2020 FX Outlook: Diamonds in the rough

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

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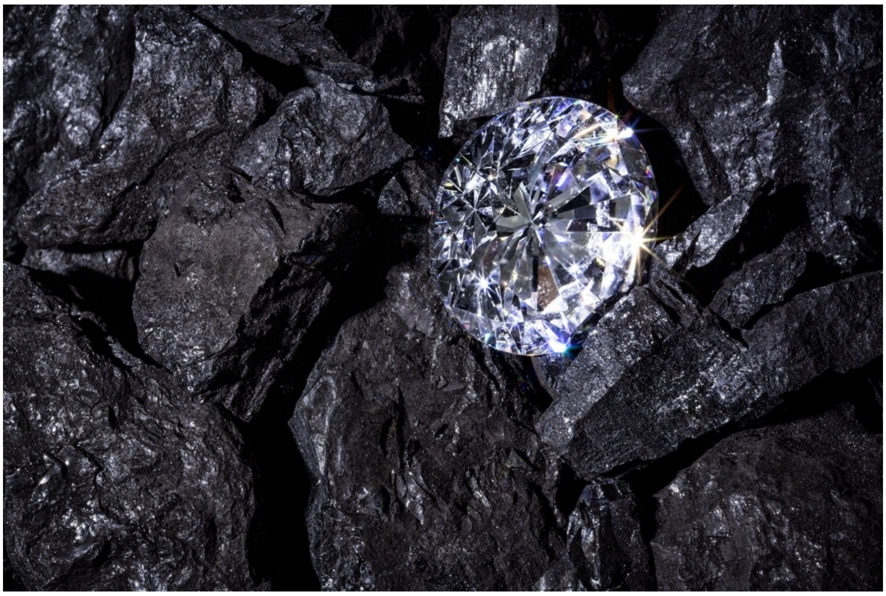
By Warren Patterson

Article | 28 November 2019 **FX**

2020 FX Outlook: Diamonds in the rough

In an FX market priced for secular stagnation, our call for 2020 is to identify undervalued currencies able to hold their own against the dollar – but are also backed by yield and growth. Screening for these characteristics, we find commodity currencies should perform well in 2020. But what of the dollar? Unlike others, we don't see a clear dollar bear trend



Source: Shutterstock

- 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, 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.

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'.

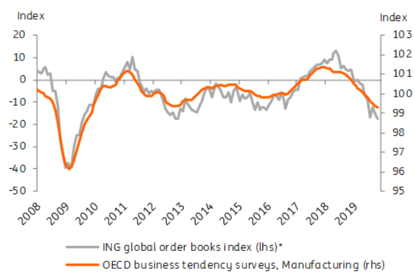
Nobody is talking about a 'great rotation' at the moment, but a few are talking about a broad dollar decline in 2020 on the back of the end in US exceptionalism. We still have some sympathy with this story, but do not see the 2020 FX narrative as simply one of a clean dollar bear trend. And certainly,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

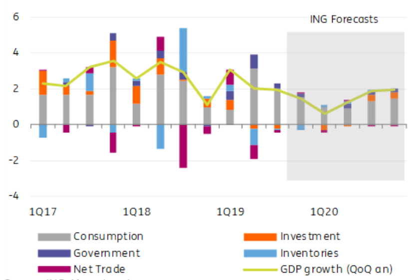
However, our team still looks for US consumption to offset investment in 2020 and deliver a full-year growth rate of 1.4%. That is slow by US standards, but far from a hard landing

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



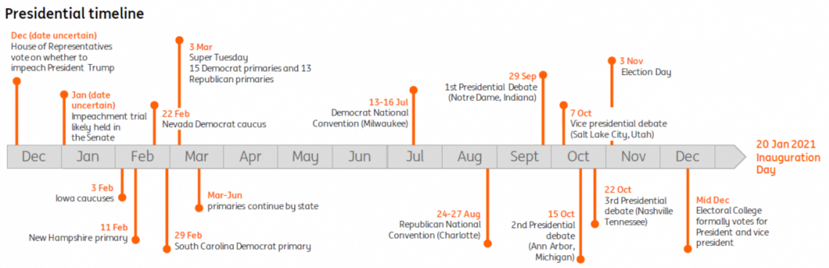
Source: ING, Macrobond

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.

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

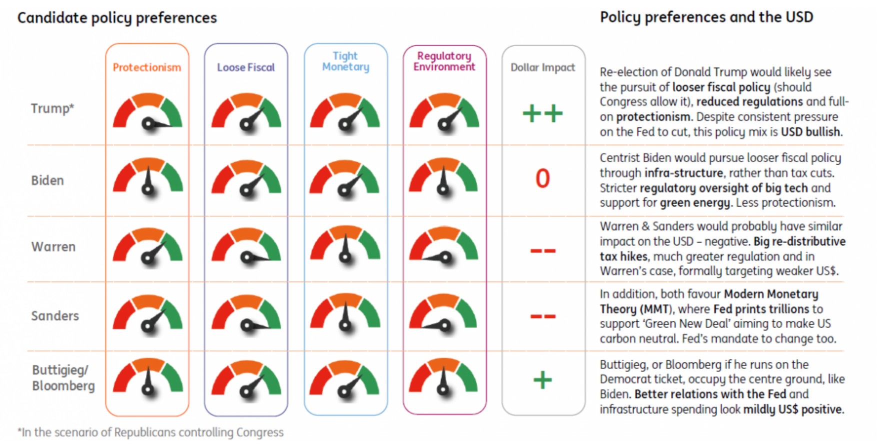


Source: ING

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.



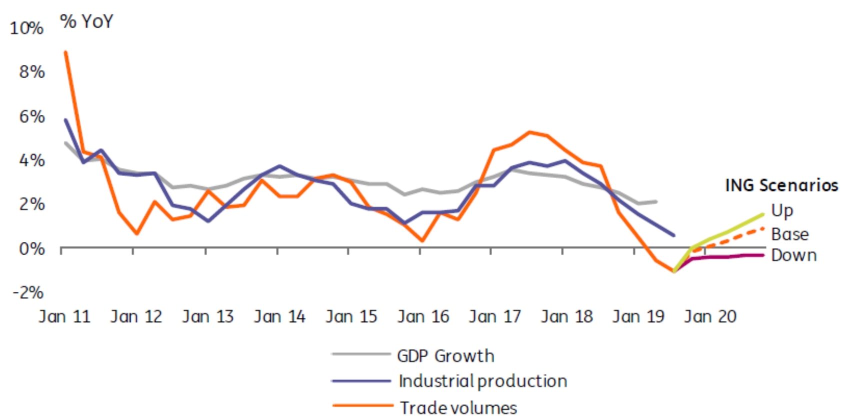
Source: ING

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.

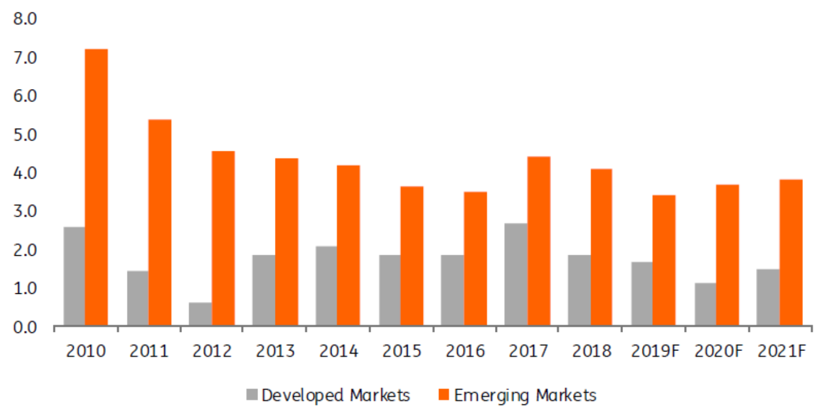
In 2020 DM growth slows for a third year in a row, while EM growth finally rises

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.

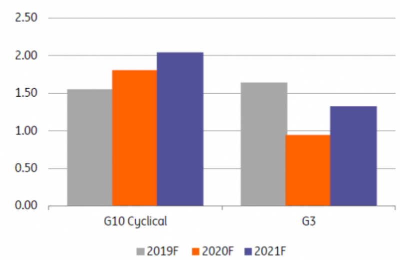
DM versus EM GDP performance and ING forecasts (% annual)



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

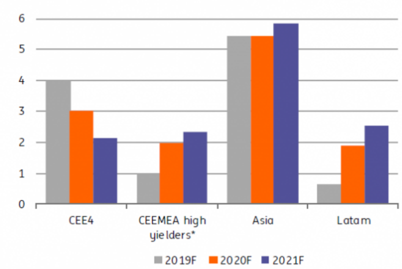
Looking within the DM and EM currency blocs, we note the following: G3 economies look to slow quite steadily. That effectively represents policy paralysis in Europe and Japan at a time when the US is moving deeper into its late cycle status. For reference, we see the US slowing down to 1.4% in 2020 versus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

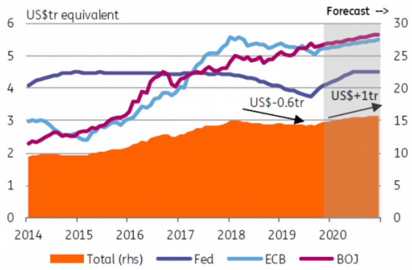
Within the EM FX space, CEE is the only region that will not show an improvement in growth next year

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.

Theme 2: Low volatility favours carry

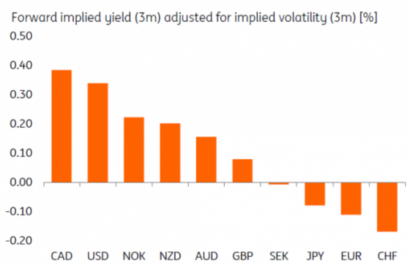
When setting the scene for 2020 it is also worth considering the volatility environment. Will 2020 be a late cycle, tighter liquidity environment which would typically mean higher volatility and outperformance of the safe haven currencies? Probably not. Instead the Fed has prematurely stopped its misnamed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

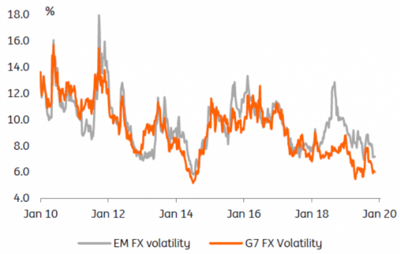
Fig 9 G10 volatility adjusted carry



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.

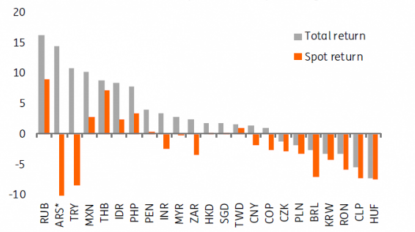
Fig 10 EM FX volatility has converged on the low G7 levels



Source: Bloomberg

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

%, EM FX returns vs USD in 2019, spot and total (spot + carry) return



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

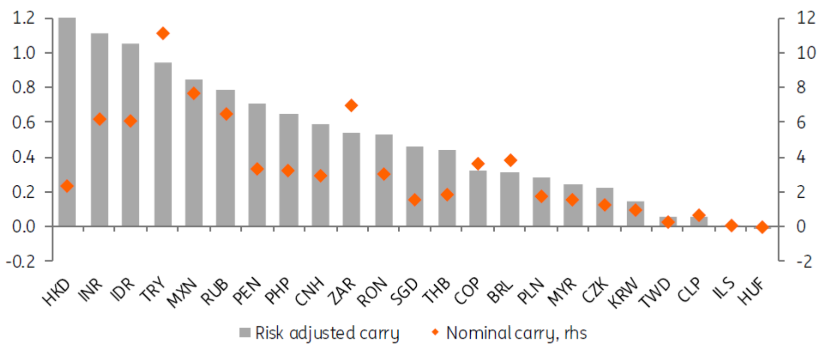
Source: Bloomberg, ING

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

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

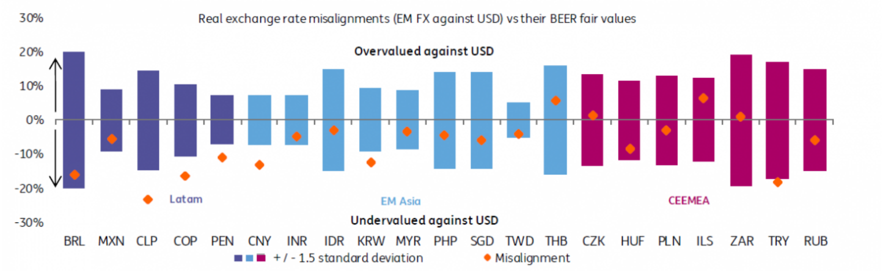
Above we make the case that some of the better growth rates and carry for 2020 is to be found in the EM world. We will start then with a look at EM FX valuation. And our basic premise here is to look for currencies priced for secular stagnation and at least identify those cheap enough to hold their value,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

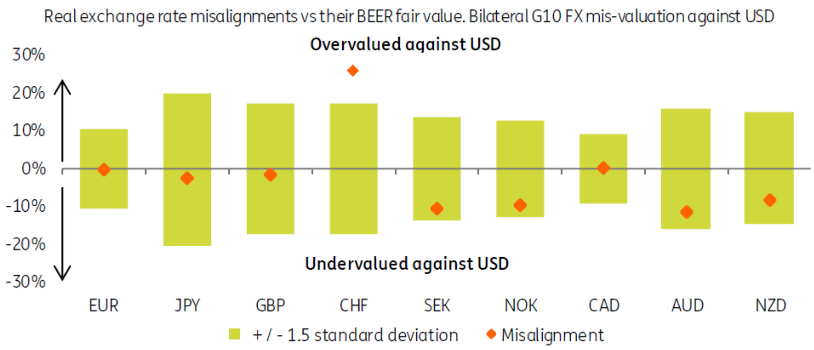
Fig 13 Most EM currencies are cheap vs USD



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

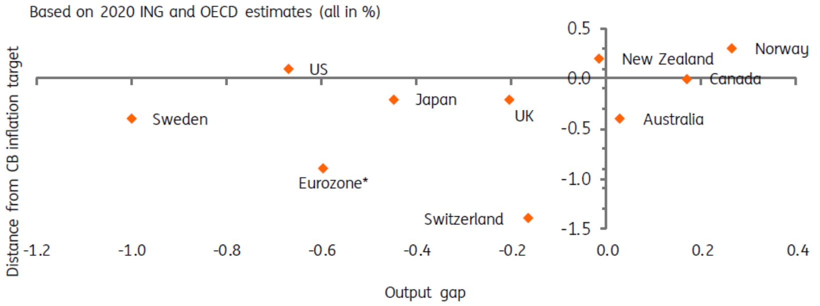


Source: ING

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

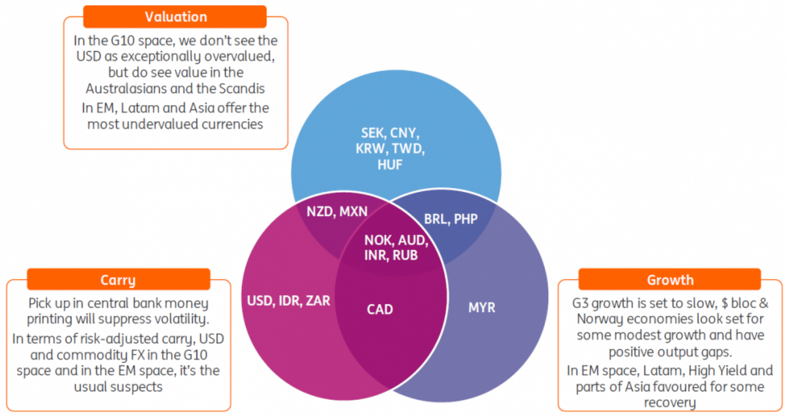
Conclusion: Diamonds in the rough

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.

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Author

Chris Turner
Global Head of Markets and Regional Head of Research for UK & CEE
chris.turner@ing.com

Francesco Pesole
FX Strategist
francesco.pesole@ing.com

USD: A different kind of decline

After a decent run for the dollar in 2019, many are now calling for broad-based depreciation. But we think things are a little more nuanced

Source: Shutterstock

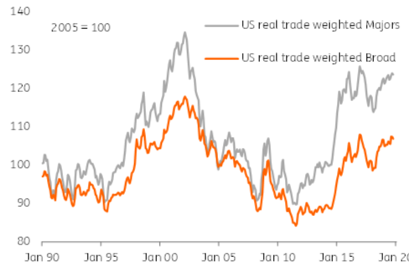
- The end of US exceptionalism is sparking calls for a weaker dollar into 2020. We think the dollar decline will be far more differentiated than broad-based
- Most US Presidential candidates favour a weaker dollar. The best way to achieve that is to improve trade relations and create attractive alternatives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

A good year but will it last?

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 (Canadian dollar, British pound) and in emerging markets (rouble, Thai baht).

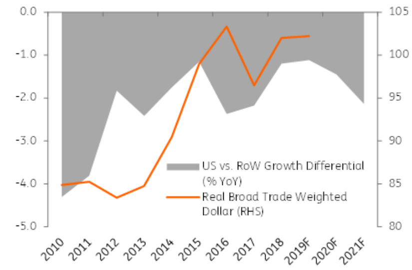
A common expectation for 2020 now seems to be one of broad dollar depreciation. Fund managers are most bearish on the dollar since September 2007 and the familiar narrative is that the end of US exceptionalism spells trouble for the dollar. Certainly, we subscribe to the view that the US growth differential 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

Rest of World to underwhelm

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% year-on-year and the dollar embarking on a broad decline.

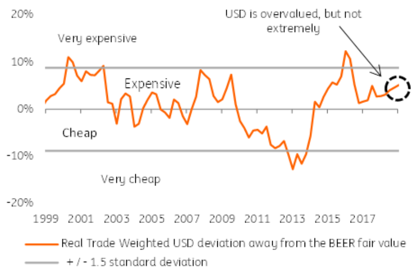
Given our view that Europe will not be a particularly attractive investment destination in 2020 and that the popular DXY is 77% weighted towards European currencies, we are not looking for a major DXY decline next year.

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 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.

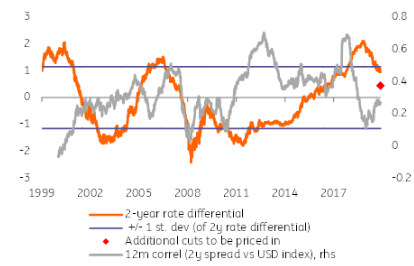
In addition, we think that the Federal Reserve has to deliver at least three to four independent cuts (relative to other central banks and in addition to the Fed rate cuts already priced in) to bring rate differentials back into a range that makes a difference for dollar pricing – see Figure 20 . One 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 100 basis points this year, but, at 2.5% per annum, 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 yield story is probably more important than we think. Looking at the portfolio flow story, both 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 12 months to September 2019, foreigners bought only a net US$41 billion of US securities (Treasuries, corporate bonds and equities) versus US$334 billion in the 12 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.

Trump and trade

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 US-Mexico-Canada 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 – 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.

Given the White House's increased use of sanctions over recent years, there will also be increasing focus on the topic of de-dollarisation. 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.

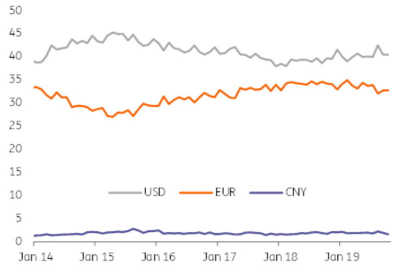
For example, China has for many years tried to encourage the use of the renminbi in international trade by signing Chinese yuan swap agreements with trading partners. Since 2008, China has signed up 33 countries to CNY swap lines – in an effort to encourage buyers of China's goods to have confidence to take on CNY payables.

Equally, Russia has made great efforts to de-dollarise 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%.

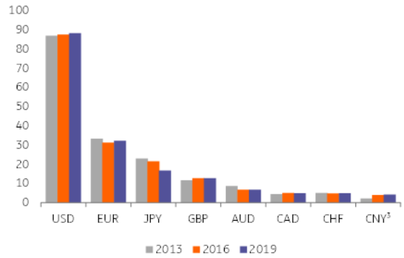
No doubt the mismanaged People's Bank of China fixing adjustment in 2015 and then the tightening rather than loosening of Chinese capital controls during the current trade war have not helped the internationalisation of the CNY.

Fig 21 FX share in global SWIFT payments (%)



Source: Bloomberg, SWIFT

Fig 22 Share in Global OTC FX turnover (%)



Source: BIS

2020 decline will be differentiated

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 five-year CDS still trades at a mere 15 basis points. 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 emerging market currencies (Latam and Asia rather than Europe) and a few of the undervalued commodity currencies in the G10 space.

This article is part of our 2020 FX outlook report.

ING FX forecasts

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

Author

Chris Turner
Global Head of Markets and Regional Head of Research for UK & CEE
chris.turner@ing.com

EUR: The funding currency

The euro is no longer cheap against the US dollar, growth remains sluggish and the prospects for ECB tightening are weak. In short, we're not excited about the euro

- **We remain unexcited about the euro. The currency is no longer meaningfully cheap vs. the US dollar, growth remains sluggish and the prospects for ECB tightening are weak.**
- **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 emerging market FX world.**
- **A 2017-like EUR/USD rally is off the table as eurozone fundamentals are weak. We look for a range bound EUR/USD (1.10-1.15) next year, with clear downside risks.**

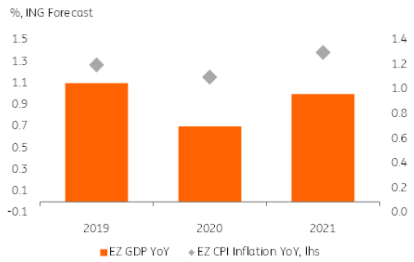
The ECB is presiding over a low growth, low yielding euro environment...

In a nutshell, the European Central Bank's policy stance and its implications should remain a drag on the euro. The September ECB easing package (10 basis point deposit rate cut and the restart of quantitative easing) was not strong enough to meaningfully improve the eurozone's 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's 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 eurozone bonds.

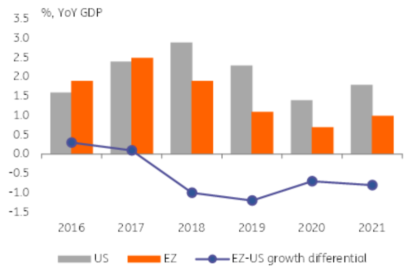
All this suggests that an idiosyncratic, domestically-driven EUR rally is unlikely. The September ECB easing package seems insufficient to change the outlook for eurozone growth and CPI but looks sufficient enough to keep the euro low – as EUR interest rates remain negative and growth is uninspiring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



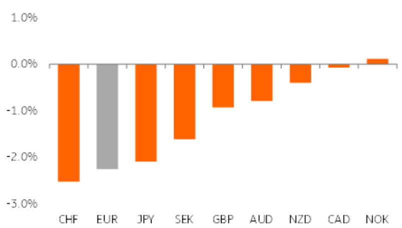
Source: ING

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

The absence of 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 eurozone growth and inflation outlooks are now meaningfully worse, any hint of ECB policy normalisation is unlikely. Not only is the ECB's stance and EUR valuation (see below) different now compared to 2017, but the eurozone 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...

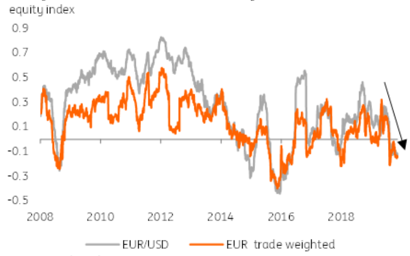
Implied yield on G10 FX crosses vs USD derived form 12-month FX forwards



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

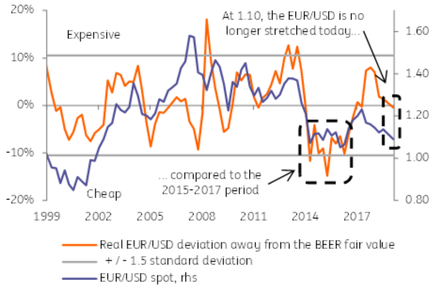


Source: ING, Bloomberg

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, the euro 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 the US dollar or Japanese yen. This means that during the period of risk-off moves, the euro 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 emerging market 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.

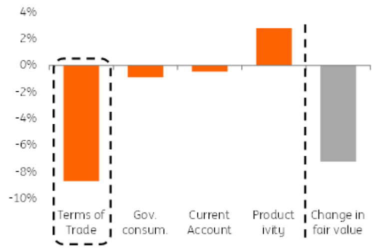
Fig 28 EUR/USD is no longer cheap (compared to 2015-17)



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 has declined

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).

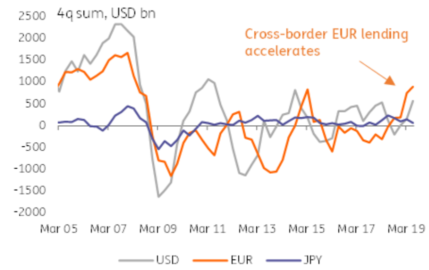
German stimulus the key hope for the euro – but unlikely

The greatest EUR hope lies with possible German fiscal stimulus. In an environment where the ECB's monetary policy stance is perceived as largely exhausted, large and credible fiscal stimulus which would improve eurozone 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). We see the odds of fiscal stimulus as rather low, meaning EUR should remain in the low growth, low yielding currency bucket.

Slowly creeping euro Japanization

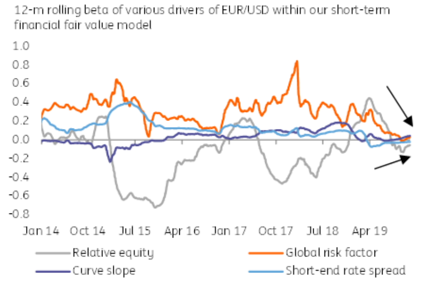
The EUR is increasingly resembling the characteristics of the Japanese yen. A low growth, low inflation, low yielding currency where the central bank delivers insufficient easing to boost the economy. While the eurozone current account is in surplus, it is offset by portfolio outflows. Depressed eurozone bond yields are starting to negatively affect the outlook for European pension fund returns, which has negative implications for pension distribution. The insufficient return potential from depressed eurozone bond yields may push some investors out of eurozone assets, searching for higher yield abroad. Additionally, cross-border lending in euro is accelerating, supporting the euro 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 compres



Source: ING

Unexciting, uninspiring euro prospects with downside risks

We remain deeply unexcited about the euro's 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 eurozone data, re-escalation of the US-China trade war (a clear negative for a large open economy such as the eurozone), 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 sensitivity 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), range bound EUR/USD trading or a slow burning decline, looks 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.

This article is part of our 2020 FX Outlook report.

ING FX forecasts

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

Author

Amrita Naik Nimbalkar
Junior Economist, Global Macro
amrita.naik.nimbalkar@ing.com

Mateusz Sutowicz
Senior Economist, Poland
mateusz.sutowicz@ing.pl

Alissa Lefebre
Economist

alissa.lefebre@ing.com

Deepali Bhargava
Regional Head of Research, Asia-Pacific
Deepali.Bhargava@ing.com

Ruben Dewitte
Economist
+32495364780
ruben.dewitte@ing.com

Kinga Havasi
Economic research trainee
kinga.havasi@ing.com

Marten van Garderen
Consumer Economist, Netherlands
marten.van.garderen@ing.com

David Havrlant
Chief Economist, Czech Republic
420 770 321 486
david.havrlant@ing.com

Sander Burgers
Senior Economist, Dutch Housing
sander.burgers@ing.com

Lynn Song
Chief Economist, Greater China
lynn.song@asia.ing.com

Michiel Tukker
Senior European Rates Strategist
michiel.tukker@ing.com

Michal Rubaszek
Senior Economist, Poland
michal.rubaszek@ing.pl

This is a test author

Stefan Posea
Economist, Romania
tiberiu-stefan.posea@ing.com

Marine Leleux

Sector Strategist, Financials
marine.leleux2@ing.com

Jesse Norcross
Senior Sector Strategist, Real Estate
jesse.norcross@ing.com

Teise Stellema
Research Assistant, Energy Transition
teise.stellema@ing.com

Diederik Stadig
Sector Economist, TMT & Healthcare
diederik.stadig@ing.com

Diogo Gouveia
Sector Economist
diogo.duarte.vieira.de.gouveia@ing.com

Marine Leleux
Sector Strategist, Financials
marine.leleux2@ing.com

Ewa Manthey
Commodities Strategist
ewa.manthey@ing.com

ING Analysts

James Wilson
EM Sovereign Strategist
James.wilson@ing.com

Sophie Smith
Digital Editor
sophie.smith@ing.com

Frantisek Taborsky
EMEA FX & FI Strategist
frantisek.taborsky@ing.com

Adam Antoniak
Senior Economist, Poland
adam.antoniak@ing.pl

Min Joo Kang
Senior Economist, South Korea and Japan

min.joo.kang@asia.ing.com

Coco Zhang
ESG Research
coco.zhang@ing.com

Jan Frederik Slijkerman
Senior Sector Strategist, TMT
jan.frederik.slijkerman@ing.com

Katinka Jongkind
Senior Economist, Services and Leisure
Katinka.Jongkind@ing.com

Marina Le Blanc
Sector Strategist, Financials
Marina.Le.Blanc@ing.com

Samuel Abettan
Junior Economist
samuel.abettan@ing.com

Franziska Biehl
Senior Economist, Germany
Franziska.Marie.Biehl@ing.de

Rebecca Byrne
Senior Editor and Supervisory Analyst
rebecca.byrne@ing.com

Mirjam Bani
Sector Economist, Commercial Real Estate & Public Sector (Netherlands)
mirjam.bani@ing.com

Timothy Rahill
Credit Strategist
timothy.rahill@ing.com

Leszek Kasek
Senior Economist, Poland
leszek.kasek@ing.pl

Oleksiy Soroka, CFA
Senior High Yield Credit Strategist
oleksiy.soroka@ing.com

Antoine Bouvet
Head of European Rates Strategy

antoine.bouvet@ing.com

Jeroen van den Broek
Global Head of Sector Research
jeroen.van.den.broek@ing.com

Edse Dantuma
Senior Sector Economist, Industry and Healthcare
edse.dantuma@ing.com

Francesco Pesole
FX Strategist
francesco.pesole@ing.com

Rico Luman
Senior Sector Economist, Transport and Logistics
Rico.Luman@ing.com

Jurjen Witteveen
Sector Economist
jurjen.witteveen@ing.com

Dmitry Dolgin
Chief Economist, CIS
dmitry.dolgin@ing.de

Nicholas Mapa
Senior Economist, Philippines
nicholas.antonio.mapa@asia.ing.com

Egor Fedorov
Senior Credit Analyst
egor.fedorov@ing.com

Sebastian Franke
Consumer Economist
sebastian.franke@ing.de

Gerben Hieminga
Senior Sector Economist, Energy
gerben.hieminga@ing.com

Nadège Tillier
Head of Corporates Sector Strategy
nadege.tillier@ing.com

Charlotte de Montpellier
Senior Economist, France and Switzerland

charlotte.de.montpellier@ing.com

Laura Straeter
Behavioural Scientist
+31(0)611172684
laura.Straeter@ing.com

Valentin Tataru
Chief Economist, Romania
valentin.tataru@ing.com

James Smith
Developed Markets Economist, UK
james.smith@ing.com

Suvi Platerink Kosonen
Senior Sector Strategist, Financials
suvi.platerink-kosonen@ing.com

Thijs Geijer
Senior Sector Economist, Food & Agri
thijs.geijer@ing.com

Maurice van Sante
Senior Economist Construction & Team Lead Sectors
maurice.van.sante@ing.com

Marcel Klok
Senior Economist, Netherlands
marcel.klok@ing.com

Piotr Poplawski
Senior Economist, Poland
piotr.poplawski@ing.pl

Paolo Pizzoli
Senior Economist, Italy, Greece
paolo.pizzoli@ing.com

Marieke Blom
Chief Economist and Global Head of Research
marieke.blom@ing.com

Raoul Leering
Senior Macro Economist
raoul.leering@ing.com

Maarten Leen

Head of Global IFRS9 ME Scenarios
maarten.leen@ing.com

Maureen Schuller
Head of Financials Sector Strategy
Maureen.Schuller@ing.com

Warren Patterson
Head of Commodities Strategy
Warren.Patterson@asia.ing.com

Rafal Benecki
Chief Economist, Poland
rafal.benecki@ing.pl

Philippe Ledent
Senior Economist, Belgium, Luxembourg
philippe.ledent@ing.com

Peter Virovacz
Senior Economist, Hungary
peter.virovacz@ing.com

Inga Fechner
Senior Economist, Germany, Global Trade
inga.fechner@ing.de

Dimitry Fleming
Senior Data Analyst, Netherlands
Dimitry.Fleming@ing.com

Ciprian Dascalu
Chief Economist, Romania
+40 31 406 8990
ciprian.dascalu@ing.com

Muhammet Mercan
Chief Economist, Turkey
muhammet.mercan@ingbank.com.tr

Iris Pang
Chief Economist, Greater China
iris.pang@asia.ing.com

Sophie Freeman
Writer, Group Research
+44 20 7767 6209
Sophie.Freeman@uk.ing.com

Padhraic Garvey, CFA
Regional Head of Research, Americas
padhraic.garvey@ing.com

James Knightley
Chief International Economist, US
james.knightley@ing.com

Tim Condon
Asia Chief Economist
+65 6232-6020

Martin van Vliet
Senior Interest Rate Strategist
+31 20 563 8801
martin.van.vliet@ing.com

Karol Pogorzelski
Senior Economist, Poland
Karol.Pogorzelski@ing.pl

Carsten Brzeski
Global Head of Macro
carsten.brzeski@ing.de

Viraj Patel
Foreign Exchange Strategist
+44 20 7767 6405
viraj.patel@ing.com

Owen Thomas
Global Head of Editorial Content
+44 (0) 207 767 5331
owen.thomas@ing.com

Bert Colijn
Chief Economist, Netherlands
bert.colijn@ing.com

Peter Vanden Houte
Chief Economist, Belgium, Luxembourg, Eurozone
peter.vandenhoute@ing.com

Benjamin Schroeder
Senior Rates Strategist
benjamin.schroder@ing.com

Chris Turner

Global Head of Markets and Regional Head of Research for UK & CEE
chris.turner@ing.com

Gustavo Rangel
Chief Economist, LATAM
+1 646 424 6464
gustavo.rangel@ing.com

Carlo Cocuzzo
Economist, Digital Finance
+44 20 7767 5306
carlo.cocuzzo@ing.com

GBP: Light at the end of the tunnel

The outlook for the pound all hinges on Brexit

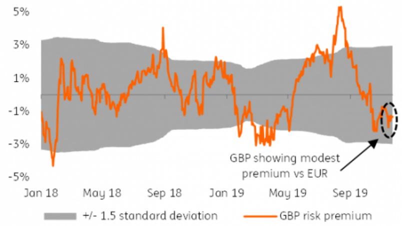
- **With the Conservative Party leading the polls, GBP is likely to gain over the next one to two months as we get more clarity on the Brexit path. EUR/GBP to reach 0.83.**
- **Even if the Withdrawal Agreement is passed by next January, this isn't the end of the Brexit saga. Uncertainty about extension 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 a valuation which is no longer cheap will tame its upside.**

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

The GBP outlook for the coming one to three 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.

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

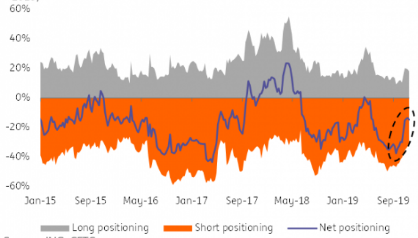
The estimate of the EUR/GBP risk premium. Residual between EUR/GBP short-term financial fair value and the spot.



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

Transition period uncertainty to tame 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).

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).

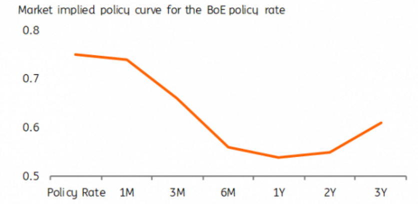
…as extension will be necessary but the path towards it won't be straightforward

The question of 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.

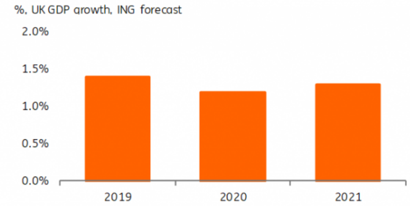
While all the above is heavily scenario-conditional and still some time away (we need to see the election outcome first) the issue of extending the transition period is, in our view, another risk event for GBP and should therefore tame the potential optimism in the case of the Parliament successfully 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 mispricing

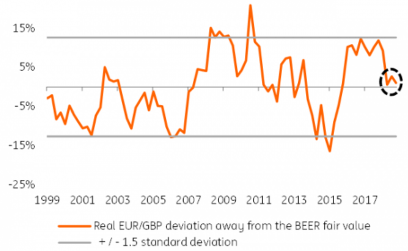
Assuming the UK will avoid a hard Brexit and achieves the extension of the transition period by June 2020 (in our view, the EU will want to know by this deadline whether the UK contribute to the budget in order to be able to plan for the new EU budget) or a little later, we expect sterling to settle 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...

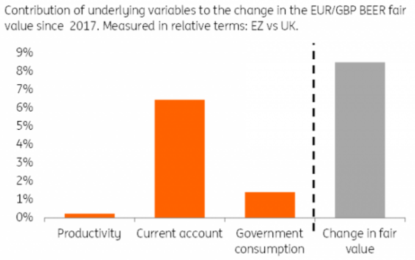
On the less positive side, two factors should prevent a meaningful GBP rally. First, the economic growth will remain subdued in 2020. Our economists pencil in growth around 1.2% next year (Figure 42), due in part to the constrained investment as 2020 will still feature plenty of uncertainties (such as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



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 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.

This article is part of our 2020 FX Outlook report.

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

Author

Amrita Naik Nimbalkar
Junior Economist, Global Macro
amrita.naik.nimbalkar@ing.com

Mateusz Sutowicz
Senior Economist, Poland
mateusz.sutowicz@ing.pl

Alissa Lefebre
Economist
alissa.lefebre@ing.com

Deepali Bhargava
Regional Head of Research, Asia-Pacific
Deepali.Bhargava@ing.com

Ruben Dewitte
Economist
+32495364780
ruben.dewitte@ing.com

Kinga Havasi
Economic research trainee
kinga.havasi@ing.com

Marten van Garderen
Consumer Economist, Netherlands
marten.van.garderen@ing.com

David Havrlant
Chief Economist, Czech Republic
420 770 321 486
david.havrlant@ing.com

Sander Burgers
Senior Economist, Dutch Housing
sander.burgers@ing.com

Lynn Song
Chief Economist, Greater China
lynn.song@asia.ing.com

Michiel Tukker
Senior European Rates Strategist
michiel.tukker@ing.com

Michal Rubaszek
Senior Economist, Poland
michal.rubaszek@ing.pl

This is a test author

Stefan Posea
Economist, Romania
tiberiu-stefan.posea@ing.com

Marine Leleux
Sector Strategist, Financials
marine.leleux2@ing.com

Jesse Norcross
Senior Sector Strategist, Real Estate
jesse.norcross@ing.com

Teise Stellema
Research Assistant, Energy Transition
teise.stellema@ing.com

Diederik Stadig
Sector Economist, TMT & Healthcare
diederik.stadig@ing.com

Diogo Gouveia
Sector Economist
diogo.duarte.vieira.de.gouveia@ing.com

Marine Leleux
Sector Strategist, Financials
marine.leleux2@ing.com

Ewa Manthey
Commodities Strategist
ewa.manthey@ing.com

ING Analysts

James Wilson
EM Sovereign Strategist
James.wilson@ing.com

Sophie Smith
Digital Editor
sophie.smith@ing.com

Frantisek Taborsky
EMEA FX & FI Strategist
frantisek.taborsky@ing.com

Adam Antoniak
Senior Economist, Poland
adam.antoniak@ing.pl

Min Joo Kang
Senior Economist, South Korea and Japan
min.joo.kang@asia.ing.com

Coco Zhang

ESG Research
coco.zhang@ing.com

Jan Frederik Slijkerman
Senior Sector Strategist, TMT
jan.frederik.slijkerman@ing.com

Katinka Jongkind
Senior Economist, Services and Leisure
Katinka.Jongkind@ing.com

Marina Le Blanc
Sector Strategist, Financials
Marina.Le.Blanc@ing.com

Samuel Abettan
Junior Economist
samuel.abettan@ing.com

Franziska Biehl
Senior Economist, Germany
Franziska.Marie.Biehl@ing.de

Rebecca Byrne
Senior Editor and Supervisory Analyst
rebecca.byrne@ing.com

Mirjam Bani
Sector Economist, Commercial Real Estate & Public Sector (Netherlands)
mirjam.bani@ing.com

Timothy Rahill
Credit Strategist
timothy.rahill@ing.com

Leszek Kasek
Senior Economist, Poland
leszek.kasek@ing.pl

Oleksiy Soroka, CFA
Senior High Yield Credit Strategist
oleksiy.soroka@ing.com

Antoine Bouvet
Head of European Rates Strategy
antoine.bouvet@ing.com

Jeroen van den Broek

Global Head of Sector Research
jeroen.van.den.broek@ing.com

Edse Dantuma
Senior Sector Economist, Industry and Healthcare
edse.dantuma@ing.com

Francesco Pesole
FX Strategist
francesco.pesole@ing.com

Rico Luman
Senior Sector Economist, Transport and Logistics
Rico.Luman@ing.com

Jurjen Witteveen
Sector Economist
jurjen.witteveen@ing.com

Dmitry Dolgin
Chief Economist, CIS
dmitry.dolgin@ing.de

Nicholas Mapa
Senior Economist, Philippines
nicholas.antonio.mapa@asia.ing.com

Egor Fedorov
Senior Credit Analyst
egor.fedorov@ing.com

Sebastian Franke
Consumer Economist
sebastian.franke@ing.de

Gerben Hieminga
Senior Sector Economist, Energy
gerben.hieminga@ing.com

Nadège Tillier
Head of Corporates Sector Strategy
nadege.tillier@ing.com

Charlotte de Montpellier
Senior Economist, France and Switzerland
charlotte.de.montpellier@ing.com

Laura Straeter

Behavioural Scientist
+31(0)611172684
laura.Straeter@ing.com

Valentin Tataru
Chief Economist, Romania
valentin.tataru@ing.com

James Smith
Developed Markets Economist, UK
james.smith@ing.com

Suvi Platerink Kosonen
Senior Sector Strategist, Financials
suvi.platerink-kosonen@ing.com

Thijs Geijer
Senior Sector Economist, Food & Agri
thijs.geijer@ing.com

Maurice van Sante
Senior Economist Construction & Team Lead Sectors
maurice.van.sante@ing.com

Marcel Klok
Senior Economist, Netherlands
marcel.klok@ing.com

Piotr Poplawski
Senior Economist, Poland
piotr.poplawski@ing.pl

Paolo Pizzoli
Senior Economist, Italy, Greece
paolo.pizzoli@ing.com

Marieke Blom
Chief Economist and Global Head of Research
marieke.blom@ing.com

Raoul Leering
Senior Macro Economist
raoul.leering@ing.com

Maarten Leen
Head of Global IFRS9 ME Scenarios
maarten.leen@ing.com

Maureen Schuller
Head of Financials Sector Strategy
Maureen.Schuller@ing.com

Warren Patterson
Head of Commodities Strategy
Warren.Patterson@asia.ing.com

Rafal Benecki
Chief Economist, Poland
rafal.benecki@ing.pl

Philippe Ledent
Senior Economist, Belgium, Luxembourg
philippe.ledent@ing.com

Peter Virovacz
Senior Economist, Hungary
peter.virovacz@ing.com

Inga Fechner
Senior Economist, Germany, Global Trade
inga.fechner@ing.de

Dimitry Fleming
Senior Data Analyst, Netherlands
Dimitry.Fleming@ing.com

Ciprian Dascalu
Chief Economist, Romania
+40 31 406 8990
ciprian.dascalu@ing.com

Muhammet Mercan
Chief Economist, Turkey
muhammet.mercan@ingbank.com.tr

Iris Pang
Chief Economist, Greater China
iris.pang@asia.ing.com

Sophie Freeman
Writer, Group Research
+44 20 7767 6209
Sophie.Freeman@uk.ing.com

Padhraic Garvey, CFA
Regional Head of Research, Americas

padhraic.garvey@ing.com

James Knightley
Chief International Economist, US
james.knightley@ing.com

Tim Condon
Asia Chief Economist
+65 6232-6020

Martin van Vliet
Senior Interest Rate Strategist
+31 20 563 8801
martin.van.vliet@ing.com

Karol Pogorzelski
Senior Economist, Poland
Karol.Pogorzelski@ing.pl

Carsten Brzeski
Global Head of Macro
carsten.brzeski@ing.de

Viraj Patel
Foreign Exchange Strategist
+44 20 7767 6405
viraj.patel@ing.com

Owen Thomas
Global Head of Editorial Content
+44 (0) 207 767 5331
owen.thomas@ing.com

Bert Colijn
Chief Economist, Netherlands
bert.colijn@ing.com

Peter Vanden Houte
Chief Economist, Belgium, Luxembourg, Eurozone
peter.vandenhoute@ing.com

Benjamin Schroeder
Senior Rates Strategist
benjamin.schroder@ing.com

Chris Turner
Global Head of Markets and Regional Head of Research for UK & CEE
chris.turner@ing.com

Gustavo Rangel
Chief Economist, LATAM
+1 646 424 6464
gustavo.rangel@ing.com

Carlo Cocuzzo
Economist, Digital Finance
+44 20 7767 5306
carlo.cocuzzo@ing.com

Article | 28 November 2019 FX

CNY: Entering a volatile year

The direction of the Chinese yuan in 2020 will depend on progress in the trade war

USD/CNY movements will continue to depend on the progress of 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.

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

Year-to-date, 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 direction has become increasingly frequent as we approach the final stages of discussions in the so-called phase one deal between China and the US.

Earlier in the year there was optimism in the market that a phase one 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.

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 one 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 one deal, with some rollback of tariffs signed before year-end. But we assign a small probability to this event.

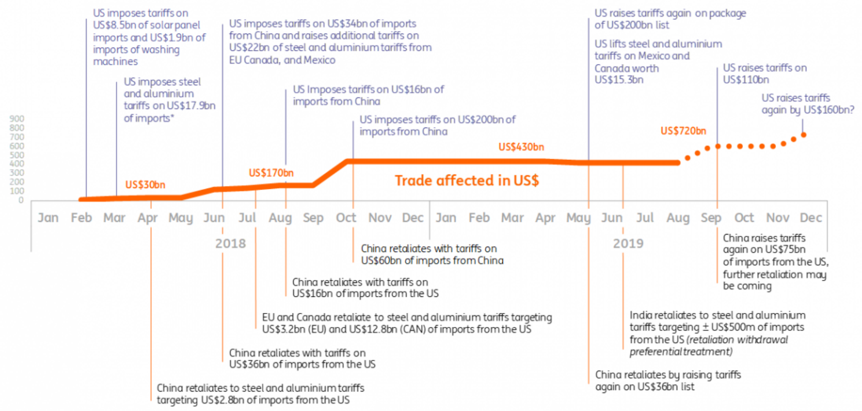
There will be many similar drivers of the yuan in 2020 compared to 2019

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.

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 one deal because the market will then start to question the likelihood of phase two or three 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.

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.

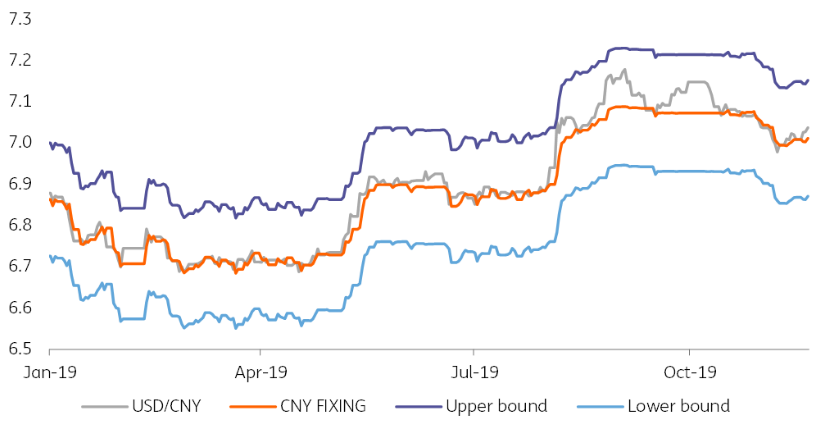
The main elements of such a clause concern the reporting of official interventions in FX markets, including data on FX reserves and positions in forward markets.

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 one 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." Signing up to a bilateral deal on the currency with the US might well be seen by China as an unacceptable loss of sovereignty.

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



Source: Bloomberg

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% 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 CNY2 trillion.

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 1-year and 5-year Medium-Lending Facility interest rates by five 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.

This article is part of our 2020 FX Outlook report.

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

Author

Iris Pang
Chief Economist, Greater China
iris.pang@asia.ing.com

LATAM: Reversal of fortunes

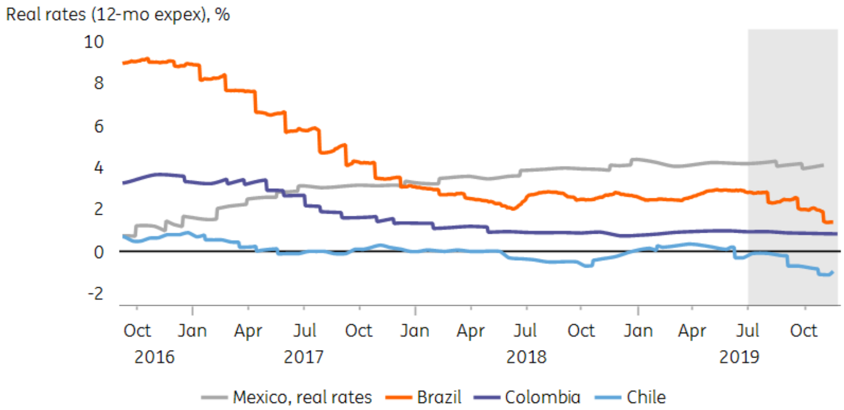
Trade war concerns and the appreciation of the US dollar kept many LATAM currencies under pressure in 2019 but there were significant differences between countries. In 2020, things could look quite different

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.

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



Source: Macrobond

Interest rate differentials were crucial in explaining relative performance in 2019

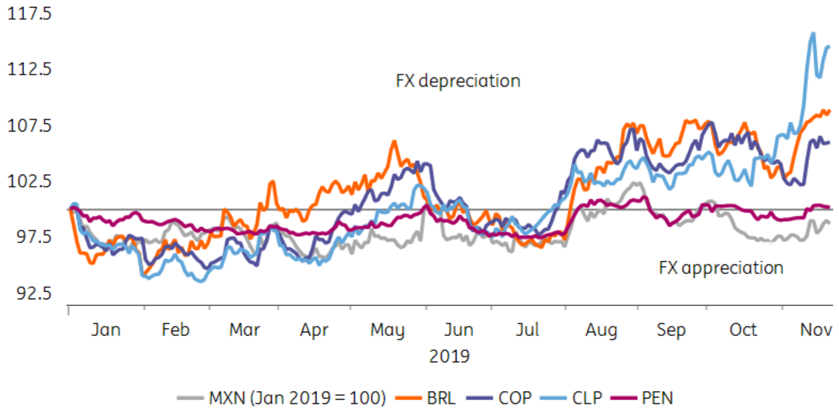
External headwinds, as represented by the gradual appreciation of the USD in the past couple of years and persistent trade-war concerns, helped keep LATAM currencies under pressure in the past year. But idiosyncratic risks were large enough to generate substantial intra-regional performance differentiation,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

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 three years, to decouple from the US Fed.

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.

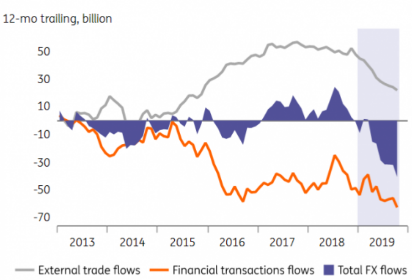
The PEN should, meanwhile, continue to outperform during market sell-offs and to underperform during rallies, which suggests that the currency should underperform its peers in a scenario of relatively benign outlook for risk appetite. Such a relatively benign market environment would benefit especially 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.

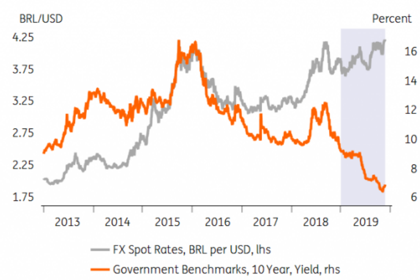
As in the past, an eventual FX policy preference for keeping the ARS at "competitive" levels, as some have suggested as a means to strengthen external trade and growth, would eventually conflict with the need to use FX as a price anchor. And as policy priorities fluctuate between the need to boost exports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

Fig 80 FX outflows surged throughout 2019



Source: Macrobond

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



Source: Macrobond

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.

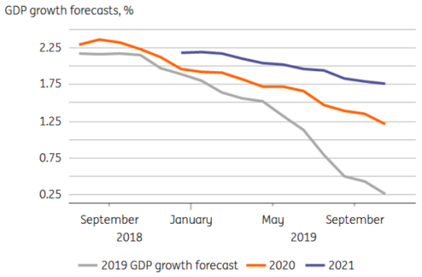
These outflows reflect, to a large extent, debt-management operations by local corporates that are taking advantage of newly-available cheap local funding to pay down FX-denominated debt. By their nature, these developments are long-term positive for the BRL, as they reduce the stock of FX liabilities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

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.

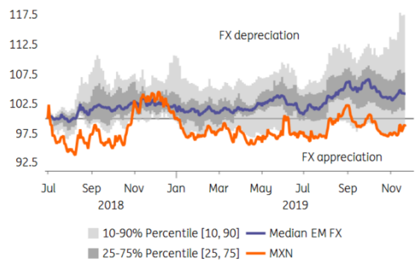
Overall, Brazil's fundamentals should display a more substantial improvement throughout 2020, as the effect of the aggressive monetary easing seen in recent months and the improved fiscal outlook, resulting from fiscal reforms, should result in faster economic activity. But the inability to execute a 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.

Fig 82 GDP growth expectations show persistent decline



Source: Macrobond

Fig 83 MXN outperformance should be harder to sustain



Source: Macrobond

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 cancellation 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%.

In the very near term, high interest rates should remain an effective stabilising factor for the MXN, which should keep the USD/MXN trading close to 19.5. A steady pace of 25 basis point 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 150 basis points, 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.

This article is part of our 2020 FX Outlook report.

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

Author

Gustavo Rangel
Chief Economist, LATAM
+1 646 424 6464
gustavo.rangel@ing.com

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2020 commodities preview

Trade talk optimism provided some support to commodity markets during the first half of 2019, while slowing global activity and reduced volatility were features of the second. This preview formed part of our 2020 FX Outlook. Our full Commodities Outlook is due later in December

Source: Shutterstock

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.

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

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

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 persist

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

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

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.

This article is part of our 2020 FX outlook report.

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

Author

Warren Patterson
Head of Commodities Strategy
Warren.Patterson@asia.ing.com