on the view that the EUR is emerging as a useful funding currency. GBP may enjoy a brief rally should the Tories win a working majority and start to 'get Brexit done', but uncertainty over the transition period will limit gains. EUR/GBP is thus unlikely to dip much below the 0.82/0.83 area.

In EMEA, the slowdown in Western Europe is starting to weigh on the CEE. However, the CNB looks set to push ahead with a hike and we favour CZK outperformance amongst CE4 (mainly versus HUF). Elsewhere the rouble should holds its gains through 1Q20.

The vagaries of the trade war have made Asian FX a particularly difficult story. Asian FX underperformance has been compounded by the electronic cycle, where high inventory levels and delays in 5G roll-outs have hit some of the key players hard. However, all currencies (barring THB) look undervalued and if, it's a big if, trade tensions do not get dramatically worse, high beta currencies like CNY and KRW can recover.

In the Latam space, the 2020 story should be one of a reversal of fortunes. The high yield MXN may stand to lose its armour if Banxico embarks on an independent easing cycle. And, after a tough year, we're looking for a recovery in BRL. After worthwhile fiscal reforms this year and as growth picks up, a re-rating story should see notable BRL gains – more likely to be seen after Argentina has restructured its debt in March 2020.



2020 FX Outlook: Diamonds in the rough

- **Somewhat surprisingly 2019 produced strong returns in most asset classes. And many calls, including our own, that the dollar would peak may still prove correct. Yet the dollar story in 2020 looks far from straightforward. Instead 2020 looks like it will be a 'currency-pickers' market, with our job to identify relative value.**
- **Making a call on the trade environment looks almost impossible. All we can say is that with the industrial sector already in recession, we doubt world trade volumes can fall much further. After all, this is not the global financial crisis, where the financial plumbing of world trade – trade credit – completely seized up.**
- **Instead then we see world trade building a base and – after a period of inventory draw-down – some stabilisation in the industrial sector. Softening growth and money printing central banks will likely keep G3 currencies relatively range-bound during this period. The bigger story for 2020 will be total return considerations.**
- **In an FX market priced for stagnation, we think investors will favour undervalued currencies, offering both yield and growth. Screening for these criteria, we see outperformance in many commodity currencies in 2020 – both in the DM and EM space. Also we expect EUR to increasingly become the funding currency of choice.**

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Maybe the dollar does peak in 2019

This time last year in our 2019 FX Outlook entitled *Peak Dollar*, we felt we could see some modest dollar strength against the low yielders through the early part of the year, but 'as 2019 progresses… a safe descent from the dollar summit should start the great rotation out of the US and into the undervalued asset markets overseas'.

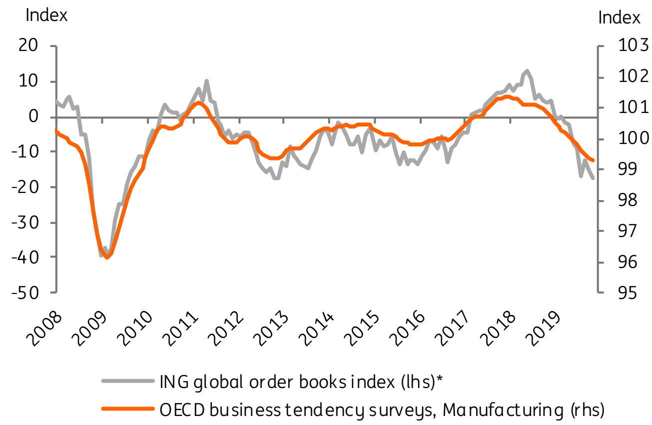
Nobody is talking about a 'great rotation' at the moment, but a few are talking about a broad dollar decline in 2020 on the back of the end in US exceptionalism. We still have some sympathy with this story, but do not see the 2020 FX narrative as simply one of a clean dollar bear trend. And certainly we do not see 2020 delivering many of the bullish FX outcomes witnessed in 2017.

Let's take stock of where we are at the moment. Most leading indicators of activity (mainly industrial) are heading lower and are in contraction territory. These are mainly the manufacturing PMIs and business confidence surveys, reflecting an industrial sector already in recession. The big question is whether low unemployment rates can sustain consumption and buy time for the industrial cycle to turn?

The US economy is a good case in point here. After the fiscal-fuelled boom of 2018, the US economy has started to slow. Leading that decline has been investment, which has not contributed to growth since 1Q19 and may not contribute to growth until 3Q20. That places an inordinate burden on the US consumer.

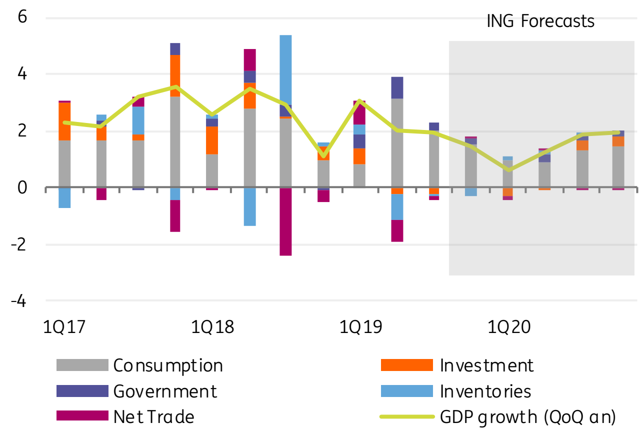
However, our team still looks for US consumption to offset investment in 2020 and deliver a full year growth rate of 1.4%. That is slow by US standards, but far from a hard landing.

Fig 1 Order books and confidence: not pretty



*The index is calculated as the average order books level weighted by GDP share. The number of countries approximately 70% of world GDP.
Source: OECD, ING

Fig 2 US GDP profile: Relying on the consumer

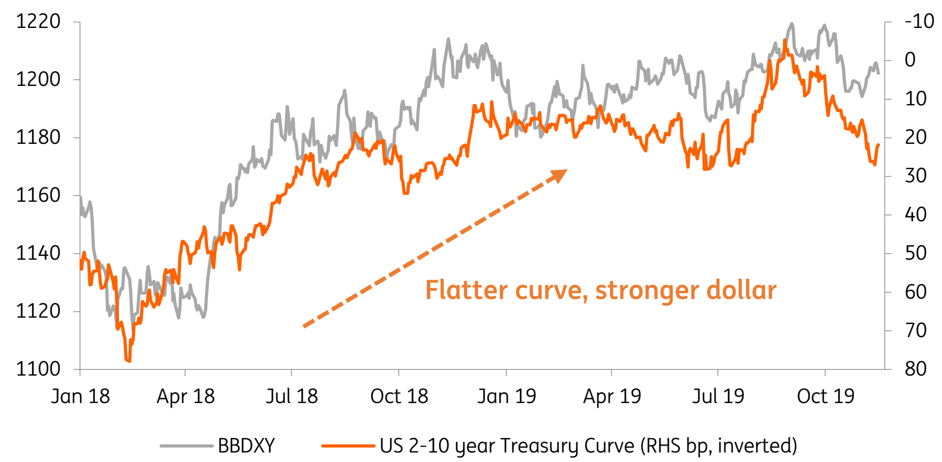


Source: ING, Macrobond

As fears of a 2020 US recession have dissipated, even the much maligned US yield curve has turned higher on the view that this year's three Fed rate cuts – plus some rapprochement between Washington and Beijing – can stave off any hard US landing.

As we have noted frequently this year, we think the US yield curve has been a good barometer for risk appetite and secular stagnation fears have largely been a dollar positive.

Fig 3 US dollar and yield curve



Source: Bloomberg, ING

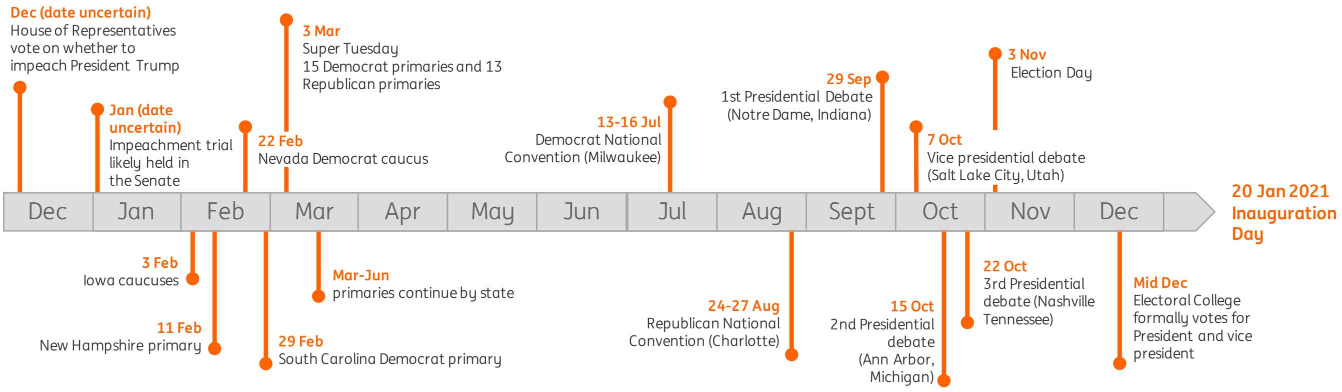
In theory then, could a steeper US yield curve spark a negative turn in the dollar more broadly? We have two issues with that:

1) Our rates strategy team see the US 2-10 year curve locked in a zero to 30bp range for 1H20, largely based on the soft US macro view and the possibility of one or two more Fed rate cuts expected by our US macro team.

2) Even if the dollar did start to sell off, we doubt European currencies would be major beneficiaries, largely because this is not 2017 – when pent up European optimism was unlocked after the French election and the ECB signalled the 'all-clear' on the deflation scare.

What November 2020 means for USD

Presidential timeline



Source: ING

When examining the presidential election and its implication for economic policy there are three key areas to focus on. Firstly, there is the stance of **fiscal policy**. Loose fiscal policy, either through lower taxes, more spending, or a combination of the two typically results in the Federal Reserve running tighter monetary policy. Historically this has been a positive backdrop for the US dollar.

Secondly, there is the **regulatory framework**. Tighter regulations may be interpreted as a hindrance to business activity and may lower growth even though, if properly implemented, it provides safeguards and can create incentives. The perception of slightly weaker growth may result in lower interest rates and be a mild dollar negative.

Then, thirdly, there is **protectionism**. The implementation of tariffs as a tool to extract trade concessions under Trump's Presidency has hurt business sentiment by creating uncertainty and raising costs. With China responding in kind, both economies have experienced headwinds. Amidst weak global growth the US economy has outperformed and the dollar has stayed firm. If trade tensions were to persist then this could maintain a safe haven bid for the dollar. Should they ease then this could create an environment for better global growth and see investment flows start to move out of the US dollar.

Candidate policy preferences

Policy preferences and the USD

Re-election of Donald Trump would likely see the pursuit of **looser fiscal policy** (should Congress allow it), **reduced regulations** and full-on **protectionism**. Despite consistent pressure on the Fed to cut, this policy mix is **USD bullish**.

Centrist Biden would pursue looser fiscal policy through **infra-structure**, rather than tax cuts. Stricter **regulatory oversight of big tech** and support for **green energy**. Less protectionism.

Warren & Sanders would probably have similar impact on the USD – negative. **Big re-distributive tax hikes**, much greater regulation and in Warren's case, formally targeting weaker US$.

In addition, both favour **Modern Monetary Theory (MMT)**, where **Fed prints trillions** to support 'Green New Deal' aiming to make US carbon neutral. Fed's mandate to change too.

Buttigieg, or Bloomberg if he runs on the Democrat ticket, occupy the centre ground, like Biden. **Better relations with the Fed** and infrastructure spending look **mildly US$ positive**.

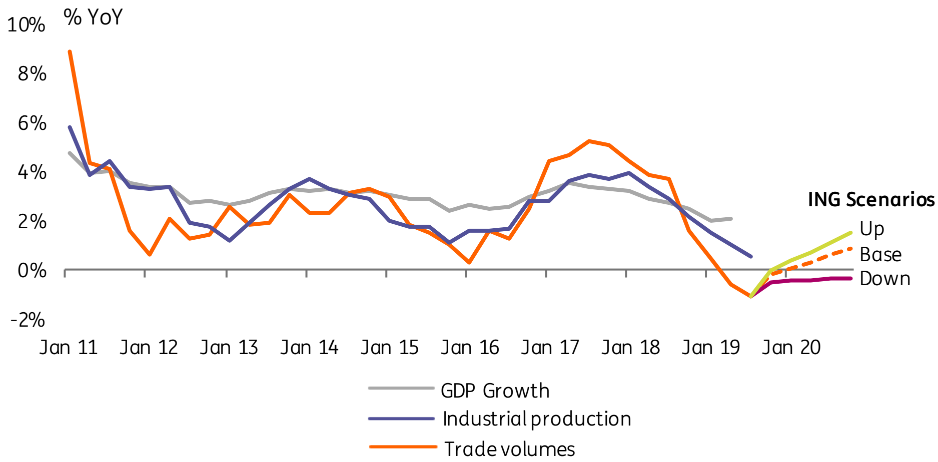
*In the scenario of Republicans controlling Congress
Source: ING

Three themes for 2020

Theme 1: Bottoming growth

Protectionism has frustrated global growth for a second year and, in the case of Asia, pressure from the trade war has been compounded by the low-point in the global tech cycle. Our baseline view sees a marginal pick-up in global trade volumes into 2020, though our trade team feel that 5-10% YoY growth rates may be a thing of the past – supply chains having been shortened after the 2018-19 trade shock.

Fig 4 World trade: Finding a base in 2020



Source: CPB, ING

As highlighted in Figure 4, our trade team's expectations for trade volume growth in 2020 are very conservative – but importantly their bearish scenario assumes that things do not get materially worse than we are witnessing currently – ie, a modest contraction.

In all, our macro team see 2020 global growth around or slightly above 2019 levels although there will be a growing disparity between the DM and EM economies.

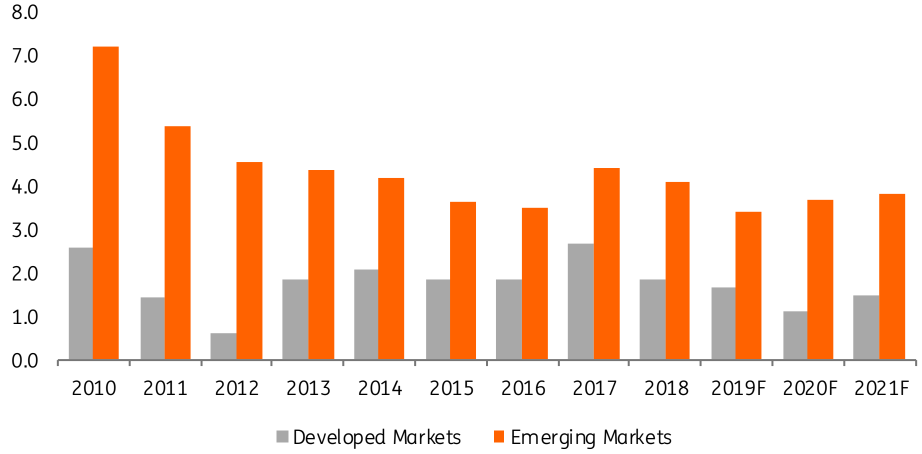
"In 2020 DM growth slows for a third year in a row, while EM growth finally rises"

Indeed, it will be no surprise that investors will be looking to EM shores in 2020. In Figure 5, we highlight ING's growth forecasts for 2020 and 2021 in both the developed and emerging markets. The main take-away for 2020 is that aggregate DM growth slows for a third year in a row, while EM growth finally rises. After all, some of these large EM monetary easing cycles and big currency declines should be providing some support.

These diverging growth rates will have some significant implications for interest rate policies and also capital flows as flat or negative yield curves in the G3 space prompt pension fund managers to search further afield in terms of yield.

Historically, asset and liability matching has been a major challenge for the Japanese pension fund industry. But into 2020, expect to hear more of European pension funds with low coverage ratios forced to look further afield (increasingly outside of the G3) in search for higher-yielding products.

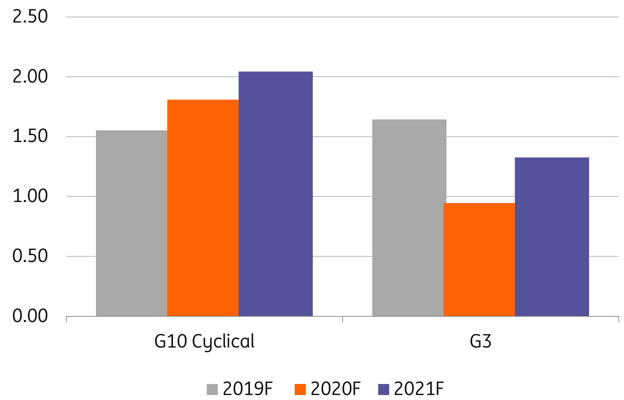
Fig 5 DM versus EM GDP performance and ING forecasts (% annual)



EM weighted according Barclay EM Local Currency Bond Index
Source: ING, WEO

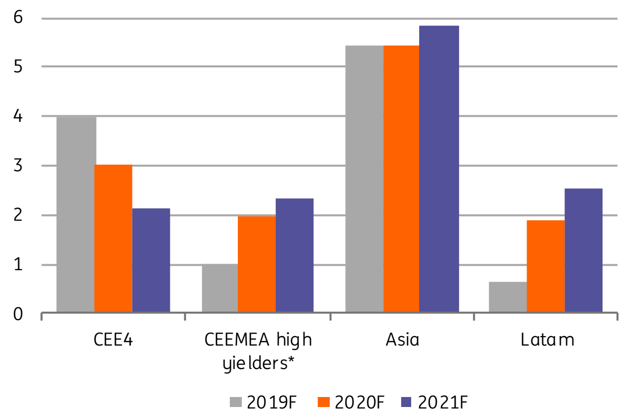
Looking within the DM and EM currency blocs, we note the following: G3 economies look to slow quite steadily. That effectively represents policy paralysis in Europe and Japan at a time when the US is moving deeper into its late cycle status. For reference, we see the US slowing down to 1.4% in 2020 versus 2.3% in 2019, and the Eurozone and Japan dropping to 0.7% (1.1%) and 0.2% (1.2%), respectively.

Fig 6 Within DM, we favour cyclicals over G3



Source: Macrobond, ING

Fig 7 Latam, Asia and some high yield to outperform



*Russia, Turkey, South Africa, Ukraine
Source: Macrobond, ING

While we do see a modest slowdown in Chinese growth, we are looking for recoveries in the likes of Brazil, Russia, Mexico, India and several other Asian countries. Unlike many in the market, we tend to agree with the IMF that EM growth will be sufficient to offset the DM slowdown and keep 2020 world growth at similar levels to this year. That's not bad.

From an FX perspective, the above means the following: (1) the growth outlook favours EM FX versus DM FX (Figure 5); (2) within the DM/G10 FX space, cyclical currencies should be better positioned versus the major, low yielding currencies where growth is slowing (Figure 6). This means that USD, JPY and EUR should lag AUD, NZD, CAD or NOK; and (3) within the EM FX space, CEE is the only region that will not show an improvement in growth next year (Figure 7). With local CE4 currencies being low yielders, they should generally underperform the high yielders in the rest of world, where growth is set to accelerate. The still depressed volatility environment further supports this case.

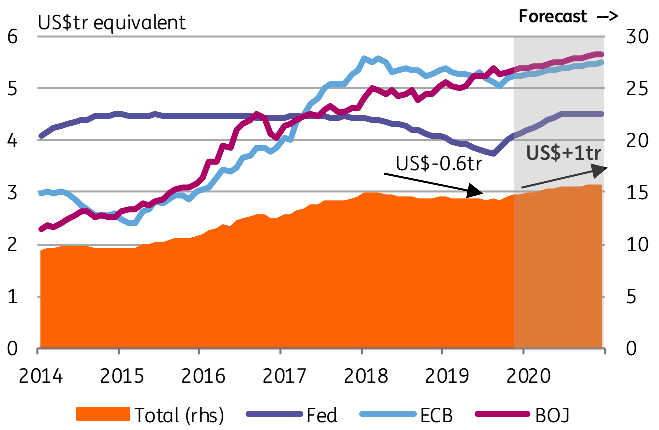
"Within the EM FX space, CEE is the only region that will not show an improvement in growth next year"

Theme 2: Low volatility favours carry

When setting the scene for 2020 it is also worth considering the volatility environment. Will 2020 be a late cycle, tighter liquidity environment which would typically mean higher volatility and outperformance of the safe haven currencies? Probably not.

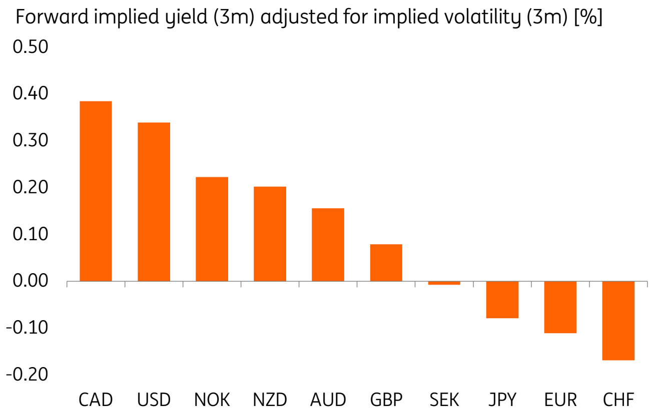
Instead the Fed has prematurely stopped its misnamed quantitative tightening – having found the biting point in US money markets where liquidity was deemed as scarce. And our US macro team actually see risk of one or two more Fed cuts in early 2020.

Fig 8 G3 central bank balance sheets expand again



Source: ING Rates Strategy Team

Fig 9 G10 volatility adjusted carry

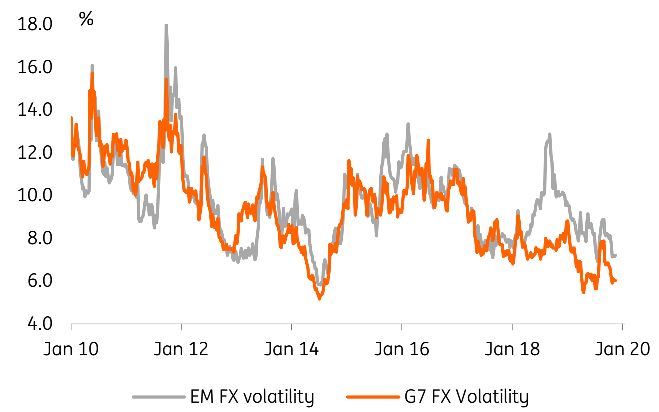


Source: Bloomberg, ING

This comes at a time when the BoJ's balance sheet is still growing (by around 4% of GDP per year) and the ECB has re-started asset purchases. After US$600bn of balance sheet shrinkage since 2018, it looks like G3 central balance sheets could revert to growth of around US$1trn by the end of 2020.

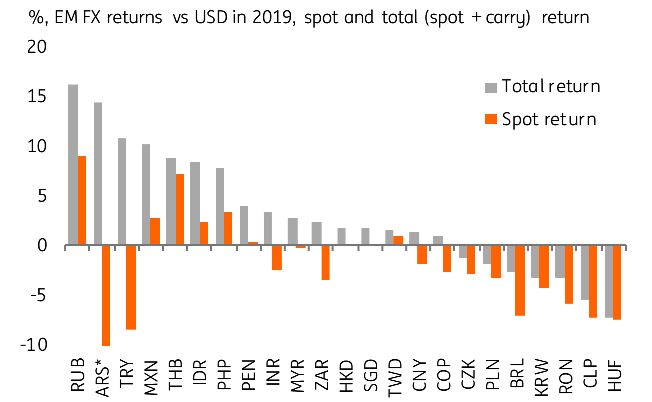
Thus, the case for a volatility pick up on a late cycle liquidity withdrawal has therefore evaporated, undermining those bull cases for both JPY and CHF. And low volatility typically supports carry trade strategies – suggesting continuing demand for the USD and commodity currencies – largely at the expense of Europe.

Fig 10 EM FX volatility has converged on the low G7 levels



Source: Bloomberg

Fig 11 EM FX didn't do too badly in absolute return terms



*ARS fell 37% vs USD in spot terms in 2019 (not fully shown in the chart)

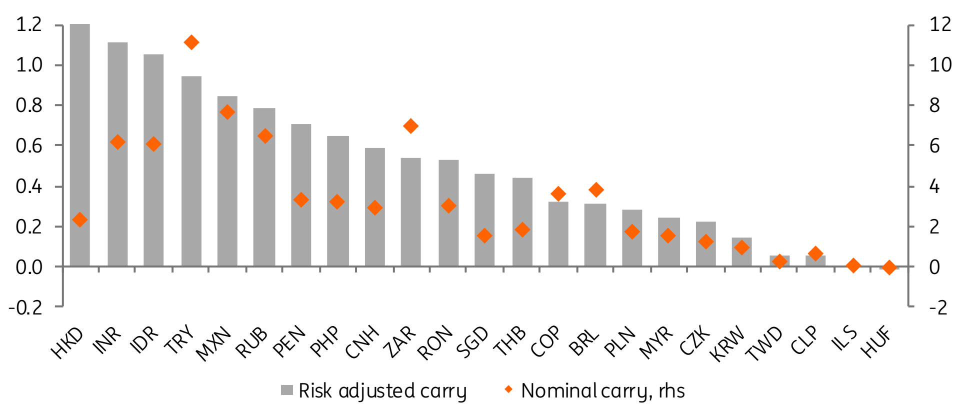
Source: Bloomberg, ING

Bottoming growth, the stabilizing US-China trade conflict and the depressed FX volatility environment will in our view benefit EM high yielders. As Figure 11 shows, EM FX has not performed too poorly so far this year in absolute return terms (two-thirds of EM currencies actually showed positive return versus USD – grey line). This is quite an achievement in a year where declines in trade volumes and global growth would not be seen by many as EM FX carry friendly.

Were trade and growth to stabilize/improve next year, this EM FX segment should offer even better returns, with the carry component being also accompanied by some positive contribution from potential spot gains (as opposed to this year, where the majority of EM currencies depreciated versus USD in spot terms – orange bar Figure 11).

Fig 12 EM risk-adjusted and nominal 3 month carry

Risk adjusted carry - calculated as implied 3-month FX yield over 3-month implied volatility



Source: Bloomberg, ING

"The carry component will remain the key part of the expected EM FX return"

However, as long as there are limited idiosyncratic negatives for the dollar, 2020 EM FX appreciation in spot terms versus the dollar is unlikely to be overly aggressive (ie, not a one-way, across-the-board dollar decline). This means that the carry component will remain the key part of the expected EM FX return. Figure 12 shows those currencies that offer the best risk adjusted carry potential. The Asian high yielders stand out both in nominal and risk-adjusted terms as do some EMEA high-yielders and the MXN. TRY continues to offer attractive yields, but double-digit inflation warns that carry gains are undone by nominal depreciation.

But growth and carry alone may not be enough to deliver FX outperformance in 2020. Since the global economy will not be firing on all cylinders and the vagaries of US-China politics will play out, a third factor needs to be taken into consideration: **valuation**.

Theme 3: Search for undervaluation

Above we make the case that some of the better growth rates and carry for 2020 is to be found in the EM world. We will start then with a look at EM FX valuation. And our basic premise here is to look for currencies priced for secular stagnation and at least identify those cheap enough to hold their value, even if global growth conditions deteriorate.

A large majority of EM currencies are cheap against the dollar (Figure 13). In terms of regions, Latam and EM Asia offer only cheap currencies versus the dollar (with the exception of THB), while all of the regional high yielders also look undervalued.

In contrast, the CEEMEA region offers clear diversity in terms of valuation. It hosts: (a) the most expensive currency (ILS); (b) the cheapest currency (TRY); (c) the least attractive EM high yielder (ZAR).

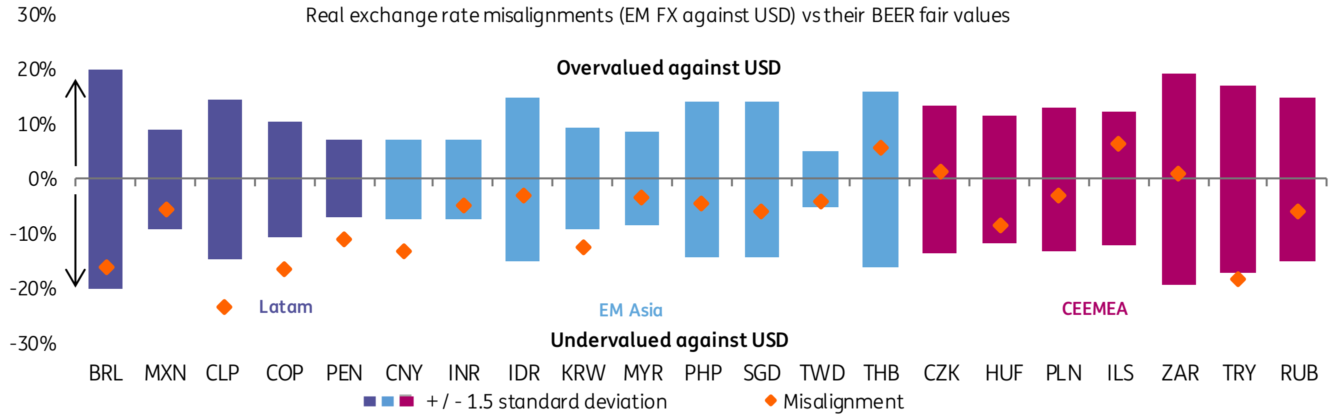
And given the region is populated by a high number of low yielders (which, with one exception, are not attractive from the valuation point of view), we would expect the CEEMEA FX region to underperform the other two EM regions in terms of returns in 2020. With CEE economic growth projected to slow the most next year (in terms of difference versus 2019) this corroborates the case for underperformance versus its global EM peers. Thus, value seems to be in the Latam and EM Asia spaces.

Elections in 2020

Date	Country	Elections
11 Jan 2020	Taiwan	Presidential
21-24 Jan 2020		World Economic Forum
26 Jan 2020	Peru	Parliamentary
21 Feb 2020	Iran	Parliamentary
Feb 2020	Cameroon	Parliamentary
02 Mar 2020	Guyana	General
by March 2020	Slovakia	Parliamentary
12 Apr 2020	North Macedonia	Parliamentary
15 Apr 2020	South Korea	Parliamentary
by April 2020	Serbia	Parliamentary
17 May 2020	Dominican Republic	General
20 May 2020	Burundi	Presidential
May 2020	Ethiopia	Parliamentary
May 2020	Mali	Parliamentary
Jun 2020	Mongolia	Parliamentary
10-12 June 2020		G7 Summit
30 Aug 2020	Belarus	Presidential
04 Oct 2020	Kyrgyzstan	Parliamentary
11 Oct 2020	Lithuania	Parliamentary
31 Oct 2020	Ivory Coast	General
by Oct 2020	Georgia	Parliamentary
by Oct 2020	Montenegro	Parliamentary
03 Nov 2020	**US**	**Presidential**
Nov 2020	Belize	General
Nov 2020	Ghana	General
by Nov 2020	New Zealand	Parliamentary
by Dec 2020	Croatia	Parliamentary
by Dec 2020	Romania	Parliamentary
by Dec 2020	Sri Lanka	Parliamentary
end-2020	Azerbaijan	Parliamentary
end-2020	Jordan	Parliamentary
Unscheduled	**Country**	**Elections**
2020	Burkina Faso	General
2020	Burundi	Parliamentary
2020	Egypt	Parliamentary
2020	Iceland	Presidential
2020	Kuwait	Parliamentary
2020	Moldova	Presidential
2020	Poland	Presidential
2020	Seychelles	Presidential
2020	Somalia	Parliamentary
2020	Sudan	General
2020	Suriname	Parliamentary
2020	Tajikistan	Presidential
2020	Tanzania	General
2020	Togo	Presidential
2020	Trinidad & Tobago	General
2020	Ukraine	Local
2020	Venezuela	Parliamentary

Source: EIU, IFES, NDI, OSCE, local governments

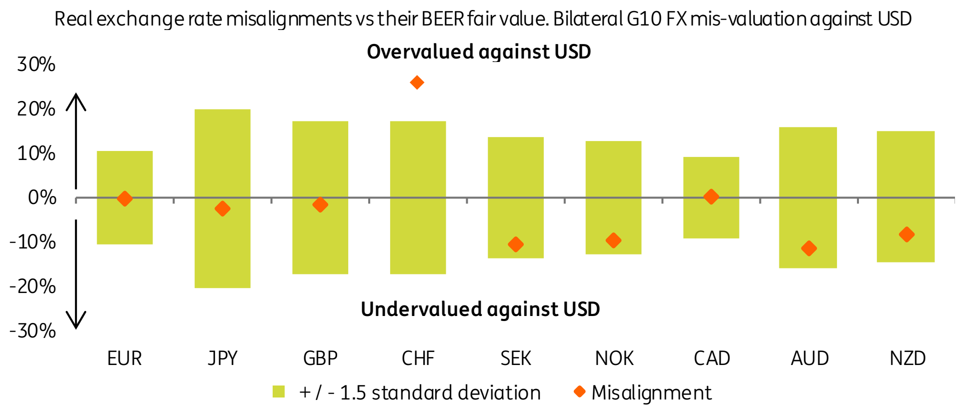
Fig 13 Most EM currencies are cheap vs USD



Source: ING

Within the G10 FX segment, there is clear divergence between the dollar valuation against other low yielding major currencies, such as EUR, JPY or GBP (being close to its fair values, but undervalued vs CHF) and the pro-cyclical currencies such as NOK or AUD (where the dollar is in most cases meaningfully overvalued). This is evident in Figure 14.

Fig 14 Divergence in the G10 FX valuation: unattractive majors

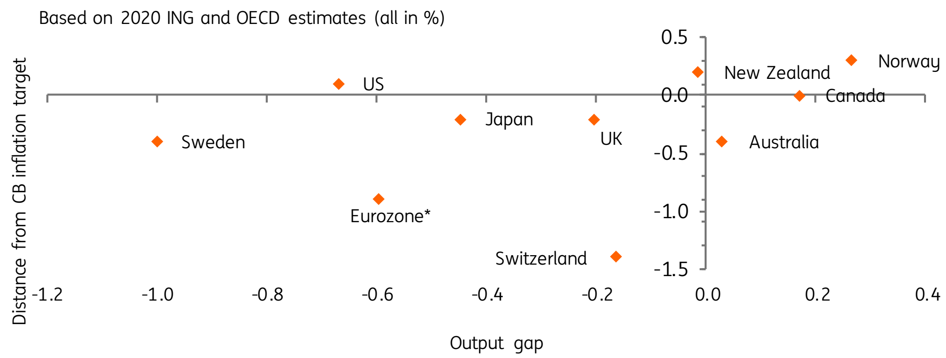


Source: ING

Bar the SEK, all the cyclical G10 currencies also show a positive or close to neutral output gap and inflation close to target - as illustrated in Figure 15 (these currencies are in the desirable top-right quadrant). We say desirable here, since central banks in these economies may be less prone to more aggressive monetary easing.

Again with the exception of the SEK, the cyclical G10 FX segment offers relatively good yield (Figure 9). All this makes most of the G10 pro-cyclical currencies an attractive proposition for 2020, in our view.

Fig 15 Most cyclical G10 FX show close-to-target CPI and non-negative output gap



'*Eurozone Potential GDP calculated by a weighted average of 16 EZ countries covered by OECD report

Source: ING, OECD

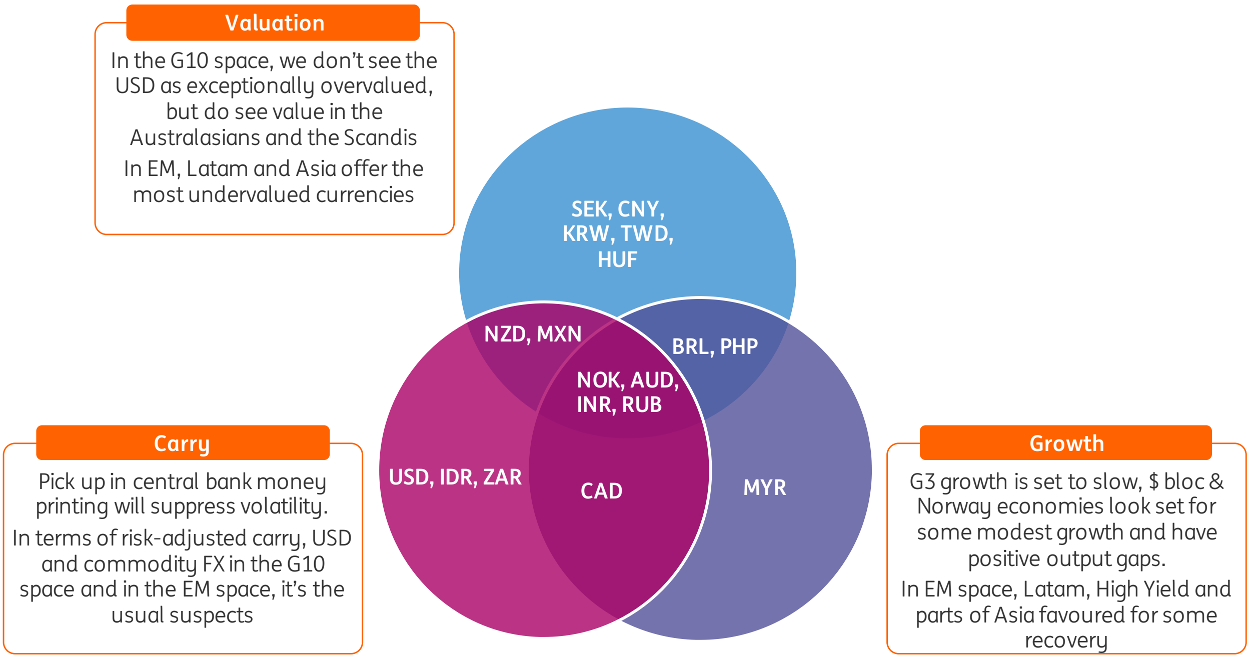
Conclusion: Diamonds in the rough

Into 2020 then, it looks a question of wading through the pessimism and trying to dig out currencies that could shine. The starting point, we believe, is to use the screening criteria we have outlined above.

Of the G3 currencies, notably the USD only appears under the carry criterion. The EUR and JPY do not feature anywhere and we particularly like the EUR as a funding currency in 2020. In this publication we are also revising up our USD/JPY forecasts, looking for a 105-110 trading range through 2020.

In the DM space, we think the NOK meets all three criteria and we forecast close to 7% total returns in NOK against the USD by the end of 2020. CAD meets two of the criteria and should deliver 6% total return over the same period. The AUD screens well, although we are worried by the risk of RBA QE in 2Q20 – which would be very negative for AUD. In that region we prefer NZD over AUD, especially in 1Q20.

Fig 16 Discovering the diamonds that exhibit carry, growth and valuation characteristics



Source: ING

In the EM space, on a total return basis we highlight BRL, which could deliver 10%+ against the dollar by the end of 2020. The RUB meets all the criteria, but we favour holding the position only through 1Q20 (and against the EUR to pick up additional yield). The INR screens well, but twin deficits suggest gains will be seen purely from the carry rather than nominal INR appreciation. IDR carry also looks interesting in a low yield environment.

Unlike in 2019, we do not think 2020 is the year to look for MXN out-performance. Banxico may be cutting more aggressively than the Fed and our forecast total return of holding MXN against the USD of just 3% in 2020 may prove too thin given the risks.

Of course there are lots of individual stories at play here, which may undermine some of the recommendations made through the above screening process. That is why we encourage our readers to look through the individual currency sections for all the local considerations and the detailed set of forecasts.

USD: A different kind of decline

- **The end of US exceptionalism is sparking calls for a weaker dollar into 2020. We think the dollar decline will be far more differentiated than broad-based.**
- **Most US Presidential candidates favour a weaker dollar. The best way to achieve that is to improve trade relations and create attractive alternatives overseas.**
- **Russia and China are making steps to de-dollarize their economies. Progress has been slow and the dollar is still by far the most favoured transaction currency.**

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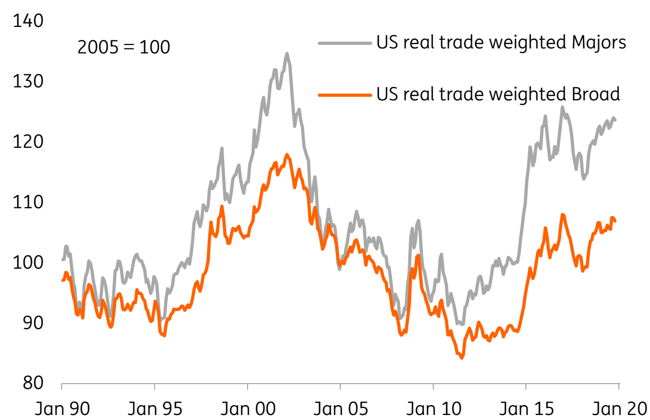
2019 has generally been a good year for the dollar. Marginal new highs have been seen in the rally that started in February 2018 – when the White House fired the opening salvos in the trade war. The dollar rally has largely been concentrated against pro-cyclical currencies with the occasional exceptions in G10 (CAD, GBP) and in EM (RUB, THB).

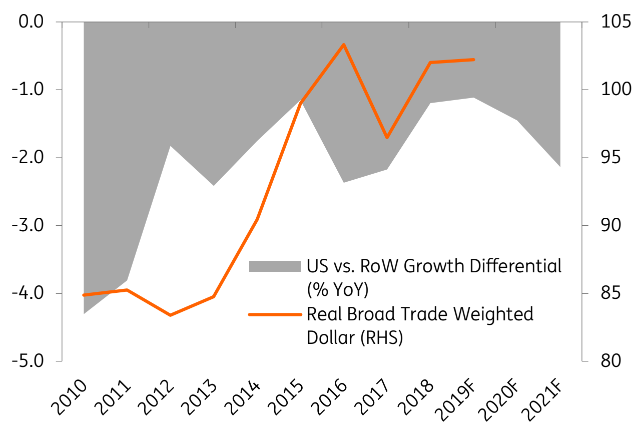
A common expectation for 2020 now seems to be one of broad dollar depreciation. Fund managers are most bearish on the dollar since September 2007 and the familiar narrative is that the end of US exceptionalism spells trouble for the dollar. Certainly, we subscribe to the view that the US growth differential against the Rest of the World (RoW) will shift against the US over the next couple of years.

Fig 17 Dollar has nudged higher this year…



Source: Bloomberg

Fig 18 …but RoW may start outperforming US in 2020/21



Source: Macrobond, ING

The difference is that we expect the growth performance in the RoW to be far from uniform. Most importantly, 2020 will not be a repeat of 2017 when the world economy was firing on all cylinders (even Europe participated). Back then synchronised global growth saw trade volumes growing 5% YoY and the dollar embarking on a broad decline.

Given our view that Europe will not be a particularly attractive investment destination in 2020 and that the popular DXY is 77% weighted towards European currencies, we are not looking for a major DXY decline next year.

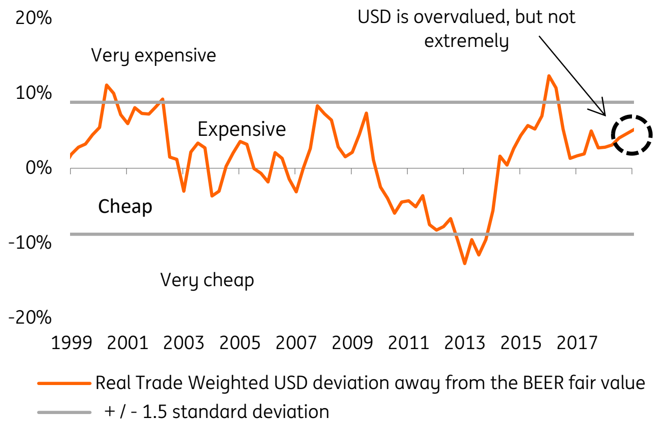
Based on our view of only modest upside for EUR/USD (1.13 end-2020) we expect DXY to fall just over 2% next year. If EUR/USD is closer to 1.10 rather than 1.13 at the end of 2020, then that DXY decline is under 1%.

> “We also take issue with some views that the dollar is materially over-valued”

We also take issue with some views that the dollar is materially overvalued. Our medium-term fair value measures have it nowhere near as overvalued as it was in early 2017, largely because we have seen a fall in EUR and GBP fair values versus the USD.

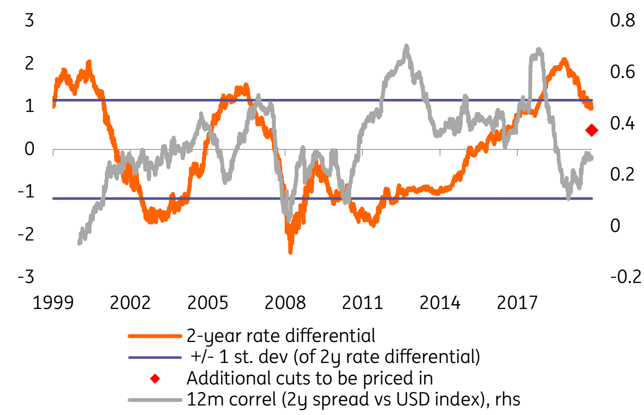
In addition, we think that the Fed has to deliver at least three to four independent cuts (relative to other central banks and in addition the Fed rate cuts already priced in) to bring rate differentials back into a range that makes a difference for dollar pricing – see Figure 20. One of the core stories in 2019 has been that, despite three Fed rate cuts, dollar hedging costs have still been too expensive to make a difference. For example, the costs for European investors to hedge USD exposure have fallen 100bp this year, but, at 2.5% pa, they are still too high in a low yield world.

Fig 19 The dollar is not particularly overvalued



Source: ING

Fig 20 Dollar differentials need to narrow a lot further



Source: ING

The above yield story is probably more important than we think. Looking at the portfolio flow story both from ECB and US Treasury data suggests hot money – or short-term financial flows - could be driving exchange rates. For example, we talk about US exceptionalism and the US sucking in capital, but data does not bear this story out.

Through the twelve months to September 2019, foreigners bought only a net US$41bn of US securities (Treasuries, corporate bonds and equities) versus US$334bn in the twelve months to September 2018. Instead then we believe short-term financial flows are driving dollar strength. Unless the Fed cuts very aggressively in 2020 (eg, three or more times) we do not see a stampede out of USD deposits.

When it comes to Washington’s FX policy, it is fair to describe this as mercantilist. The White House occasionally rails against the strong dollar, but its biggest bug-bears are the cheap currencies of China and Europe that have contributed to the huge US trade deficit. Should a Phase One Deal with China be signed, look out for any currency clause.

Such a clause may mirror the one suggested in the USMCA deal, which effectively backs a free-float and transparency on FX intervention. In theory this would prevent massive FX intervention from the Chinese to support USD/CNY should the dollar trend turn lower. Interference with an orderly Balance of Payment adjustment is Washington’s concern.

> “We doubt that President Trump would turn to physical FX intervention to weaken the dollar”

We doubt that President Trump would turn to physical FX intervention to weaken the dollar – though he does have the authority. And occasional bills in Congress to effectively tax short-term capital inflows are unlikely to gain much cross-party support – where capital flow measures are more frequently associated with emerging economies.

> "There will also be increasing focus on the topic of de-dollarization"

Given the White House's increased use of sanctions over recent years, there will also be increasing focus on the topic of de-dollarization. Pricing trade in currencies other than the dollar has long been a desire for strategic rivals of the US – a desire more recently compounded by the long reach of the US Treasury when it comes to sanctions.

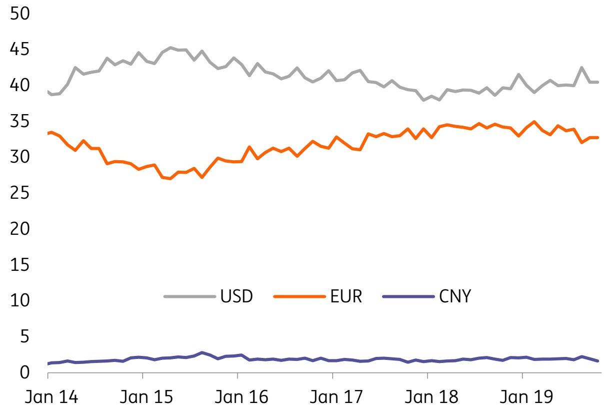
For example, China has for many years tried to encourage use of the Renminbi in international trade by signing CNY swap agreements with trading partners. Since 2008, China has signed up thirty three countries to CNY swap lines – in an effort to encourage buyers of China goods to have confidence to take on CNY payables.

Equally, Russia has made great efforts to de-dollarize its economy since 2013. Our Chief Economist in Russia, Dmitry Dolgin, recently released a detailed report on the subject. And the European Commission has a stated aim of strengthening the international role of the Euro. For example, why does Europe still pay for its energy imports in dollars?

Despite these initiatives, so far there has been very little erosion in the dollar's dominance. In terms of trade flows tracked by SWIFT, the dollar comprises a consistent 40% in world trade flows. The CNY remains around the world's fifth/sixth most used currency in terms of trade flows – but consistently under 2%.

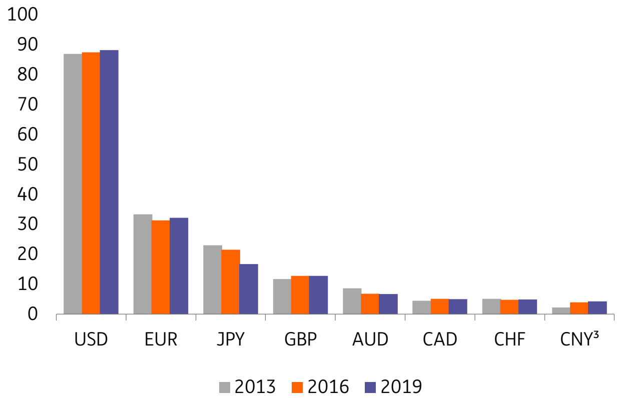
No doubt the mismanaged PBOC fixing adjustment in 2015 and then the tightening rather than loosening of Chinese capital controls during the current trade war have not helped the internationalisation of the CNY.

Fig 21 FX share in global SWIFT payments (%)



Source: Bloomberg, SWIFT

Fig 22 Share in Global OTC FX turnover (%)



Source: BIS

> "So far there is absolutely no sign of investors demanding a risk premium in US assets"

Looking more broadly at both trade and financial flows, the BIS triennial FX turnover survey shows no change in the position of dollar hegemony. Higher US rates have probably helped and so far there is absolutely no sign of investors demanding a risk premium in US assets. Despite fears of President Trump generating unsustainable twin deficits with the 2018 tax cut, the US sovereign 5-year CDS still trades at a mere 15bp.

On balance then we think the 2020 dollar decline will be a lot more differentiated. Rather than a broad-based move, we look for pockets of selective weakness against EM currencies (Latam and Asia rather than Europe) and a few of the undervalued commodity currencies in the G10 space.

ING FX forecasts

	Spot	4Q19	1Q20	2Q20	3Q20	4Q20
DXY	98.30	98.00	98.00	97.50	96.50	95.50

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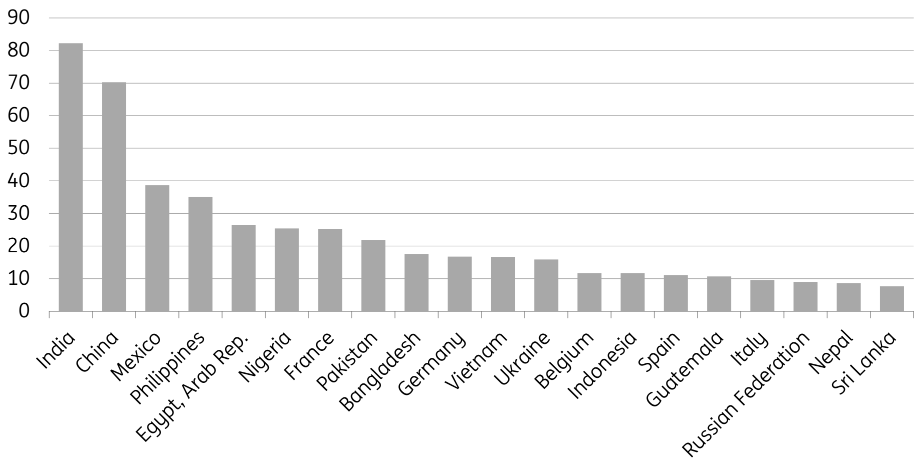
Digital currencies: keep an eye on remittances

Shortly after Facebook's announcement regarding the development of its own digital currency Libra, policymakers around the globe have rushed with comments highlighting the potential pitfalls and risks of launching such a project on a global scale. Their immediate concerns relate to the disintermediation of the traditional banking system and the potential loss of monetary sovereignty. Nonetheless, one unintended consequence is that it has greatly accelerated the debate on the development of digital currencies, including the possibility that central banks could launch their first pilot of Central Bank Digital Currency (CBDC) within the next five years. So what would be an immediate link between digital currencies and markets and how would it work?

Remittances could be an immediate use case for digital currencies

The global remittances market reached US$689 billion in 2018 and will grow beyond US$700 billion by the end of this year, according to World Bank estimates. The market is growing at an exceptional rate: if we exclude China, remittances now outpace foreign direct investment (FDI) flows. Moreover, the global average cost of sending remittances currently stands around 6.84 percent, which is relatively high. The rise of digital currencies could push transaction fees lower and give rise to more frequent and cheaper transactions.

Fig 23 Top 20 remittance recipient countries in 2019, US$bn (estimates)



Source: KNOMAD, World Bank

The end of dollarisation?

So what does this mean for the currency market? Let's take a look at Ukraine, which is a highly dollarised economy. The World Bank estimates that Ukrainian workers will send some US$16 billion (11.8 percent of Ukraine's GDP) back to their home country this year.

Moreover, the total average cost for sending US$200 of remittances from the United States to Ukraine stands at around US$9.90 (or 4.95 percent)[1]. This includes both the transaction fee and the exchange rate margin cost. The launch of either a privately or a publicly issued digital currency (eg, the National Bank of Ukraine conducted an e-hryvnia pilot this year already) could compress both costs, which would offer Ukrainians another (digital) channel to send their remittances back to their home country.

And if digital currencies are accepted by retailers at point-of-sale and on e-commerce platforms, this could in theory diminish dollar demand. Surely, regulatory and policy challenges are unlikely to disappear, nonetheless, markets should start thinking about these issues and their immediate implications.

[1] Source: The World Bank, Remittance Prices Worldwide, available at http://remittanceprices.worldbank.org

EUR: The funding currency

- **We remain unexcited about the EUR. The currency is no longer meaningfully cheap vs. USD, growth remains sluggish and there are little prospects of ECB tightening.**
- **With EUR offering deeply negative implied yields, it should be used as the funding currency of choice for investors searching for yield in the undervalued EM FX world.**
- **A 2017-like EUR/USD rally is off the table as EZ fundamentals are weak. We look for a range bound EUR/USD (1.10-1.15) next year, with clear downside risks.**

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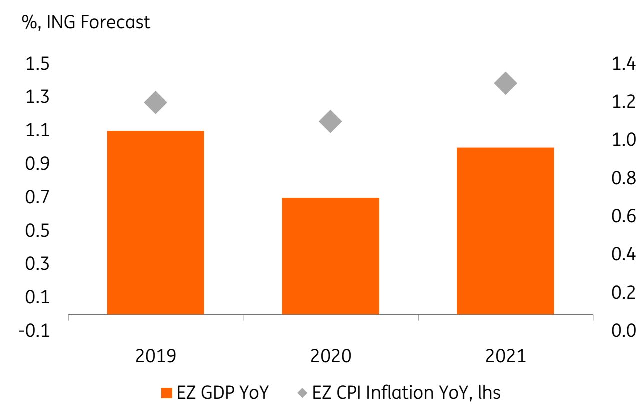
The ECB is presiding over a low growth, low yielding euro environment...

In a nutshell, the ECB's policy stance and its implications should remain a drag on the euro. The September ECB easing package (10bp deposit rate cut and the restart of QE) was not strong enough to meaningfully improve the EZ growth and inflation prospects. As Figure 24 shows, economic growth will remain lacklustre (growth rate at / below 1.0% over the next two years) and inflation should remain persistently below the 2% target. On a comparative basis, EUR screens as one of the least appealing G10 currencies from an output gap and CPI targeting point of view (Figure 15 on page 12). Indeed, with the ECB forward guidance conditional on CPI "robustly" converging to the target, this means one thing. Any ECB policy normalisation remains off the table, with the policy rate staying negative and the ECB continuing to purchase EZ bonds.

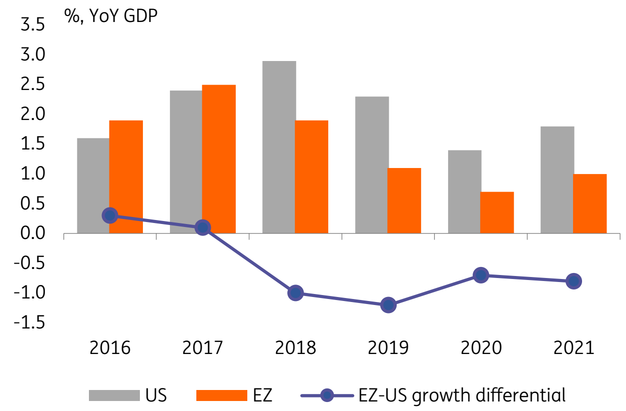
All this suggests that an idiosyncratic, domestically driven EUR rally is unlikely. The September ECB easing package simply seems insufficient to change the outlook for EZ growth and CPI but looks sufficient enough to keep EUR low – as EUR interest rates remain negative and growth uninspiring (and the latter confirming the need for the former).

Fig 24 Uninspiring EZ growth and inflation prospects



Source: ING

Fig 25 EZ GDP growth still to lag the growth in the US



Source: ING

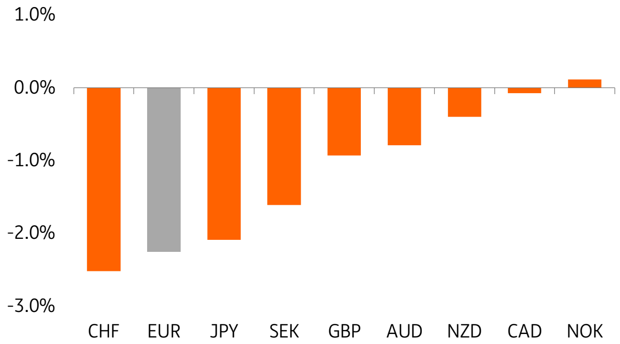
...making a 2017-like EUR/USD rally unlikely

The absence of a potential ECB policy normalisation makes us reluctant to call for a meaningful rise in EUR/USD. A repeat of the significant 2017-like EUR/USD rally is, in our view, off the table. Back in 2017 it was the market pre-positioning for the ECB QE tapering that was the key driver behind the EUR rally. As both EZ growth and inflation outlooks are now meaningfully worse, any hint at ECB policy normalisation is unlikely.

Not only is the ECB stance and EUR valuation (see below) different now compared to 2017, but the EZ GDP growth differential vs the US was also more appealing for EUR in 2017. As per Figure 25, it was marginally positive in 2017 while in 2020 it should stay negative (albeit modestly less so than this year). This should also limit EUR/USD upside potential.

Fig 26 EUR exerting attractive funding characteristics…

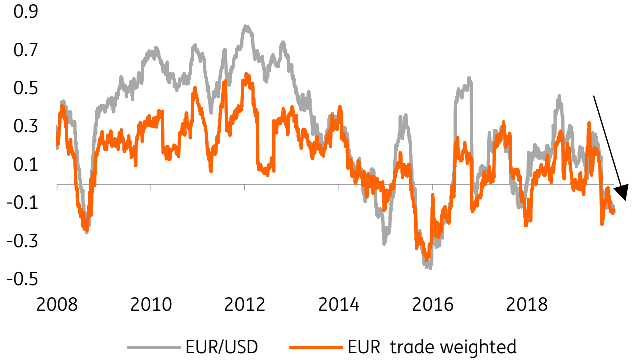
Implied yield on G10 FX crosses vs USD derived form 12-month FX forwards



Source: ING, Bloomberg

Fig 27 …being no longer positively correlated with risk

90-day correlation of EUR/USD and trade weighted euro with MSCI World equity index

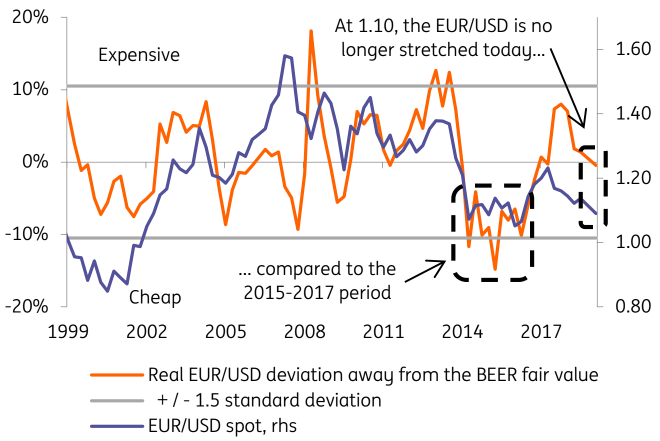


Source: ING, Bloomberg

Appealing characteristics of a funding currency

With EUR offering the second lowest/most negative implied yield in the G10 FX space (Figure 26) and little prospect for a credible turnaround, EUR should become a funding currency of choice. On a risk-adjusted basis, EUR funding characteristics look more appealing vs its peers as it does not exert the same safe-haven properties as USD or JPY. This means that during the period of risk-off moves, EUR is unlikely to appreciate as much as the dollar or the yen, in turn reducing the possible loss/probability of a stop loss being hit on long EM FX positions/high beta FX positions when funded in EUR. In fact, we have already seen the first signs of EUR attaining funding currency characteristics as EUR/USD and trade weighted euro correlations with risk turned negative in recent months (Figure 27). This means that EUR no longer benefits much during risk-on days.

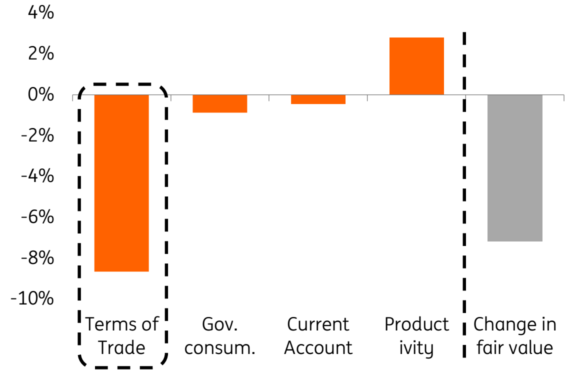
Fig 28 EUR/USD is no longer cheap (compared to 2015-17)



Source: ING

Fig 29 EUR/USD fair value deteriorated

Contribution of various factors to the evolution of EUR/USD BEER fair value since Q1 2017



Source: ING

EUR is no longer cheap as its fair value declined

> *"EUR/USD no longer screens as undervalued"*

Importantly, as Figure 28 shows EUR/USD no longer screens as undervalued based on our medium-term BEER valuation framework. This is a meaningful change from the period of 2015-17 when at that time EUR/USD around 1.10 screened as heavily cheap. What has changed is the EUR/USD fair value, which has deteriorated by around 7% since 2017 largely due to the terms of trade dynamics (Figure 29). The lack of undervaluation also limits the scope for any meaningful EUR/USD upside (such as the one observed in 2017).

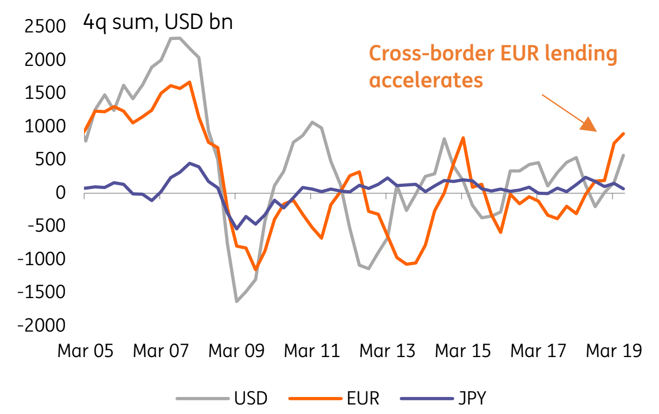
German stimulus the key hope for the euro – but unlikely

The greatest EUR hopes lie with possible German fiscal stimulus. In an environment in which the ECB's monetary policy stance is perceived as largely exhausted, large and credible enough fiscal stimulus that would improve EZ growth and the inflation outlook would be a game changer for EUR as it would unleash the euro reflation trade and lead to higher EUR/USD (with the market upgrading the EZ growth outlook and expecting ECB policy normalisation). As discussed in detail on the next page, we see odds of fiscal stimulus as rather low, meaning EUR should remain in the low growth, low yielding currency bucket.

Slowly creeping euro Japanization

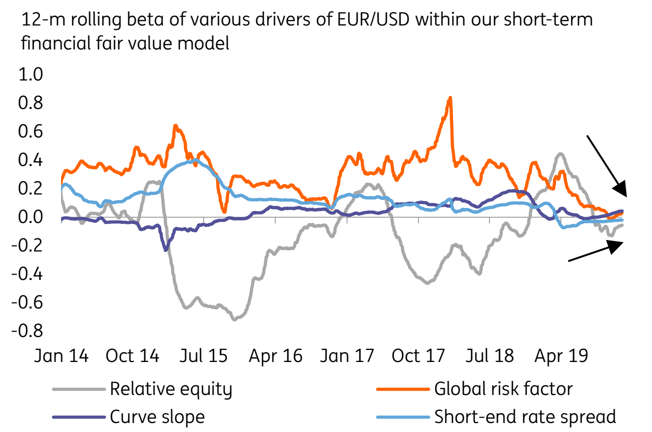
The EUR is increasingly resembling the characteristics of JPY. A low growth, low inflation, low yielding currency where the central bank delivers insufficient easing to boost the economy. While the EZ current account is in surplus, it is offset by portfolio outflows. On the latter, depressed EZ bond yields start to negatively affect the outlook for European pension funds returns with its negative implication for pension distribution. Insufficient return potential from depressed EZ bond yields may push some investors out of the EZ assets, searching for higher yield abroad. Additionally, cross-border lending in EUR is accelerating, supporting views of EUR as a preferred funding currency. (Figure 30).

Fig 30 Cross-border lending in EUR takes off



Source: BIS, ING

Fig 31 EUR/$ Financial Fair Value: Rolling betas compress



Source: ING

Unexciting, uninspiring euro prospects with downside risks

> *"EUR/USD may just slowly but surely creep lower"*

We remain deeply unexcited about the EUR prospects and look for a range bound EUR/USD (1.10-1.15) next year, with risks skewed to the downside (ie, EUR/USD below 1.10). These risks include another set of disappointing EZ data, re-escalation of the US-China trade war (a clear negative for a large open economy such as the EZ), possible auto tariffs, and the never-ending internal Eurozone political risks. Moreover, with the USD-EUR interest rate differential unlikely to decline meaningfully from here (in turn cementing the dollar's carry advantage), the EUR/USD may just slowly but surely creep lower in a very slow burning fashion – simply because there will be (yet again) nothing to see in the Eurozone and the euro next year.

With EUR/USD losing its sensitivities to many of its usual short-term drivers (as Figure 31 shows, the betas of various EUR/USD driving factors have recently converged to zero within our short-term financial fair value model), the range bound EUR/USD trading, or its slow burning decline, look like a real possibility. With the forward curve rather steep (12-month EUR/USD forwards at 1.1265 vs spot 1.1016), speculative long EUR/USD positions remain unattractive and offer limited return potential.

ING FX forecasts

	Spot	4Q19	1Q20	2Q20	3Q20	4Q20
EUR/USD	1.11	1.10	1.10	1.11	1.12	1.13

Eurozone: Let's get fiscal!

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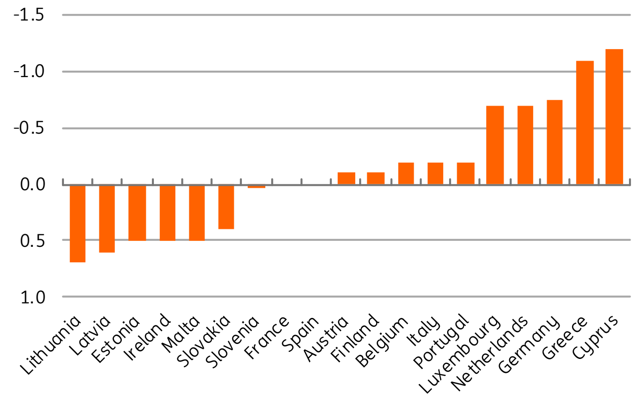
The Eurozone ends 2019 with a lot of uncertainty about the economy. Sluggish growth has persisted over the course of the year as the industrial recession has dragged on. Even though there are early signs of optimism, concerns about anti-cyclical measures in a downturn are prominent as the ECB has a relatively empty toolbox and what is left is worn out. Because of this, and the weak longer-term growth outlook, a key question for 2020 is whether governments are going to step in and invest. With interest rates negative for the entire curve for the strongest Eurozone countries and even Greece borrowing at negative rates on the short end of the curve, the time seems right.

Some spending is set to happen next year but the overall fiscal push will be modest. The most relevant fiscal easing is expected in the Netherlands and Germany with a neutral stance in France and Spain (Figure 32). Italy is expected to implement very mild expansionary fiscal policy, as a more conservative budget has been constructed under the new government.

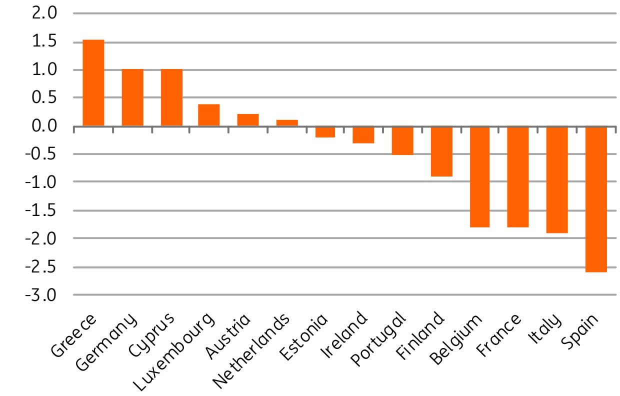
The medium-term budgetary objective (MTO) is the structural fiscal balance required to manage debt sustainability in the long run. The difference between current balance and MTO provides a proxy for the fiscal space that countries have. In 2020, few countries have extra room to spend (Figure 33). Germany stands out with about 1% of GDP that its government could use to lower its structural surplus and remain compliant with Commission rules.

Fig 32 Countries with fiscal space are set to spend modestly in 2020... (% of GDP)



Source: European Commission, ING Research

Fig 33 ...but Germany in particular still has a lot of room for spending left (% of GDP)



Source: European Commission, ING Research

Another important question is why extra spending in the Eurozone should happen in the first place. With economies still growing and labour markets showing only tentative signs of a weakening, there is little reason to agree on large scale short-term stimulus as in 2008/9. Any kind of 'emergency' fiscal stimulus would probably only be triggered by a significant weakening of the labour market.

However, the need for investment to increase the longer-term growth potential of the Eurozone is high given the low potential growth rate and transitions the constituent economies are going through. Eurozone potential growth could benefit from investment in (digital) infrastructure, education or energy transition.

In this regard, there is some momentum for investment, both at a European and national level. The German government just agreed on a €50bn package over the next few years to tackle climate change, the Dutch government is contemplating a national investment fund and the new European Commission has not only put the Green New Deal at the top of the political agenda but has also floated the idea of a European Sovereign Wealth fund to stimulate global competitiveness for European businesses.

In sum, the big fiscal push that some hope for is probably still more a dream than reality for 2020. However, governments are gradually willing to step up investment efforts, just not as quickly or by as much as many financial market participants would like.

JPY: Crowded out

- **We look for another year of relatively tight ranges in USD/JPY as Japanese investors continue to go offshore in search of returns. 105-110 may be the range.**
- **Despite late cycle fears, the resumption in money printing from the Fed and the ECB suggests volatility levels remain low and the JPY is soft on the crosses.**
- **In a low yield world, US rates need to fall a lot further for Japanese investors to reconsider hedging US assets. The current 3m hedging cost of 2.3% pa is too high.**

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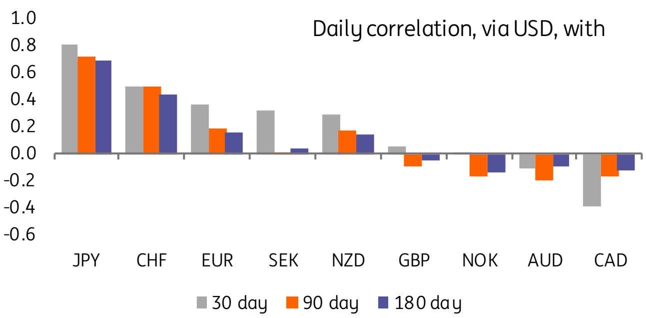
It has been another relatively quiet year for USD/JPY. One year realised volatility has dropped back to 6% annualised, while implied volatility is 7% – both very low by the standards of USD/JPY. Instead of a pick-up in volatility as liquidity became more scarce, early easing by both the Fed and the ECB has ensured that liquidity is ample.

USD/JPY also retains a strong correlation with equity markets, meaning that this year's sea of green in world equity indices has provided little sustained demand for the JPY. Yes, the occasional Trump tweet and equity drawdown has briefly lifted the JPY – but these moves have proved the exception.

Of course the equity cycle may well change into 2020 – especially were the US economy to slow more than expected and open the door for some left-wing Democrats into the November election – but that scenario is currently parked under 'alternative' for now.

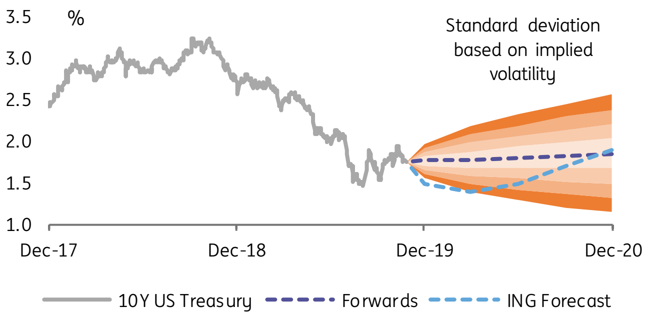
More likely, our macro team thinks, is a scenario in which the Fed considers cutting rates again in 1Q20 – the low point in the US 2020 GDP cycle – before US Treasury yields work their way back towards 2.00% by the end of 2020. Given that the JPY's correlation with US 10-year yields seems only to be strengthening, that scenario could pressure USD/JPY again in the early part of 2020.

Fig 34 USD/JPY retains tightest correlation with US 10-year yields



Source: ING. Correlation with daily changes

Fig 35 ING's forecast for US 10-year yields vs forwards

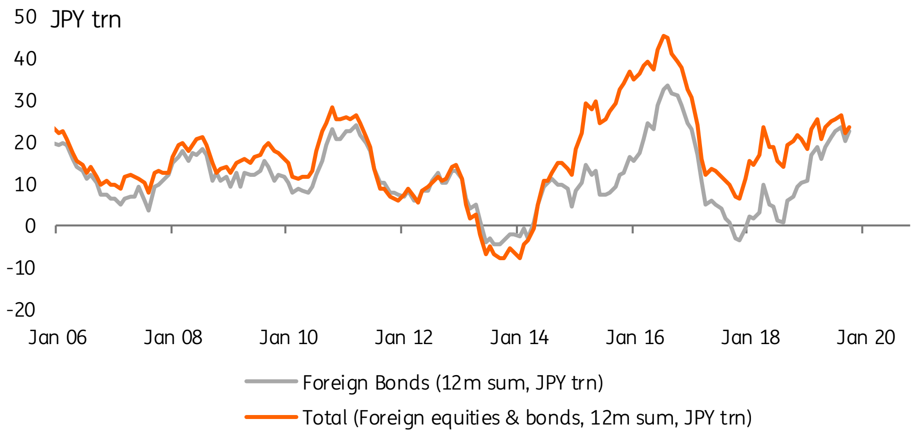


Source: ING Rates Strategy Team

Our over-riding feeling on USD/JPY, however, is one of continued tight trading ranges and probably very good demand from Japanese investors for FX when USD/JPY trades under 105. The narrative for 2020 should be one of Japanese investors crowded out of domestic bond markets by continued BoJ buying of JGBs and looking for returns in foreign markets.

Data from Japan's ministry of finance does indeed show increased Japanese demand for foreign assets – mainly foreign bonds. Currently, Japanese investors are buying around JPY23tr (US$212bn) of foreign bonds over a twelve-month period – that's the fastest rate since late-2016.

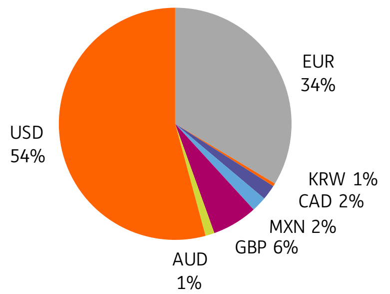
Fig 36 Japanese investors resume interest in foreign bonds



Source: Bloomberg, ING

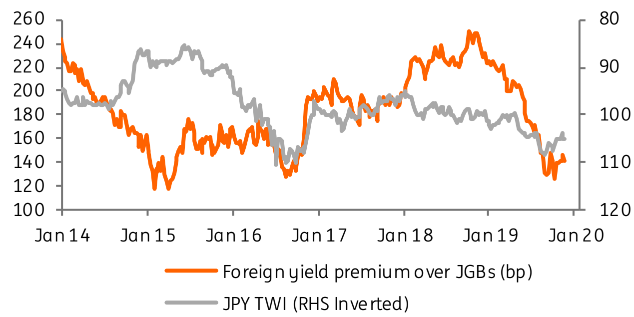
Insights into Japanese investment habits can be drawn from the world's largest fund manager – Japan's Government Pension Investment Fund (GPIF). The GPIF has quite a pro-growth benchmark of: foreign equities (25%), foreign bonds (15%), domestic bonds (35%) and domestic equities (25%). It is also planning another significant review of its asset mix next March – probably in favour of a greater weight to foreign asset markets.

Fig 37 GPIF foreign bond holdings by currency (%)



Source: GPIF Annual Report Fiscal Year 2018

Fig 38 Yield advantage of foreign bond portfolio vs JPY



Weighted yield in 10-year sector vs JGBs
Source: ING

In October the GPIF suggested that hedged foreign bond holdings could be re-classified as domestic bonds, effectively freeing up room for more foreign bond buying. As Figure 37 highlights, most of the GPIF's foreign bond holdings are in USD and EUR, but the overall weights and currencies in the GPIF's foreign bond portfolio look remarkably similar to a central bank reserve manager.

Even though the weighted yield advantage (over JGBs) on foreign bond holdings has fallen more than 100bp over the past year (Figure 38), our feeling into 2020 is that Japanese investors will be crowded into overseas bond markets. We suspect this means good Japanese demand for FX if and when USD/JPY trades below 105.

ING FX forecasts

	Spot	4Q19	1Q20	2Q20	3Q20	4Q20
USD/JPY	108.40	108.00	108.00	108.00	108.00	108.00

GBP: Light at the end of the tunnel

- **With the Conservative Party leading the polls, GBP is likely to gain over the 1-2 months as we get more clarity on the Brexit path. EUR/GBP to reach 0.83.**
- **Even if the Withdrawal Agreement is passed by next January, this isn't the end of Brexit saga. Uncertainty about extension of the transition period will weigh on GBP in 2Q20.**
- **If the transition period is extended, GBP should do well in 2H20 but sluggish growth and no longer cheap valuation will tame its upside.**

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Current pre-election polls suggest GBP strength over the next 1-2 months

The GBP outlook for the coming 1-3 months primarily hinges on the outcome of the 12 December Parliamentary elections and its implications for the Brexit path. As current polls are predicting a non-negligible lead of the Conservative Party (and it achieving a Parliamentary majority) such an outcome should be beneficial for sterling as it would sharply increase the odds of the Withdrawal Agreement being ratified in Parliament and thus reduce the Brexit uncertainty. We expect EUR/GBP to reach 0.83 (and GBP/USD to 1.33) over the next two months.

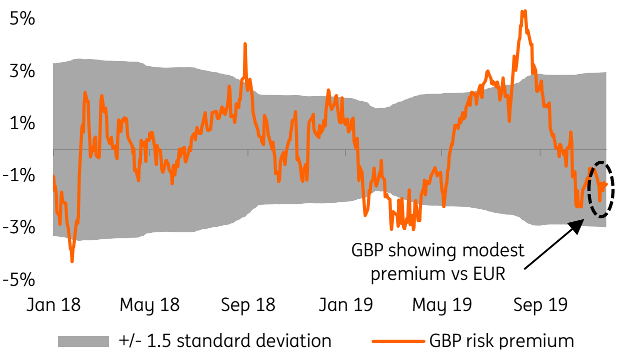
Transition period uncertainty taming GBP upside in 2Q20...

Yet, the Withdrawal Agreement being passed in Parliament and the UK leaving the EU early next year (by January – albeit still within the transition period parameters) do not mean GBP firing on all cylinder and a pronounced GBP rally.

First, the market is already partly expecting a GBP positive outcome (as Figure 39 shows, GBP trades with a modest premium vs EUR based on our short-term financial fair value model). So while positive, more Brexit clarity should lead to a less pronounced GBP rally compared to the one observed this October when GBP corrected from stretched (Figure 39) and oversold (Figure 40) levels. As for the speculative positioning, it is now also less stretched than it was prior to the October GBP rally (Figure 40 again).

Fig 39 GBP currently trades with a modest short-term premium

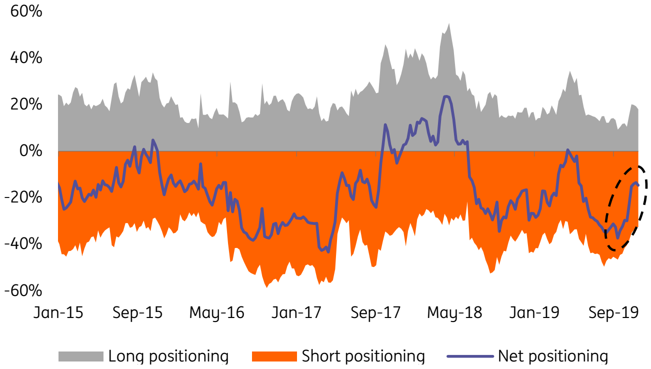
The estimate of the EUR/GBP risk premium. Residual between EUR/GBP short-term financial fair value and the spot.



Source: ING

Fig 40 Speculative GBP shorts corrected since October

GBP/USD speculative positioning, as % of open interest (as of 19th November 2019)



Source: ING, CFTC

Second, once the UK withdraws from the EU, the hard work of negotiating trade deals with its international partners begins (including the EU). With the current transition period set to expire by the end of 2020, this means less than a year (assuming the UK leaves by end-January 2020) for the UK to conclude the new (and necessary) trade deals. We see it as highly unlikely for the UK to conclude such complex deals within such a relatively short period of time. Hence, the extension of the transition period beyond 2020 (likely to 2022 as a starting point) will be necessary, in our view. If the transition period is not extended and the new trade deals are not in place, this would be equivalent to a hard Brexit (by end-2020).

…as extension will be necessary but the path towards it won't be straightforward

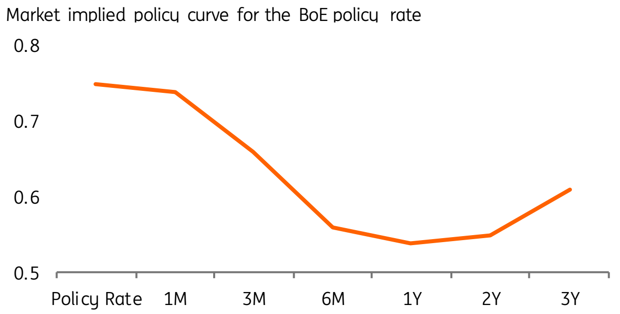
"The question of a transition period will tame GBP upside in mid-2020"

The question of the extension and the associated conditions (as the extension won't come for free) will, in our view, tame GBP upside during a significant part of the second quarter of 2020 (and possibly third quarter if the negotiations about the extension drag on). We expect the EU to be open to prolonging the transition period, but in return it will likely require the UK to contribute to the EU budget (as enjoying the access to the EU single market for little longer would not come for free). The EU budget payments are likely to be fairly unpopular and a contentious issue in the UK Parliament, very likely to be opposed by the pro-Brexit/anti-EU wing of the Conservative Party.

Some degree of uncertainty about the transition period extension therefore should, in our view, lead to some reversal of GBP post-election gains. We also note that a thin Conservative Party majority is likely to lead to a larger reversal of GBP gains in 2Q20 than would be the case under a large Conservative majority outcome as it would increase the risk of the transition period being not (easily) extended - as hard-line pro-Brexit MPs (mainly from the ERG) – would have issues with EU budget payments.

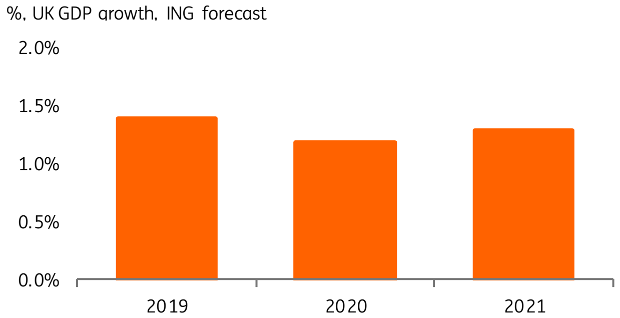
While all the above is heavily scenario-conditional and still some time away (we need to see the election outcome first) the issue of extending the transition period is, in our view, another risk event for GBP and should therefore tame the potential optimism in the case of the Parliament successfully ratifying the Withdrawal Agreement and the UK leaving the EU. That's why we kink EUR/GBP and GBP/USD profiles, pencilling initial GBP strength (next 1-3 months) and some reversal in 2Q20.

Fig 41 The partial BoE cut may be priced out of the curve



Source: ING, Bloomberg

Fig 42 Uninspiring UK growth, not far away from 1%



Source: ING

2H20 outlook: Less uncertainty but also less mispriced sterling

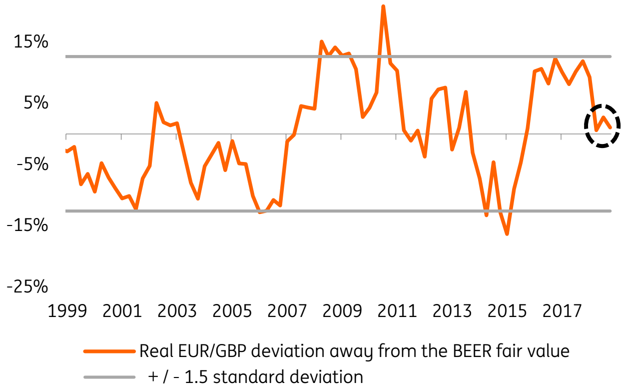
Assuming the UK will avoid a hard Brexit and achieves the extension of the transition period by June 2020 (in our view, the EU will want to know by this deadline whether the UK contribute to the budget in order to be able to plan for the new EU budget) or a little later, we expect sterling to settle at stronger (yet not too strong) levels later in 2020. EUR/GBP to reach around 0.82 level and GBP/USD around 1.38 by end 2020.

On the positive side, both the passage of the Withdrawal Agreement and the transition period extension will take away some degree of Brexit uncertainty. With the transition period extended to 2022, this can give some breathing room to the economy and should cause the market to price out the currently pencilled in partial BoE cut (Figure 41 - and even potentially price in a partial hike) if the new government runs loose fiscal policy.

No spectacular economic growth...

On the less positive side, two factors should prevent a meaningful GBP rally. First, the economic growth will remain subdued in 2020. Our economists pencil in growth around 1.2% next year (Figure 42), due in part to the constrained investment as 2020 will still feature plenty of uncertainties (such as the issue of extending the transition period). This should restrict the BoE from delivering actual hikes next year.

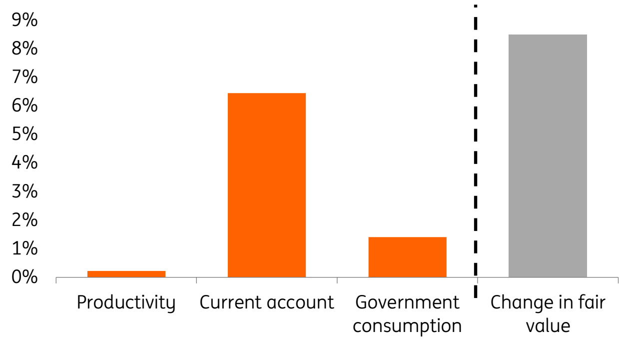
Fig 43 GBP no longer undervalued vs EUR



Source: ING

Fig 44 Current account dynamics behind GBP fair value fall

Contribution of underlying variables to the change in the EUR/GBP BEER fair value since 2017. Measured in relative terms: EZ vs UK.



Source: ING

...and no spectacular GBP valuation

Second, compared to conventional wisdom, we don't see GBP as materially undervalued based on our medium-term BEER valuation framework (Figure 43). Not only has GBP rallied recently but also its fair value has declined over recent quarters. The latter should not come as a surprise as Brexit uncertainty has weighed heavily on the UK economy (translating into sub-optimal growth) and translated into a deterioration of GBP fair value vs EUR of 8-9% since 2017. As Figure 44 shows, this was primarily driven by the worsening relative current account position of the UK. Sterling's fair value decline against the US dollar has been even larger than was the case against the euro as this has been further exaggerated by the drop in EUR/USD fair value.

EUR/GBP at 0.82 would actually bring the cross into modestly undervalued territory (ie, modestly expensive GBP). The lack of a meaningful medium-term undervaluation should limit the scale of GBP upside (compared to early October, when EUR/GBP at 0.93 screened almost 10% overvalued and thus had plenty of potential for a sharp decline).

Better year for sterling ahead, but it won't be (yet again) a smooth ride

In short, given our assumptions (Conservative Party election victory, Withdrawal Agreement passed by January 2020, transition period extended), next year should deliver stronger sterling vs 2019. Yet, it won't be a smooth ride, bumps in the form of question marks about the transition period are ahead and GBP is not as cheap as it was earlier in the year. This suggests contained GBP upside vs EUR, but upside nonetheless. Against USD, sterling should record more gains due, in part, to our modestly higher EUR/USD in 2H20 (at 1.13). This means that GBP should be one the best performing European currencies next year and the best performing low yielder in the G10 FX space in 2020.

ING FX forecasts

	Spot	4Q19	1Q20	2Q20	3Q20	4Q20
EUR/GBP	0.86	0.83	0.83	0.85	0.85	0.82
GBP/USD	1.29	1.33	1.33	1.31	1.32	1.38

CNY: entering a volatile year

- **USD/CNY movements will continue to depend on the progress of the trade agreements, with very little clarity in a US election year.**
- **It is important to keep in mind that the yuan is not a market-based currency and the PBOC will continue to exert control.**
- **Monetary policy will not be relevant for yuan movements.**

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The key driver of the yuan remains the uncertainty of the trade war

Year to date 2019, the yuan has weakened 2.4% against the dollar. The USD/CNY has ranged between 6.6691 and 7.1847, which is a 7.73% difference.

Not only is this range quite large, the change in trend direction has become increasingly frequent as we approach the final stages in the discussions over the so-called "Phase 1 deal" between China and the US.

Earlier in the year there was optimism in the market that a Phase 1 deal would be reached, however limited in scope. This positive view pushed the yuan to below 7.0 per dollar. But this optimism has not lasted in light of the almost daily news describing how difficult it is for the two sides to reach common ground in these negotiations.

China has requested a rolling back of US tariffs. In early November, it was reported that China wanted the US to lift the tariffs imposed in September, and to offer assurances that it would not implement the remaining tariffs planned for December.

The latest version of China's demands reported in mid-November appears even more forthright. China apparently is asking for a rollback of tariffs to the situation as it stood in May. One can imagine that this would create tremendous hurdles in the US from a political standpoint.

We have not jumped on the optimistic bandwagon, as we believe that even if there were to be a Phase 1 deal, it may not have much substance, may not include any tariff rollbacks, but could include clauses to defer the December tariffs.

Based on this view, our USD/CNY forecast for the end of 2019 is 7.00.

We could be wrong. And there could be a meaningful Phase 1 deal, with some rollback of tariffs signed before year-end. But we assign a small probability to this event.

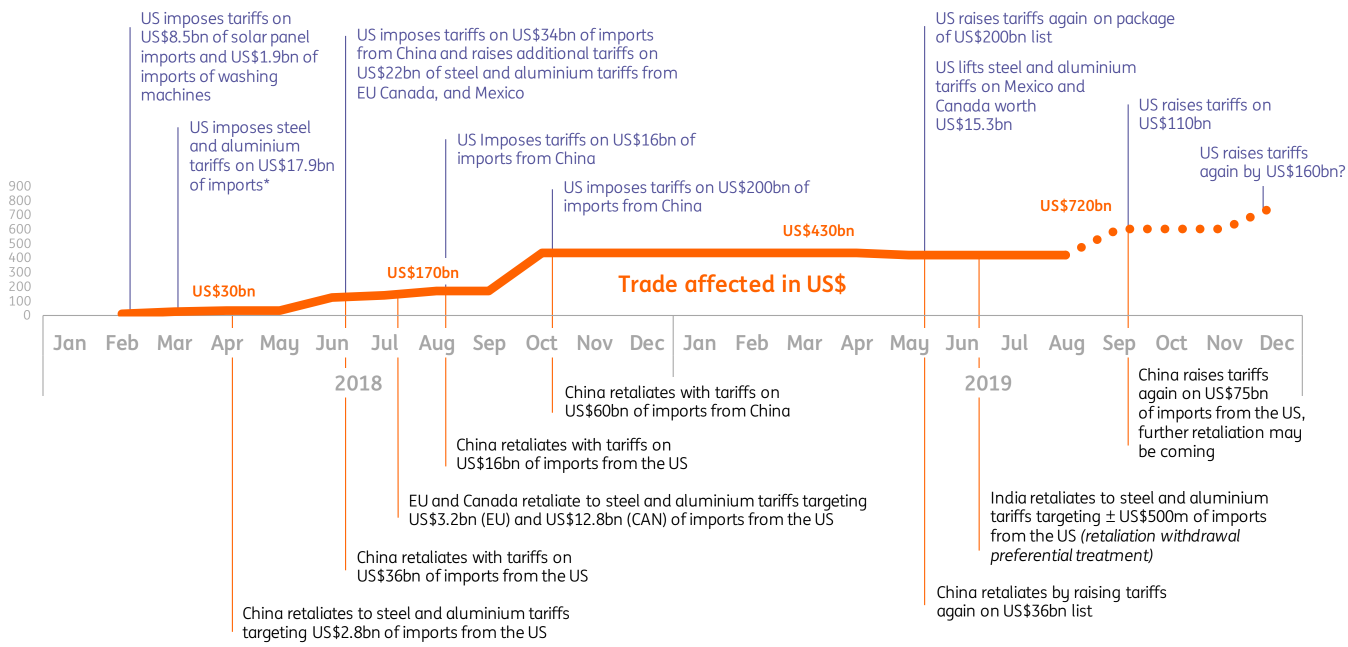
There will be many similar drivers of the yuan in 2020 compared to 2019

We expect the yuan to continue to be trade-talk-driven in 2020. In our 2020 outlook report we discuss the risks and opportunities for the Chinese economy and point out that the trade war is expected to continue into 2020.

It is inevitable that the yuan exchange rate will be very volatile. News on the trade talks, including tariffs, tension related to technology companies and tension over international political issues, will impact on any future trade agreements to varying degrees.

High CNY volatility will continue even if there is a Phase 1 deal because the market will then start to question the likelihood of Phase 2 or 3 deals. The market is likely to remain sceptical on progress of the trade talks after the US Presidential election. It seems likely that trade tensions will persist even if there is a new US president, which is also uncertain.

Fig 45 Trade war timeline



Source: ING

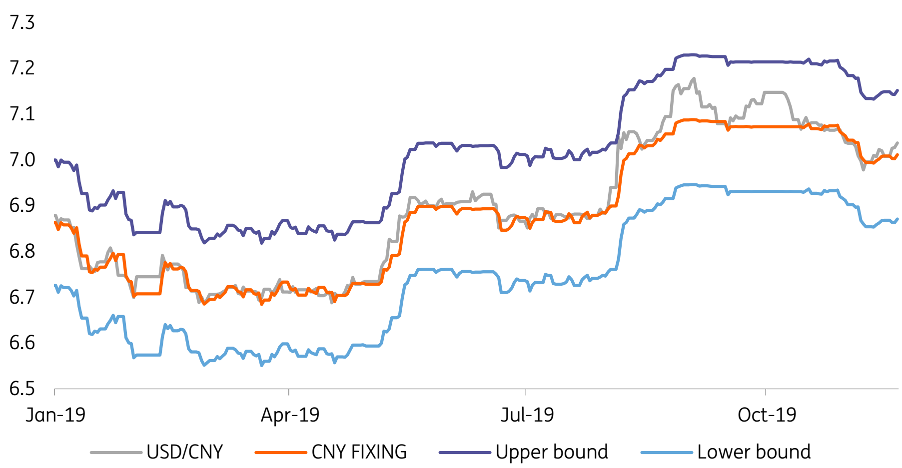
Daily fixing will still be the determinant of the spot rate

The market generally assumes that all currencies are moved by more-or-less the same set of factors. China is an outlier.

We have to keep in mind that the yuan is not a purely market-based currency. Reform of the currency mechanism will be slow for the duration of the trade war in order to avoid unnecessary uncertainty created by any new mechanism.

We expect the daily fixing to continue to be the main guide for USD/CNY. Though we saw deviation of the spot rate from the daily fixings in August and September, the experiment was short-lived. The yuan has returned to a time when fixing is in the driving seat.

Fig 46 PBOC's USD/CNY fixing, bands and USD/CNY movement



Source: Bloomberg

There has been considerable speculation that any trade deal between the US and China could include some form of currency manipulation clause. Exactly what this may look like is a subject for the negotiators. But there is a ready-made blue-print in the form of Chapter 33 of the US Mexico Canada (USMCA) Free Trade deal[2].

The main elements of such a clause concern the reporting of official interventions in FX markets, including data on FX reserves and positions in forward markets.

The parties involved meet annually to discuss the arrangement and any alleged infringements, and there is scope for parties that believe they have suffered a loss according to the behaviour of the other signatories, to seek financial redress.

Something similar was also agreed in the revamped Free Trade deal with South Korea. And it looks like it may become a "boilerplate" inclusion for any US trade deal.

We remain doubtful that China will want to sign up to a clause like this, which may explain part of the hold up on a Phase 1 deal. China may argue that it already fulfils these obligations by reporting to the IMF, and might refer to their IMF article IV assessment which notes that "China's disclosure of FX intervention data meets international standards since joining IMF's SDDS[3]." Signing up to a bilateral deal on the currency with the US might well be seen by China as an unacceptable loss of sovereignty.

Portfolio flows

In 2019, one of the factors that has occasionally supported the yuan has been inflows from portfolio investments.

MSCI increased the China A share inclusion factor to 20% in three steps in 2019, with increments of 5 percent in May, August and November. It is reported that the November increment will draw another US$35-40 billion of funds into the A-share market. FTSE also has included A-shares into its index.

In April 2019, the Bloomberg Barclays Global Aggregate Index started the inclusion of Chinese bonds. As of November data, foreign holdings of yuan bonds reached CNY2tr.

We should read these encouraging numbers with care. There could be outflows if there are redemptions of investments from these indices when the market is rocky, which could occur were the trade war to damage the Chinese economy further.

Monetary policy will not be relevant for yuan movements

Monetary policy seldom has a material impact on USD/CNY movements. Take 20 November as an example, where the PBoC cut both the 1Y and 5Y Medium-Lending Facility interest rates by 5 basis points, but the yuan strengthened during China's trading hours from 7.0336 to 7.0309.

We have commented several times that the yuan does not move with interest rate differentials because arbitraging activities on interest rates are difficult to operate in China – since China's capital account is only half open.

ING FX forecasts

	Spot	4Q19	1Q20	2Q20	3Q20	4Q20
USD/CNY	7.03	7.00	7.05	7.00	6.95	6.85
EUR/CNY	7.78	7.70	7.76	7.77	7.78	7.74

[2] CHAPTER 33 MACROECONOMIC POLICIES AND EXCHANGE RATE MATTERS https://ustr.gov/sites/default/files/files/agreements/FTA/USMCA/Text/33_Macroeconomic_Policies_and_Exchange_Rate_Matters.pdf

[3] Page 19 Section 27. https://www.imf.org/en/Publications/CR/Issues/2019/08/08/Peoples-Republic-of-China-2019-Article-IV-Consultation-Press-Release-Staff-Report-Staff-48576

CHF: Highly valued

- **There has been little change in the SNB's attitude to the CHF. It is still seen as 'highly valued' and the SNB will continue to use negative rates and intervention.**
- **CHF strength is largely apparent in nominal terms. Low inflation in Switzerland means that in real terms the CHF hasn't moved much at all.**
- **Despite fears of CHF demand to settle mis-sold Polish mortgages, cross border pay down of CHF claims seems to be slowing – helping EUR/CHF build a floor near 1.05.**

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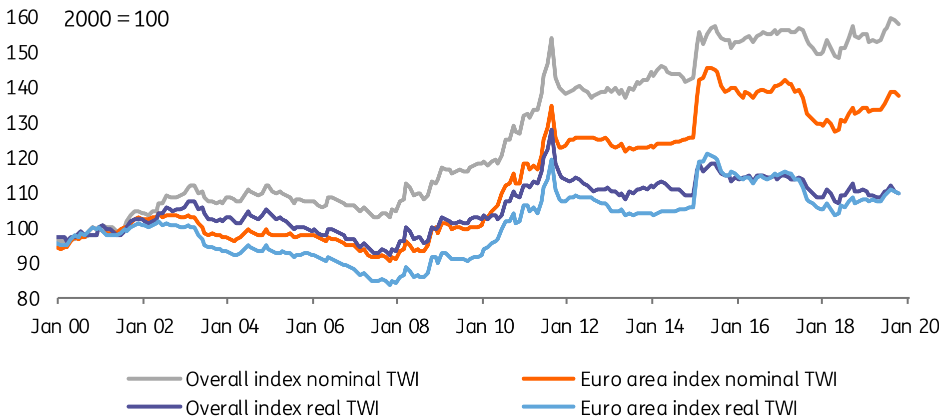
Like the rest of Europe, Switzerland has suffered on the back of the US-China trade war and the ensuing industrial stagnation. The SNB forecasts growth in 2019 somewhere in the 0.5-1.0% region and we only see it marginally higher next year. The risk of deflation is very real for Switzerland, where the SNB sees 2020 full year CPI at just 0.2%.

Little has changed in terms of SNB policy since the January 2015 decision to discontinue the EUR/CHF floor at 1.20. The targeted SNB policy rate (recently renamed ahead of Libor's demise) has remained at -0.75% and the SNB continues to engage in sporadic bouts of FX intervention – FX reserves having increased around CHF30bn this year.

Fig 47 Nominal trade-weighted CHF on highs, but real TWI CHF hasn't budged



Source: SNB

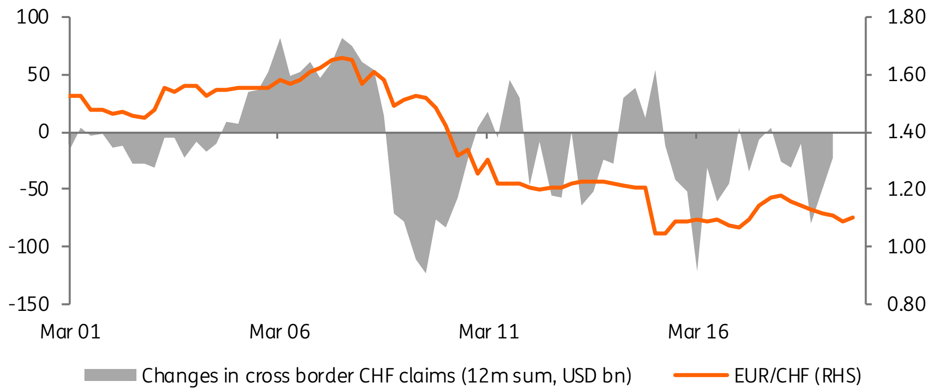
The SNB continues to describe the CHF as 'highly valued' – although as Figure 47 suggests, this is largely an issue for the nominal CHF. Because of Switzerland's very low inflation, the real CHF remains relatively subdued. This perhaps suggests the SNB's tolerance of CHF strength might actually be greater than it would have us believe.

Earlier this year, we released an article suggesting why EUR/CHF could fall to 1.05. EUR/CHF did fall but found a base at 1.08. It seems that the SNB has not had to intervene in the foreign exchange markets as much as we expected and European politics has been relatively calm by recent standards.

Looking through Switzerland's balance of payments data, it also seems that Switzerland is starting to witness net portfolio outflows, suggesting that the big negative yield in the CHF is discouraging safe haven buying of the CHF – at least during a benign period for global asset markets.

Is the SNB facing any constraints to its negative interest rate policy? So far, the SNB seems happy to see off criticism from the banks and the pension fund industry over negative rates. Economic growth (and portfolio returns) would be much worse, the SNB argues, were the SNB to pull back from negative rates. In fact, in September the SNB altered the mechanism for the charges applied to CHF sight deposits, suggesting it was looking to protect local financial institutions if rates were to be taken any more negative.

Fig 48 12m change in cross border claims in CHF (US$bn) versus EUR/CHF



Source: BIS, ING

In addition to the CHF safe haven and negative rates story, we also think cross border CHF borrowing dynamics play a role in CHF pricing. As Figure 48 shows, cross border lending in CHF was very popular ahead of the global financial crisis and its unwinding (pay-down of CHF lending) was a key driver of the subsequent EUR/CHF decline.

Appetite to borrow in CHF has been very weak since the global financial crisis, although the first two quarters of 2019 saw the first consecutive period of rising CHF borrowing since 2014. This comes at a time when cross-border EUR borrowing is popular as well. This suggests that the SNB might have a better chance of holding EUR/CHF at 1.05.

On the subject of CHF loans, we also need to say a word about the Polish FX mortgage story. Our Polish economists have covered the issue in detail here. Earlier this year there had been fears that a ruling by the European Court of Justice (ECJ) could mean that Polish banks might jump to hedge some of their PLN130bn in FX (largely CHF) mortgage exposure – were the ECJ to deem clear mis-selling and somehow force the banks to take back the mortgages at the original CHF/PLN rate.

The subsequent ruling from the ECJ was not the worst outcome for the Polish banks and our team believe that given the case-by-case nature of this story, there will be no wholesale buying of CHF as Polish banks seek pre-emptive hedges of what could become their own, rather than their customers', short CHF positions.

"It may well be that EUR/CHF traces out something like a 1.08-1.12 range for much of 2020"

Elsewhere, the CHF remains overvalued on most valuation metrics – but it has for a long time. Unless we see some surprising recovery in trade and in Europe growth – such that the ECB can stop printing money – it may well be that EUR/CHF traces out something like a 1.08-1.12 range for much of 2020.

ING FX forecasts

	Spot	4Q19	1Q20	2Q20	3Q20	4Q20
EUR/CHF	1.10	1.10	1.10	1.10	1.12	1.15

2020 commodities outlook

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2019 has been 'a year of two tales' for the commodities complex. The trade talk optimism has provided some support to the overall market during 1H, while there has been reduced volatility in 2H and markets remained weighed down by slowing global activity. Uncertainty around trade talks and global growth are likely to remain key drivers for the commodities complex over 2020.

Crude oil – OPEC+ action needed

The oil market is set to return to surplus over the first half of 2020, and so expectations are that prices will weaken over 1H20. We are currently forecasting that ICE Brent will average US$59/bbl over the first part of the year, whilst averaging US$62/bbl for the year as a whole. However, this is assuming that we see OPEC+ not only extend the current output cut deal beyond March 2020, but that it also makes deeper cuts at least over 1Q20. The magnitude of additional cuts needed to keep the market in balance is up to 1MMbbls/d, we believe. The issue with deeper cuts though, is who is willing to cut even more than they currently are. The only real option is that Saudi Arabia takes on more, but it will clearly push other nations to fully comply with the current deal before doing so. OPEC+ will be meeting in Vienna on 6 December, where we will likely get more clarity on what the strategy is for 2020.

NOK RUB
RUB CAD

For 2019, a key price driver has been the demand story. Clearly oil demand growth over 2019 has disappointed, with estimates revised down from 1.4MMbbls/d at the start of the year to just 900Mbbls/d currently. Trade war uncertainty and slowing economic growth has certainly had an impact on oil demand, and whilst demand growth is expected to pick up in 2020, this will depend on how quickly China and the US come to a resolution in their ongoing trade war.

	4Q19	1Q20	2Q20	3Q20	4Q20
ICE Brent (US$/bbl)	65	60	58	62	67

Copper – Trade concerns and macro still in focus

CLP PEN

Copper prices have been weighed down heavily by concerns over the ongoing trade war and slowing global manufacturing activities. A constructive mine supply side has provided little support to the prices over the year. On the refined side, both refined capacities and output are still growing out of China while demand growth has struggled across major China and major European consumers.

Moving into 2020, copper mine supply growth is set to increase although the outlook still looked vulnerable to potential disruptions. The benchmark TC/RC for 2020 came in at US$62 per tonne/US¢6.2/lb compared to US$80.8/US¢8.08 in 2019, a level that is cutting into some marginal smelters' margins. Demand in China is hoping for some support from stimulus measures from the infrastructure sector, but it is still too premature to be sanguine on the global demand recovery until we see solid signs of stabilisation in global activity as well as solid developments from China-US trade talks. We are currently slightly bearish towards prices in 2020 and forecast LME 3M copper to average at US$5,750/tonne as base case prices but the risks are largely dependent on macro uncertainties.

	4Q19	1Q20	2Q20	3Q20	4Q20
LME Cu (US$/t)	5,610	5,600	5,700	5,800	5,900

Iron ore – More supply to return

AUD BRL ZAR INR CNY

2019 has been a volatile year for the iron ore market. The unfortunate Vale dam accident in Brazil raised concerns over supply tightness, with Vale forced to take around 90mtpa of capacity off the market. This pushed prices to as high as US$124/t. Although this move was clearly exaggerated by speculative activity. However, as we have seen a return of some capacity, along with a recovery in Chinese iron port stocks, prices have come under pressure once again, with the market trading sub US$80/t recently. To add to the bearish tone, steel mill margins have come under pressure, leading to some steel producers cutting operating rates.

For 2020, we continue to hold a fairly bearish outlook for iron ore prices. We expect that further Brazilian capacity will be brought back to the market over the course of the year, whilst there is still plenty of uncertainty around the global economy, and so this is likely to keep some pressure on steel mill margins. We currently forecast that iron ore prices will average US$81/t over 2020. The risk to this view is that we do not see Vale capacity continuing to return as quickly as anticipated, which could keep the seaborne market tighter than expected.

	4Q19	1Q20	2Q20	3Q20	4Q20
Iron ore (US$/t)	95	85	85	80	75

Coal – Weakness to persist

AUD IDR COP ZAR RUB

Coal prices remain under pressure, with European prices down more than 35% since the start of the year, leaving them to trade just above US$50/t. For Europe, the outlook for prices remains weak. This is due to two factors. Firstly, EU carbon prices have been fairly strong. Secondly, gas prices in Europe have been very weak, with a significant amount of LNG making its way into the region, as LNG export projects ramp up. These two factors have supported a coal to gas switch for power generation, which has weighed on coal demand.

	4Q19	1Q20	2Q20	3Q20	4Q20
API2 Coal CIF ARA (US$/t)	60	60	58	60	70

Soybeans – Trade war dependent

BRL

Soybeans have been the poster child for the trade war between the US and China. However more recently, as we have seen progress with phase one of the trade deal, Chinese buyers have returned to the market for US soybeans, with the government providing tariff free quotas. This has clearly been supportive for CBOT soybeans. However, we will likely need to see tariffs fully removed rather than just quotas being provided, in order to turn significantly more bullish on the market. On the supply side, the US soybean crop is set to be significantly smaller this marketing year. Firstly, given the ongoing trade war, farmers reduced 2019 soybean plantings. This lower acreage combined with weaker yields means that US soybean production is expected to fall year on year, and this smaller crop should help to lower elevated stock levels.

For 2020 US plantings, a lot will depend on how trade talks evolve over 1Q20. However, right now, the soybean/corn price ratio suggests that farmers should plant more corn at the expense of soybeans. Overall, we expect the CBOT soybean price to trend higher moving into 2020, with prices averaging US$9.10/bu over the year, driven by falling global ending stocks. A quick resolution to the trade war, however, could mean further upside. While a trade deal would provide upside to CBOT soybeans, it would in fact be bearish for Brazilian soybean cash values, with Chinese buyers likely to switch back to US soybeans.

	4Q19	1Q20	2Q20	3Q20	4Q20
Soybean (US¢/bu)	870	890	920	910	900

AUD ZAR RUB

PEN CNY CAD

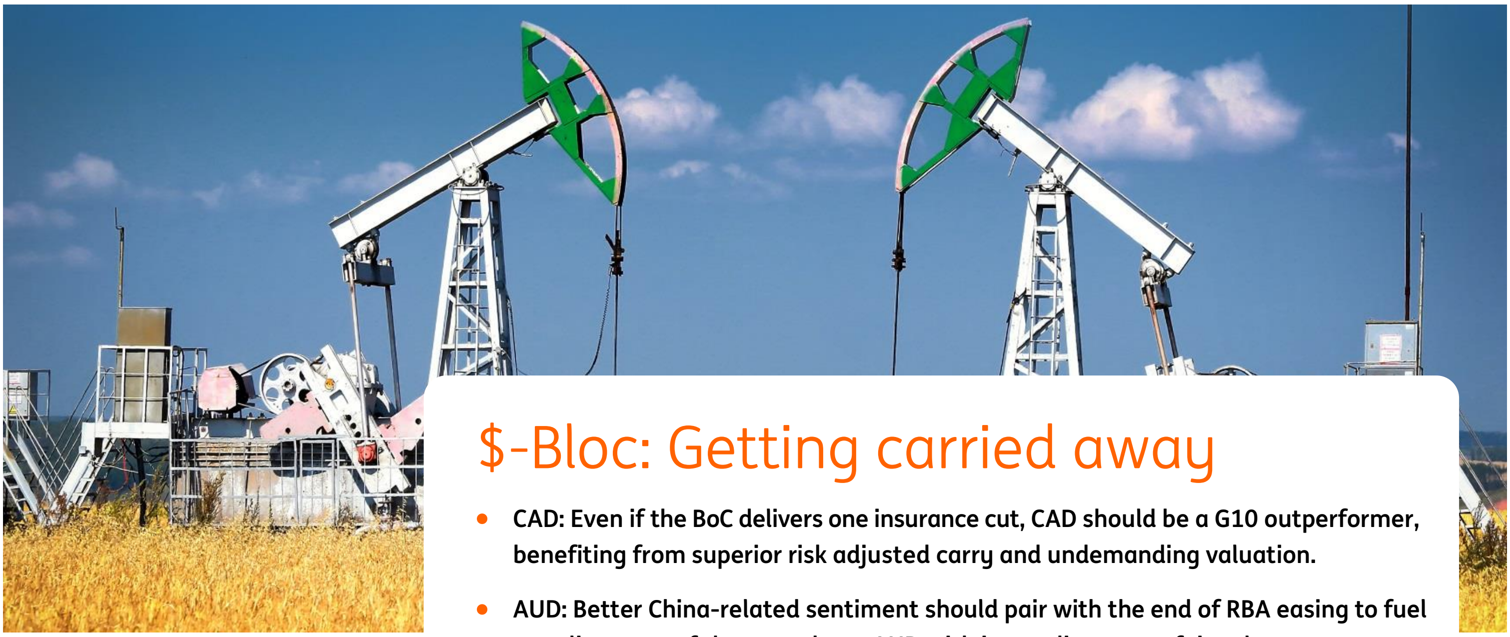
IDR

Gold – Safe haven appeal

The gold market has had a strong year, with prices up as much as 21% at one stage, hitting a multi-year high of US$1,554/oz. This strength shouldn't come as too much of a surprise, given the growing uncertainty in the global economy, with slowing growth and escalating trade tensions. These factors have increased the appeal for safe haven assets such as gold. Furthermore, more dovish policy from central banks has also provided support to gold.

Looking to 2020, we believe that prices will be dictated by the same themes as this year. As a result of trade uncertainty and concerns over global growth we do see upside to gold prices from current levels. While if the US Fed turns increasingly more dovish, this only provides further upside. We currently forecast that gold prices will average around US$1,475/oz over the course of 2020.

	4Q19	1Q20	2Q20	3Q20	4Q20
Gold (US$/oz)	1,500	1,500	1,470	1,470	1,480



$-Bloc: Getting carried away

- **CAD: Even if the BoC delivers one insurance cut, CAD should be a G10 outperformer, benefiting from superior risk adjusted carry and undemanding valuation.**
- **AUD: Better China-related sentiment should pair with the end of RBA easing to fuel a realignment of the very cheap AUD with its medium-term fair value.**
- **NZD: Valuation, abating risk aversion, stable commodity outlook and the RBNZ's neutral stance all point to Kiwi outperformance next year (vs USD and AUD).**

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We consider the $-bloc as a highly attractive pool of currencies for the coming year. The main underlying assumption for this view is that no further deterioration in the US-China trade spat will contribute to a further stabilisation in global risk sentiment that will ultimately push investors towards high yielding and pro-cyclical currencies in an attempt to secure attractive returns.

We expect carry trades to be the strategy of choice thanks to low expected volatility and this should come particularly to the benefit of CAD that, as shown in Figure 9 currently holds the most attractive risk-adjusted carry. The yield on AUD and NZD appears less attractive after their respective central banks cut rates in 2019, but both currencies can leverage on their very attractive undervaluation (as shown in Figure 14).

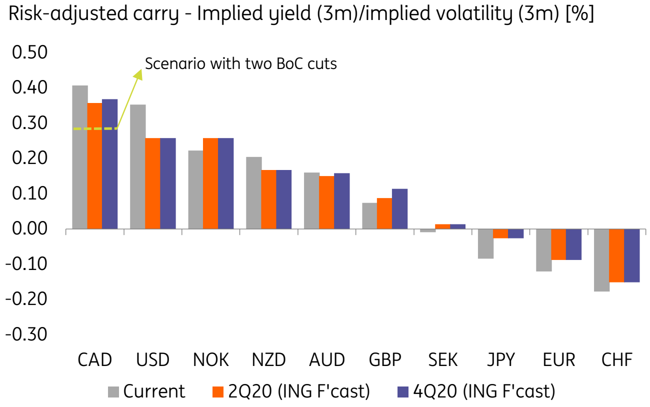
CAD: Carry to prevail over economic woes

A big chunk of CAD's resilience to swings in risk sentiment this year is attributable to its steadily supportive rate advantage, that remained intact as the Bank of Canada kept rates unchanged against the global easing trends. However, things have changed in the past couple of months. In its latest policy meeting (30 October 2019), the BoC stressed the downside risks to the economic outlook and likely opened the door (implicitly) to monetary easing. At this stage, we think the BoC will cut the rates by 25bp either at the December meeting (currently only 8% priced in) or in early 2020 (45% priced in for 1Q20). We suspect this will be a one-off 'insurance' move, and we expect rates to stay at 1.50% at least through 4Q20. At the same time, we acknowledge a non-negligible risk that the BoC may move twice even if external or internal conditions don't materially deteriorate.

> *"CAD will be able to retain a significant carry advantage in the case of BoC easing"*

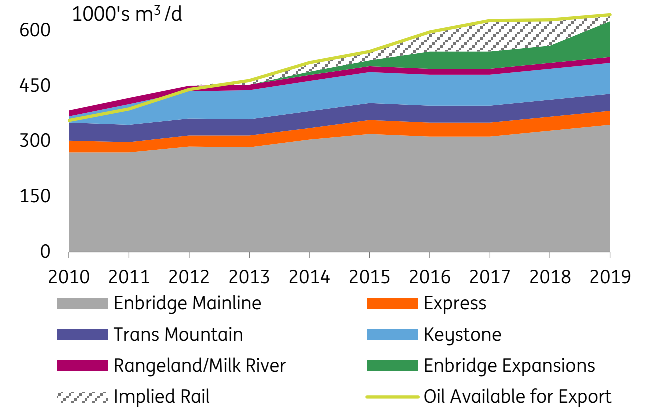
One could conclude that this dovish shift by the BoC would erode CAD's rate advantage but, in reality, it would hardly dent it. Using the ING-forecast 3m yields for G10 currencies, it is possible to see (Figure 49) how CAD would still be able to retain a significant carry advantage in the case of a 25bp BoC cut (which is in our forecast). We acknowledge the risk of two rate cuts but, also in that case (as shown by the dashed line in Figure 49), CAD would remain the king in terms of carry advantage within the G10 space.

Fig 49 CAD carry to dominate in G10 even if BoC cuts



Source: Bloomberg, ING

Fig 50 Pipeline capacity still insufficient

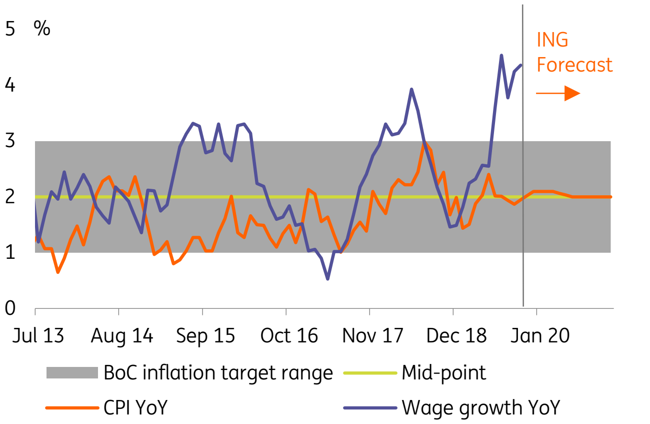


Source: Canada Energy Regulator

We expect such carry attractiveness to sustainably drive CAD strength throughout 2020: such strength may be more visible versus the low yielders (in line with the carry-trade logic) but will be evident in the form of an approximate 6% appreciation of the loonie versus the USD: we see USD/CAD at 1.25 in 4Q20.

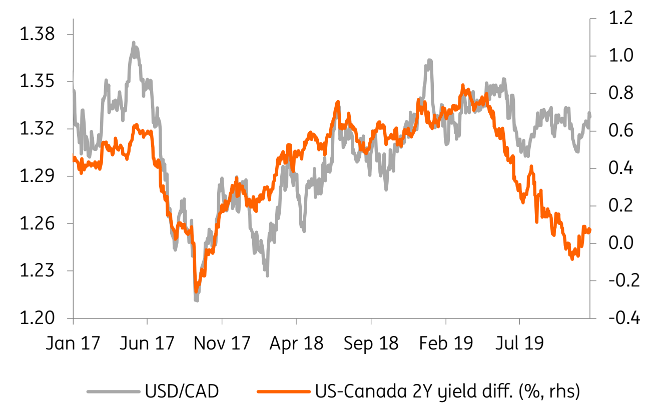
The downside risks to the CAD are, however, not absent. The most obvious risk is related to a breakdown in trade negotiations between the US and China, along with the implications for the outlook of the very open Canadian economy. Latest GDP reports already highlighted a sustained downward trend in capital investments, in particular in the energy sector, which accounts for around 11% of the nominal GDP. The oil industry is facing a double trouble: low global oil prices and a shortage of pipeline capacity (Figure 50) that has kept the Western Canada Select/WTI spread quite elevated. Neither of these two issues are likely to see a resolution in 2020. Our commodities team is expecting global crude oil prices to stay on the back foot at least through the first half of 2020 and see WTI averaging US$55/bbl in the year. The pipeline expansion projects will not be completed by 2020, which should keep WCS prices fairly subdued.

Fig 51 Inflation at target limits need for BoC easing



Source: Bloomberg, ING

Fig 52 Rate differential points at more USD/CAD weakness



Source: Bloomberg, ING

However, our economics team is expecting Canadian activity to hold up fairly well, with growth hovering around 1.6% YoY in 2020 and inflation around target (2%). The long-awaited ratification of the USMCA should also contribute to lift the economic outlook, especially by supporting investments. In conclusion, the downside risks to the Canadian economy are unlikely to materialise in 2020 and even when adding one or even two cuts by the BoC, the rate advantage is likely to prevail in driving CAD higher next year. Incidentally, it must be noted that the USD/CAD rate has still to fully realign to the widening rate differential in favour of CAD (as shown in Figure 52).

The risk of another downturn in oil prices in the first half of the year suggests that most of the strength in the loonie will manifest in 2H20. Our end-2020 forecast for USD/CAD at 1.25 embeds not only the inflows to CAD thanks to the rate advantage but also some weakness in US dollar. Although such a profile may suggest an interesting short USD/CAD opportunity, we trust the most effective way to cash in on CAD's strength in 2020 is by entering 'pure' carry trades, thereby buying CAD and shorting low-yielders. In this sense, such as long CAD/SEK (in line with our weak SEK forecast). Also, long CAD/CHF and CAD/EUR currently offer good value, given that the two positions combine a very attractive carry return with a low implied volatility (CAD, CHF and EUR have the lowest 3m vols in G10).

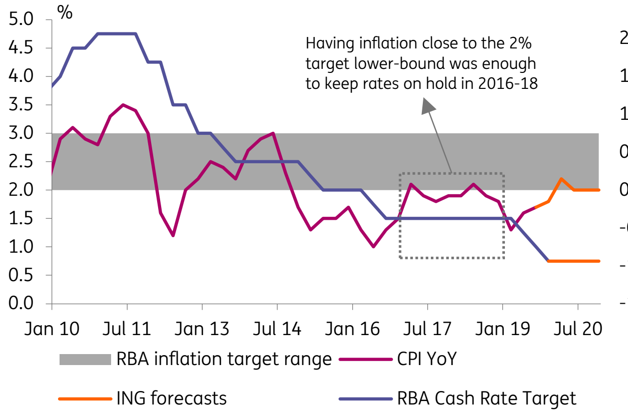
AUD: Surfing the 'gentle turn'

We expect the Aussie $ to follow the commodity bloc upward and to come out as an outperformer in 2020. With a broadly supportive risk environment in the background, the undervalued AUD can start to realign with its fair value, also aided by a 'gentle turn' (as RBA Governor Lowe likes to put it) in the economy and from the end of the RBA easing cycle. We expect AUD/USD to reach 0.72 in 4Q20.

Indeed, the RBA has two very ambitious targets: inflation at 2.5% (target range mid-point) and unemployment at 4.5%. The currently provided stimulus does not appear sufficient to trigger such required adjustments in the two indicators. In turn, the RBA is likely facing two options now: go 'all in' and deliver another significant amount of easing (possibly entering QE) or extend the pause and welcome the improvement in price dynamics. We think the second option is more likely.

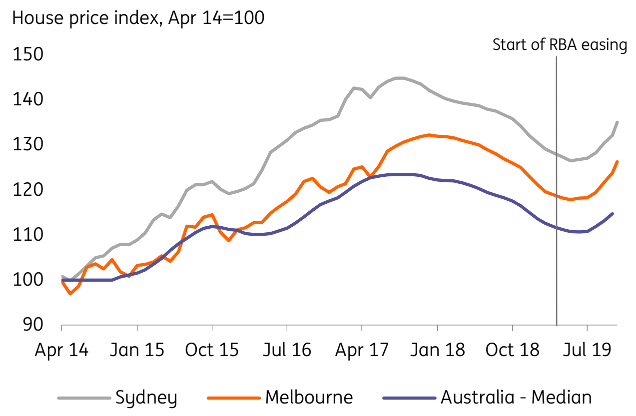
Inflation (currently at 1.7%) has inched up in the past two quarters and, while it is evident that there is still a gap to fill to reach the RBA target, we must consider that inflation has consistently undershot the target band in the past five years (Figure 53). In the 2016-18 period, inflation stayed slightly below the 2% target lower-bound and it was enough to convince the RBA not to cut more: we expect a similar dynamic in 2020.

Fig 53 Inflation outlook suggests the RBA may be done



Source: Bloomberg, ING

Fig 54 RBA 'medicine' has helped a recovery in housing



Source: CoreLogic, ING

The latest data indicates a rebound in the national housing market (Figure 54), suggesting that the RBA "medicine" (rate cuts) seems to have worked to avoid a property crash. This is allowing the RBA and consumers to see the 2018-early 2019 drop as a physiological correction rather than the inception of a crisis. Given the importance of real estate for average household wealth in Australia, this should positively impact consumer spending: a gauge that the RBA recently said will be monitored very closely.

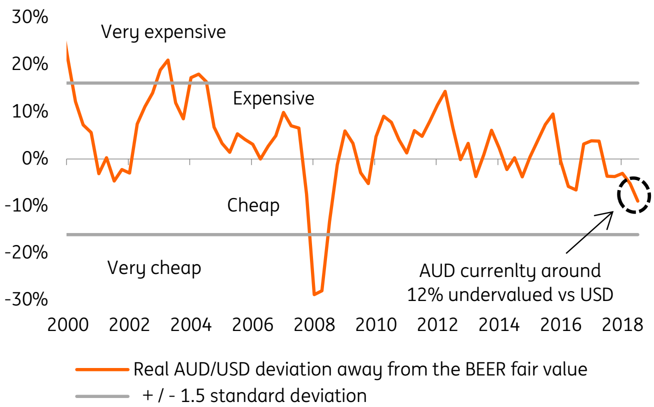
These two positive developments should be able to offset the less optimistic dynamics in the labour market (unemployment recently moved back up to 5.3%), and our base-case is that the RBA will keep rates at 0.75% in 2020. However, we cannot ignore mounting market speculation with regards to another round of monetary easing next year. In this sense, the main risk is that another cut could revamp expectations that the RBA will embark in unconventional monetary tools (given that rates are already close to 0%).

Shape and impact of a possible RBA QE
In October, we looked into the possibility of the RBA embarking in quantitative easing some time in 2020 and tried to forecast the consequent impact on AUD (see full article here). In our view, three conditions need to be met to push the RBA to embark in QE: Cash Rate at 0.25% (now at 0.75%), inflation at 1.5% (now at 1.7%) and unemployment rate at 5.5% (now at 5.3%). We see this scenario as quite unlikely, especially given the recent uptrend in inflation and the increasingly less dovish RBA stance. However, should such conditions materialise and the RBA decide to start QE, we suspect it would be quite limited in size. We think it would consist of around AU$28bn of purchases per month, that in monetary basis terms equals to around half of the size of the Fed's 2009/10 QE. The lack of emergency in Australian financial conditions (no slump in asset prices, fairly robust growth, no risk of deflation) suggests that a larger programme would be unwarranted. We estimate the impact of QE to be around -5% on AUD/USD.

"We expect the undervalued AUD to converge to its medium-term fair value"

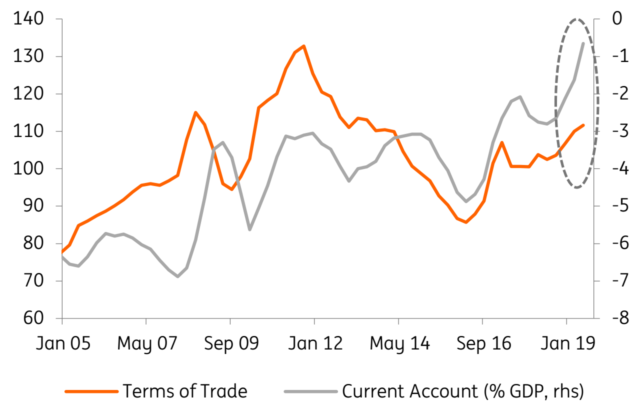
Our BEER model estimates indicate that AUD is the cheapest currency in the G10 space. Looking at the historical mis-valuation (Figure 55), AUD/USD is currently at the most undervalued point (-12%) since the financial crisis. Among other factors, AUD fair value has remained supported over the past few quarters thanks to some positive dynamics in the current account and in the terms of trade (Figure 56). Looking at the next year, there do not seem to be not enough reasons to expect these two factors to face substantial headwinds. The two key risks derive from: (1) lingering trade tensions (that dries up demand for Australian exports); (2) a drop in prices of the main Australian commodities.

Fig 55 AUD outlook helped by current undervaluation



Source: ING

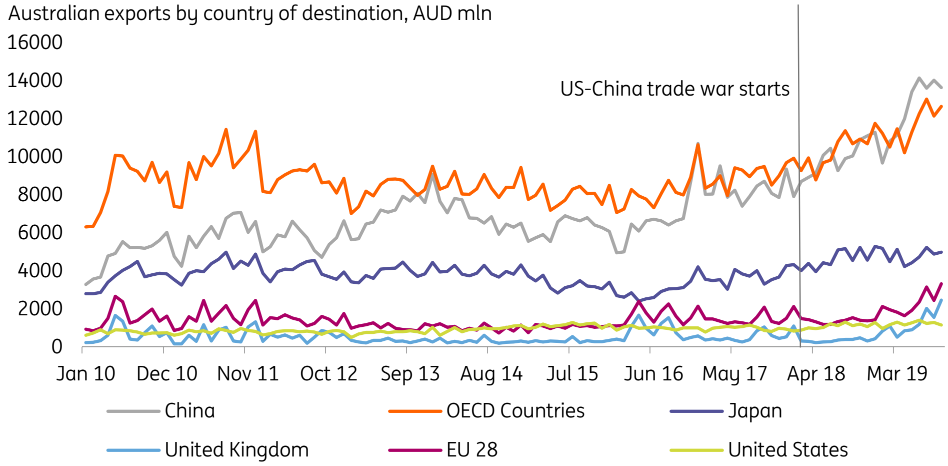
Fig 56 Terms of Trade and CA rose despite trade wars



Source: Bloomberg, Australian Bureau of Statistics

Looking at the first eventuality, the dynamics of the current account and the terms of trade in 2019 (both ascending) indicate no spillover effect of the escalation of trade tensions. A deeper look into the geographical decomposition of trade flows (Figure 57) confirms this notion, as exports to China (that were expected to take the hardest hit) increased in line with exports to the OECD countries.

Fig 57 Australian exports on the rise, even those to China



Source: Australian Bureau of Statistics, Macrobond, ING

The commodity picture for Australia is likely going to be a mixed one in 2020, and we expect it to have a net neutral impact on AUD throughout next year. Iron ore prices are expected to head down (we expect a 2020 average around US$80/t) as production in Brazil is gradually restored, but should partly be compensated by supported gold prices (third-largest Australian export), which we expect to average at US$1,475/oz in 2020. The outlook for coal is also not looking very encouraging and we see prices hovering around 60 US$/t during the first three quarters of 2020 before rebounding in 4Q (in line with most commodities). However, Australia has recently become the largest LNG producer in the world and seems well positioned ahead of the shift from coal to natural gas in global demand: it seems reasonable to expect further investments in the booming LNG industry in the country. Please refer to our commodities section for further detail.

NZD: No longer the black sheep of G10

The Kiwi dollar has been the worst performer in the $-bloc in 2019 (-4.3% vs the USD) as an early dovish shift by the RBNZ left the currency without any support as trade tensions escalated. A snapshot of the current situation, however, suggests the woes to the NZD may be close to an end.

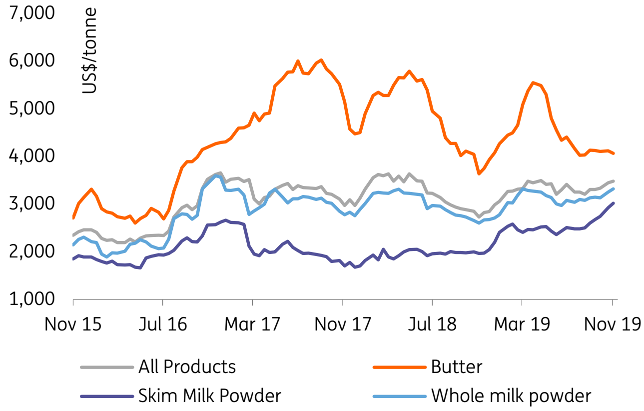
First and foremost, the RBNZ seems to be done cutting rates. The Bank frontloaded the rest of G10 space twice in 2019 in terms of monetary easing: first, when it lowered the policy rate in March and then when it delivered a surprising 50bp cut in August. While it has been pointed out more than once this year how the Fed seemed to be aligning its policy with markets expectations, the RBNZ has shown to have an opposite approach. In the latest policy meeting (13 November), the Bank held rates on hold despite markets pricing in around 70% of a cut and Governor Adrian Orr has hinted that the policy rate will remain on hold at 1% for an extended period of time.

"We expect no more easing by the RBNZ"

The RBNZ hopes are that the stimulus already provided will ultimately feed a recovery in inflation and support economic activity. Inflation remains below-target (1.5%), but the unemployment rate is close to its historical lows (4.3%) and wage growth is robust (3.9%). Our economics team expect headline CPI to move back to the 2% mid-target and hover around that level for most of 2020, and are also seeing a fairly supportive activity outlook with average GDP growth at 2.5% next year. When adding a less concerning external outlook, the RBNZ should be able to stick to its recently-adopted neutral stance and keep the rates at 1% (although market is still pricing around 20bp of easing for next year). In November 2020, New Zealanders will head to the polls as current PM Jacinda Ardern (Labour Party) seeks a second term after leading a minority government. Early polls suggest Labour is tied to the centre-right Nationals, but much will depend on the performance of smaller parties

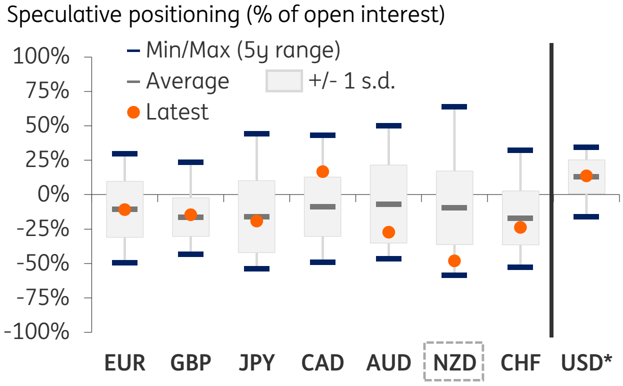
(Greens and nationalists NZ First, above all) to determine the chance for Ardern's re-election. Either way, we do not see a major market impact of the elections.

Fig 58 Milk price stabilisation is key for NZ economy



Source: AHDB, GlobalDairyTrade Holdings Ltd

Fig 59 NZD is the biggest G10 speculative short



As of 19 Nov 2019 - *aggregate USD positioning vs G10 FX

Source: CFTC, Bloomberg, ING

New Zealand is a highly export-focused economy, with strong ties to Chinese demand, but – differently to Australia – its export is mostly focused on agricultural alimentary products. This has two main implications: it makes global demand less reliant on economic cycles than other commodities (such as industrial metals) but it is also strictly dependent on weather conditions on the production side, which adds some unpredictability. That said, the outlook for NZ main commodities appears fairly constructive. The average auction price of milk and milk-related products (that make around a quarter of NZ total exports) has been on the rise in 2H19 (Figure 58) and Fonterra (NZ's main dairy co-operative) has recently announced an upward review of its farmgate milk price forecast for the 2019/20 season from NZ$6.25-7.25 to NZ$6.55-7.55 per kgMS. The outlook for the forestry industry (9% of total exports) had worsened during the summer of 2019 as prices slumped, but latest data suggests the worst is behind – especially as fears of drying Chinese demand abated - and our expectations for no further escalations in trade tension also supports a stable outlook for 2020.

As shown in Figure 14 NZD is currently trading below its medium-term fair value. Most of the negatives that kept the NZD on the back foot in 2019 appear more likely to fade than re-intensify in 2020 as trade tensions and RBNZ easing have likely peaked. NZD can also benefit from being the biggest speculative short in the G10 market (Figure 59) at the moment (CFTC net positioning is at -48% of open interest, at the time of writing), which should exacerbate rallies in the currency as the tide turns.

All this leads us to expect a solid rebound in the Kiwi dollar across the board in 2020 which, in line with the other commodity currencies, should mostly manifest in the second half of the year – we see NZD/USD at 0.67 in 4Q20. In the shorter-run, we expect a continuation of the recent downward-sloping trajectory of AUD/NZD, that should continue to be pressured by the policy differential. Looking ahead, we expect the pair to flatten up at around 1.05, although the balance of risks should stay tilted to the downside as we see another cut by the RBA to be more likely than one by the RBNZ (despite our forecasts include no easing by either of the two).

ING FX forecasts

	Spot	4Q19	1Q20	2Q20	3Q20	4Q20
USD/CAD	1.30	1.32	1.30	1.29	1.26	1.25
AUD/USD	0.70	0.69	0.68	0.70	0.71	0.72
NZD/USD	0.60	0.65	0.65	0.66	0.67	0.68

Scandies: Another year of SEK underperformance

- **Yet again, 2020 won't be the year of SEK. December's Riksbank hike should take place amidst low growth/inflation and doesn't alter SEK's low yield characteristics.**
- **SEK to remain a laggard among G10 cyclical FX. EUR/SEK to stay flat around 10.60, with clear risk of re-testing the 11.00 level. NOK/SEK to head back above 1.10.**
- **Also undervalued, yet high yielding NOK is better positioned than SEK. EUR/NOK to modestly decline to 9.80. Seasonality suggests front-loaded NOK strength in 1Q20.**

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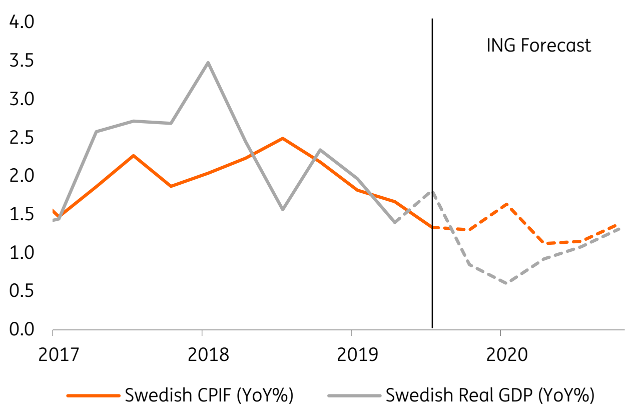
SEK: Riksbank's hike won't help the krona...

The signalled December Riksbank hike might not be well received by the market as it will be delivered in a slowing growth/CPI environment. We expect the December rate meeting to confirm the one-and-done nature of the rate hike, preventing market participants from expecting more tightening and thus more SEK strength. The dovish hike should have a little positive effect on SEK. If anything, with domestic growth remaining soft and CPI to continue dropping, the risk is that the market may start pricing in (partial) cuts should the global environment deteriorate again. Yet, with the Riksbank's vigorous approach towards its goal of exiting the negative interest rate territory, the bar for eventual cuts back below zero is set very high. While optically this may be seen as non-negative for SEK, to the extent which it signals the Riksbank's unwillingness/inability to stimulate the economy and inflation, this points to a weaker currency stemming from resulting weak fundamentals.

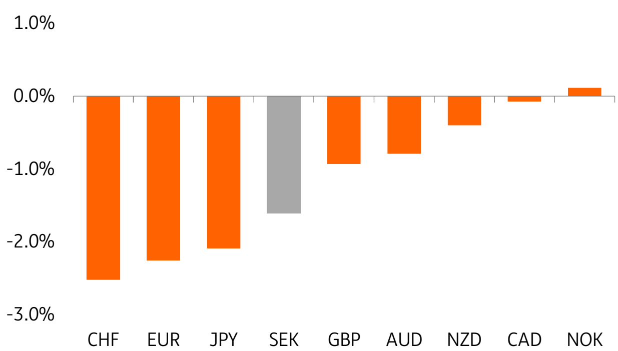
Fig 60 Uninspiring growth and inflation outlook in Sweden



Source: ING

Fig 61 SEK not attractive among cyclical currencies

Implied yield on G10 FX crosses vs USD derived form 12-month FX forwards



Source: ING, Bloomberg

...as economy and CPI outlooks remain soft and suggest no further tightening

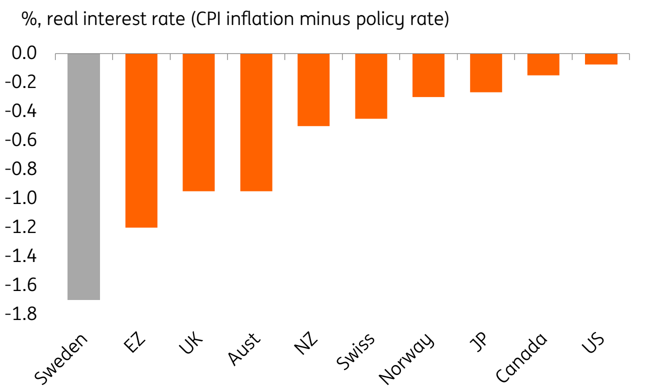
Indeed, neither economic, nor inflation outlooks look appealing (Figure 60). The Swedish economy looks vulnerable to a more pronounced global growth slowdown – more so than Norway, which while open, is less directly reliant on international supply chains.

Reduced capacity utilisation and lack of new orders suggest investment could decline in 2020, while export growth could slow further. The inflation outlook looks relatively benign – a lot depends on the wage negotiations next year. But with the jobs market faltering and inflation expectations slipping in the labour market, it looks unlikely that the unions will be able to secure steeper, multi-year rise in wages. This benign inflation outlook suggests the Riksbank won't raise rates much beyond the December hike. As has been the case in 2019, the housing market doesn't look like a major story for 2020.

Despite the Riksbank's hike, SEK is still the lowest yielding G10 cyclical currency

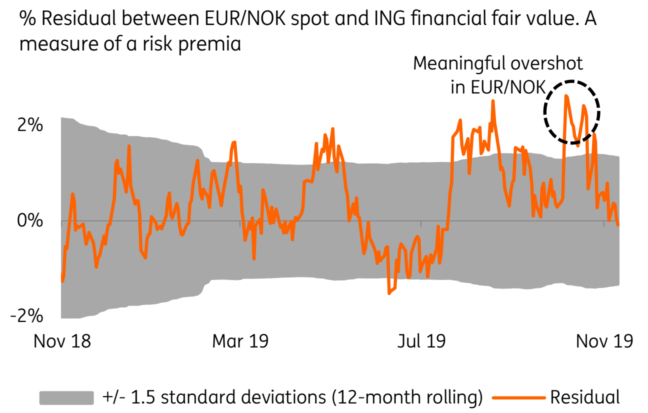
Although we expect the global risk environment to stabilise, we don't see SEK as the prime beneficiary. Rather the currency should continue to lag its high beta G10 FX peers, including NOK. This is because the higher yielding FX should be the key beneficiary from flows into risk assets from the unappealing G10 core low yielders. Even after fully pencilling in a Riksbank December hike, SEK still does not fit these characteristics. The currency still screens the least attractive from the yield perspective among cyclical peers (Figure 61) and retains the lowest real yield in the G10 FX space (Figure 62). With the economic growth remaining deeply below the potential, and CPI off the target (as per Figure 15 on page 12), the currency should remain an unattractive outright long and should still be rather seen as a funding than an asset currency.

Fig 62 Sweden having the lowest real rate in G10 FX space



Source: ING, Bloomberg

Fig 63 EUR/NOK heavily overshot its short-term fair value



Source: ING

SEK to underperform NOK and not to appreciate against EUR

Granted, SEK might look ultra-cheap but so do most of its cyclical peers in the G10 world. As Figure 14 on page 12 shows, NOK, AUD and NZD are by and large as undervalued as SEK. Hence, from a perspective of value chasing, these higher yielding currencies with better idiosyncratic stories offer better value than SEK, in our view. The current stretched SEK valuation should be beneficial for the currency to the extent to which it may act as a hurdle for EUR/SEK to breach the 11.00 level. While we look for EUR/SEK stability (around EUR/SEK 10.60 for most of the year) we view risks as skewed to the weaker SEK should global growth slip yet again. The year of 2020 will be another déjà vu for SEK – yet again it will not be the year of the SEK.

NOK: Hard to justify sell-off in late 2019 to be followed by seasonal 1Q20 rebound

The NOK sell-off and its underperformance this October was stunning, with EUR/NOK aggressively overshooting our short-term financial fair value estimate (Figure 63). As our model captures factors such as the oil price, general risk environment, domestic equity market and domestic rates, it is challenging to justify the scale of the sell-off on a fundamental basis. Rather, it looks like a mix of poor liquidity, positioning and investors front-running the seasonal year end / 4Q NOK underperformance (Figure 64). This suggests some reversal, particularly during the first two months of next year (January especially) in line with the usual seasonality (also depicted in Figure 64).

Solid economy and above target CPI to keep possible NB hike on the table

Against the euro, NOK should undergo some modest reversal and appreciate somewhat next year. The economy should continue to perform relatively well, with the ripple effects of stronger energy-sector investment being felt across the economy Figure 65. Consumer activity looks set to strengthen next year, and with wage growth above 3%, inflation will remain above the target. The risks to the housing market also look fairly contained (although with some areas experiencing oversupply, there is a tail risk of a sharper fall in construction).

> *"NOK remains heavily undervalued vs EUR and USD"*

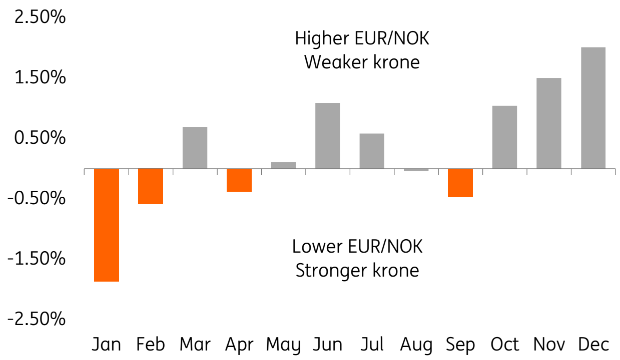
While Norges Bank has signalled it is taking a pause having hiked three times in 2019, we wouldn't rule out another hike in 2020, particularly if the currency doesn't appreciate materially, and if oil investment continues to outperform (break-even costs are well below current market pricing). As for oil prices, our commodities team looks for range bound moves (see commodities outlook on page 32).

EUR/NOK to move back below 10.00 but upside to cheap NOK won't be unconstrained

As per our BEER model, NOK remains heavily undervalued vs EUR and USD (Figure 14 on page 12). Coupled with the yield advantage and the recent unjustified EUR/NOK overshoot, the pair should grind modestly lower in 2020 (mainly in 1Q). While a modest decline in EUR/NOK is likely, one should not look for fireworks (in spot terms) as stabilising rather than rebounding global (and European) growth also suggest limited spot gains. This suggests EUR/NOK moving back below 10.00 and potentially reaching the 9.70/9.80 area, but not lower. With carry vs EUR at around 2.4% this means around 5% total expected return.

Fig 64 Seasonality suggests weaker NOK at the year-end

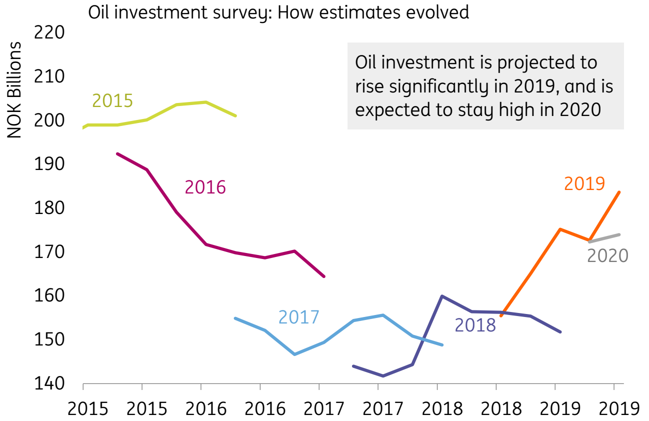
%, Seasonal EUR/NOK monthly performance throughout the year. 5-year trailing average



Source: ING, Bloomberg

Fig 65 Ripple effects of stronger energy-sector investment

Oil investment survey: How estimates evolved



Source: ING

Attractive yield to return support to NOK - NOK/SEK to breach the 1.10 level

Among the cyclical higher beta G10 currencies, NOK is positioned well from the yield advantage perspective. Along with CAD, it offers the highest yield within this currency segment (Figure 61). This should be enough for NOK to outperform SEK and NOK/SEK to breach the 1.10 level again.

ING FX forecasts

	Spot	4Q19	1Q20	2Q20	3Q20	4Q20
EUR/SEK	10.60	10.70	10.60	10.60	10.60	10.60
EUR/NOK	10.12	10.10	9.80	9.80	9.80	9.70

CEEMEA: Unattractive low yielders, diversity in high yielders

- **From a global perspective, the relatively low yielding CEE FX should lag its EM peers in 2020. CEE growth is slowing, EUR/USD is to stay range-bound, and both CEE FX valuation and carry are not attractive in USD terms to get overly excited about.**
- **Yet, most of CEE FX (even RON) should do relatively well vs EUR due to (modest) carry. Our top pick is CZK as global risks are receding and the CNB may hike. We are HUF negative as policy is too loose for weakening C/A dynamics.**
- **2020 should benefit CEEMEA high yielders. RUB and TRY stand out on valuation - carry matrix. We prefer RUB. ZAR, the only EM high yielder not cheap vs USD, remains unattractive, partly due to the downgrade risk.**

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And the EMEA Economics Team

Underweight CEE FX globally, locally overweight CZK vs underweight HUF

It is unlikely to be a stellar year for CEEMEA low yielders. Bar HUF, CZK, PLN and ILS do not show an appealing valuation (being either around their fair values or overvalued) while by their virtue of being low yielders, they won't be seen as overly desirable in what we anticipate will be a search for higher yields. As Figure 66 shows, the bulk of these currencies find themselves in the undesirable bottom-right quadrant (offering low risk adjusted carry and non-appealing valuation).

> "For global investors, the CEE FX segment won't find much appeal in 2020"

Adding to it is the non-exciting eurozone economic growth prospect, slowing CEE growth (Figure 67) and non-appreciating EUR/USD. Thus the CEE FX segment won't find much appeal among the international investment community next year, likely warranting a regional underweight, particular from the USD-based investors' point of view. But against the euro, the currencies shouldn't do too badly, with CZK, RON and PLN all exerting a degree of carry protection – in contrast to HUF. We are no longer CZK negative as the worst for the koruna seems to be behind us. CEE FX wise, we prefer to be CZK overweight, HUF underweight and neutral on PLN and RON (the latter purely due to carry consideration).

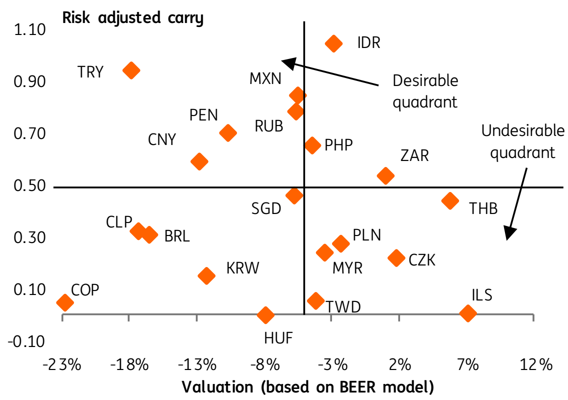
More value in CEEMEA high yielders, with RUB yet again standing out

In contrast, the likes of RUB and TRY offer cheap valuation and attractive risk adjusted carry (the desirable top-left quadrant in Figure 66), a sought-after attribute in what is likely to be search for higher yield, characterised by stabilising global growth and no meaningful escalation in the US-China trade conflict. Yet as the dollar won't be weakening for idiosyncratic reasons (limited, if no, cuts from the Fed), EM FX spot gains vs USD won't be stellar - suggesting carry will be an important factor from a total return perspective. While TRY looks good on the above matrix, we prefer RUB as the lira is likely to continue depreciating in nominal terms to avoid real TRY appreciation due to persistently high inflation. We shy away from ZAR due to its unattractive valuation (the only high yielding EM currency not undervalued vs USD – Figure 13 on page 12), the risk of a credit rating downgrade and slowing growth (vs higher growth in Russia and Turkey). CEEMEA high yielders wise, we prefer RUB overweight, TRY neutral and ZAR underweight.

CZK: The worst for the koruna is over –stability ahead

We are no longer negative on CZK. The external environment should stabilise in our view, making the still overbought CZK less vulnerable to bouts of risk aversion. Although the foreign holdings of CZGBs (a gauge for positions in CZK – Figure 68) remain high, this positioning proved rather sticky during periods of risk aversion this year, with EUR/CZK not even breaking above the 26.00 level. This suggests that on a speculative basis, it has been primarily real money accounts rather than fast money having long positions in CZK and CZK-denominated assets.

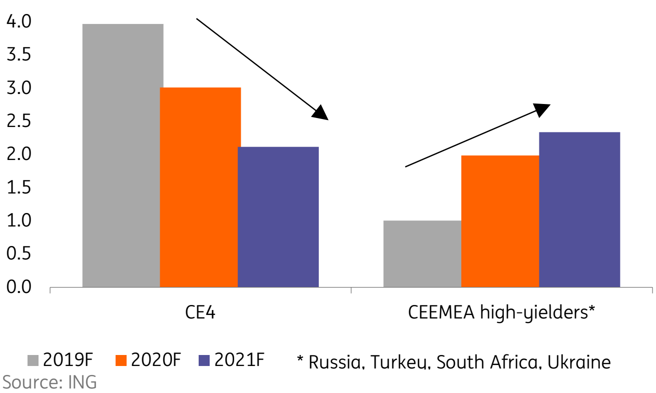
Fig 66 CEE FX unattractive on carry-valuation matrix



Source: ING

Fig 67 CEE decelerating, while HY economies accelerating

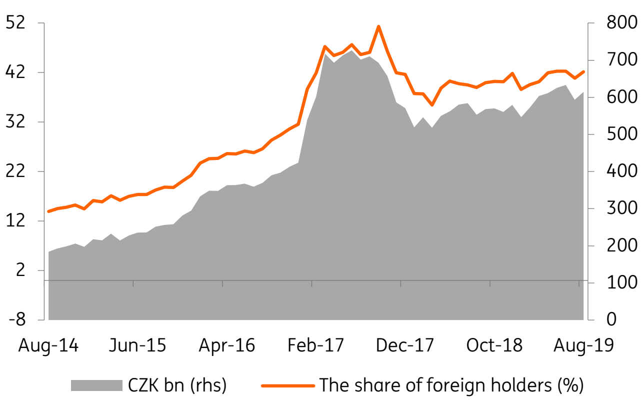
%, ING GDP forecast for various EM regions (GDP weighted)



Source: ING

As the carry factor should remain an important consideration in 2020, the low volatility, high carry CZK (in relative terms - within the region and Europe as a whole) should stay supported against EUR, particularly if the CNB is likely to embark on additional tightening. We see a non-negligible probability of a CNB rate hike in 1H 2020 (conditional on the external environment), further improving the CZK carry advantage. While staying supported against EUR, we look for a flattish EUR/CZK path rather than appreciating CZK. This is because the positioning remains saturated, and albeit attractive vs EUR, in a global context CZK (as well as other CEE FX) doesn't stand out from valuation - carry prospective. These two factors should tame CZK upside.

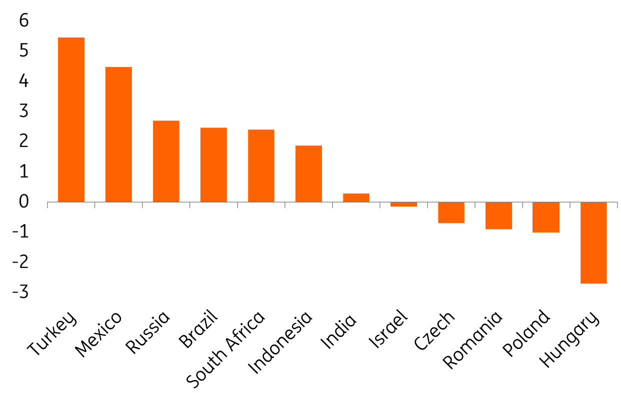
Fig 68 CZK remains overbought



Source: ING, Czech MinFin

Fig 69 Hungary exerts the lowest real rate

%, real interest rate (we use 3m Bubor as a policy rate for Hungary)



Source: ING, Bloomberg

Still, with around 2.2% implied yield vs EUR, the stable koruna should remain attractive, particularly vs HUF which exhibits polar opposite characteristics to CZK (see below). We expect EUR/CZK to stay range bound around the 25.50 level throughout 2020, with the cross unlikely breaking the 26.00 level (unless the US imposes auto tariffs). Importantly, compared to Poland or Hungary, there doesn't appear to be a preference/desire for a weaker currency from local authorities in Czech Republic (particularly from the CNB).

HUF: Gradual weakness as the policy is too loose for changed C/A dynamics

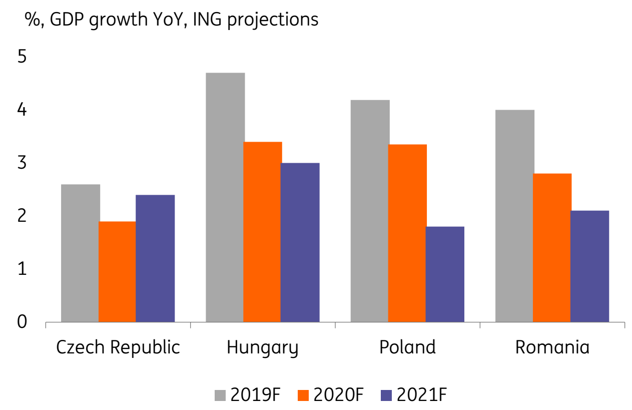
HUF remains the least attractive currency in the region. The current account surplus all but vanished (and is currently in deficit) and the NBH monetary stance is too loose to allow for stable / sustainably higher HUF. With Bubor at a mere 0.19%, HUF exhibits the most negative real yield in the EM FX space (Figure 69), with the NBH pushing liquidity into the system via FX swaps. Unlike back in 2018, we don't see a specific HUF level as a line in the sand (i.e., EUR/HUF 330 at the time) as a weaker HUF will be seen as a helping factor to offset the growth slowdown and the NBH's perceived disinflationary risk from abroad.

> *"HUF exhibits the most negative real yield in the EM FX space"*

Moreover, with the highest inflation target in the region (3%) and CPI running close to, yet modestly above the target, in the absence of around 2% HUF depreciation vs EUR on a yearly basis, HUF will appreciate in real terms vs EUR (assuming a 2% inflation differential between the EZ and Hungary). While HUF currently screens as undervalued vs EUR (Figure 13 on page 12), the higher domestic CPI pressures suggest that the valuation gap will be closing via the inflation channel, making the current mis-valuation less of a hurdle against further gradual forint weakness.

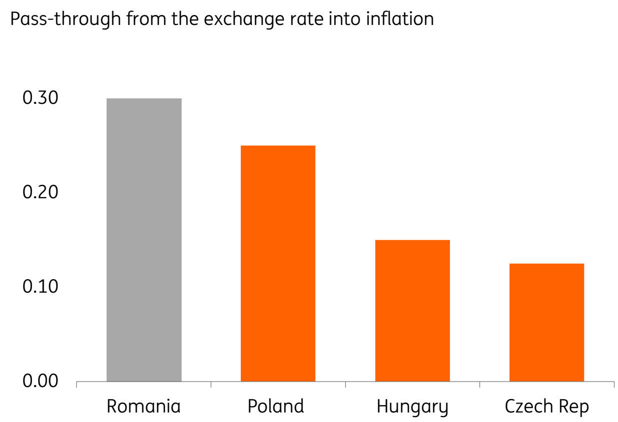
While we look for higher EUR/HUF, we don't expect the 2018-like pace of HUF depreciation as Bubor remains in check and inflation concerns are less imminent (as the worst in terms of the CPI rise is behind us, in our view). We believe EUR/HUF will break 340 by 1Q20 with a risk of testing the 345 level (yet at these levels, the valuation should act as a hurdle against further currency weakness). Just like the euro should be perceived globally, the forint should be the regional funding currency of choice.

Fig 70 Polish slowdown to be most pronounced over two yrs



Source: ING

Fig 71 RON exerts the highest FX pass through in CEE



Source: ING, Local Central Banks estimates

PLN: Mortgage story overhang still in place and limiting zloty upside potential

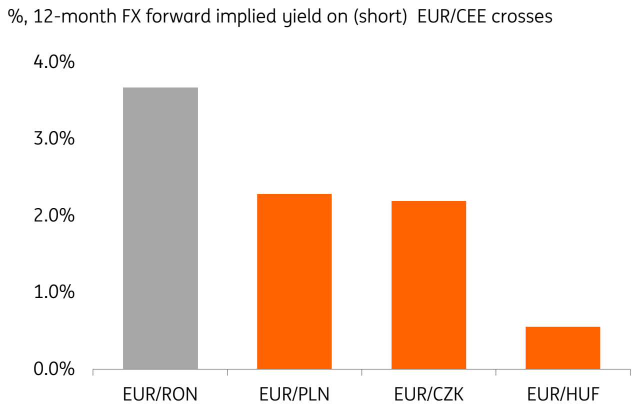
The risk of the Polish mortgage story does not appear imminent (following the ECJ ruling in early October which did not fulfil worst-case fears), yet it is still in place and is likely to have a slow burning drag on the zloty (as the cases will hit the courts and newsflow, and banks build FX provisions), preventing the currency from longer lasting gains. Yet equally, the material downside to the zloty looks unlikely as possible cases will be dispersed over time, in turn avoiding a one-off, large pressure on the currency. The possible sale of mBank from a foreign owner to a state governed institution (which would involve the sale of PLN/purchase of EUR) could also be PLN negative next year. As in Hungary, a weaker currency should not be seen as negative, but rather as a tool helping to offset the economic slowdown (which should be apparent across the CEE countries next year and most pronounced in Poland over the next two years – Figure 70).

On a valuation basis, the zloty does not screen as significantly mis-valued vs the euro (around 2% cheap based on our BEER model) and like other lower yielding currencies in the CEEMEA region (ie, CZK and ILS) does not provide a bullish valuation case from the wider EM FX perspective. With EUR/USD contained, the repeat of 2017 zloty rally (when the currency was, along with CZK, the top EM FX performer) is unlikely. Rather EUR/PLN should be broadly trading around the 4.30 level.

RON: Fundamentally weak, yet tightly managed currency!

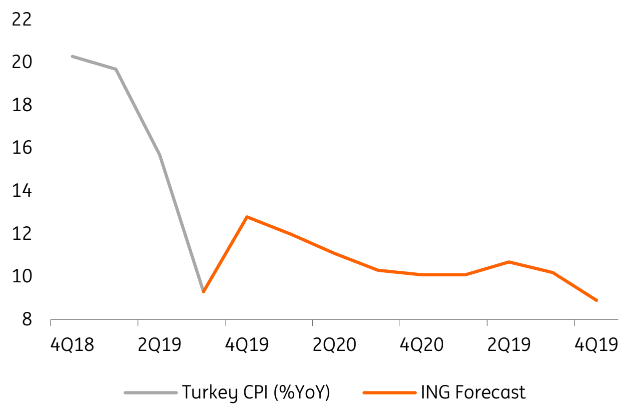
Purely from a fundamental point of view, RON is not appealing (twin deficit, an expensive currency in real terms). Yet, EUR/RON is a managed exchange rate, exerts the highest FX pass through in the region (Figure 71) and the steepest forward curve. The curve is, in our view, too steep (3.7% implied yield over a 12-month time horizon vs EUR – Figure 72) for long EUR positions to make a positive return in absolute terms over the course of the year. Hence long EUR/RON positions remain unattractive (unless perfectly timed ahead of the occasional shifts in the EUR/RON trading range higher by NBR).

Fig 72 RON benefits from highest carry in the CEE space



Source: ING, Bloomberg

Fig 73 The adjustment in Turkish CPI is now behind us



Source: ING

With Romanian CPI set to hover around/above the target next year, meaningful RON depreciation (meaningful enough to outperform the forwards) would likely move CPI above the tolerance band. Such a situation would not bode well for the inflation targeting NBR, meaning that the central bank will maintain a tight grip on the currency and allow only for a limited EUR/RON appreciation, with EUR/RON staying below the forward curve. If anything, we would see spikes in EUR/RON higher / adjustment in the EUR/RON trading range higher as a tactical opportunity to go short EUR/RON and pick up the carry – a theme for early next year.

> *"Yet again, RON is very expensive to short"*

Indeed, the risks to RON are plentiful. Bar the persistently weak fundamentals (twin deficit, expensive currency in real terms), the possible pension increase planned for September 2020 risks a further deterioration in the already weak fiscal position. Yet, this is more of a risk to ROMGBs (not managed by the NBR) rather than to RON (tightly managed by the NBR) in our view.

RUB: The favoured CEEMEA high yielder

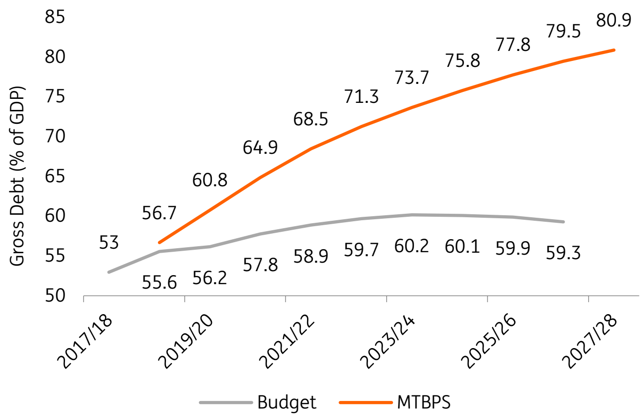
Despite its impressive performance in 2019, we see RUB as being best positioned among CEEMEA high yielders for 2020. Growth should continue to accelerate in 2020, declining inflation may prompt further CBR cuts (in turn keeping local bonds attractive), the BoP seasonality is favourable this quarter and next (with only 30-40% of the current account surplus to be sterilised by FX purchases) and the currency screens attractive on our valuation – risk adjusted carry matrix (Figure 66). With the overhang of sanctions moving further into the background and RUB showing a remarkable stability during bouts of global stress, the currency remains attractive, in our view.

While RUB lags TRY both in valuation and risk adjusted terms, the lower geopolitical risk factors associated with RUB (vs TRY) makes in our view RUB a better proposition. With Russian inflation relatively subdued, this will translate into a lower pace of rouble appreciation in real terms via the inflation channel, allowing for nominal RUB appreciation to close some of the mis-valuation gap (as opposed to the Turkish lira, where still high inflation will close the valuation gap naturally, in real terms).

TRY: Attractive on many measures but caution still warranted

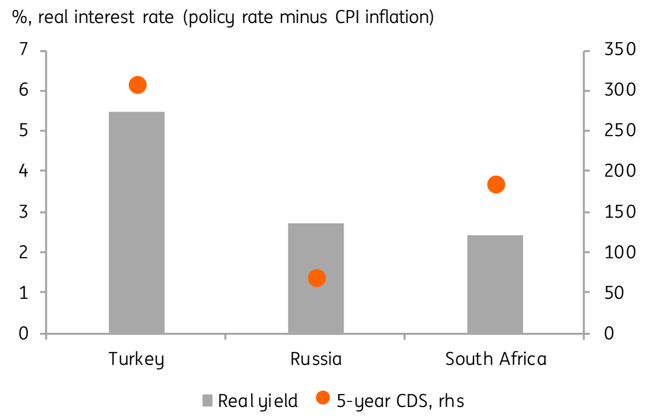
With growth rebounding, prior deceleration in inflation, a still high real rate (Figure 75) and appealing risk adjusted carry – valuation dynamics, TRY screens attractive. Yet, the geopolitical risk and the decreasing pace of inflation normalisation from here (CPI staying above 10% in most of 2020 – Figure 73) suggests some caution. With CPI still high, TRY depreciation in nominal terms is likely to prevent appreciation of the lira in real terms. While TRY may outperform the forwards during the first months of 2020 if the global environment stays benign (characterised by the search for yield), as past years have shown, caution is warranted. That is why we prefer RUB to TRY.

Fig 74 Worrying debt path an issue for ZAR



Source: ING

Fig 75 ZAR real yield not high enough for the level of CDS



Source: ING, Bloomberg

ZAR: Not undervalued, with carry not compensating for fiscal/rating risks

We view ZAR as the least attractive high yielder in the region. Unlike the case for Russia and Turkey, growth should continue to slow, there is a clear risk of a rating downgrade from Moody's next year (as slowing growth is translating into non-stabilising/increasing Debt/GDP path – Figure 74) and on a valuation basis, ZAR does not screen cheap vs USD.

While both risk-adjusted carry and real yield don't look unattractive, they don't account for the fiscal risk present in ZAR assets. As evident in Figure 75, ZAR's real yield does not compensate for the high levels of CDS (when compared to RUB and ZAR). With 2020 unlikely to be an across-the-board risk-on environment (as global growth will remain subdued and USD won't be depreciating for idiosyncratic reasons), there won't be much hiding for ZAR. Rather, other high yielding currencies should be preferred in our view (both within the CEEMEA region and globally).

ING FX forecasts

	Spot	4Q19	1Q20	2Q20	3Q20	4Q20
EUR/CZK	25.53	25.60	25.50	25.50	25.50	25.50
EUR/HUF	333.00	338.00	340.00	340.00	335.00	335.00
EUR/PLN	4.29	4.28	4.30	4.34	4.33	4.32
EUR/RON	4.78	4.80	4.82	4.82	4.83	4.85
USD/ILS	3.47	3.51	3.50	3.45	3.40	3.35
USD/RUB	63.99	64.00	64.00	66.00	68.00	66.00
USD/TRY	5.69	5.90	6.15	6.25	6.40	6.50
USD/ZAR	14.82	15.00	15.50	15.20	15.10	15.00

Balkans: Convergence story goes ahead

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After facing various headwinds and delays but for different reasons, both Bulgaria and Croatia are hopeful that they will join the ERM-II in 2020. While Croatia's accession looks almost certain, Bulgaria could still face some delays from the ECB, though some important milestones have been achieved. This should be rating positive for both countries but will not change anything in Bulgaria's peg regime or Croatia's quasi-pegged FX management. The Serbia dinar, on the other hand, while not being under a (official or not) peg regime, has come under a tight managed floating regime lately, with the NBS very active in the currency market. Using a mix of policy instruments, the NBS loosened its policy, helping the re-dinarisation of the economy and gaining credibility in its inflation targeting strategy. The EU accession road, however, doesn't look as clear nor as rapid as it did in the not so distant past. 17 out of the total 35 negotiation chapters with the EU have been opened, only 2 being provisionally closed. Hence, the convergence story goes ahead, but the speed varies.

EUR/BGN: Finally, some hope that ERM-II will become a reality

The longstanding ambition to join the euro area seems to be slowly but steadily turning into reality. Bulgaria passed most intermediary steps, such as transposing relevant EU legislation into the national one, obtaining EIOPA's support and the conclusion of the Cooperation and Verification Mechanism under which the EU was monitoring Bulgaria's judicial reforms. Otherwise, Bulgaria still exceeds the suggested IMF's ARA metrics (assessment of reserve adequacy) for EM and the continuous inflow of EU funds are further improving the situation. The Bulgarian leva is likely to remain expensive in real terms versus its CEE peers, but this is an issue to which local companies have already adapted well. However, as natural as the ERM-II entry might look, the convergence process is still affected by relatively limited productivity gains which, if unaddressed, could hit back and leave the country exposed to painful internal devaluation in the future.

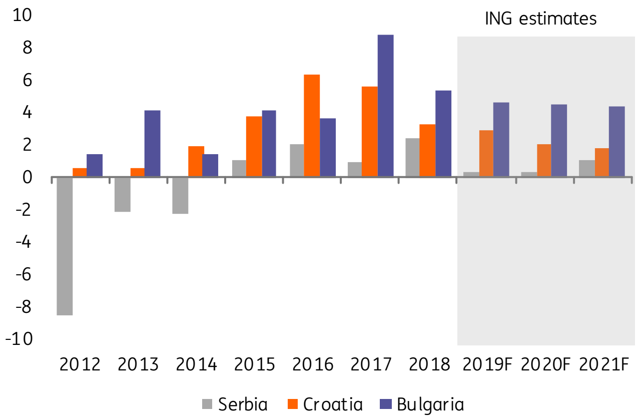
EUR/HRK: ERM-II looks a done deal

The likely admission of Croatia into ERM-II in mid-2020 has slightly changed the rules of the game for the kuna. The Croatian National Bank (CNB) turned a touch more restrictive in allowing the usual swift summer months appreciation of the kuna. Overall though, the picture remains broadly unchanged, with the tourism-generated current account surpluses remaining supportive for the kuna, well contained inflationary pressures and a loose monetary stance, mimicking the ECB. We continue to see the 7.45 level as a likely central parity rate once admitted into ERM-II. Otherwise, it should be business as usual for the CNB, with official bids below 7.40 when seasonal inflows start to pour in and a return to the 7.45 area when they dry up. ERM-II admission is likely to trigger another round of rating upgrades, after an already impressive 2019 when the country regained its investment grade from S&P and Fitch.

EUR/RSD: Strong capital inflows to continue to support the dinar

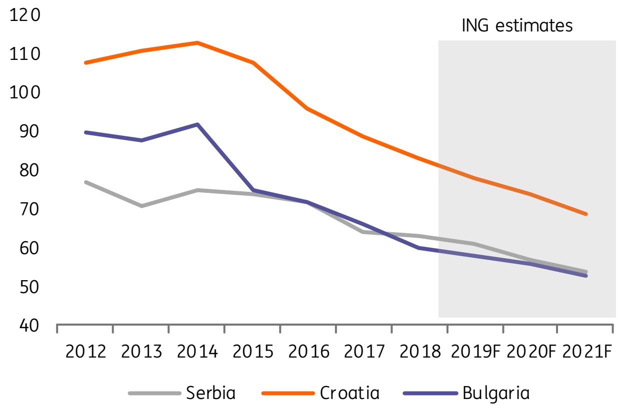
FX interventions to curb dinar strengthening have become a norm in 2019 and – alongside subdued inflation – led the National Bank of Serbia (NBS) to resume its monetary easing. Judging by the current account data and fixed income market developments, capital inflows have been both FDI and bond related, though the former are likely to have prevailed. The 118.00 line in the sand turned more into a moving target throughout the year and we believe that this will continue into 2020 as well. We see the EUR/RSD inching lower towards 117.00 in a controlled manner throughout 2020. EU integration and the general convergence story might slow down as major EU member countries are reluctant to see swift EU enlargement. On the rating side, as the country approaches the investment grade area, qualitative factors such as the institutional framework, rule of law and judicial independence will start to weigh on more than just the fiscal and economic developments which have prevailed so far. Hence, obtaining an investment grade might not come earlier than 2021 in our view.

Fig 76 C/A+FDI as a percentage of GDP



Source: National sources, ING estimates

Fig 77 Debt metrics improving across the board (% of GDP)



Source: National sources, ING estimates

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LATAM: Reversal of fortunes

- **Mexico's high-carry was the crucial anchor to its stellar FX performance in 2019, but that advantage should shrink in 2020 as Banxico's rate-cutting cycle deepens.**
- **The reduced rate differential suggests that economic fundamentals may play a more central role in determining FX performance within LATAM* in 2020.**
- **Brazil has the biggest upside for improvement in its macro outlook, but resolution of social conflicts across the Andes, and a reduction in trade-war concerns would add material room for correction from stressed FX levels in the Andean region.**

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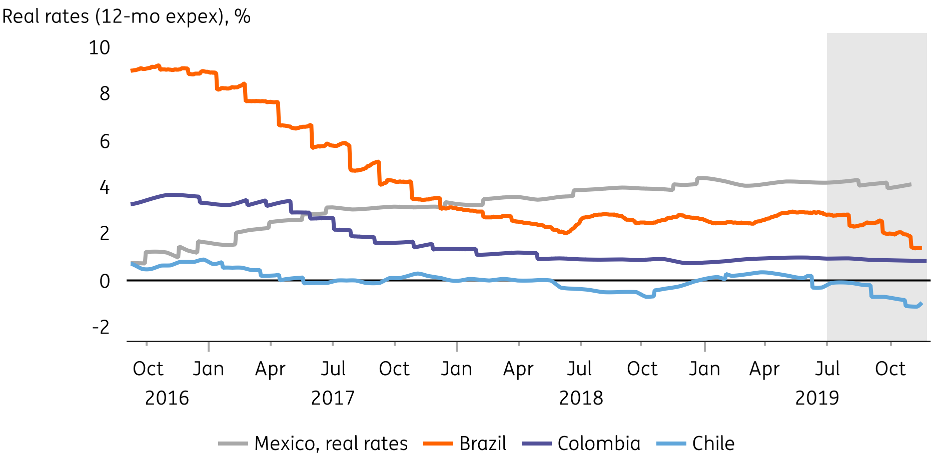
Interest rate differentials were crucial to explain relative performance in 2019

External headwinds, as represented by the gradual appreciation of the USD in the past couple of years and persistent trade-war concerns, helped keep LATAM currencies under pressure in the past year. But idiosyncratic risks were large enough to generate substantial intra-regional performance differentiation, especially towards year-end.

The crucial role played by interest rates, in the context of high global liquidity and low volatility across financial markets, stood out. High interest rates were, perhaps, the crucial driver behind the outstanding performance by the Mexican *peso*, especially in contrast with the Brazilian *real* in the latter part of 2019, when Brazil's aggressive monetary easing cycle intensified.

Fig 78 Mexico's high interest rates, and Brazil's falling rates, stood out in 2019



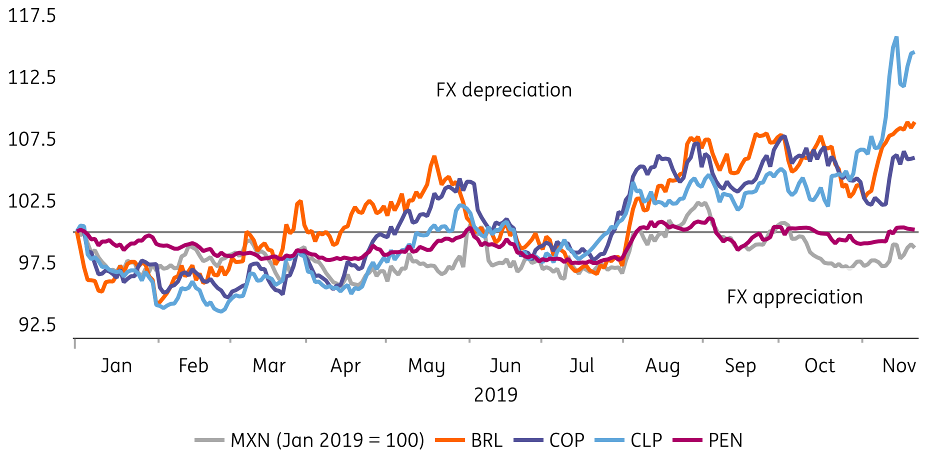
Source: Macrobond

Monetary policy prospects across the region suggest however that, during 2020, the rate differential between Mexico and its peers should drop. This reflects both the much-reduced room for policy easing elsewhere in LATAM and Banxico's new guidance, stating that the bank is finally ready, after almost 3 years, to decouple from the US Fed.

* Throughout this article, intra-regional comparisons refer just to Brazil, Mexico, Colombia, Chile and Peru. References to Argentina will be clearly specified.

As a result, Mexico's far-superior ability to conduct monetary easing should reduce its carry advantage and translate into a relatively less resilient MXN in 2020.

Fig 79 High rates helped solidify the MXN's outperformance in recent months



Source: Macrobond

For 2020, idiosyncratic risks seem more favourable to 2019's FX underperformers

As Mexico's monetary policy becomes less of an outlier, interest rate differentials should play a reduced role in driving intra-regional FX performance. This should allow for other catalysts, better aligned with the evolution of economic fundamentals, to determine relative performance in the coming quarters.

Among those catalysts, Mexico's relative weakness in terms of economic activity stands out. In particular, judging by 2020 consensus estimates, Mexico is on track to print two consecutive years with the lowest GDP growth in LATAM.

That poor growth performance helps explain why Mexico, which is the only sovereign with a negative credit rating outlook by two agencies in the region, is the most likely credit to suffer a rating's downgrade next year.

Brazil, meanwhile, stands apart as the credit most likely to be considered for a rating's upgrade. This would be consistent with the recent approval of the social security reform but, in order for that to happen, we suspect GDP growth needs to accelerate and, possibly, surprise market expectations in the coming quarters.

Social unrest should remain an important driver for the region's FX outlook

Episodes of social unrest was another important catalyst for relative value performance in recent quarters. And given that the political environment remains unsettled across much of the Andean region, political risk should remain an important driver for the region's FX outlook.

No major presidential election is scheduled for 2020, but off-schedule elections in Peru and Bolivia are possible, and the renewed energy seen in recent social protests calls for caution throughout the region. In particular, recent episodes demonstrated that, once started, their impact on local financial markets was deeper than initially expected, often demanding a heavy cost in terms of fiscal accounts and loss in economic activity.

The eventual resolution of social conflicts across the Andes, together with reduced trade-war concerns suggest however that there is material room for correction from stressed FX levels in the Andean region.

Even though FX correlation with commodity prices has reduced materially in recent months, especially where those correlations were strongest, ie, in Chile and in Colombia, the outlook for commodity prices should remain an important driver for relative currency performance among the Andean countries.

ING's commodity team expects copper prices, ie, the chief driver for Chile's terms-of-trade, to rise gradually from current levels, while the outlook for oil prices, the crucial driver for Colombia's COP, is more balanced. This suggests greater room for a catch-up correction in the CLP, when compared to the COP.

The PEN should, meanwhile, continue to outperform during market sell-offs and to underperform during rallies, which suggests that the currency should underperform its peers in a scenario of relatively benign outlook for risk appetite. Such a relatively benign market environment would benefit especially the currencies that are more sensitive to external drivers and risk aversion generally, such as the COP and the BRL.

Some caution is warranted, however, when considering the unpredictability of social conflicts and the fact that they have also triggered intra-region contagion. Financial market contagion should be relatively short-lived, as intra-regional trade is relatively small in LATAM. Having said that, the possibility of a disorderly default in Argentina late in 1Q should be monitored as a potential catalyst for (temporary) FX weakness, especially in Brazil.

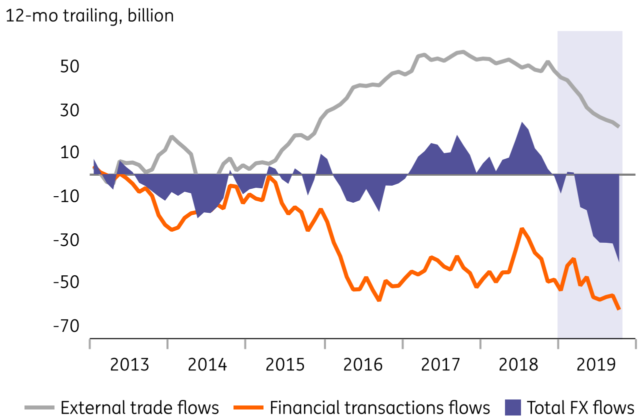
Apart from a stated desire to restructure government debt by the end of 1Q, the policy priorities of the upcoming Alberto Fernandez administration remain far from clear. The continued use of strict FX controls together with the much-improved external trade balance should help moderate FX volatility. However, the expected preference for a deep monetary easing program, together with prospects for difficult negotiations with debt-holders, as Argentina aims to return its debt metrics to a sustainable trajectory, suggests that FX dynamics should remain hard to predict.

As in the past, an eventual FX policy preference for keeping the ARS at "competitive" levels, as some have suggested as a means to strengthen external trade and growth, would eventually conflict with the need to use FX as a price anchor. And as policy priorities fluctuate between the need to boost exports or, alternatively, to control inflation, the ARS should experience faster or slower depreciation relative to inflation.

Brazil's BRL has been under pressure as local markets adjust to a new low-rate reality

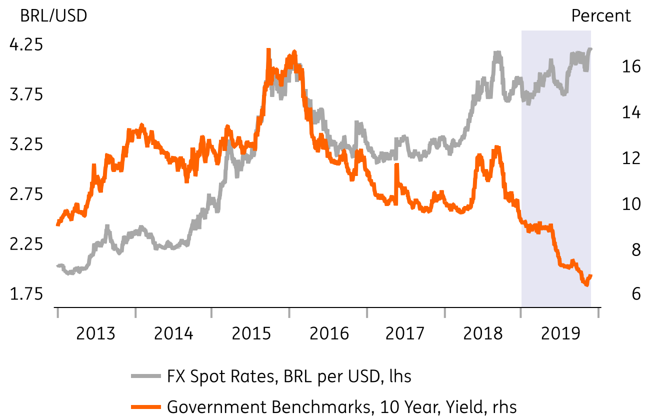
The approval of the social security reform helped re-anchor Brazil's fiscal accounts and paved the way for the central bank to re-launch a deep monetary easing cycle. As the SELIC rate, which should end the year at 4.5%, has reached new lows, FX outflows have intensified, resulting in a sustained weakening pressure on the BRL.

Fig 80 FX outflows surged throughout 2019



Source: Macrobond

Fig 81 BRL could catch-up with other local assets in 2020



Source: Macrobond

These outflows reflect, to a large extent, debt-management operations by local corporates that are taking advantage of newly-available cheap local funding to pay down FX-denominated debt. By their nature, these developments are long-term positive for the BRL, as they reduce the stock of FX liabilities by locals, but they are BRL-negative in the short term, when the outflows take place.

As central bank officials have highlighted, this should continue to exacerbate FX outflows and add a persistent near-term weakening bias for the BRL in the nearer term. This should keep the currency close to the upper-end of the 4.0-4.20 range, which we continue to see as a strong near-term reference-range for the USDBRL.

We still consider these levels to be higher than equilibrium for the pair, but the consolidation of a sub-4.0 level for the currency may take a while to materialise. In our view, it depends chiefly on a faster recovery of economic activity in Brazil, which remains a pre-condition for Brazil to strengthen its fiscal accounts, improve its credit rating and, as a result, improve prospects for FX inflows.

Overall, Brazil's fundamentals should display a more substantial improvement throughout 2020, as the effect of the aggressive monetary easing seen in recent months and the improved fiscal outlook, resulting from fiscal reforms, should result in faster economic activity. But the inability to execute a fiscal stimulus package suggests that this recovery could be slower than past recoveries, with its pace heavily dependent on the private sector's "animal spirits". This suggests that the consolidation of a stronger BRL trajectory is more likely towards the latter part of 2020.

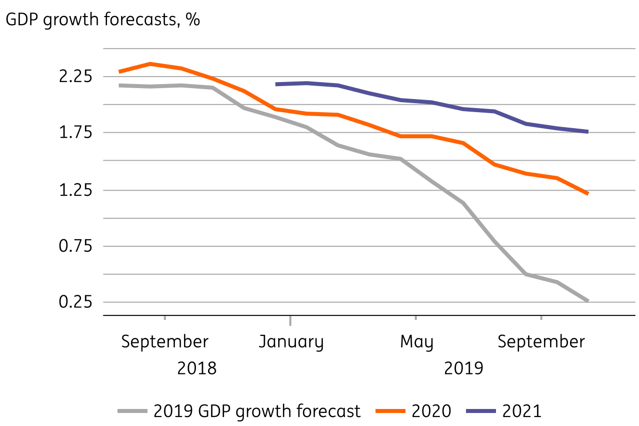
In Mexico, we expect a less supportive environment for the peso

Economic data continues to depict a scenario of low growth and low inflation in Mexico. The growth stagnation reflects, to a large extent, the collapse in investment that has taken place in the past year, since approximately the announcement of the cancelation of the Mexico City airport construction.

Investment prospects remain generally dim, as private sector perception of elevated risk in regulated sectors, together with lingering uncertainties in the future of the US/Mexico trade relations, especially in the run-up to the US Presidential election, suggest that a turnaround in investment dynamics is unlikely in the near future.

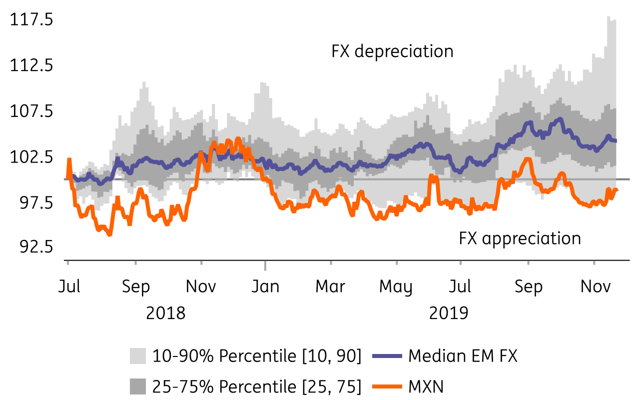
The government's limited ability, or inclination, to conduct policy stimulus also suggests a reduced scope for a government-led recovery. As a result, after the stagnation seen in 2019, we expect GDP growth to stay low in 2020, coming near consensus at 1.2%.

Fig 82 GDP growth expectations show persistent decline



Source: Macrobond

Fig 83 MXN outperformance should be harder to sustain



Source: Macrobond

In the very near term, high interest rates should remain an effective stabilising factor for the MXN, which should keep the USDMXN trading close to 19.5. A steady pace of 25bp cuts suggests, however, that high rates should gradually become a less effective FX anchor, while the risk of a more frontloaded monetary easing cycle has increased, adding greater uncertainty to the outlook for the currency in the longer-term.

Our base case is for Banxico to cut the policy rate an additional 150bp, with the policy rate ending 2020 at 6.0%. But poor activity data could increase pressure on the bank to bring monetary policy more firmly into neutral territory (possibly closer to 5.5%), while a change in the board's composition at the end of 2020 could set the stage for a more substantial change in policy bias.

Javier Guzmán, often seen as the most hawkish board-member, concludes his term at the end of 2020, providing President Lopez Obrador with the opportunity to appoint a majority at the monetary policy board. This could weigh on the *peso* late in 2020.

Overall, our view is that Mexico's inferior GDP growth outlook, lingering risk of credit rating downgrades, among other factors, suggest that the scope for MXN outperformance should become increasingly challenging throughout 2020. In fact, our expectation is that the USD/MXN gradually depreciates towards 20.0 by the end of 2020.

ING FX forecasts

	Spot	4Q19	1Q20	2Q20	3Q20	4Q20
USD/MXN	19.42	19.30	19.20	19.50	19.80	20.00
USD/BRL	4.20	4.20	4.15	4.05	3.90	3.80
USD/CLP	795	780	755	740	735	730
USD/ARS	60.00	61.00	64.00	70.00	77.00	84.00
USD/COP	3,440	3,400	3,350	3,300	3,260	3,240
USD/PEN	3.38	3.37	3.36	3.35	3.34	3.33

Asia: Trading on trade

- **The single biggest determinant of Asian FX in 2020 is likely to be the US-China trade war and investor appetite for Asia's open economies' currencies. But the outlook here is incredibly uncertain and could change imminently, for better or worse**
- **Overlaying the trade war, a potential cyclical recovery for the big electronics producers in the region may be a further differentiator for some currencies...**
- **...but with most central banks running out of room to ease, and no tightening expected, local policy is unlikely to play a big role**

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Trade wars, which way next?

2019 has been a tough year for Asia. The US-China trade war, which had been largely verbal in 2018 turned increasingly real, with tariffs flung about by both sides, though predominantly by the US on China.

The effect on the Chinese economy has been profound – but it has also hit global trade hard and, as a result, delivered a degree of collateral damage elsewhere in the region, particularly to the region's small and very open economies.

There have been some well documented "winners" from the trade war, such as Vietnam. They have picked up some of China's manufacturing from the trade battlefield. Malaysia and Thailand have also been named in this diversification trade story. But we would still rate their victories as "relative" rather than "absolute".

It is no exaggeration to say that the direction taken by the trade war in 2020 will largely determine the direction of currencies in the region. At the time of writing, a phase one deal is believed to be close, though we would caution against taking it for granted.

> *"...the direction taken by the trade war in 2020 will largely determine the direction of currencies in the region"*

Our base assumption is that we will see some form of constrained deal struck either late-2019 or early-2020 (see also *China* section). Market sentiment and, consequently, Asian FX strength would benefit from this. But there may also be some excessive optimism building up after a year of fairly relentless misery.

The peak in Asian FX strength is likely to coincide with any public signing of a phase 1 trade deal. There was talk of this happening in November, and then suggestions that it would not happen until December. But the timing is less important than the content.

Our base case assumes any such phase 1 deal is followed by a broader deal, which if true could see a removal of existing tariffs (not just postponement or deferral of pending ones), improvement in Asian growth prospects and trade flows (supporting Asian FX). US growth prospects would also likely improve and, ultimately, thoughts of a reversal of the mid-cycle adjustment may return, and be priced into 2021 futures contracts, which could be bad news in particular for Asia's current account deficit currencies (INR, IDR).

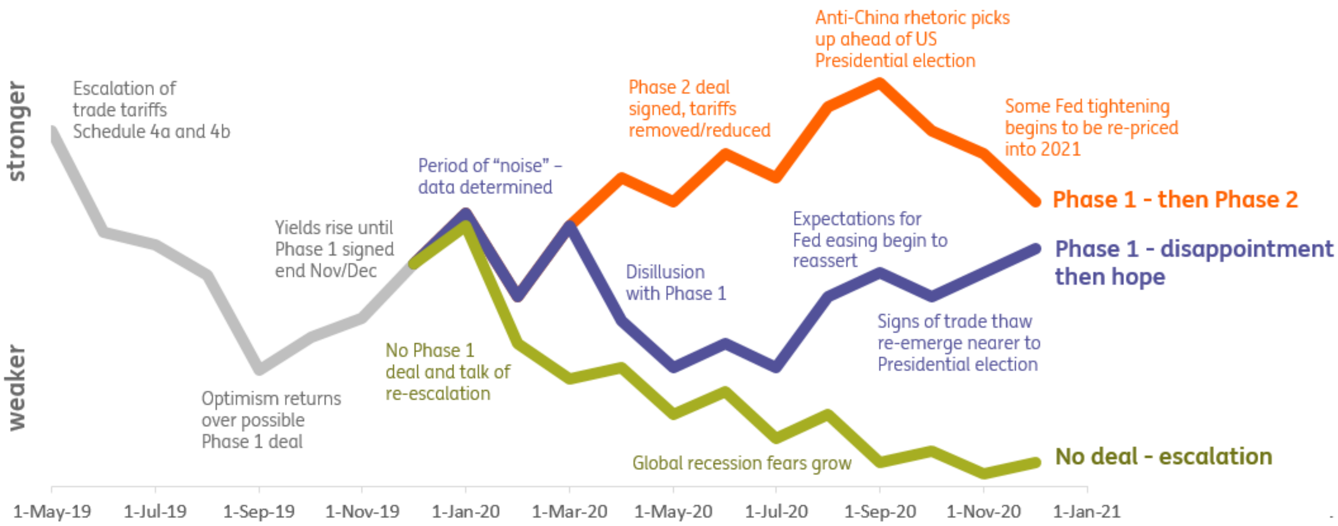
A deal of some sort does look possible, but it is not a certainty

But there are many big risks attached to these assumptions. Even if a deal is agreed, which is by no means a given, a phase one deal may lack real substance, and a broader deal still looks a difficult bridge to cross for both sides.

So in our consideration of where Asian FX goes, we also consider possible a post-phase one deal period of calm or further slight gains quickly giving way if the "deal" is picked apart and markets start to turn more bearish again. Any Asian currency weakness following this might be limited by expectations of Fed easing returning on a gloomier trade and domestic US prognosis. Then again, there could also be signs of a trade détente nearer the US Presidential election which could also help underpin Asian FX later in 2020. Or as plausible, there may be no deal at all, in which case, Asian FX will fall more sharply.

Such stylised outcomes are reflected in Figure 84. The lines could reflect any currency index (up equals stronger, down weaker). The low conviction of our base case on trade means that we don't have a strong preference between these three stylised outcomes, or indeed, any one of an almost infinite permutation of other alternatives.

Fig 84 Stylised view of FX scenario alternatives



Source: ING

For example, the hypothesis that the US will soften its position on trade as the Presidential election race unfolds could provide an excuse for some Asian currency appreciation later in 2020. But there are good reasons not to bank on this. Easing up on China by the current US administration could well be a vote loser – depending on how the US domestic economy looks at that time – and that is also highly uncertain.

To sum up then, the single biggest driver of FX in the region is also the most uncertain in both timing and direction. Later on, we consider how different currencies are likely to fare under different scenarios. Indeed, as there is a very good chance that this note is overtaken by events soon after publication, this seems a far more sensible way to proceed.

If not trade, then what else?

Trade war is not the only game in town for Asian FX

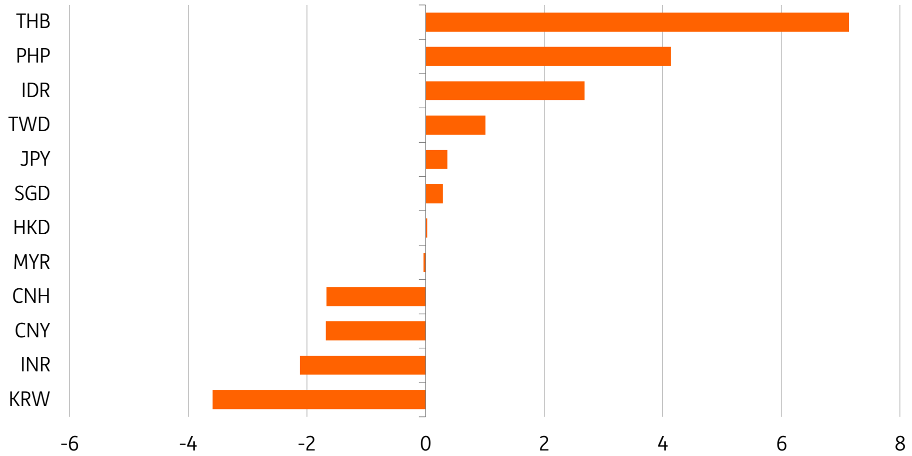
While the trade war has received most of the press coverage in Asia this year, another event has been far more damaging to some of the region's economies and, by extension, to their currencies.

Double-digit declines in Asian exports in 2019 have typically been dominated by extreme weakness in the electronics sector. There is a degree of overlap here with the trade war, but little causation. This was happening anyway.

Over-investment meeting headlong with plunging demand created a toxic cocktail of falling export volumes and prices (see also "*The Chips are Down – Asia and the global technology slump*"[5]).

It is not for nothing that the Korean won has been one of the worst performing currencies in 2019, the dire performance of its hugely important electronics sector has been a big contributor to KRW weakness.

Fig 85 Currency performance: Asia vs USD (%YTD)



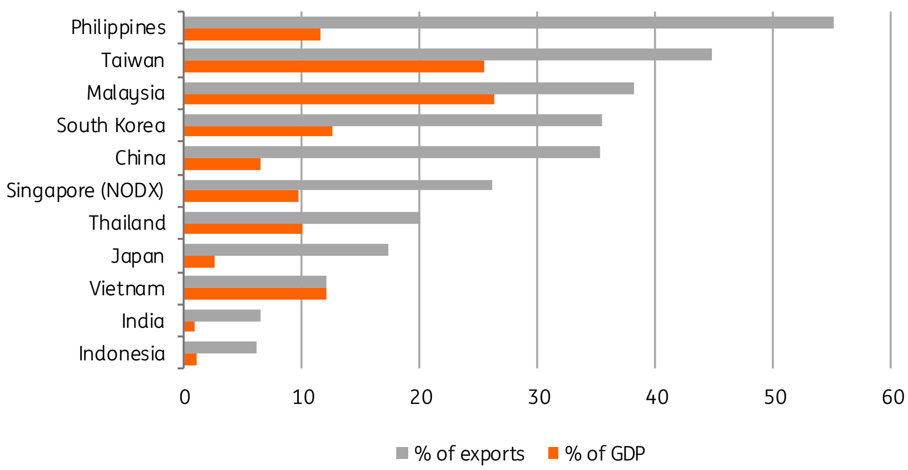
Source: Bloomberg

Singapore has also suffered under this electronics slump, though its managed currency regime has shielded the SGD from as much damage as the KRW.

Almost all of Asia is exposed to the electronics sector

Very few economies in Asia are particularly insulated from the electronics slump. To some degree or other, electronics is a big factor for most economies, though a huge electronics export percentage does not necessarily mean it is a big contributor to economic strength.

Fig 86 Asian electronics as percentage of total exports and GDP



Source: SITC, CEIC

At the extreme end of this industry as well as Korea and Singapore, lies Taiwan, another electronics giant. TWD weakness in 2019 has been managed. And recently, the currency has benefited from investment flows as Taiwanese technology companies operating in Mainland China have returned to Taiwan, lifting the economy and the currency.

[5] https://think.ing.com/uploads/reports/Asia_and_the_global_tech_slump_301019.pdf

The biggest electronics exporters are not always the most exposed to this sector

The Philippines seems like an unlikely electronics giant, but 55% of all of its exports are electronics. Saying that, the low value added nature of this industry in the Philippines, (testing and packaging as well as commodity diode component production) has ironically provided some shielding for the Philippines and the PHP against the technology slump. This, plus a very favourable starting point in early 2019 and return to surplus for the current account has meant that the PHP has been one of Asia's outperformers in 2019. Though that may also limit any upside in 2020.

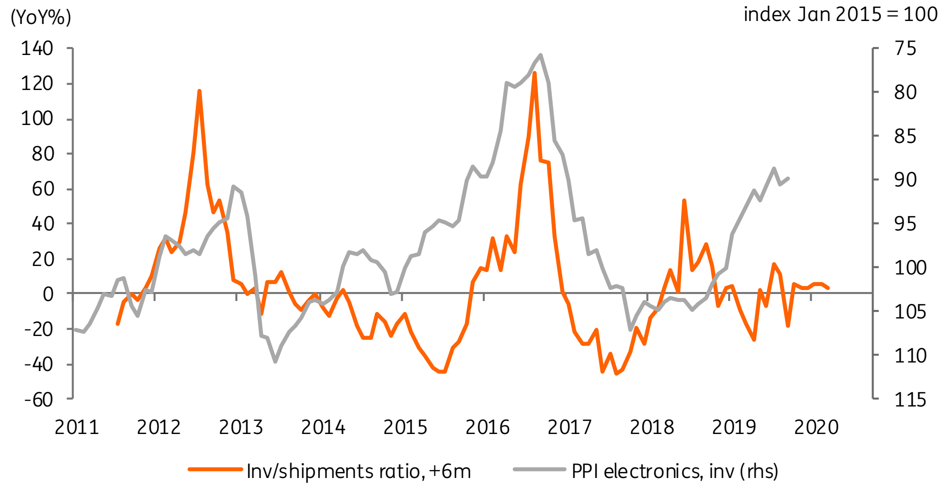
"The future for the electronics industry is looking less bleak"

Thailand and Malaysia also have significant electronics industries. Malaysia has dodged much of the weakness that has hit its smaller neighbour to the south (Singapore), and we suspect it has also been picking up market share from other economies in the region. Thailand too may have been a relative trade war winner, but the THB story is dominated by its large current account surplus, so it too has emerged largely unscathed. That also suggests any further upside for the THB in 2020 may be more limited than more beaten up currencies such as the KRW.

There is some evidence that electronics is no longer falling, or that the decline has slowed

The future of this sector is definitely looking less bleak. Inventories of key electronics components have fallen so far that production and exports are beginning to stabilise, as too are prices. There still isn't much evidence of a recovery, though, and we don't really expect much of one in 2020. This may be more of a story for 2021.

Fig 87 Korean semiconductor inventory ratio and PPI



Source: CEIC, ING

5G development and rollout is likely to be the main catalysts for this sector. Huge investments are estimated as being necessary for 5G to become the new standard for electronics. An end to the trade war will significantly hasten recovery of the 5G rollout, boosting electronics sensitive currencies.

So the trade war and the electronics cycle are definitely linked and reinforce each other. But they have independent origins and shouldn't be confused.

The rollout of 5G will be enormously positive for Asia's economies and FX

The electronics industry in 2020 will probably be all about stabilisation, not acceleration. That might not be a good reason to get too excited about Asian FX, but it at least removes one of the main negatives from currencies such as the KRW. But by 2021, when electronics demand may really start to find its feet again, the electronics giants and their currencies, KRW, TWD, SGD, could fly as 5G demand takes off. This could result in a multi-year boost. Until then, broad stability is not a bad outcome.

Domestic policies – monetary policy constrained

The amount of monetary easing in 2019 has not been substantial. India takes the medal for the most easing, with a cumulative 135bp of policy interest rate cuts as the RBI has switched to a much more growth centric stance under Governor Das. That, though, is probably only a small part of the explanation for the underperformance of the INR this year, second only to the battered KRW. Electronics isn't the culprit for INR weakness. Instead, rising twin deficits, disappointing growth and a suspicion that low inflation rates won't last, have been the main sources, despite a relatively benign risk sentiment and commodity (low oil price) backdrop.

> *"Room for additional policy easing is probably limited"*

Room for additional monetary easing in the rest of Asia is also limited. Figure 88 shows the difference between nominal policy rates and inflation rates. Very crudely, the gap shows a decomposed version of the real (inflation expectations adjusted) interest rate.

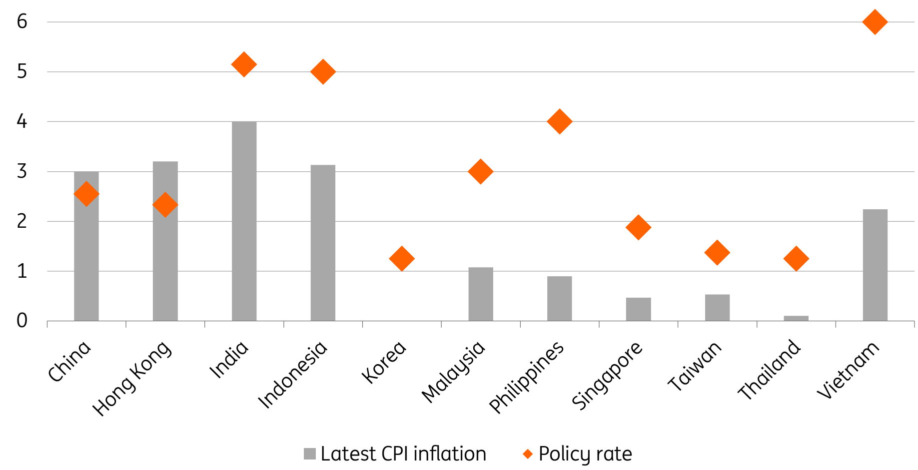
For developing Asia, not only is a zero real interest rate probably close to a lower bound, below which the currency would begin to weaken significantly, but there probably also needs to be a small positive buffer, depending on the credibility of the respective central bank, the degree of overseas financing required (current account deficit) and the economic outlook (growth and inflation).

> *"The only economies where there currently looks room for some significant additional easing are Indonesia, Malaysia, the Philippines, and Vietnam"*

Consequently, the only economies where there currently looks room for some significant additional monetary easing are Indonesia, Malaysia, the Philippines, and Vietnam. In all of these economies, inflation is low relative to where we think it will go in 2020.

Current inflation in Asia is flattered by comparison with 2018, where in many cases, food prices spiked higher on bad weather. More seasonal weather in 2019 coupled with improved import supply in the case of the Philippines, has brought food prices down. But this beneficial comparison won't last. Asian swine fever is pushing up meat prices around the region, especially in China. This also won't last, but for 2019/2020, it helps speed up the unwinding of favourable base effects.

Fig 88 Real policy rates de-constructed (%)



Market 3m rates for Singapore
Source: Bloomberg, ING

Asia's inflation rates will not be as low in 2020, making further easing harder

Indian inflation is also pushing higher on rising onion and tomato prices. There is an element of seasonality to this, which will also drop away in time, allowing for one more Reserve Bank of India (RBI) rate cut in 4Q19. But the ex-food inflation trajectory for India is also rising, and there is unlikely to be any room for more easing after this.

For the region as a whole, inflation is likely to rise during 2020. This will close the real interest rate gap for many central banks in the region. So not only is the absolute scope for easing shrinking, but the window of opportunity to move is also shutting. Those central banks that have been slow to move (Bank of Korea, Bank of Thailand) may find that there is neither room nor time for them to ease further in 2020.

Consequently, we don't see much room for local monetary policy to play a role in the region as a differentiator between different currencies.

"Consequently, we don't see much room for local monetary policy to play a role in the region as a differentiator between different currencies"

On the fiscal side, policy room is also limited. India has already used up a lot of its fiscal degrees of freedom in the re-election stimulus for President Modi. That hasn't yet delivered the growth dividend that was expected, nor have subsequent budget measures and cuts to the corporate tax rate. At 5%, 3Q19 GDP growth was India's weakest since 1Q13. That should improve in 2020, but probably by less than the government and markets hope. We don't see growth returning to 7% in 2020, which we view as a pre-requisite for the RBI to remove any of its recent easing. All of which should constrain any INR appreciation (ING forecast for 4Q20 USD/INR is 71.0).

Fiscal policy unlikely to change the outlook, merely moderate the existing one

Korea implemented a more expansionary budget in 2020, and this could support any cyclical turnaround in the electronics sector. We are also beginning to see some positive growth responses where fiscal policy has already been turned up to stimulate infrastructure spending, for example, in the Philippines, Indonesia and Thailand. But on the whole, we don't see fiscal policy doing much more than taking the rough edges off the prevailing cyclical picture, so it probably will not play strongly into the FX picture.

Summary

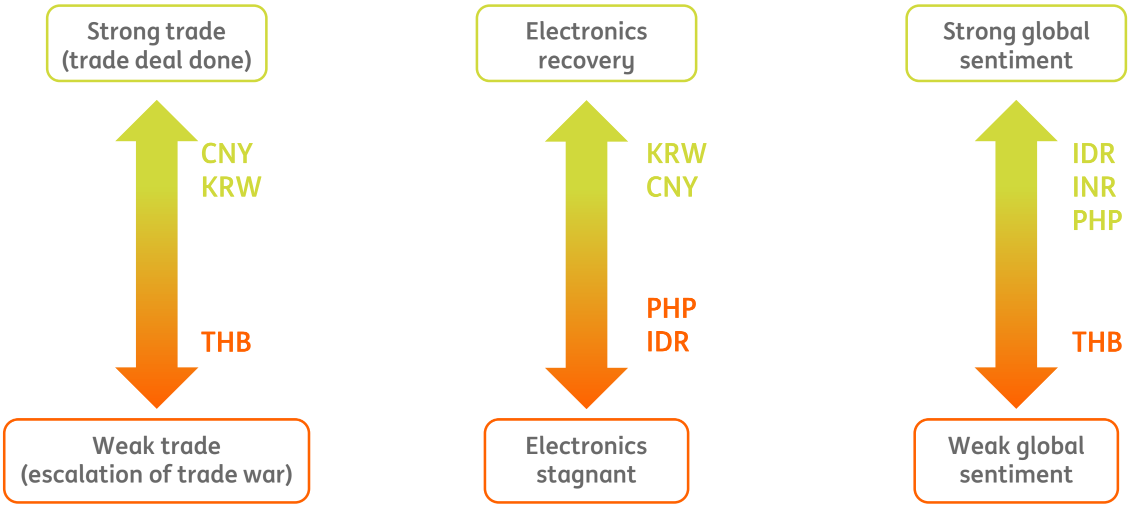
Putting these often-competing elements together to form a single unified FX forecast for the region is next to impossible. The outlook for Asian currencies depends critically not just on the highly uncertain outlook for the trade war and the global electronics cycle, but on related, but separate questions of global risk sentiment and domestic policy responses in these environments.

"The CNY and KRW would outperform in an environment of trade war progress and electronics cycle upturn"

Perhaps a better operating framework is to consider how different Asian currencies perform under different scenarios for trade, electronics, and global stability/policy and continually try to assess where we are headed as we forge deeper into 2020.

In Figure 89, we highlight what we anticipate to be the winners in each extreme of the various theatres of concern we need to follow, though it is also fair to note that we have picked the currencies we would expect to outperform at the extremes, and what we might get instead, is a much blander version of one or many of the scenarios assessed below.

Fig 89 Currency outperformers under different scenarios



Source: ING

A couple of currencies, SGD, MYR, and TWD tend to be less cyclical, more managed and less volatile than some of the others. And for that reason, they may be good choices in a world of significant uncertainty, though returns probably won't be spectacular.

CNY and KRW likely to outperform in an environment of trade war progress

Otherwise, we suggest that both the CNY and KRW would outperform in an upbeat environment of trade war progress and electronics cycle upturn. Both would clearly be rank underperformers in a worsening trade environment. In contrast, the THB would likely continue to provide some upside in the event of a trade war escalation.

In a renewed electronics downturn, the low electronics content of Indonesia and low value added environment of the Philippines electronics industry could see IDR and PHP outperform the rest of the Asian FX pack. But not if this were accompanied by a worsening global risk sentiment, as both currencies and the IDR would likely do poorly, as they have in the past. In such an environment, again, the THB would likely be the safest option.

ING FX forecasts

	Spot	4Q19	1Q20	2Q20	3Q20	4Q20
USD/CNY	7.03	7.00	7.05	7.00	6.95	6.85
USD/HKD	7.83	7.84	7.84	7.84	7.84	7.82
USD/IDR	14,095	14,100	14,200	14,250	14,222	14,100
USD/INR	71.80	72.00	72.50	71.80	71.30	71.00
USD/KRW	1,170	1,150	1,180	1,150	1,140	1,120
USD/MYR	4.17	4.15	4.16	4.14	4.13	4.12
USD/PHP	50.87	51.62	52.41	52.68	53.07	53.25
USD/SGD	1.36	1.36	1.36	1.36	1.35	1.34
USD/TWD	30.49	30.50	30.30	30.00	29.70	30.00
USD/THB	30.19	30.40	30.50	30.60	30.50	30.50

Appendix

What can we learn from FX markets in 2019?

If, a year ago, one had perfect foresight of a continuing slump in world trade and the Fed responding with three rate cuts, what would one have expected of FX performance in 2019? A weaker dollar against safe havens and broad underperformance of activity currencies? Well, year-to-date 2019 performance has actually been a lot more mixed and we can perhaps take some of those themes into 2020.

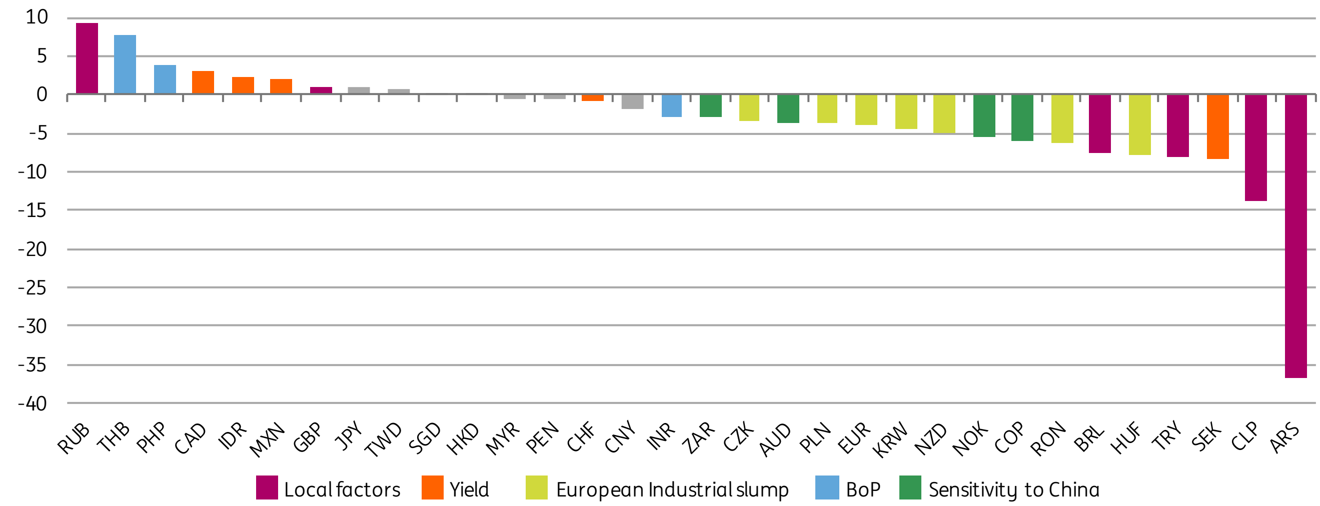
In Figure 90 we take a stylised look at the key factors which have driven FX performance against the dollar this year. Of course idiosyncratic factors will always play a role – eg, Argentina and Chile – and here we are not looking for social unrest spreading to the likes of Brazil and Mexico.

"A core story linking Brazil and the best performing currency of the year, the Russian Rouble, has been massive disinflation and monetary easing"

In fact a core story linking Brazil and the best performing currency of the year, the Russian rouble, has been massive disinflation and monetary easing. These easing cycles generated very different outcomes for the RUB and the BRL. Huge portfolio flows into the local currency bond market (OFZ) supported the RUB, but in Brazil local corporates took advantage of historically low local interest rates to pay down hard currency debt.

Another important theme in a low volatility world was the available carry. Here, CAD, MXN and IDR all performed well (the former two helped by proximity to the US and the prospect of the USMCA being signed). Equally we felt the negative yield held many European currencies back. This underperformance was compounded by the slump in European industrial activity (partially auto-related) which is now spreading to CE4.

Fig 90 FX performance against USD year-to-date 2019 and stylised ING rationale



Source: Bloomberg, ING

And of course the ongoing slowdown in China weighed on those Asian regional and commodity currencies most closely linked to its activity path. Here the gyrations of the renminbi as trade tensions blow hot and cold dragged blocs of currencies with it.

Mostly highly correlated to the CNH in the G10 space this year were AUD, NZD, NOK, SEK and CAD and, in the EM space, ZAR, followed by RUB, BRL, MXN and COP. Bucking the trend of Asian FX correlation with the renminbi was the THB, where a surprisingly resilient trade story managed to deliver outsize returns. Even though 2019 was largely a story of trade, the performance of the THB suggested that Balance of Payments should not be neglected.

ING foreign exchange forecasts

EUR cross rates	Spot	4Q19	1Q20	2Q20	3Q20	4Q20	USD cross rates	Spot	4Q19	1Q20	2Q20	3Q20	4Q20
Developed FX													
EUR/USD	1.11	1.10	1.10	1.11	1.12	1.13	DXY	98.30	98.00	98.00	97.50	96.50	95.50
EUR/JPY	120.00	119.00	119.00	120.00	121.00	122.00	USD/JPY	108.40	108.00	108.00	108.00	108.00	108.00
EUR/GBP	0.86	0.83	0.83	0.85	0.85	0.82	GBP/USD	1.29	1.33	1.33	1.31	1.32	1.38
EUR/CHF	1.10	1.10	1.10	1.10	1.12	1.15	USD/CHF	0.99	1.00	1.00	0.99	1.00	1.02
EUR/NOK	10.17	10.10	9.80	9.80	9.80	9.70	USD/NOK	9.19	9.18	8.91	8.83	8.75	8.58
EUR/SEK	10.72	10.70	10.60	10.60	10.60	10.60	USD/SEK	9.69	9.73	9.64	9.55	9.46	9.38
EUR/DKK	7.47	7.47	7.47	7.47	7.47	7.47	USD/DKK	6.76	6.79	6.79	6.73	6.67	6.61
EUR/CAD	1.47	1.45	1.43	1.43	1.41	1.41	USD/CAD	1.30	1.32	1.30	1.29	1.26	1.25
EUR/AUD	1.62	1.59	1.62	1.59	1.58	1.57	AUD/USD	0.70	0.69	0.68	0.70	0.71	0.72
EUR/NZD	1.72	1.69	1.69	1.68	1.67	1.66	NZD/USD	0.60	0.65	0.65	0.66	0.67	0.68
EMEA													
EUR/PLN	4.29	4.28	4.30	4.34	4.33	4.32	USD/PLN	3.88	3.89	3.91	3.91	3.87	3.82
EUR/HUF	333.00	338.00	340.00	340.00	335.00	335.00	USD/HUF	301.00	307.00	309.00	306.00	299.00	296.00
EUR/CZK	25.53	25.60	25.50	25.50	25.50	25.50	USD/CZK	23.08	23.27	23.18	22.97	22.77	22.57
EUR/RON	4.78	4.80	4.82	4.82	4.83	4.85	USD/RON	4.32	4.36	4.38	4.34	4.31	4.29
EUR/HRK	7.44	7.45	7.43	7.40	7.43	7.45	USD/HRK	6.73	6.77	6.75	6.67	6.63	6.59
EUR/RSD	117.60	117.50	117.50	117.40	117.20	117.00	USD/RSD	106.00	107.00	107.00	106.00	105.00	104.00
EUR/RUB	70.77	70.40	70.40	73.26	76.16	74.58	USD/RUB	63.99	64.00	64.00	66.00	68.00	66.00
EUR/UAH	26.72	28.60	29.15	29.97	30.80	31.64	USD/UAH	24.16	26.00	26.50	27.00	27.50	28.00
EUR/KZT	428.30	423.50	424.60	430.10	435.70	440.70	USD/KZT	387.00	385.00	386.00	388.00	389.00	390.00
EUR/TRY	6.29	6.49	6.77	6.94	7.17	7.35	USD/TRY	5.69	5.90	6.15	6.25	6.40	6.50
EUR/ZAR	16.40	16.50	17.05	16.87	16.91	16.95	USD/ZAR	14.82	15.00	15.50	15.20	15.10	15.00
EUR/ILS	3.84	3.86	3.85	3.83	3.81	3.79	USD/ILS	3.47	3.51	3.50	3.45	3.40	3.35
EUR/AZN	1.87	1.87	1.87	1.89	1.90	1.92	USD/AZN	1.70	1.70	1.70	1.70	1.70	1.70
LATAM													
EUR/BRL	4.65	4.62	4.57	4.50	4.37	4.29	USD/BRL	4.20	4.20	4.15	4.05	3.90	3.80
EUR/MXN	21.48	21.23	21.12	21.65	22.18	22.60	USD/MXN	19.42	19.30	19.20	19.50	19.80	20.00
EUR/CLP	880	858	831	821	823	825	USD/CLP	795	780	755	740	735	730
EUR/ARS	66.10	67.10	70.40	77.70	86.20	94.90	USD/ARS	60.00	61.00	64.00	70.00	77.00	84.00
EUR/COP	3,811	3,740	3,685	3,663	3,651	3,661	USD/COP	3,440	3,400	3,350	3,300	3,260	3,240
EUR/PEN	3.74	3.71	3.70	3.72	3.74	3.76	USD/PEN	3.38	3.37	3.36	3.35	3.34	3.33
Asia													
EUR/CNY	7.78	7.70	7.76	7.77	7.78	7.74	USD/CNY	7.03	7.00	7.05	7.00	6.95	6.85
EUR/HKD	8.66	8.62	8.62	8.70	8.78	8.84	USD/HKD	7.83	7.84	7.84	7.84	7.84	7.82
EUR/IDR	15,590	15,510	15,620	15,818	15,929	15,933	USD/IDR	14,095	14,100	14,200	14,250	14,222	14,100
EUR/INR	79.44	79.20	79.75	79.70	79.86	80.23	USD/INR	71.80	72.00	72.50	71.80	71.30	71.00
EUR/KRW	1,295	1,265	1,298	1,277	1,277	1,266	USD/KRW	1,170	1,150	1,180	1,150	1,140	1,120
EUR/MYR	4.61	4.57	4.58	4.60	4.63	4.66	USD/MYR	4.17	4.15	4.16	4.14	4.13	4.12
EUR/PHP	56.35	56.78	57.65	58.47	59.44	60.17	USD/PHP	50.87	51.62	52.41	52.68	53.07	53.25
EUR/SGD	1.51	1.50	1.50	1.51	1.51	1.51	USD/SGD	1.36	1.36	1.36	1.36	1.35	1.34
EUR/TWD	33.74	33.55	33.33	33.30	33.26	33.90	USD/TWD	30.49	30.50	30.30	30.00	29.70	30.00
EUR/THB	33.38	33.44	33.55	33.97	34.16	34.47	USD/THB	30.19	30.40	30.50	30.60	30.50	30.50

Source: Bloomberg, ING

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