19 November 2020

Please note that this is the non-investment research version of 2021 FX Outlook and does not include the investment strategies contained in the Global Markets Research version of this report

2021 FX Outlook
Back on Track

FX Strategy Team

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This is a non-investment research version of our full report dated 19 November 2020

Executive summary

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- **In 2021, exchange rates will increasingly be driven by how quickly confidence builds in a, hopefully, post-pandemic global recovery. This year has been a wild ride for FX markets, masked by a trade weighted dollar unchanged on the year.**
- **It is clear that investors are being encouraged to move out along the credit curve and out of the dollar, too. Aggressive fiscal and monetary policy support packages have certainly helped here.**
- **2021 will be the year that FX markets, diverted by two years of President Trump's protectionism and then by one year of the Covid-19 crisis, get back on track as the gravitational pull of the dollar fades. We forecast the dollar to broadly decline in 2021 - generally by 5-10% against most currencies.**
- **It will not be a straight-line sell-off in the dollar - the legacy of Covid-19 in both Europe and the US will see to that. And key risks to our bullish call on global currency pairs stem from the world economy failing to exit stall speed or the Fed taking away the punchbowl too early.**

Key views

Our FX outlook firmly sits at the bullish end of the spectrum, while acknowledging the challenges that the northern hemisphere especially faces from Covid-19 this winter. Of the many factors supporting our position, we would probably highlight very reflationary Fed policy and the dollar typically selling off in the early stages of a recovery cycle.

There are two things central to that bearish dollar call. First, that policymakers provide sufficient fiscal and monetary policy support such that inflation expectations rise. Second, the Fed keeps policy rates on the floor such that US real interest rates stay very negative.

This very loose US monetary setting, plus a reversal of the White House's protectionist policies, should allow currencies in the Rest of the World to breathe again. Who will accept a stronger currency? Strikingly Chinese authorities have embraced a stronger renminbi since July. Market liberalisation measures should allow USD/CNY to reach 6.30.

Battling deflation and faced with the huge task of returning economies to pre-Covid-19 levels, eurozone policymakers are certainly less tolerant of euro strength. Yet our conviction call of an exodus from precautionary USD holdings and into emerging markets in 2021 suggests the weak dollar trend will dominate and that the ECB will have to wage war against EUR/USD at 1.25.

Elsewhere in Europe we expect a 'skinny' EU:UK trade deal to provide some modest support to the GBP. A bigger move may be seen in lower levels of GBP volatility, however. Expect the Scandies as usual to be at the forefront of the recovery story, while the CHF should lag. In the CEE region, we continue to favour CZK, backed by one of the few central banks ready to tolerate currency strength.

Strong appetite for carry in 2021 will also see good demand for the EMEA high yielders. As usual these currencies are high yield for a reason. But a policy shift could see some stability in TRY, while the RUB could also outperform in the early stages of a Biden presidency. The ZAR will attract inflows, yet investments here could quickly reverse.

Reflationary policies will generate much talk of steeper yield curves and higher commodity prices in 2021. Among $-bloc commodity currencies, CAD's relatively attractive rate profile and a recovery in oil prices should send USD/CAD to 1.23. AUD and NZD should also stay supported. In LATAM, we favour the Colombian peso, backed by relatively stable politics.

And in addition to the steady gains in the renminbi, the Korean Won stands to do very well, buoyed by heavy weights in EM benchmark indices.

But, of course, everything depends on us getting out of the coronavirus crisis just as soon as we can.

2021 FX Outlook: Back on track

- **After a three-year diversion in the form of President's Trump domestic agenda and then the global tragedy that is Covid-19, the global economy promises to get back on track with a return to more balanced global growth in 2021. Despite some scarring in supply chains, global trade volumes look set to rebound.**
- **This environment should allow monetary policy to play out in FX markets. 2020 showed that the dollar retained its central role in the financial system and the Fed its pivotal role in global monetary conditions. Fed policy in 2021 looks clear: reflate the economy, drive investors along the credit curve and out of the dollar.**
- **In a developed world characterised by zero or negative monetary policy rates, real interest rates are going to play a greater role. Those countries most successful in restoring economic confidence and driving inflation expectations higher will be rewarded with even more negative real rates and weaker currencies.**
- **A global recovery and very reflationary Fed policy both point to the US being able to export low rates across DM and EM markets. This should lead to strong portfolio outflows from the US, a 5-10% broad decline in the dollar and strong inflows into emerging markets - where China is more accepting of CNY strength.**

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A three-year diversion

It is important not to over-complicate our understanding of FX markets. What seems clear is that global financial markets and the dollar have been driven by two key themes over the past three years: 2018/19 was all about Trump's large tax cuts/tighter Fed policy and protectionism, while 2020 has been dominated by Covid-19.

Both briefly drove the dollar stronger, but both look set to go into abeyance in 2021. Unless we are all dramatically overestimating the prospect of a return to a rules-based international order under Joe Biden or underestimating the legacy of Covid-19, 2021 should be a better year for more balanced global growth – particularly from 2Q onwards.

In their *Global Macro Outlook 2021: The darkness before the dawn*, our macro team forecasts a rebound in world GDP to 4.7% next year from -5% in 2020, while we forecast world trade volumes (in YoY terms) climbing back to 5% from the trough of -15% seen this summer.

Control of Covid-19 clearly seems to be the biggest risk in the northern hemisphere right now, but unlike the legacy of the Global Financial Crisis in 2008/09, few policymakers are talking of austerity. Instead, further fiscal programmes and looser monetary policy stand at the ready. Growth and inflation, not belt tightening, is now the strategy to drive down public debt burdens running above 100% of GDP in many large economies.

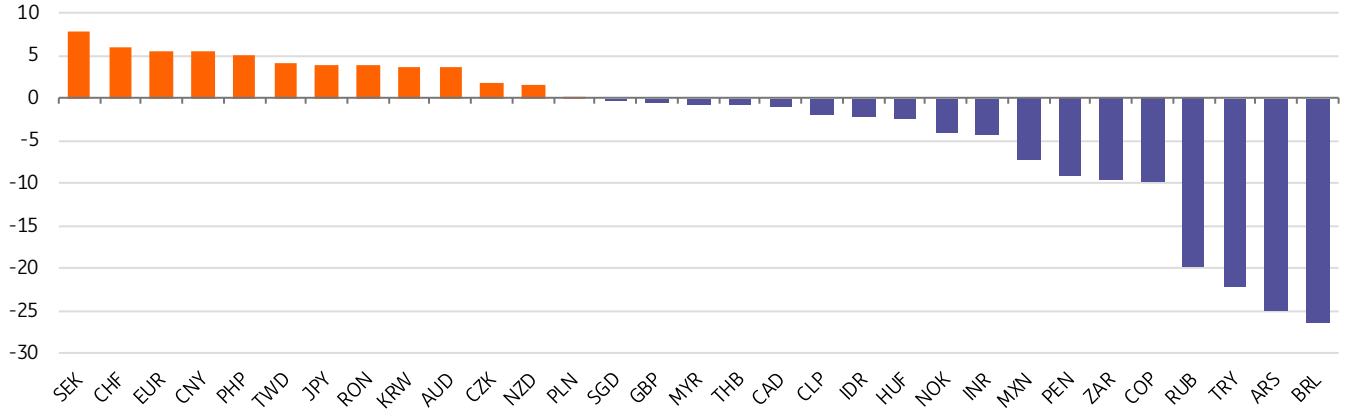
We are going to hear a lot about reflationary policies, steeper yield curves and higher asset prices in 2021. Our job as FX analysts is to identify which countries look to be most successful in achieving those aims and how those outcomes will impact international portfolio flows and perceptions of sovereign risk.

FX markets: Where do we stand?

Looking at year-to-date performance of currencies against the dollar we can see that a few currencies have completely reversed their March losses and now stand stronger against the dollar on the year. These include some European currencies (including the EUR), but also the more managed currencies of CNY and KRW.

But many emerging currencies are still heavily down on the year, largely hit by the collapse in commodity prices (after all Brent is still down some 35% YTD). Some of the underperformers have typically struggled with fiscal challenges (eg, Brazil) or more traditional balance of payments weaknesses, such as TRY and ZAR.

Fig 1 Year-to-date currency moves against the dollar: Some have recovered more than others (%)



Source: ING

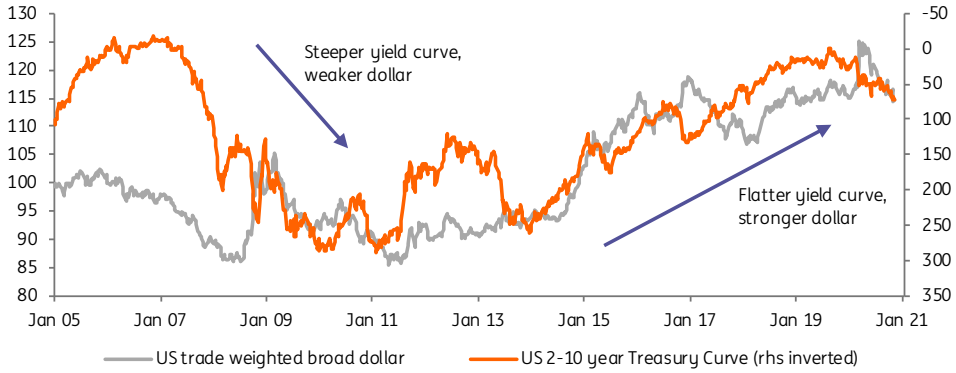
Typically, the performance of the FX high yielders is very much determined by the external environment or particularly US monetary policy settings. Some of the biggest EM sell-offs over the past decade have been driven through the prospects of tighter Fed policy, be it the 'taper tantrum' in 2013 or the prospect of a first Fed hike in 2015.

So, what will Fed policy mean for global FX markets in 2021?

Reflation, reflation, reflation

Our starting point is that global policymakers clearly want to minimise the effect of Covid-19 scarring and have set all their control dials for growth. Their success in convincing the market of their aim can be judged from the shape of yield curves.

Fig 2 If US policymakers are successful with reflation, the dollar should weaken



Source: US Federal Reserve

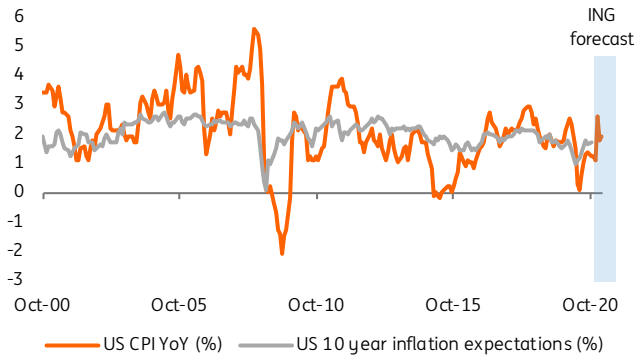
Figure 2 highlights the relationship between the US Treasury 2-10 year Curve and the broad dollar index. Typically, a flatter yield curve – where the Fed has been applying the brakes with tighter monetary policy or recession fears grow – is associated with a stronger dollar. A steeper yield curve, reflecting reflationary policies put in place (like those in 2008/09), is typically associated with a weaker dollar.

The US Treasury 2-10 year Curve has steepened around 60bp from its lows in March to around 71bp currently. Our Rates Strategy team see this curve steepening to the 100bp area in 2021 – consistent with a weaker dollar. US Treasury 10 year yields at 1.00% or even 1.25% should not prove too great a threat to the external environment and will add to the sense (assuming Covid-19 is conquered) of a 'Goldilocks' investment environment in 2021.

Real interest rates: The winner takes it all

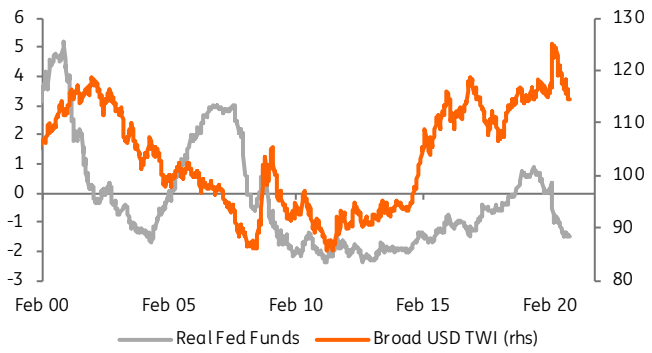
In developed markets, many central banks are dealing with rates near zero or slightly negative. While the likes of the BoE and RBNZ are threatening to take rates into negative territory, the impact on local banking systems suggest any moves in nominal rates will be modest. Instead the action will be in the real interest rate world.

Fig 3 US CPI and inflation expectations set to rise



Source: ING, Federal Reserve

Fig 4 Real Fed Funds set to drag the dollar lower



Source: US Federal Reserve. Real Fed Funds = Fed Funds less US 10yr TIPs

Here, those central banks (and policymakers) able to convince investors that economies are back on track and that inflation will return to more normal levels will be rewarded with more negative real interest rates. In Figures 3 and 4 we demonstrate this in the US, where our forecasts of US CPI returning to 2.6% next summer, likely dragging inflation expectations higher (we use those derived from US 10 year inflation-indexed Treasuries) is likely to send the real Fed Funds rate even lower.

If the world economy is to move back on track, those 10 year US inflation expectations could return to levels seen in early 2018 – in the 2.00-2.20% range – and drag the real Fed Funds level back to the -2% area that characterised the 2010-12 environment. The Fed would consider such an outcome a success given its new monetary policy strategy of Average Inflation Targeting.

In short, those policymakers able to convince investors that the economy has returned to self-sustaining expansion and a successful rise in inflation expectations will be rewarded with even lower real rates and weaker currencies – a desirable policy outcome in early stage recovery cycles. As Abba would say: the winner takes it all.

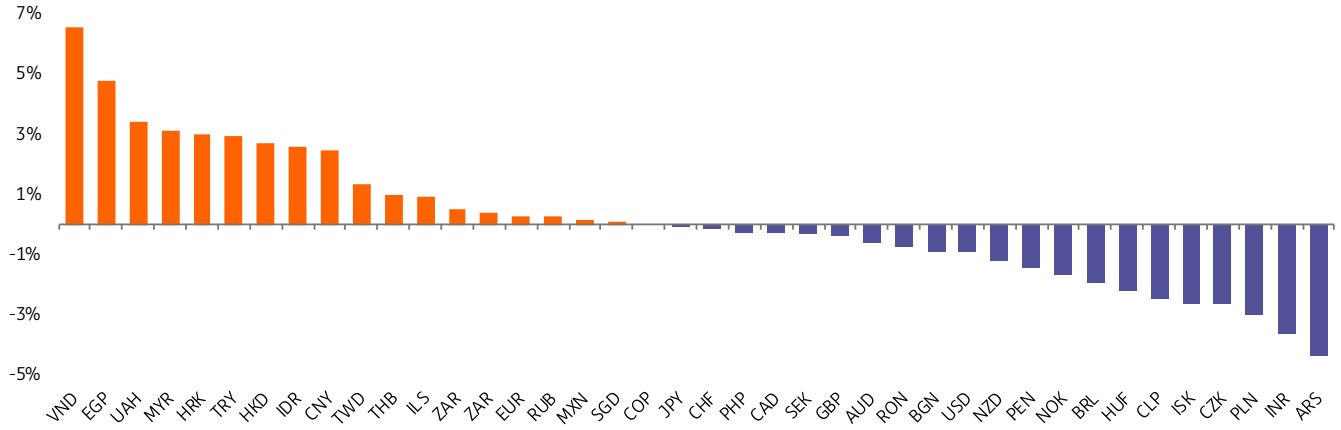
2021: The year of carry

Some estimates suggest central bank asset purchases will amount to US$6tr this year. As increasingly negative real US interest rates drive investors out of the dollar, we expect increasing focus on the carry trade, ie, searching for yield on the assumption that nominal exchange rates do not depreciate as much as priced into the forwards.

That trend should be accompanied by lower levels of FX implied volatility. After all, selling volatility is just another form of the carry trade – such as the growth in Yield Enhanced Structures (YES) during benign economic periods. We know as well that some FX reserve managers seek to improve returns on their low yield reserve portfolios by undertaking short FX volatility structures.

When looking at where the highest real interest rates are on offer (and the implied risks are the greatest), typically the EM currencies stand out. In addition to the high real rates available in Vietnam and Egypt (both countries occasionally prone to large devaluations), the CNY scores surprisingly well here. We would also highlight Asia in general here and one of our favourite nominal low-yielders, the ILS, which always performs well in a dollar bear trend.

Fig 5 Real interest rates across the FX landscape (policy rate minus latest YoY headline inflation)



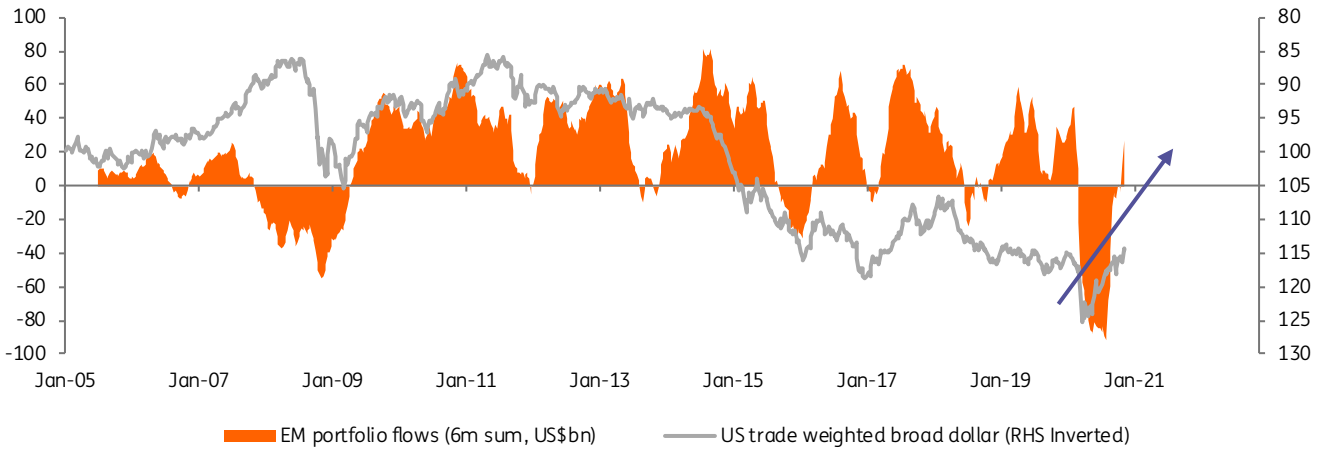
Source: Bloomberg Finance L.P., ING

2021: A banner year for flows to EM

Emerging markets will clearly have their challenges in 2021 as they deal with the fiscal fall-out of Covid-19 in particular. But our point here is this: instead of competing with developed markets for scarce liquidity, very loose US monetary policy means that investors will be actively seeking out higher yield emerging markets and are being encouraged to take more risk.

Despite the recent return of flows to emerging markets, IIF data to mid-November suggests year-to-date EM portfolio flows are still down US$73bn. The recent return to EM is just the beginning, in our opinion. Such a migration into EM has typically been associated with a weaker dollar and may well be one of the factors that drives EUR/USD higher in 2021, ie, dollar selling from portfolios being put back to work in emerging markets trumps fresh money-printing from the ECB.

Fig 6 Just the beginning: Portfolio flows return to emerging markets



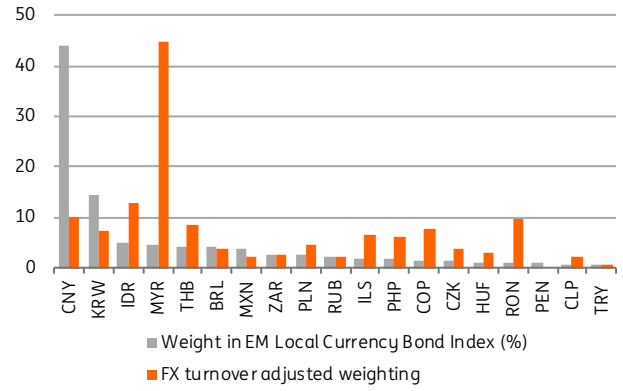
Source: IIF, US Federal Reserve

If indeed investors are to realign their portfolios less conservatively in 2021, which emerging currencies should benefit the most? We discussed the relevance of real interest rates earlier, but also important will be the country weights in some key emerging market bond and equity indices.

In Figures 7 and 8 we highlight the weightings in two key indices: the Bloomberg EM Local Currency bond index and the iShares MSCI EM equity ETF. Both show strong weightings towards north Asian FX and when we adjust those weightings by BIS FX volume data, currencies like MYR, IDR, SAR and ILS stand out too.

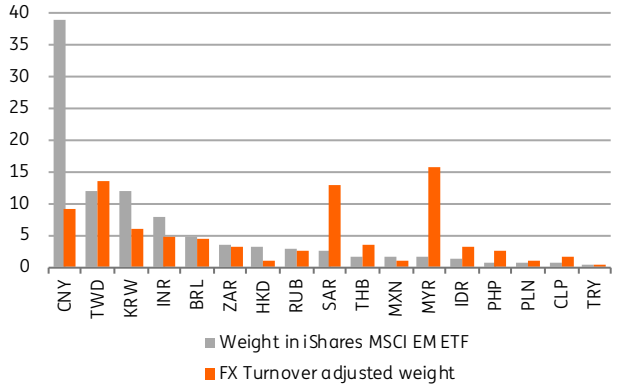
Portfolio flows are one of the reasons why our team see USD/CNY headed down to 6.30 in 2021, taking broad swathes of USD/EM with it.

Fig 7 Weighting in EM local currency bond benchmarks



Source: Bloomberg Finance L.P., BIS, ING calculations

Fig 8 Weighting in EM equity benchmarks

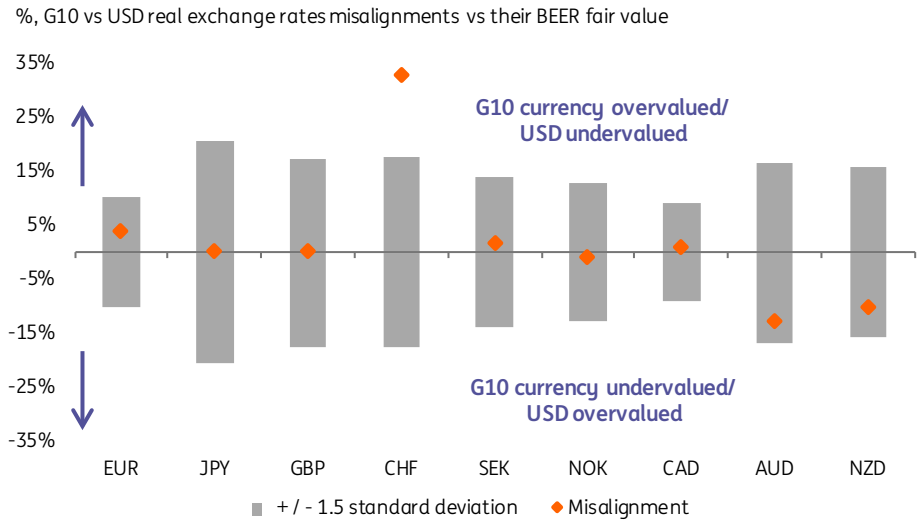


Source: iShares, BIS, ING calculations

Valuation considerations

One final consideration is that of valuation. An update of our G10 Behavioural Equilibrium Exchange Rate (BEER) model shows that the upside of no currency, apart from the structurally overvalued CHF, should be limited against the dollar on valuation grounds. Indeed, the antipodeans still look undervalued.

Fig 9 ING's Behavioural Equilibrium Exchange Rate (BEER) model for G10 currencies



Source: ING

Bringing it all together

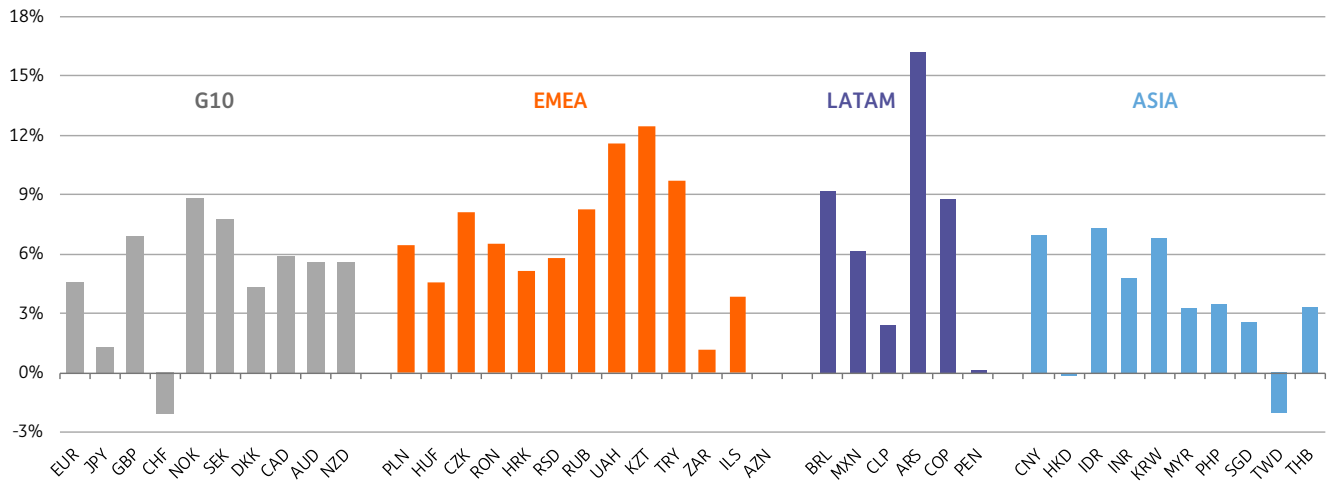
As sell-side FX analysts, one thing we cannot get away from is FX forecasts. We are constantly being asked by corporate treasurers and decision makers as to where we expect currency markets to go and why.

Based on the thoughts we detail above, we expect the dollar to decline across the board in 2021, although we do think that some unwinding of the precautionary CHF buying seen in 2018/19 could see CHF as the weakest liquid currency of 2021.

In practice this means then roughly a 4-5% decline in the Europe-centric DXY in 2021. As we discuss in the dedicated currency sections that follow, this could see NOK outperforming in the G10 space, effectively playing catch-up on 2020 losses.

In the EMEA space, factors such as: (1) being high beta on the EUR/USD rally (CZK) or a recovery backed by high local yields (RUB) could see gains against the forwards of closer to the 8-9% area. BRL is our top pick in the LATAM space, again largely on catch up. And greater FX flexibility allowed by Chinese policymakers and a 6.30 end-year forecast for USD/CNY creates a very positive environment for Asian FX.

Fig 10 ING's forecasts of FX total returns against the dollar, priced off the end year 2021 FX forward market



Source: Bloomberg Finance L.P., ING

Central Bank Digital Currency: A useful tool for unorthodox monetary policy?

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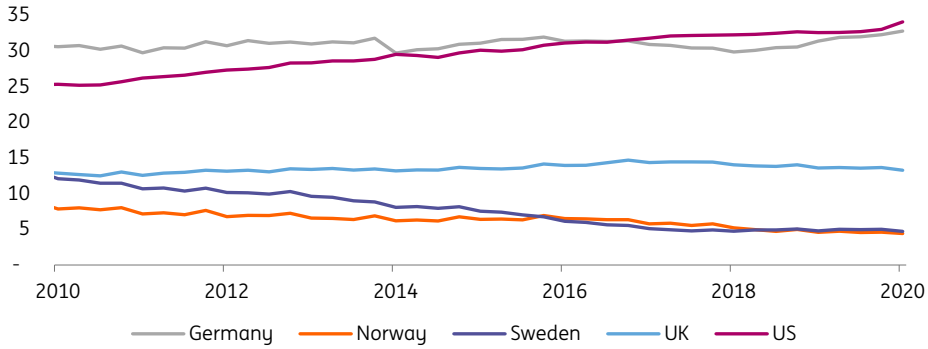
Central Bank Digital Currency (CBDC) has been a key buzzword in 2020 among academics but as we transition towards 2021 the subject will move to a more practical level as more central banks join the debate. In the advanced world, the Swedish Riksbank is by far the central bank that has done most work on the topic, and the ECB is also moving fast. The BIS together with the Riksbank, the Fed, the ECB, the Bank of England, the Bank of Japan, the Bank of Canada and the Swiss National Bank issued a joint report discussing the core features of CBDC. More recently, the People's Bank of China (PBOC) issued 10 million worth of digital yuan for trials testing around the Shenzhen area. Further advancements in the implementation of CBDC are likely to raise questions about the implications for monetary policy and exchange rates.

Fig 11 Currency in circulation as a percentage of national GDP



Source: ING estimates on OECD and national sources data; Macrobond; definitions of currency in circulation may differ slightly from country to country

The case of the ECB is a good paradigm for the discussion. Firstly, the implementation of the Negative Interest Rate Policy (NIRP) could be a lot more impactful, especially if combined with the gradual disappearance of cash and cash equivalents from the economy (Figure 11). For as long as cash and cash equivalents exist, there will always be a "floor" to how low negative interest rates can go. Secondly, if retail customers could open accounts at the ECB, the transmission channel to the economy for policies such as helicopter money could potentially be more effective. However, there is great concern about financial stability considerations and financial disintermediation risks. ECB Executive Board Member, Fabio Panetta, addressed this point in a speech at the EU Parliament, saying that one solution could be to implement a two-tiered remuneration system for CBDC and have a zero interest rate CBDC for tier 1 digital euro holders (for payment purposes) and a negative interest rate CBDC for tier 2 digital euro holders (mainly for store of value). This two-tiered option would allow central banks to conduct their monetary policy as before while avoiding financial disintermediation and would discourage the accumulation of large amounts of digital euro for investment purposes (given the negative return for tier 2 CBDC).

> *"CBDC could be built so as not to tamper with the policy direction or stability of the financial system"*

For now, it is hard to predict the impact of CDBC on exchange rates. What we saw from the ECB example could, however, be a framework for other central banks: CBDC can help implement monetary policy, but would be built so as not to tamper with the overall policy direction or stability of the financial system. Should this be the path for CBDC in the future, the implications for exchange rates could be contained, especially for currencies of advanced economies, for which the flow of remittances and other retail payments has a negligible impact. The repercussions of issuing CBDC could be more profound for smaller and highly dollarized EM economies (for instance, Ukraine).

USD: Stars align for 2021 bear trend

- **2020 taught us that the financial system is still very dependent on USD funding. Calmer conditions in 2021 should see precautionary USD purchases unwound.**
- **The regime change at the White House suggests a further reversal of the 2018/19 dollar strength seen under Trump's loose fiscal/tight monetary/protectionist era.**
- **The Fed's shift to average inflation targeting at this early stage in the recovery cycle means: (1) negative real rates; (2) steeper yield curves; and (3) a weaker dollar.**

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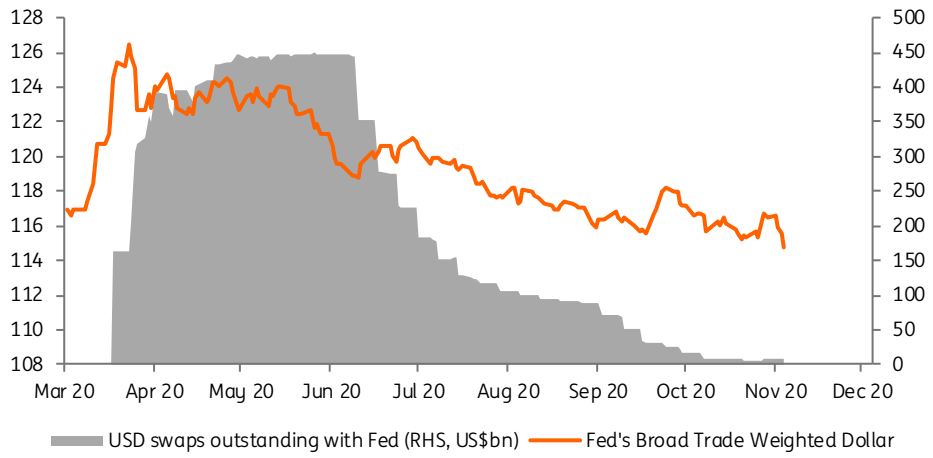
Somewhat astonishingly the broad, trade weighted dollar looks to be ending the year very close to where it started it. This unchanged status masks the wild ride through the year, but we think there are telling lessons from 2020.

The first is that the dollar remains central to the global financial system. The dislocation in USD money markets in March spread havoc across global FX markets. We wrote about this at the peak of the crisis and noted the disorderly moves especially in pairs such as USD/NOK – not normally known for jump risk.

It did take time, but the Fed once again successfully addressed challenges in USD money markets and also circumvented these by re-instituting USD swap lines with central banks around the world as a means to provide quick international access to USD funding. As we noted at the time, the Fed had a successful track record in addressing issues like these and the emergency use of the Fed USD swap lines (around US$450bn at their peak) certainly played a major role in reversing the March spike in the dollar.

Going forward, the Fed is once again asking questions of the US Prime Money Market Funds and how they added to market volatility – potentially meaning fresh regulation and a smaller chance of the events in March 2020 being repeated.

Fig 12 Central bank use of Fed USD swap lines in 2020

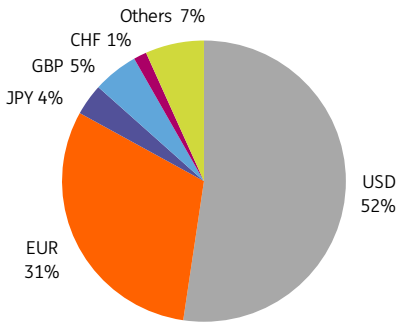


Source: US Federal Reserve

The surge in the dollar in March also serves as a reminder that the dollar is the world's most important funding currency. This means that any return to some semblance of normalcy could lead to pressure on the dollar.

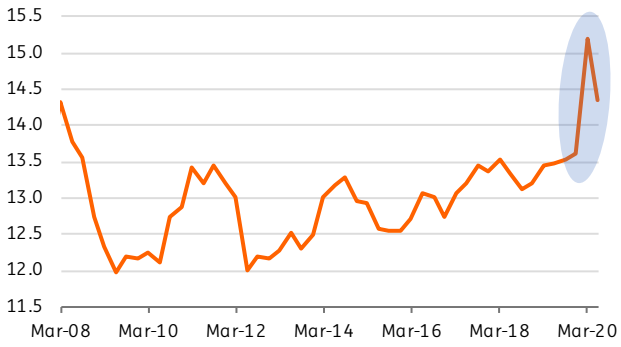
BIS (Bank for International Settlements) statistics provide some insights here. As to the importance of USD deposits in the global finance system, BIS reported USD liabilities (largely deposits) represented 52% of the total in 2Q20. These USD liabilities also surged by US$1.6tr in 1Q20 as the crisis broke. We would expect a further unwind of these precautionary USD holdings in 2021 as investors and corporate treasurers become more confident on a global recovery. This should further add to the dollar bear trend.

Fig 13 BIS reporting bank liabilities by currency (2Q20)



Source: BIS

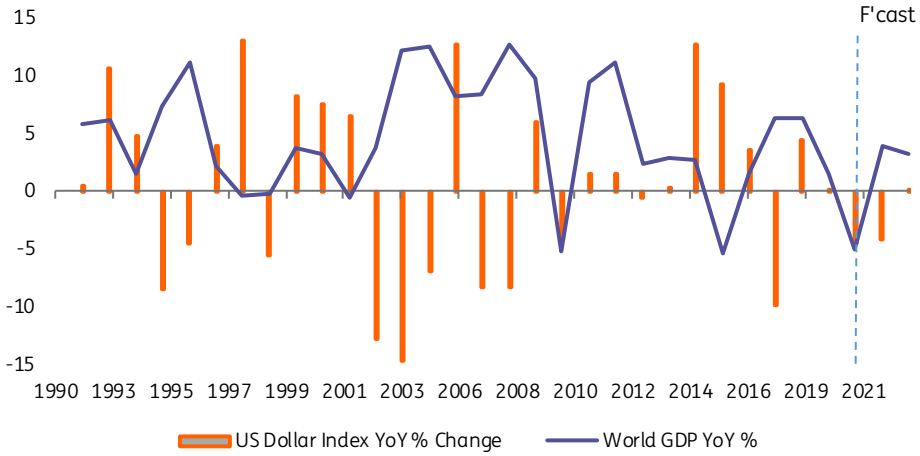
Fig 14 BIS reporting bank liabilities in USD (2Q20, US$tr)



Source: BIS

The unwind of precautionary dollar purchases should very much be driven by the rebound in global activity, which the ING macro team see coming through from 2Q21 onwards. We expect world GDP to rebound from -5% in 2020 to something like 4%+ in 2021. Typically, periods of synchronised global growth, enticing money out of USD deposits, is associated with a broadly weaker dollar.

Fig 15 As world growth recovers, so the dollar should decline (%YoY)



Source: World Bank, US Federal Reserve

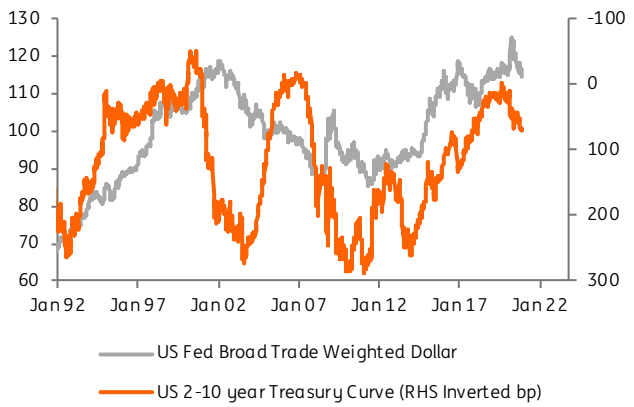
Cementing that trend of money being put to work outside the US should be the regime change at the White House. We think it is important not to over-complicate our understanding of FX trends and, looking back on the Trump Administration and the dollar, we conclude:

- The dollar weakened in 2017 on a quiet White House and Eurozone revival
- The dollar strengthened in 2018/19 once the White House, emboldened by the significant 2017 tax cut, launched protectionism from March 2018 onwards.

That combination of domestic US strength and pressure on trade partners drove a growth and interest rate wedge between the US and the Rest of the World, lifting the dollar. The return to a rules-based system of trade under a Biden administration and perhaps less exceptionalism on the fiscal front, given a divided Congress, clears the path for a dollar decline in 2021.

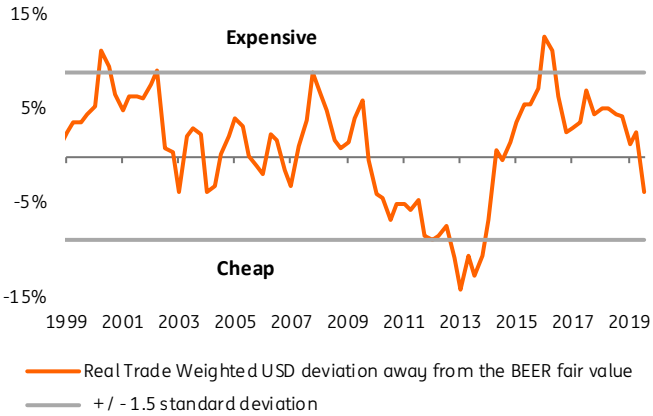
We think this trend of money leaving the dollar and headed into emerging markets would be supported by the appointment of the Fed's Lael Brainard as the next US Treasury Secretary. She would follow a long list of internationalist Democrat Treasury Secretaries (Robert Rubin, Larry Summers, Tim Geithner) who have cut their teeth in the International Affairs department at the US Treasury.

Fig 16 Steeper US yield curve typically means weaker USD



Source: US Federal Reserve, ING

Fig 17 USD: Becoming cheaper on medium term valuation



Source: ING

A less protectionist White House and a recovery in the world economy are two key ingredients in a dollar decline. The third is Fed policy. We think investors were right to take the dollar lower this summer as the Fed switched to Average Inflation Targeting. We think this story has a lot further to run and can dominate markets in 2021.

Most investors believe the global economy is moving out of recession and into an early recovery stage. If Covid-19 can be controlled and policymakers (both with fiscal and monetary controls) can convince the market that the recovery is sustainable, inflation expectations will rise and real interest rates will move deeper into negative territory (see JPY section for more).

Typically, periods of reflation and steeper yield curves have been associated with a weaker dollar. Such a trend will very much depend on: (1) the world economy not slipping back to recession; and (2) the Fed not pre-emptively tightening policy by shrinking its balance sheet too early nor talking rate hikes. Indeed the Fed seem disinclined to pop any asset bubbles with rate hikes – and will leave that to the regulators.

On a valuation basis, using our own Behavioural Equilibrium Exchange Rate (BEER) models, the dollar has plenty of room to depreciate. And these very low US interest rates may align the commercial and policy interests of central bank reserve managers and accelerate the global de-dollarization trend – which stalled in 2020.

In short, the stars look to be aligning for a benign dollar bear trend in 2021.

ING FX forecasts

	Spot	4Q20	1Q21	2Q21	3Q21	4Q21
DXY	92.64	91.10	90.80	89.60	89.00	87.90

De-dollarization: A Russian case study

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Russia has been on the frontline of the de-dollarization efforts for several years, recently supported by China. Over 2014-19, the share of USD dropped by 15-20ppt in Russia's trade and financial flows. In 2020, the push for de-dollarization continued from the top, with the Finance Ministry catching up with the Central Bank on diversification of international assets. However, the politically driven de-dollarization of state assets and foreign debt was a low-hanging fruit. Russian households and corporates need to see a trustworthy alternative to USD before any material de-dollarization of private sector trade and finance can be achieved.

Share of USD in external trade is declining thanks to support from China, and as a result of lower oil prices

Russian external trade has continued to de-dollarize in 2020, in line with 2013-2019 trends, though largely a reflection of lower oil prices putting pressure on USD exports. Russia-China trade is the only area where de-dollarization is more pronounced through a shift in oil contracts from USD to EUR. Since 2019, there have been no new milestones in terms of oil exporters switching from USD to EUR or RMB but given the global trade and foreign policy challenges China is likely to remain Russia's ally in de-dollarization.

Given the weaponization of US dollar, Russia's USD foreign debt is routinely replaced with EUR and RUB, and fiscal savings are likely to diversify from USD soon

Foreign debt continues to be actively de-dollarized, as maturing USD liabilities are being replaced by EUR and RUB. This is seen equally at the corporate and governmental level and is unlikely to be reversed any time soon given the persistent sanctions preventing the largest entities from USD borrowing. Another area of active de-dollarization is the government's savings, for the same reasons. This year, the Finance Ministry swapped a portion of USD collected in 2019 as a part of fiscal rule to purchase SBER from CBR, and called for further dilution of USD, EUR and GBP in favour of gold.

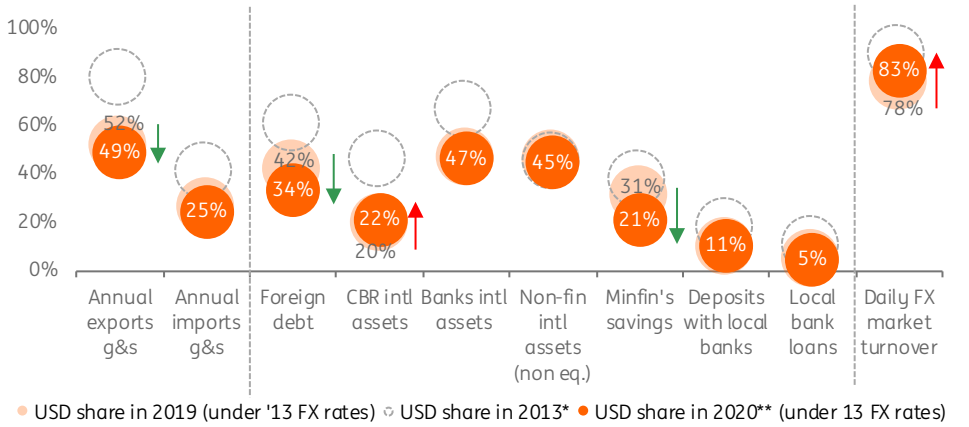
CBR sold off USD in 2018 to reflect sanction risks and growing importance of Russia-China trade relations

Meanwhile, the de-dollarization of CBR reserves stopped as, following the active post-sanction de-dollarization of 2018, the share of USD there is already low, at around 20-25% vs a stable 60% globally. Noteworthy, the share of USD in global SWIFT transactions has remained relatively unchanged at around 40% in recent years, highlighting the USD's stable footing at the international level, so far.

Private sector retains high preference for USD as FX asset despite sanctions and low yield

The area most challenging to de-dollarization in Russia is private assets, as there has been no inclination to decrease USD among banks, non-financial corporates and households. It seems the Russian private sector continues to trust USD and is willing to sacrifice yield and face sanction risk in doing so. As a result, despite the drop in oil exports, the USD trading volumes on the local FX market have even recovered in 2020. Increased trust in the local currency and emergence of a sustainable alternative to USD at a global or regional level remain the pre-requisites for progress in this area.

Fig 18 USD in Russia: evolution as a share, 2013, 2019, and 2020 (net of FX revaluation)



*ING estimates for 2013 intl. assets and 2013-20 local banks' balance sheets; **latest available data for 2020 vary from 1Q20 to 9M20. Source: Bank of Russia, Russian Customs, Finance Ministry, KUAP.RU, ING;

EUR: Not great, but there are worse

- **The EUR's idiosyncratic story isn't appealing, but plenty of bad news is priced in. The soft USD dynamics should dominate. EUR/USD to move to/above 1.25 in 2021.**
- **The EU and ECB steps this year have reduced the odds of a euro risk premia build-up next year. Even if EUR strengthens faster, there is not much the ECB can do.**
- **Against the dollar, the euro should benefit from a post-winter eurozone and global economic recovery, but it should lag European cyclical FX (be it Scandies or CEE).**

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Not an appealing domestic story...

In isolation, EUR does not offer an appealing story. The economy has been hit by the second wave of Covid-19 and related restrictive measures, the feeble growth prospects will last this quarter and next and the eurozone economy may again lag the US growth next year.

The eurozone inflation outlook remains dismal. Headline CPI remains chronically below the 2% target and is currently in negative territory. Realistically, CPI is unlikely to go back to the 2% target over the monetary policy horizon (Figure 19), with the notion of inflation exceeding the 2% level seeming like a utopia at this point (hence the Fed-like adoption of the average inflation targeting by the ECB looks not overly relevant at this point). The weak economy and downside risks to CPI have pushed the ECB into signalling another round of easing in December - we expect an additional €500bn of asset purchases, more favourable TLTROs and possible extension of tiering.

...but the dollar outlook is worse

On the surface, this does not paint an appealing picture for the common currency. But this should not derail the positive EUR/USD outlook simply because the weak USD story is more dominant, in our view (see the USD section). One by-product of the low eurozone CPI (and limited prospects of it rising meaningfully), alongside ECB unwillingness to cut rates further, is a stable eurozone real rate. This contrasts with USD, where real rates should turn more negative (as the economy and CPI recover next year, while the Fed remains behind the curve).

Hoping for a post winter eurozone economic recovery

On the economic side, while the near-term eurozone prospects are not appealing, the expected solid recovery of the eurozone economy after a tough winter (Figure 20) and a subsequent re-rating of the eurozone growth outlook (following the recent de-rating) should be positive for the currency, mainly versus the dollar, where the behind-the-curve Fed will preside over the end of the USD exceptionalism (as higher price pressures won't spillover into the tightening of monetary policy, thus keeping USD soft). Moreover, with eurozone being a large open economy levered to global growth (one of the most open economies in the G10 FX space), the currency should benefit from the recovery in global trade after a tough winter.

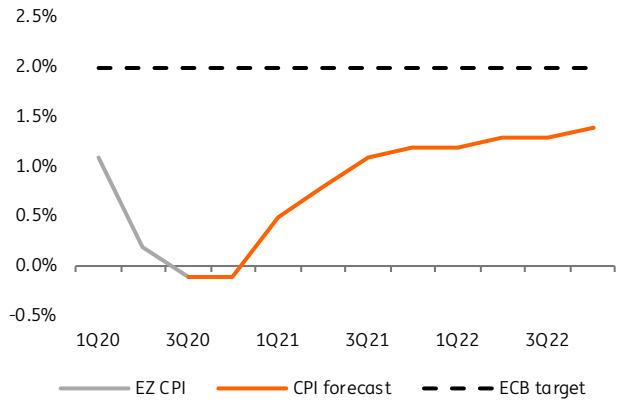
High expectations of December ECB easing in the price

We also expect the upcoming ECB easing to have a limited impact on EUR and EUR/USD. Given the very dovish President Lagarde's bias in the October ECB meeting and the build-up of expectations, it will be difficult for the ECB to exceed already dovish market expectations. Here, the ECB meeting in September 2019 provides a guide, with the ECB not exceeding the high expectations built up prior to the meeting and failing to push EUR/USD lower back then (Figure 21) despite it cutting the depo rate and restarting QE. In the absence of a rate cut or meaningfully large QE (way in excess of €500bn), the impact of the upcoming ECB easing on EUR is likely to be limited.

Difficult for the ECB to lean against the euro strength

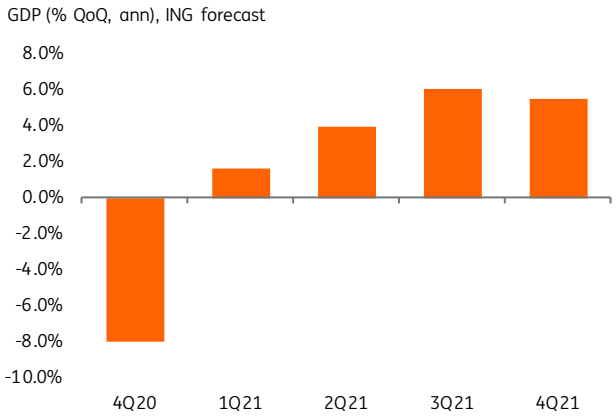
We also don't expect the ECB to be able to prevent a gradual EUR/USD appreciation to/above the 1.25 level next year. As long as it happens gradually and in an orderly way in an environment of improving economic growth outlook, the ECB should look through it. A gradual appreciation would contrast with the sharp rise in EUR/USD (in excess of ten big figures) this summer, which happened over a 3-month period and led to a verbal intervention from the ECB.

Fig 19 EZ CPI unlikely to go back to the target



Source: ING

Fig 20 EZ GDP is to rebound after tough winter months



Source: ING

Even if we see a more pronounced and front-loaded EUR appreciation, it remains to be seen what the ECB can actually do, bar verbal intervention and strengthening of forward guidance (effects of both should be limited as verbal intervention needs to be eventually followed by tangible action, while low odds of ECB policy normalisation at this point provide limited room for a dovish re-pricing in the case of dovish forward guidance). As the QE programme is expected to be extended in December and rate cuts don't seem a preferred option it appears there is not much the ECB can do. With widescale USD weakness in place, it will be difficult for the ECB to tame the EUR/USD upside.

Limited scope for a risk premium build up

We also see limited scope for a build of the euro risk premium related to either existential or fiscal concerns. On the former, and after the initial wobbles from President Lagarde (mainly during the March press conference, which led to a sell-off in peripheral bonds and a rise of the euro risk premium), it is now clear that the ECB under the new leadership is there to provide a back stop (as evident in the powerful PEPP).

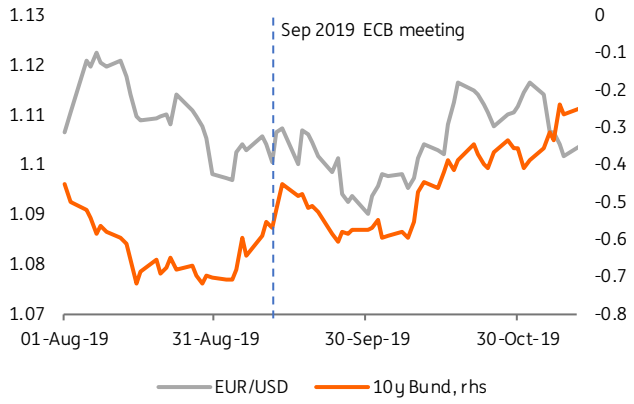
On the latter, the mix of new EU budget and EU recovery fund have put fiscal concerns at bay for now (as the emergence of grants points to solidarity, while the emergence of common bonds points to integration), particularly when more fiscal spending is being called for from and cheered by international institutions such as IMF or OECD and investors themselves. Although the EU budget and EU recovery fund are still in the process of being agreed, we expect a compromise to be found soon.

All this should prevent a re-emergence of the euro risk premium and keep the euro downside limited, leaving the EUR/USD positively exposed to and ready to benefit from the dollar weakness.

Valuation not a hurdle for more euro strength

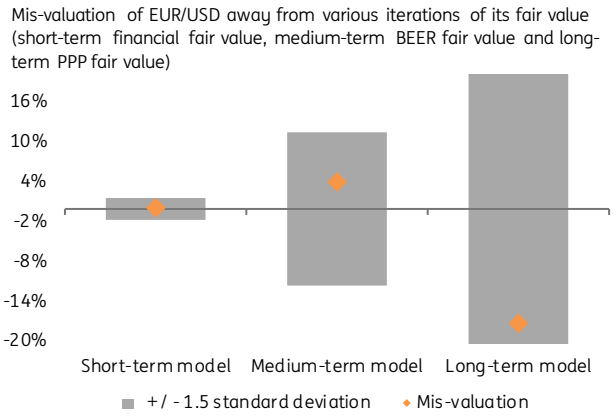
As for valuation, EUR/USD is trading in line with its short-term financial fair value, but the pair has started overshooting our medium-term BEER fair value. As is evident in Figure 22, however, the overshoot is not meaningful and is still comfortably within the 1.5 standard deviation range. This, in turn, allows for further EUR/USD strength before the pair gets stretched on the medium-term basis. In terms of the long-term outlook, the Purchasing Power Parity fair value offers an opposing picture, with the EUR/USD remaining undervalued on a long-term basis. Overall, valuation does not pose an obstacle for further EUR/USD strength, in our view.

Fig 21 Large ECB easing in Sep 2019 did hurt EUR much



Source: ING, Bloomberg Finance L.P.

Fig 22 Valuation is not a constraint for more EUR strength



Source: ING, OECD

Upside against the dollar, but more downside against European currencies

The idiosyncratic factors, on their own, do not point to strong euro dynamics. But the pronounced bearish USD trend should be more than enough to offset the uninspiring euro story and lead to higher EUR/USD. But against the cyclical European currencies, be it Scandinavian or CEE FX, the euro should lag (see Scandie and CEEMEA FX sections).

ING FX forecasts

	Spot	4Q20	1Q21	2Q21	3Q21	4Q21
EUR/USD	1.183	1.20	1.20	1.22	1.23	1.25

JPY: Tolerating 100

- **The broad dollar decline we forecast should not spare USD/JPY. Negative real yields in the US suggests USD/JPY will press and possibly break 100.**
- **Japanese policymakers may be a little more comfortable with these levels than in the past. Trade trends suggest CNY/JPY may be more important than USD/JPY now.**
- **We expect 2021 to be a carry-friendly environment. Typically, that would be a JPY negative. However, USD-funded carry should be the dominant theme for 2021.**

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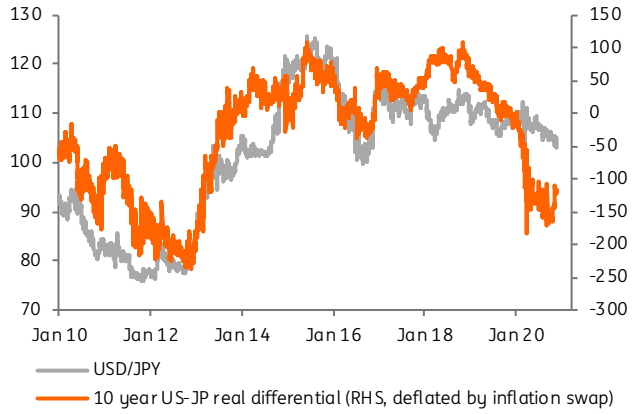
JPY watchers will have noticed a subtle change in JPY pricing around this US election result. In spite of an across-the-board rally on risk assets, USD/JPY still broke lower. In other words, the broad dollar bear-trend trumped the JPY's traditional role as a funding currency.

Driving that story, we believe, is the exodus from conservative investments, largely in USD, towards more attractive returns overseas. The sheer weight of money leaving the dollar is driving this trend on the view that US authorities will be the most successful in reflating their economy and will be rewarded with negative real yields.

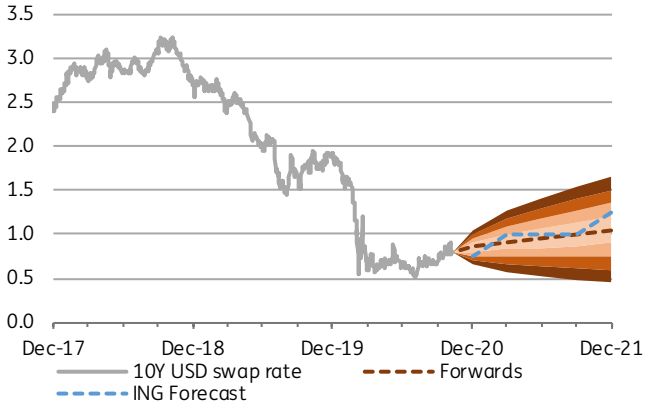
In effect, this has seen USD/JPY play catch-up with the collapse in US real yields since March. In the past, these kinds of real yield differentials have typically been associated with USD/JPY trading below 100.

Fig 23 USD/JPY versus 10-year real UST:JGB differentials



Source: ING

Fig 24 ING's US Treasury 10-year yield outlook



Source: ING Debt Strategy

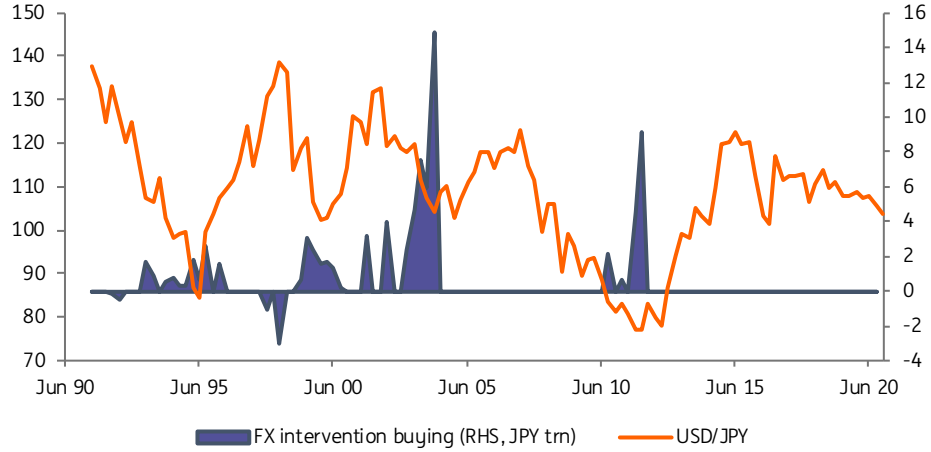
This decline in the attractiveness of US real yields also seems to be playing out in Japanese investment intentions. In March, we made a case that large Japanese asset managers would not find foreign bond markets particularly attractive this year. The weighted yield advantage of foreign bonds (FTSE WGBI ex-JPY) over JGBs has dropped to 40bp currently from 120bp at the start of the year. And Japanese foreign bond buying (looking at the rolling 52-week sum) has fallen about 40% over the past twelve months.

While our Rates Strategy team's outlook is for a modest rise in US Treasury yields into next year, we forecast the rise in nominal yields will not outpace the rise in US inflation

expectations – such that US real yields remain deeply negative and the dollar and Treasuries unattractive.

If USD/JPY is to make a move on 100, FX watchers might ask: 'Will Japan intervene?'. The reality is, however, that the Japanese authorities have not intervened against the JPY since late-2011 – when they had to deal with USD/JPY at 80 after the Great Earthquake.

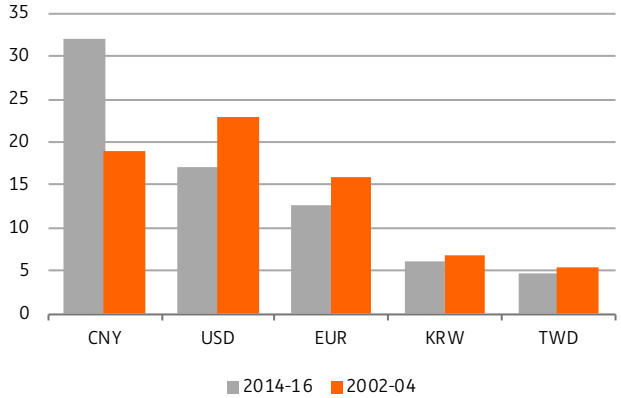
Fig 25 Japanese FX intervention since 1990



Source: Japanese Ministry Of Finance

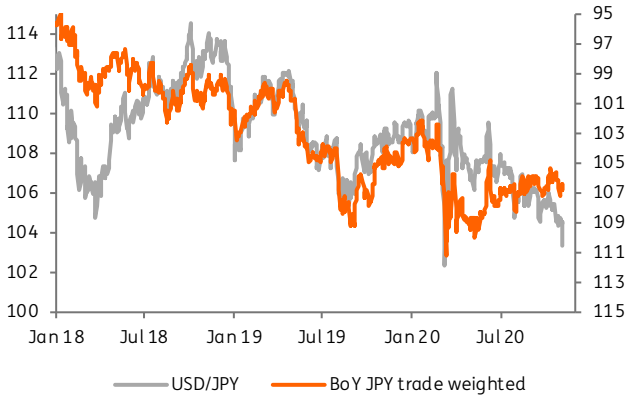
One additional factor we think is relevant to the issue of intervention is Japan's changing trade patterns and the increasing importance of the Renminbi. Below we highlight the change in Japan's trade weights over the past fifteen years (using BIS data). The Renminbi's share in the JPY trade weighted index (TWI) has risen from 19% to 32% in just over a decade.

Fig 26 Japan's trade weights have shifted to the CNY



Source: BIS

Fig 27 JPY strengthens vs USD, but not much against TWI



Source: BIS

That all means that whilst USD/JPY has headed lower recently, the JPY TWI has not moved that much (see Figure 27) since USD/CNY is dropping too. It is probably fair to say that Tokyo is now as interested in CNY/JPY as it is in USD/JPY. If we are right with our forecast of a more liberalised approach to the Renminbi from Beijing and a rebound in world trade sending USD/CNY to 6.30 next year – then a flat CNY/JPY could see USD/JPY briefly trade below 100 – without eliciting the kind of interventionist response normally expected out of Tokyo.

ING FX forecasts

	Spot	4Q20	1Q21	2Q21	3Q21	4Q21
USD/JPY	104.0	102.0	102.0	102.0	102.0	102.0

GBP: Less exciting is good

- **After five turbulent years, 2021 should be a calmer period for GBP, with politics and the UK-EU relationship uncertainty taking a less prominent role.**
- **A soft trade deal should send EUR/GBP to 0.88. Expect only a modest EUR/GBP fall given: (1) limited risk premium priced in; (2) Brexit damage done to the UK economy.**
- **With GBP risk premia reduced in 2021, GBP should enjoy the soft USD environment. GBP/USD to rally to 1.42. And less uncertainty means lower GBP implied volatility.**

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Soft trade deal is our base case

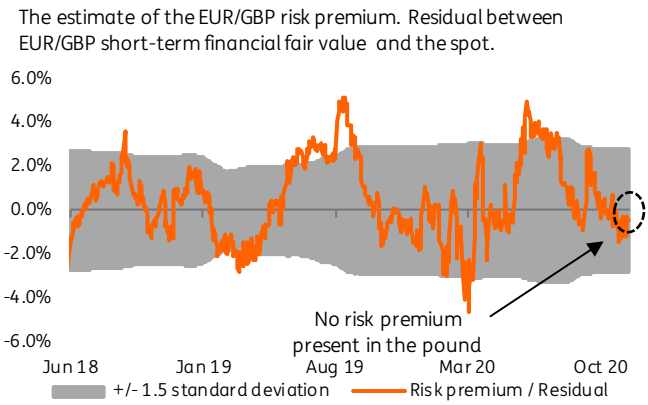
With the UK-EU trade negotiations in the final phase but the outcome not known at the time of the publication, we expect the UK and EU to reach an agreement on a soft trade deal. While soft in nature (focusing mainly on trade rather than services and accompanied by long-term costs associated with leaving the single market and the customs union), it should nonetheless be enough to provide a modest boost to sterling, largely due to the removal of the uncertainty factor – the key element that has been persistently weighing on the currency for the last couple of years.

Equally, the upside to GBP versus EUR should be fairly limited given no risk premium priced in to GBP, as evident in Figure 28. If no risk premium is priced in, the scope for a rally in response to positive news is in turn limited. Hence, we target EUR/GBP at 0.88.

Asymmetric reaction function

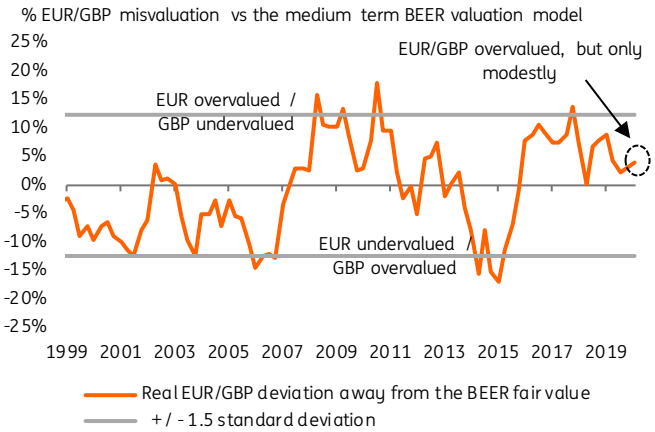
In the case of a no deal (not our base case) we expect a profound GBP collapse - EUR/GBP above 0.95, possibly briefly touching parity – given that such an outcome is not expected, and no risk premia is priced into GBP (Figure 28). This underlines the asymmetric GBP reaction function to the negotiation outcomes – a modest upside in the case of a deal, a profound downside in the case of no deal.

Fig 28 No risk premium priced in limits a scope for rebound



Source: ING

Fig 29 GBP is not undervalued on medium term basis



Source: ING

Medium-term GBP outlook versus EUR not too appealing

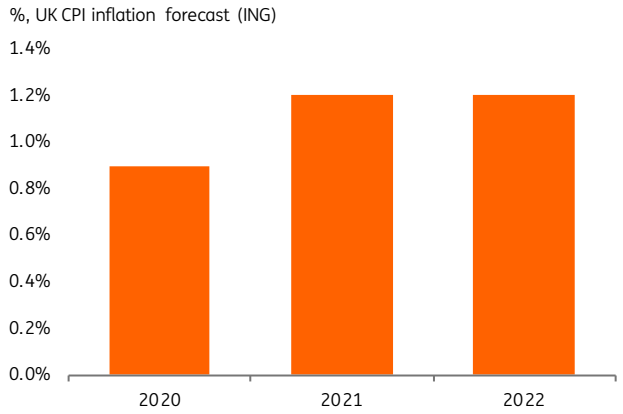
Bar the initial GBP rebound in response to a trade deal, longer lasting GBP strength versus the EUR seems unlikely. The soft nature of the trade agreement (as envisaged in our base case) will cause some permanent damage to the UK economy and will limit its scope for material outperformance, while GBP does not show signs of a meaningful medium-term mis-valuation (based on our BEER model - Figure 29) despite the profound fall in sterling since 2016. The GBP rebound to the EUR/GBP 0.88 level should largely close this current modest valuation gap (which is around 4%), but domestic factors should not push EUR/GBP much below this mark during 2021.

Indeed, with the UK economy set to struggle over the winter months and the BoE unlikely to reverse its accommodative stance (given that inflation is expected to remain below the target next year and in 2022 – Figure 30), the prospects of some permanent and meaningful outperformance versus EUR are remote, in our view. Equally, further easing from the BoE either in the form of more QE or negative interest rate is not our base case given the assumption of the UK-EU trade deal and the economic rebound next year. This further points to a rather flattish EUR/GBP profile.

Politics won't completely go away, but will have a limited impact on GBP

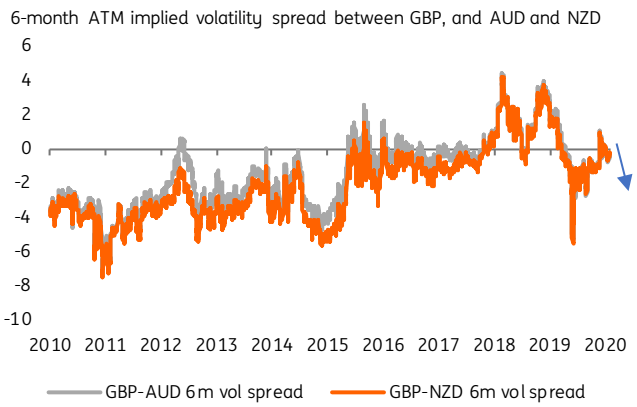
While politics should take a less prominent role in contrast to recent years in terms of the impact on GBP, the Scottish Parliamentary elections in May 2021 and the likely negative newsflow about another Scottish independence referendum shouldn't be overly positive for GBP during 2Q21. However, any negative impact is likely to be only modest given the second Scottish referendum is unlikely for several years to come, with a low probability of it happening before the next UK Parliamentary elections in 2024.

Fig 30 UK inflation to remain persistently below the target



Source: ING

Fig 31 Scope for decline in GBP volatility relative to others



Source: ING, Bloomberg Finance L.P.

GBP gains to be concentrated against USD

Overall, 2021 should be a less exciting year for GBP. This should be perceived as a positive given that recent excitements have been connected with rather negative headline news and uncertainty. From this prospective, less is good for GBP, particularly versus USD, where the compressed sterling risk premia should allow GBP to fully benefit from the weak USD dynamics and a rising EUR/USD. The GBP upside potential should be thus more prominent against USD than against EUR. We expect EUR/GBP to trade broadly flat around 0.88 in 2021 but GBP/USD to rally above 1.40 next year.

GBP implied volatility to decline further in relative terms

With the reduced UK-centric uncertainty in place and less scope for a risk premium build up, GBP implied volatility should also decline. In relative terms, it may not completely return to the pre-Brexit referendum levels, but it should be dipping further. In particular,

we find it unjustified for GBP/USD implied volatility to be on par with AUD and NZD implied volatility. The volatility spread (Figure 31) should continue dipping further.

ING FX forecasts

	Spot	4Q20	1Q21	2Q21	3Q21	4Q21
EUR/GBP	0.895	0.88	0.88	0.88	0.88	0.88
GBP/USD	1.324	1.36	1.36	1.39	1.40	1.42

CNY: PBoC fades out control

- **Exchange rate liberalisation is the key theme in 2021. Recent adjustments in the forward market and to the daily fixing are important steps to loosening control.**
- **China's better position on Covid-19, change in US Administration and stability in monetary policy should prove supportive of the Yuan in 2021.**
- **Together with interest rate liberalisation, the relationship between the exchange rate and monetary policy should become increasingly obvious.**

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The central bank's liberalisation reform is key to the movement of CNY in 2021

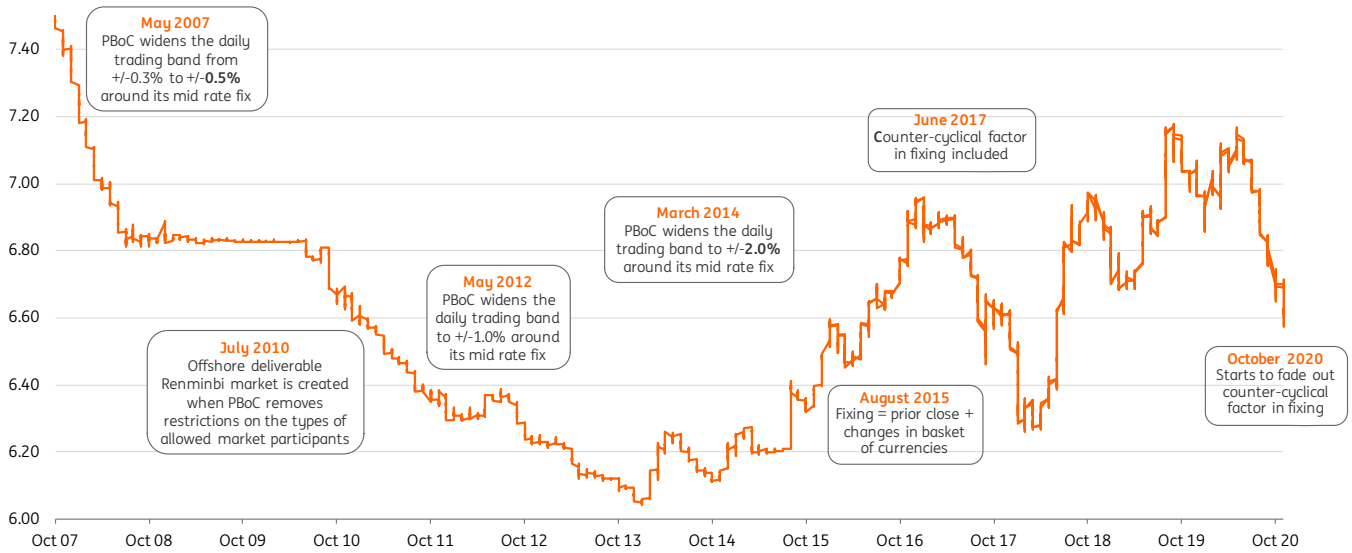
Important developments recently have seen the PBoC removing forward reserve requirements in October 2020 and, in the same month, the central bank announcing the fading out of the counter-cyclical factor used in the USD/CNY daily fixing formula.

The market interpreted the first action as the PBoC wanting to slow the appreciation of the yuan. But it looks like the market misinterpreted this move.

This is reflected by the second adjustment, the fading out of the counter-cyclical factor, which is a mechanism previously used to reduce the volatility of the USD/CNY. The factor is like a reset button that allows the PBoC to make adjustments to the USD/CNY fixing – a manual over-ride if you will. Otherwise, the USD/CNY fixing formula is simply the prior close of USD/CNY and movement of the dollar overnight. That is, without the counter-cyclical factor, the USD/CNY will be a market-oriented fixing, with high transparency.

It seems clear now that these adjustments are a step towards more liberalisation of the FX regime, rather than a means to slow Renminbi appreciation.

Fig 32 USD/CNY reform progress since May 2007



Note: Chart does not include all liberalisation related measures
Source: CEIC, ING

The major factors that could move CNY in 2021

The first factor we consider is a comparison between the Covid-19 situation within China and that outside of China. We view this as a determinant of how well the Chinese economy will perform relative to other major economies. Following China's rapid recovery from Covid-19, ING sees GDP growth at 7% in 2021, versus 1.7% in 2020.

An example is the strong yuan versus the dollar between June and September, the period in which the US presidential election campaign intensified. Yuan's appreciation during these months highlighted the relative strength of the Chinese economy versus the US economy. Effectively the strong Chinese economy positioned the yuan well during a period of uncertainty.

The second factor we believe could impact on CNY is the international trade relationship between China and the US. Though we are uncertain if the change in US government in 2021 will bring about a removal of all the tariffs targeting imports from China, it is at least possible that the trade relationship with the US could improve. The yuan depreciated against the dollar during the trade war under Trump's administration. So, if there is potential for partially reversing these tariffs, the yuan should appreciate against the dollar.

The third factor we see is the technology war. The US's increased restrictions, limiting investment and business activity with Chinese technology companies, is yuan negative. We expect this factor to become more apparent in driving the yuan in 2021 as, unlike the trade relationship where we see scope for improvement, the US technology war will, at best, see no movement and stay in its current form.

"We expect a pause in monetary easing from China"

The fourth factor is monetary policy in China. The PBoC has stopped reducing the loan prime rate since May 2020 and stayed put on RRR (reserve rate requirements) since February. We expect a pause in monetary easing from China.

In short, of these four factors, three would lead to an appreciating yuan while the fourth, an ongoing technology war, could offset any appreciation.

There are other factors to consider, but it is uncertain how they might affect the yuan. For example, Taiwan's relationship with the US under a Biden government might not be as clear-cut as the position taken by Trump on the Taiwan issue. It is as yet unknown if Biden will opt to be less hostile to the Mainland China government.

Another example is whether China can demonstrate it is no longer as concerned as it once was about managing the external value of the yuan to support business investment.

In the past, China has aimed for currency stability, together with a preference for preventing the yuan from becoming overly strong. Now, however, China has a strong domestic economy and does not rely solely on exports but also on imports, and cross border investment flows can therefore be both inbound and outbound. In short, the exchange rate is probably no longer a central determinant of the profitability of China's businesses.

In sum, we expect the CNY trend will be more market-driven, and it is likely that CNY would appreciate against USD strongly in 2021. We expect USD/CNY to reach 6.30 by end of 2021.

ING FX forecasts

	Spot	4Q20	1Q21	2Q21	3Q21	4Q21
USD/CNY	6.58	6.70	6.60	6.50	6.45	6.30

CHF: Tide turning on CHF strength

- **Struggling with deflation at 1.2% YoY and a nominal trade weighted CHF at record highs, the SNB looks unlikely to shift from policy of negative rates and intervention.**
- **To match ECB balance sheet growth in 2021, the SNB may have to intervene to the tune of CHF180-200bn – and risk the wrath of Washington.**
- **The SNB will hope that the return of more benign conditions through 2021 can see some unwinding of precautionary CHF holdings and send EUR/CHF back to 1.15.**

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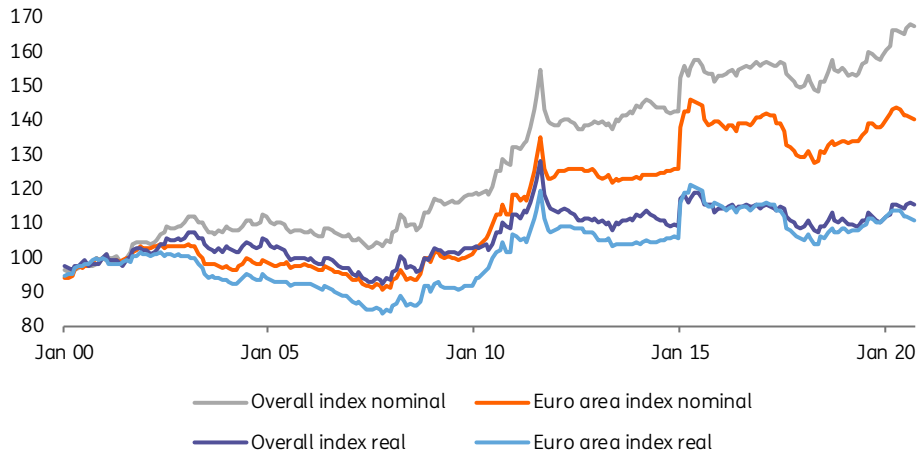
This year's dollar bear trend has posed some additional problems for the SNB. The CHF was already strong against European currencies, but the decline in USD/CHF means that the CHF nominal trade weighted index has pushed ever higher.

The fact that the real trade weighted index (TWI) has not moved much may be of little solace to the SNB. Whilst it may mean the CHF is still competitive in international trade, the reason for the real TWI being so low is Switzerland's deflation. Here CPI is running at around -1.2% YoY currently and is only projected to climb to 0.5% by summer 2023.

Fig 33 Nominal trade weighted CHF continues to push higher



Source: SNB

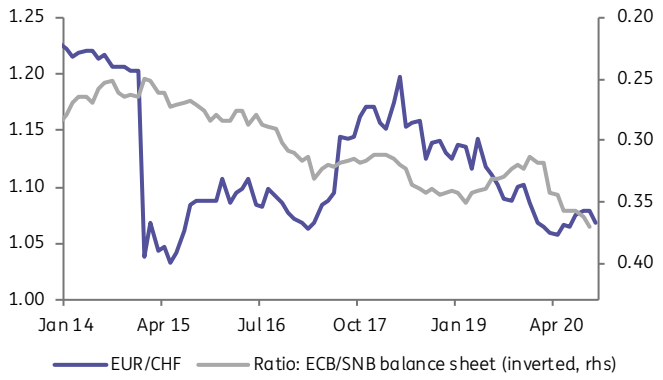
It therefore seems highly unlikely that the SNB is prepared to alter its preferred policy of negative rates (3m SARON at -0.75%) and large-scale FX intervention.

The challenge for the SNB will potentially be the further demands on its FX intervention desk as the ECB fulfils its planned EUR liquidity injections under its PEPP scheme. Here a further €400-500bn is expected from the ECB in December and our Rates Strategy team estimate that will see the ECB's balance sheet grow to 66% of GDP from 59% currently.

That is important since the ECB feel that QE is an effective tool in potentially weakening the EUR. The SNB also implicitly acknowledges the impact of QE on FX rates. After all, when abandoning the 1.20 EUR/CHF floor in January 2015, the SNB blamed the move on the forthcoming wall of EUR liquidity from the ECB's first foray into QE.

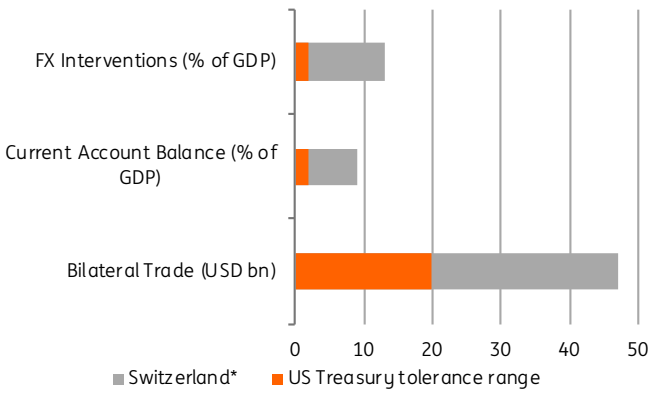
Below we highlight that there does seem to be a loose relationship between relative balance sheet expansion – ECB versus SNB - and EUR/CHF. ECB expansion has outpaced that of the SNB and probably weighed on EUR/CHF. To match the ECB's expansion in 2021, we estimate that the SNB will need to buy around CHF180bn of FX – which is huge.

Fig 34 EUR/CHF versus ECB/SNB balance sheet



Source: ING

Fig 35 Switzerland ticks the manipulator box



*ING estimates using IMF, US Census and SNB data for the period
Source: ING

Continued large FX buying from the SNB will surely see Switzerland fall foul of the US Treasury's three criteria to be designated a currency manipulator. And Switzerland is already on Washington's Monitoring List. So far, however, the SNB is showing no signs of suffering any limitations to its FX intervention.

Given a likely ECB QE top-up in December, likely front-loaded ECB balance sheet expansion and Europe struggling with lockdowns through the winter, we forecast EUR/CHF to stay under pressure over the next three to six months – probably trading well within a 1.05-1.10 range.

Looking further into 2021, however, synchronised global growth and a pickup in world trade volumes could start to take the pressure off EUR/CHF. After all, EUR/CHF was trading close to 1.20 right before President Trump started his trade war with the Rest of the World in March 2018.

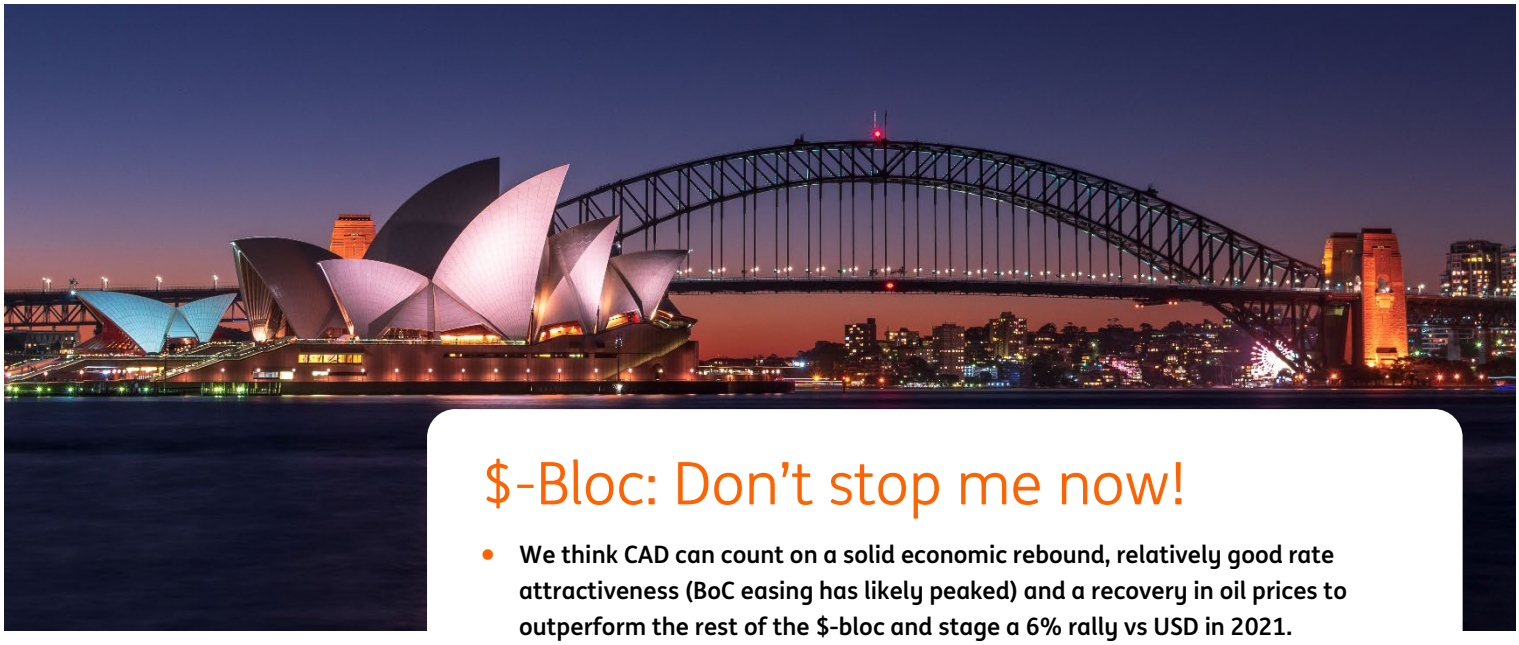
If we are correct with our view that EUR/USD pushes towards the 1.25 area through 2021, EUR/CHF should be able to rotate up to the 1.15 area. Typically, EUR/CHF is indeed positively correlated with EUR/USD trends, although it could be argued that because of Covid-19, EUR/CHF failed to respond to the summer rally in EUR/USD.

A discussion of EUR/CHF must also include a view on European integration and the prospects for another sovereign debt crisis. Fortunately, it seems European policymakers have learned their lessons from the 2008/09 Global Financial Crisis and have:
(1) impressed with a EUR1.8tr EU Recovery Fund substantially benefitting southern Europe; and (2) carried out aggressive and front-loaded buying of peripheral Eurozone debt under PEPP.

Adding to the view that EZ peripheral debt will not pressure EUR/CHF is the Italian political calendar. 3 August 2021 marks the start of the last six months of tenure of the Italian President. During this period the President is constitutionally inhibited from dissolving the parliament. We think it unlikely that members of the current PD-5SM coalition would want early elections in 1H21, possibly missing out on the political benefits – an 'electoral shield' – of EU money in 2H21.

ING FX forecasts

	Spot	4Q20	1Q21	2Q21	3Q21	4Q21
EUR/CHF	1.08	1.08	1.08	1.10	1.12	1.15



$-Bloc: Don't stop me now!

- **We think CAD can count on a solid economic rebound, relatively good rate attractiveness (BoC easing has likely peaked) and a recovery in oil prices to outperform the rest of the $-bloc and stage a 6% rally vs USD in 2021.**
- **The highly undervalued AUD should keep benefitting from the global reflation story and extend its run into 2021, but it is facing severe downside risks from trade tension with China and a possible fall in iron ore prices.**
- **NZD is also facing large undervaluation and should remain on an appreciating path in 2021 as global recovery progresses. The RBNZ, and its aversion to a strong NZD, remains the key risk to the outlook, but we expect no more rate cuts.**

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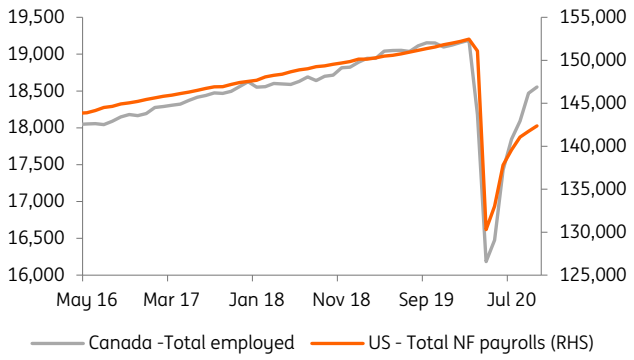
If 2021 is to be about reflation trades, the high-beta CAD, AUD and NZD look set to stay on an appreciating trend. AUD and NZD staged greater gains this year as risk appetite rebound from the March lows and still offer an attractive valuation profile, however, we think: (1) the real rate advantage; (2) better commodity outlook; (3) low exposure to geopolitical and trade tensions; and (4) lower chances of further monetary easing all suggest CAD is a safer bet than the antipodeans in 2021.

CAD: Solid fundamentals, oil remains key uncertainty

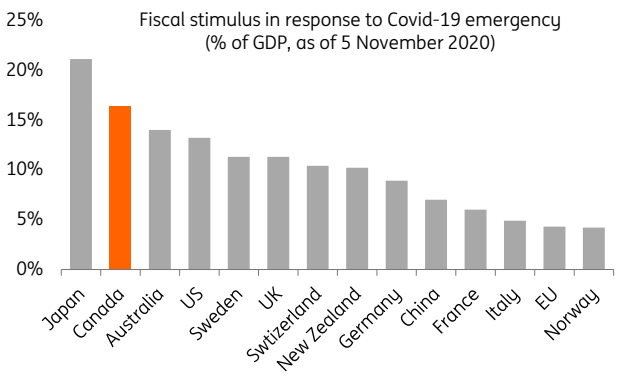
As we approach the new year, we think a decently paced domestic economic recovery in Canada will continue to provide a floor to CAD. The Bank of Canada (BoC) has recently revised its projections for the slump in activity in 2020 from -6.8% to -4.3%, and the jobs market (Figure 36) appears to be recovering at an even faster pace than in the US.

Fig 36 Canadian jobs market rapidly returning to pre-Covid-19 levels (000)



Source: Bloomberg Finance L.P., ING

Fig 37 Canada has been aggressive on the fiscal stimulus side compared with other major economies



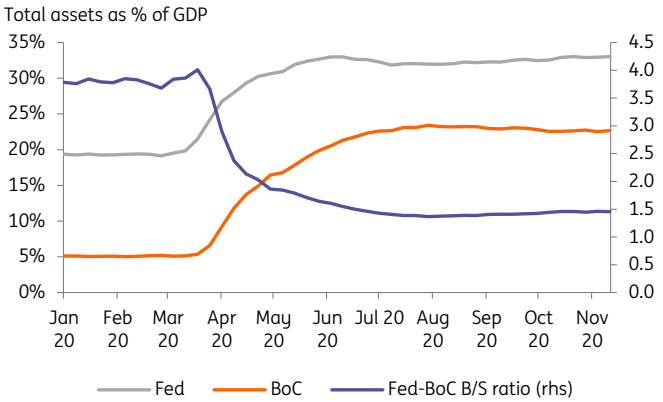
Source: IMF, ING

We see no reason at this stage to expect the recovery to lose steam into 2021. The Trudeau administration – despite navigating uncertain waters on the back of political scandals – has deployed one of the largest fiscal support packages in the developed world, worth more than 16% of GDP (Figure 37). Simultaneously, the BoC is offering a large amount of stimulus and should allow the government to expand its deficit without

triggering more debt-related concerns (Canada was downgraded to AA+ by Fitch in June) considering low yields will stay in place for longer and the Bank has now started to buy longer-dated government bonds. On the epidemic side, Canada is seeing a less concerning second wave and hasn't enforced fresh lockdowns for now, which also bodes well for the economic recovery. Still, concerns around the export sector remain quite strong. Exports make up 32% of the GDP, which suggests a slower recovery than in other less trade-dependent economies (see Figure 44 below). A normalisation of crude prices has provided a breather to Canadian oil producers, but the energy sector is struggling significantly to recover from the pandemic hit and fresh containment measures worldwide indicate global trade is going to face more turbulent times. One positive sign when it comes to exports is the expected normalisation in geopolitical relations across the globe as current US President-elect Joe Biden takes office in January. Being so exposed to global trade dynamics, the unwinding of President Trump's protectionist agenda (which has included tariffs on Canadian aluminium for some time) surely bodes well for Canada.

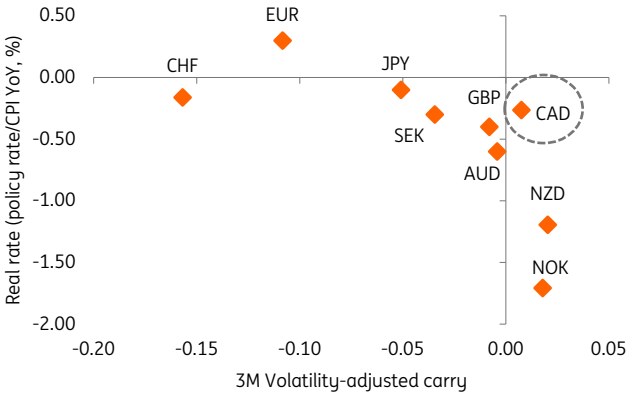
As highlighted in the introduction of our FX outlook, the concept of real rates could be central in driving reflation trades in 2021. In essence, this means formulating expectations around both monetary policy and inflation. The Bank of Canada reacted to the pandemic with rate cuts and extensive QE, expanding its balance sheet from 5% to 20% of GDP. To provide an idea of the scale of the BoC's QE, the Fed-BoC balance sheet ratio (as a percentage of GDP) dropped from 4 to 1.5 this year (Figure 38).

Fig 38 An aggressive balance-sheet expansion by the BoC



Source: Statistics Canada, ING

Fig 39 CAD offers good risk-ajusted carry and real rate



Source: Bank of Canada, Bloomberg Finance L.P., ING

With global and domestic conditions improving, the BoC has started to reduce its balance sheet expansion and at the latest policy meeting (28 October) the Bank announced a reduction of the minimum amount of weekly asset purchases from C$5bn to C$4bn. At this stage, we see the amount of stimulus provided as sufficient to assist the recovery and see no indication – from economic/financial indicators and from the BoC language – that the BoC will have to do more in the foreseeable future. The BoC provided some forward guidance by explicitly forecasting rates to stay at the lower bound (0.25%) until 2023, when inflation is set to recover in the Bank's projections. While negative rates are a common consideration for policymakers in recent times, we think the likelihood of the BoC cutting rates again is very low. More QE also does not seem likely if global conditions improve (as we expect) in 2021 and we may actually see the bank unwinding its asset purchases further.

In terms of the inflation outlook, we are in line with the Bank of Canada's projections and expect the rebound of CPI in 2021 to fall short of the 2% BoC inflation target. This would allow the Bank to keep providing the monetary stimulus to the recovery while staying consistent with its inflation-oriented objectives. From a currency perspective, this may

actually prove to be a positive for CAD as it would put a floor below real interest rates. In the G10 space, only Canada, the US and New Zealand have a 0.25% policy rate: of those three, Canada is the one with the lowest inflation profile and thus offering the most appealing real rate profile, especially considering that the Fed allows inflation overshooting and inflation has held up relatively well in New Zealand (1.4% vs 0.5% in Canada). From a carry perspective, CAD is one of the three G10 currencies (with NOK and NZD) that offers a positive carry when taking the 3M implied yield as a reference. When adjusting for implied volatility, the carry attractiveness of CAD is very close to those of NZD and NOK, but CAD retains a better real rate thanks to lower inflation, as shown in Figure 39.

If the set of fundamentals plays in CAD's favour in 2021, we suspect a significant recovery in oil prices is a prerequisite for CAD to stage a strong rally. Our commodities team (see 2021 *commodities outlook Special Feature*, page 36) expect oil prices to stay on a uptrend in 2021, with WTI averaging at US$53/bbl and reach US$58/bbl by year-end. Still, we highlight how delays in the vaccine roll-out, new restrictions and a lack of OPEC+ support on the supply side are all material risks to a bullish oil outlook. The Western Canada Select (WCS) proved less volatile than WTI during the pandemic but the WCS-WTI spread is currently around multiyear highs and may start to tighten in 2021.

With all the other pieces of the puzzle in place for a CAD rally in 2021, oil may the biggest element of uncertainty. Still, in line with our bearish outlook on the US dollar and our general reflation story, and considering the lingering attractiveness of CAD from a rate-advantage perspective and its undemanding valuation in the medium term (refer to Figure 9), we see USD/CAD drift lower by approximately 6% in 2021 and reach 1.23 in 4Q21. In addition, CAD could also benefit from some short-squeezing effect as it remains the only G10 currency holding a net-short position vs USD.

AUD: All about the love-hate relationship with China

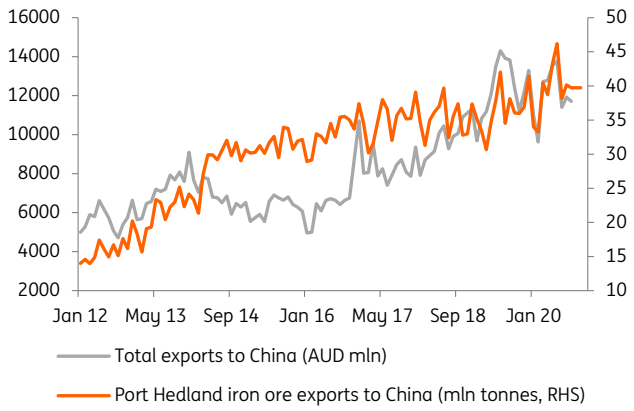
This year, AUD has been the perfect testament to inflated risk assets and a market's aggressive frontloading of the global economic recovery. So, what lies ahead for AUD in 2021 as the recovery is set to finally unfold? The answer is highly conditional – even more so than usual with activity currencies – on non-domestic factors.

Australia has entered its first recession in almost 30 years, but the slump in activity in 2Q20 (-6.3% YoY) has been markedly less severe than for most developed countries and close peers such as New Zealand. In the third quarter, a resurgence in Covid-19 cases forced a long lockdown in the state of Victoria, which put a curb on the ability to recover in late summer, when many developed economies in the northern hemisphere enjoyed looser restrictions. We estimate GDP to have contracted by 4.4% YoY in 3Q. This still keeps the economic fallout from the pandemic as largely less severe in Australia compared to most developed economies. The epidemic numbers in Australia, even at their summer peaks, were significantly lower than those recorded in Europe or the US, and if the summer months proved to be beneficial for lowering contagion in the northern hemisphere, we can expect the Australian summer to pair with geographical factors and strict border rules to keep Australia a near virus-free oasis. Accordingly, the outlook for a recovery in consumption and domestic activity looks quite encouraging, especially when combined with the Australian government's stretch from its public finance rigor – fiscal stimulus worth 14% has already been deployed (Figure 37). As in Canada's case, the support from the central bank through large bond purchases along the curve is set to open a significant amount of room for the government to widen its deficit as it can issue debt at low rates.

Still, exports are still a big question mark. What is sure is that tourism and education exports (which made up around 3.1% and 2.7% of GDP in 2019, respectively) are not set to recover any time soon. When it comes to the commodity side – the core of Australian

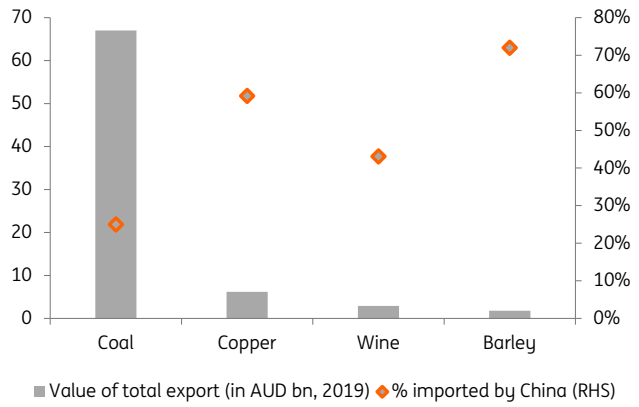
exports – the "China factor" (the key external factor we mention above) comes into play. China is the destination for nearly 40% of total Australian exports, and the unexpected resilience of Chinese demand this year (Figure 40) constituted a significant buffer to the economic fallout of the pandemic. In particular, China continued to heavily purchase iron ore (Australia's biggest export), which incidentally saw a surge in prices. This benign combination for Australian exporters is facing a two-fold risk as we approach the new year: trade tensions with China and a possible fall in iron ore prices.

Fig 40 No slump in Australian exports to China



Source: Bloomberg Finance L.P., ING

Fig 41 Coal the largest industry at risk from Chinese duties



Source: Australian Bureau of Statistics, ING

Diplomatic tensions between Beijing and Canberra erupted this year after Australia joined other countries in requesting an independent inquiry into China's handling of Covid-19 at the early stages. Since then, relations between the two countries have been on a slippery slope and soon involved trade. China imposed duties on Australian barley in September and has taken steps to ban or reduce imports of Australian coal, copper, wine, sugar, timber, cotton, beef and lobster in the past few weeks. In Figure 41 we look at how much some of these products count for Australia's exporting machine. The biggest risk at this stage is that Beijing doubles down on this trade spat and includes iron ore and LNG in its protectionist plans, along with possibly hitting two key Australian exported services – education and tourism – where China is the biggest user. So far, AUD has retained a fairly complacent stance to Sino-Australian tensions and a diplomatic solution still looks to be materially possibly. But we must note that the potential downside risk for the Australian economy and AUD from a further escalation is very significant. Should a fully-fledged trade war between China and Australia be averted (as we are inclined to think), the overall easing of geopolitical tensions and, in particular, an improved US-China relationship under a Biden presidency, should remove a key factor of uncertainty from the AUD outlook – which partly explained AUD's extraordinary post-US election rally.

Turning to iron ore prices, the outlook looks rather grim (we discuss in detail in our *Commodities Special Feature* section). Iron ore demand from China appears, in fact, to have peaked thanks to the post-pandemic government-led stimulus, as signalled by rising inventories at ports. To see iron ore prices stay at 2020 levels, we would probably need to see further supply disruptions. Otherwise, according to our commodities' team forecasts, we could see prices fall decisively below the US$100/tn mark and to the US$75/tn area towards the end of the year. Other exports, like coal, LNG, copper and gold, are less likely to face equally strong selling pressures, but that would not compensate for the loss of profit for Australian exporters if iron ore prices stumble.

With regards to the monetary policy factor, the Reserve Bank of Australia's extra-accommodative stance is set to put up some obstacles to further AUD rallies, but will

equally not be enough to generate sustained depreciating pressure if the global risk backdrop remains supportive, in our view. The reason it may limit further AUD upside stems from the latest policy measures introduced by the Bank at its November meeting. With the cut of the Cash Rate and 3Y yield target to 0.10%, the RBA eroded some of the AUD rate advantage and – as shown in Figure 39 – AUD is the only G10 commodity currency currently offering a negative carry on the 3M tenor. Incidentally, the introduction of a volume target for QE (A$100bn over six months) and extension of purchases along the curve pose the risk of a lower yield curve than improving global conditions would warrant, which is undoubtably a negative factor for the currency. The reasons we doubt the RBA will be able to effectively dampen the Aussie dollar are: (1) we think the RBA has fired its last bullets, and will not add or credibly signal more stimulus; (2) part of the QE effect has already been priced in; (3) Australian yields' high sensitivity to global factors and UST (US 10yr Treasuries) makes it hard for the RBA to control the long-end.

Governor Lowe has been quite clear in ruling out negative rates - despite market expectations in this sense having risen quite significantly in recent times – and in a recent speech, Deputy Governor Debelle suggested FX interventions may be a more viable option instead. This denotes how the RBA monetary policy has been taking the currency impact into serious consideration in recent months. For now, the extraordinary policy measures should partly limit the AUD upside and we think the RBA may call it a success if AUD/USD doesn't trade above 0.77 for most of 2021 (as in our forecasts) in a globally risk-prone environment, with little need for extreme measures like FX interventions or negative rates.

After all, the Aussie dollar is the most undervalued currency in the G10 according to our BEER valuation (refer to Figure 9). We think this warrants a profile for AUD/USD (considering we retain a bearish view on USD) that is still upward-sloping in 2021. The factors mentioned above - an aggressive RBA with a rapidly expanding balance sheet, a slow recovery in exports, potential further escalation in tensions with China, a grim outlook for iron ore prices – are all suggesting the headwinds for AUD will not be scarce in 2021, and we therefore expect the undervaluation of AUD to remain in place while AUD/USD could gain some 5% into year-end 2021 and approach the 0.77 region.

NZD: Calling the RBNZ bluff

New Zealand stood out in 2020 as a successful case of tackling the Covid-19 pandemic, although this has come at a cost: very strict border controls left no room for an even short-term rebound in the lucrative tourism industry and strict lockdowns in Auckland (which accounts for around a third of national GDP) put a curb on economic recovery. When looking ahead, however, and with the same seasonal and geographical considerations we make for Australia, New Zealand is enjoying a desirable combination of loose containment measures (Figure 42) and near-zero daily infections.

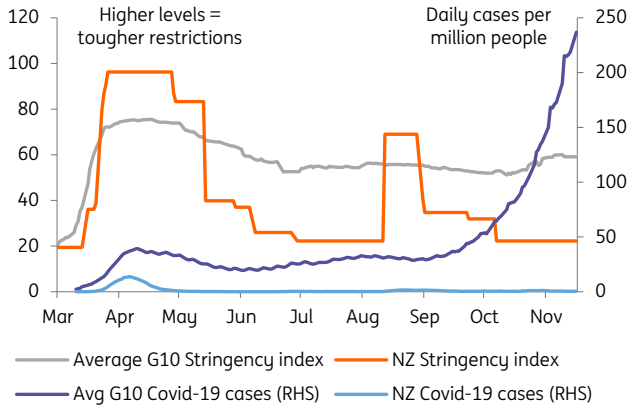
In terms of hard economic data, New Zealand offers a very mixed picture. The slump in 2Q activity (-12.4% YoY) was double that recorded in Australia and one of largest in the developed world (the average for OECD countries was -10.6%). Still, the extensive jobs support schemes have put a cap to the unemployment rate, which rose to only 5.3% in 3Q after surprisingly edging lower in 2Q. For comparison, the OECD total unemployment rate peaked at 3% above its pre-pandemic levels in 2Q and was at 7.60% in 3Q. The Reserve Bank of New Zealand (RBNZ) projects the peak of unemployment to be at 6.2%.

As in many of the developed economies, the New Zealand government has deployed substantial fiscal stimulus, with a package worth 19.5% of GDP through to FY2023-24 and a policy response to the virus of around 11.3% of GDP. As highlighted for Canada and Australia, the same is true for New Zealand: while we see reason to think domestic consumption will recover at a good pace, the export sector is set to face longer term

headwinds. New Zealand's fully closed borders bode ill for any revamp in the tourist sector that accounts for 5.8% of GDP directly and a further 4.3% indirectly. However, prices on key exported products - dairy, meat and forestry – may fare fairly well into 2021 if global reflation unfolds and with circumstances differing from the case of iron ore for Australia.

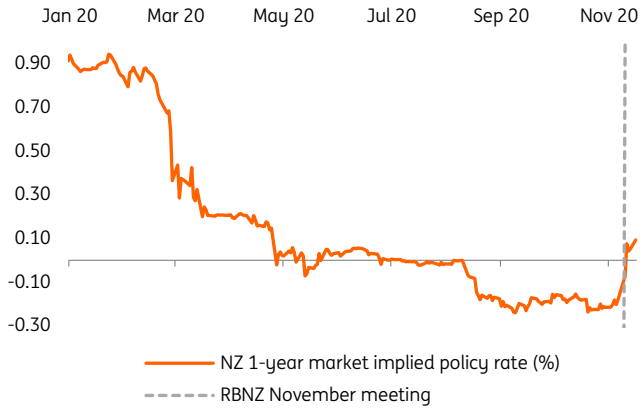
The RBNZ has proven to be a curbing factor for NZD amid the widespread pro-cyclical rally across G10 countries. The Bank's stimulus includes an asset purchase programme worth up to NZ$100bn and a pledge not to hike rates in the foreseeable future. However, the Bank has been flirting with the possibility of negative rates for several months, explicitly suggesting that negative rates (NIPR) were part of the toolkit and were under serious consideration. After markets had largely priced in a move to negative rates in 1H21, the RBNZ switched to a less dovish tone in November. Despite deploying the Funding for Lending scheme (cheap loans for banks, seen as anticipating a move to negative rates), the projections around a less pronounced slump in activity and employment in 2021 prompted markets to reconsider the expectations around negative rates. We have long been reluctant to forecast NIPR in New Zealand, and the recent hawkish shift by the RBNZ further convinced us 0.25% should remain the policy rate throughout 2021. At the same time, we cannot ignore that preparations for a jump into negative rates have been made and we don't claim this scenario has been completely ruled out by the RBNZ. In other words, NZD remains the commodity currency that has the higher probability of facing negative rates in 2021, and therefore the one that is bearing the biggest deal of monetary-policy-related downside risk.

Fig 42 Low restrictions and low contagion in New Zealand



Source: Bloomberg Finance L.P., ING

Fig 43 Negative rate expectations fading



Source: Bloomberg Finance L.P., ING

We don't exclude the possibility that the RBNZ will deliver more stimulus ahead, possibly adjusting and expanding its QE. This may happen not only in the case of a material further deterioration in the economic outlook (as mentioned above, not our base case), but may be simply driven by the Bank's aversion to a strong NZD. For now, the RBNZ has highlighted that the currency is hindering the recovery in exports, but should NZD rally much further, we would not be surprised if the RBNZ switched to a tougher stance. This could equate to further QE (the most likely in our view) and possibly a switch to yield curve control (YCC), a revamp of the threat of negative rates (although the credibility risk may start to become an issue here) but also an introduction of the theme of FX interventions. We discuss a scenario in which the RBNZ starts Swiss-style FX interventions in this article (*RBNZ emulating the SNB? The risk could be an antipodean currency war*, 17 August 2020) and noted that this might imply the purchase of large amounts of AUD if the purpose is to drive down the effective (or trade-weighted) NZD exchange rate. The risk of an adverse reaction from the RBA and an antipodean "currency war" may be enough of a deterrent.

We think more RBNZ action is the biggest source of downside risk for NZD into 2021, but at the same time we forecast that the Bank will not deliver on its threats when it comes to negative rates and FX intervention discussions may not be triggered at low-0.70 levels of NZD/USD. Along with a benign risk sentiment, NZD can count on medium-term undervaluation (Figure 9) and a decent risk-adjusted carry (Figure 39) to support its appreciating path next year. We target 0.73 for NZD/USD in 4Q21 and expect AUD/NZD to stay in the 1.05-1.07 range for most of the year, targeting 1.05 in 4Q21.

ING FX forecasts

	Spot	4Q20	1Q21	2Q21	3Q21	4Q21
USD/CAD	1.310	1.30	1.27	1.25	1.24	1.23
AUD/USD	0.726	0.73	0.75	0.76	0.76	0.77
NZD/USD	0.689	0.68	0.70	0.72	0.72	0.73

2021 commodities outlook

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Covid-19 has dictated price action across the commodities complex in 2020. While further waves of Covid-19 are a clear risk, we believe that the complex should broadly edge higher over 2021, with the post Covid-19 recovery boosting commodities demand.

Crude oil – Upside to prices, but further action needed

NOK RUB CAD COP

While we are seeing significant oil production cuts from the OPEC+ group, the latest wave of Covid-19 that we are seeing, coupled with the return of Libyan supply, does leave the oil market in a fragile state over 1Q21. Therefore, we believe that OPEC+ will need to roll over current cuts of 7.7MMbbls/d through until at least the end of 1Q21, in order to ensure that the oil market draws down inventories over the quarter. If this were to happen, we would expect that the oil market will draw down inventories throughout the whole of 2021, which should be supportive for prices. Therefore, we currently forecast that ICE Brent will average US$55/bbl over 2021.

There are clear risks to this view, which include OPEC+ failing to extend current cuts, further waves of Covid-19 over the course of next year which disrupts the demand recovery, failure to get a vaccine to market, as this would suggest that international travel is likely to remain extremely constrained, and finally the return of Iranian oil supply to the market. A Biden presidency does mean the potential for a softer approach towards Iran, and so the possibility that we see a lifting of sanctions. This could see 1.5-2MMbbls/d of supply coming back to the market. However, the big unknown is timing, with it unclear how high Iran is on Biden's priority list. If we see Iranian supply coming onto the market in 1H21, the market is likely to struggle to absorb this additional supply, however if this event was to happen more towards the end of 2021 and into 2022, the market will be better placed to face this additional supply, given the expectation of stronger demand over 2H21.

	4Q20	1Q21	2Q21	3Q21	4Q21
ICE Brent (US$/bbl)	42	48	55	58	60

Copper – Market rebalancing with a 'green recovery' for demand

CLP PEN

Covid-19 had caused disruptions to copper supply chains this year, predominantly with mining activities in South America. In total, pandemic-related disruptions, along with other production losses has meant that global mine supply is estimated to fall by 2% in 2020, before rising by 3.6% in 2021. We currently expect a more balanced concentrate market for next year, assuming no major disruptions. However, there are major risks to mine supply that could easily push the market into deficit.

Ex-China demand is expected to see robust growth next year, although this is from a lower base in 2020, and absolute volumes are likely to return to pre-pandemic levels from only 2022. We expect Chinese demand to hold firm over 2021, with more vigorous growth from new energy vehicles (NEVs) and the related power infrastructure. As the world is pivoting towards a 'green recovery' post-Covid-19, there is increasing investment into renewable energy and NEVs. Based on existing government plans, we expect green investment induced copper demand to register double-digit growth in the next five years.

Global reportable copper inventories (exchanges and China bonded) have fallen by 25% from the start of this year and have remained low on an historical basis, and the refined copper market is seen to be relatively balanced in 2021, with a negligible surplus. Given it is estimated that the disruption rate for mine supply next year will still be above the long-term average, along with expectations for a synchronised recovery in global demand, the outlook for copper prices remains constructive.

	4Q20	1Q21	2Q21	3Q21	4Q21
LME Cu (US$/t)	6,880	6,890	7,000	6,980	7,000

Iron ore – Current levels unsustainable

AUD BRL ZAR INR CNY

Despite supply recovering from major miners, iron ore prices have performed very strongly since late 2Q20, and the market has managed to hold onto these gains as a result of continued robust demand from China. Earlier in the year, Australian supply was disrupted by cyclone activity, whilst in Brazil, Covid-19 related disruptions weighed on the country's output. However, since then we have seen a rebound from both countries, and in fact Brazilian miner, Vale, produced a record quarterly amount in 3Q20 from its Northern System.

On the demand side, China imported 975mt of iron ore (+11.2% YoY) in the first ten months of 2020, and full year volumes are expected to grow by around 10% YoY. This stronger demand has been driven by government-led stimulus following the Covid-19 outbreak, while margins for steel mills have remained attractive. Blast furnaces in China have been operating at record levels, whilst steel producers elsewhere in the world struggle to get back to pre-Covid-19 production levels. While the seaborne iron ore market has been tight this year, it is expected to loosen over the course of next year, which suggests that prices should trend lower from current levels. Chinese iron ore port inventories have already started to edge higher, while there are risks around the Chinese property market, which could weigh on new starts, and as a result on iron ore as well. We currently forecast that iron ore prices will average US$87/t over 2021. A key risk to our view is if we see further supply disruptions over the course of next, much like we have seen over the past two years.

	4Q20	1Q21	2Q21	3Q21	4Q21
Iron ore (US$/t)	115	102	95	75	75

Coal – there is upside, but likely limited

AUD IDR COP ZAR RUB

Thermal coal prices have been under pressure for much of the year, with weaker demand related to Covid-19 lockdowns, along with weak natural gas prices weighing on the market. Meanwhile China's apparent ban of Australian coal has certainly not helped the market. However, more recently, prices have started to strengthen as we have seen a recovery in natural gas prices, while strong domestic coal prices in China suggests that we could see the government take action to increase domestic supply moving forward. This could be done through increasing domestic production or by allowing more imports. If the latter, this would obviously be supportive for seaborne coal prices.

Looking ahead, and North Asia could see a colder-than-usual winter, which could provide some upside to coal prices in the short term. US government forecaster, NOAA, estimates that there is an 85% chance of a La Nina weather event over the Northern Hemisphere winter, which generally means colder-than-normal weather in North Asia. Meanwhile, as we see a post Covid-19 recovery around the globe, this should be supportive for coal demand, and as a result offer some upside to prices. However, we believe this upside will be modest. India has indicated its intentions to increase domestic production, in order to reduce its reliance on imports. Meanwhile, coal's share in the global energy mix continues to decline. In the longer term in Asia, China, Japan and South Korea have set carbon neutral targets, which will weigh on coal demand in the years ahead. We currently expect Newcastle coal to average US$58/t over 2021.

	4Q20	1Q21	2Q21	3Q21	4Q21
Newcastle coal (US$/t)	59	59	52	56	65

BRL

Soybeans- The China effect

CBOT soybean prices have rallied by more than 20% since the start of the year, trading to levels last seen back in 2016, while the speculative net long has moved within striking distance of the record position it held back in 2012. The key catalyst for the move has been Chinese buying. China has already bought a record amount of US soybeans for this stage in the marketing year, and while part of this may be to meet its target in the first year of the phase one trade deal, it is not the only reason. Soybean crush margins in China remain strong, suggesting robust domestic demand. The country is rebuilding its pig herd following the outbreak of African Swine Fever last year, and so this has been constructive for feed demand. Cumulative soybeans over the first 10 months of the year stand at a record 83.22mt, up almost 18% YoY. Meanwhile export data from the US shows that China has bought almost 27.6mt of US soybeans in the current marketing year, up 248% YoY.

Looking ahead, and it does appear that strong Chinese buying will persist into 2021, given the strength in domestic crush margins. Meanwhile, next year will also be the second year of the phase one trade deal between China and the US, and so we will need to see continued strong buying from China in order to meet the second-year target. Despite expectations that Brazil will see a record soybean harvest in the 2020/21 season, global ending stocks are still set to tighten over the season, which should continue to support prices. While in the US, domestic stocks are set to end the season at the lowest levels since 2013/14.

	4Q20	1Q21	2Q21	3Q21	4Q21
CBOT Soybeans (US¢/bu)	1,070	1,170	1,250	1,200	1,100

Scandies: Gains ahead but little divergence between SEK and NOK

- **EUR/SEK should breach the 10.00 level in 1H21 primarily benefitting from external factors. In contrast to prior years, Riksbank should not be a dovish outlier.**
- **NOK gains ahead, but given the deeply negative real rate (and limited prospects for a turnaround), a EUR/NOK return to pre-pandemic levels is unlikely.**
- **While NOK/SEK should remain rangebound and lack direction, we could see a convergence of NOK implied vol to SEK vol as the risk environment remains benign.**

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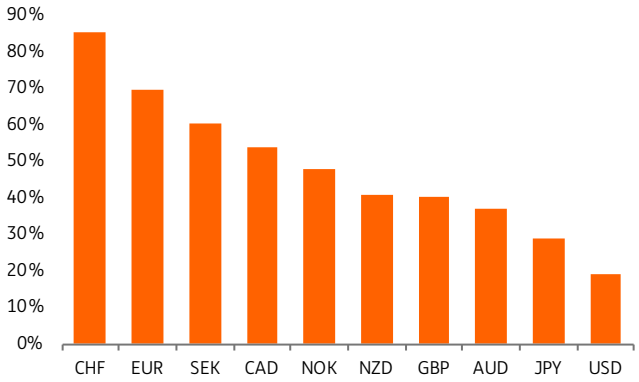
SEK: Benefitting from the global recovery

The 2021 SEK outlook appears bright and we look for frontloaded SEK gains during the first half of the next year, targeting the EUR/SEK 9.90 level. On the external side, two key factors are favouring SEK prospects. First, the new US administration should move away from the strategy of unpredictable trade wars. With Sweden being a small open economy dependent on global trade (Figure 44), less downside risk to the trade outlook should be beneficial for SEK. Second, the expected recovery in European and Swedish growth from 2Q21 onwards (with the region experiencing a sharp rebound in the second quarter after the tough winter months) and the re-rating of the regional growth outlook should be beneficial for cyclical SEK.

On the domestic side, and in sharp contrast to 2014-18, Riksbank should not be leaning materially against SEK strength at the current juncture (unless EUR/SEK materially breaches our forecast of 9.90), partly because of its low appetite to move interest rates back into negative territory. Moreover, with inflation expected to accelerate sharply early next year and headline CPI potentially touching the 2% level in April (Figure 45), the near-term probability for a materially dovish shift in the Riksbank stance is low, in our view.

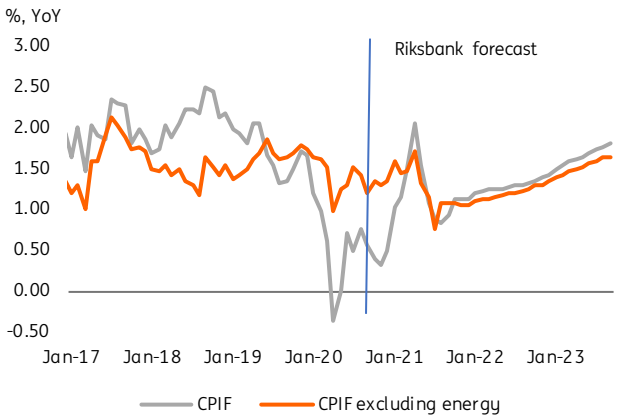
Fig 44 Sweden is a small open economy levered to trade

Openness of the economy (exports+imports as % of GDP)



Source: ING

Fig 45 Riksbank expects a sharp rebound in CPI in 1H21



Source: Riksbank

Riksbank unlikely to lean against SEK strength

Although the Riksbank won't help SEK via tighter monetary policy, it should no longer be penalising the currency compared to the stances of other central banks of its cyclical FX peers. Hence, in contrast to prior years, SEK should this time around benefit from the global economic recovery.

As for the EUR/SEK, the anticipated further easing from the ECB this December gives the Riksbank a free option to also top up its QE programme (should it feel necessary) without weighing on SEK versus EUR too much. We don't expect the Riksbank to cut rates back into negative territory next year (rates should remain flat as suggested by the Riksbank's own forecast) and only see scope for further QE extension (beyond 1H21) if needed, though this is not our base case at this point.

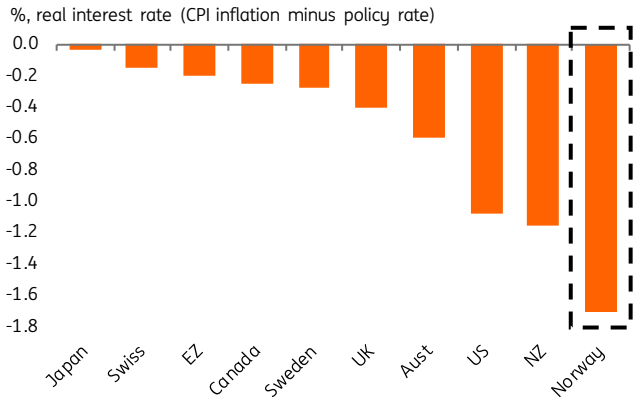
Despite its post Covid-19 sell-off rally, SEK is still cheap versus EUR

While a large part of the EUR/SEK valuation gap has closed during the SEK rally since March this year, the pair still remains overvalued by around 2-3% (Figure 9). A fall in EUR/SEK below 10.00 is consistent with the current valuation gap to bring the pair to fairly valued levels. Moreover, as long as EUR/SEK trades on the overvalued rather than undervalued side, this also raises the bar for Riksbank to actively lean against the currency strength again.

NOK: Deeply negative real rate limiting the scale of NOK appreciation

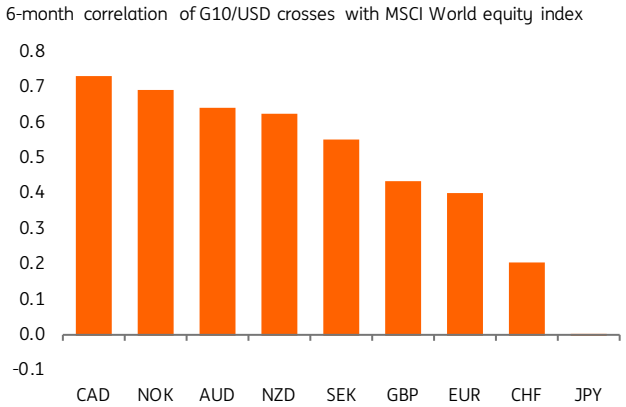
After profound Covid-19 related volatility, 2021 should be less unpredictable for NOK. We expect EUR/NOK to dip below 10.50 but a move towards/below the pre-pandemic level of 10.00 is unlikely due, in part, to the deeply negative real rate the NOK suffers from (currently the lowest real rate in the G10 space – Figure 46). With CPI and CPI ATE expected to remain elevated throughout most of next year and the central bank of Norway unlikely to move towards a more hawkish bias during the upcoming winter months, NOK should cement its position of the currency with the most negative real rate. This should limit the pace of NOK appreciation.

Fig 46 NOK suffers the most negative real rate



Source: ING, Bloomberg Finance L.P.

Fig 47 NOK has one of the highest correlations with risk



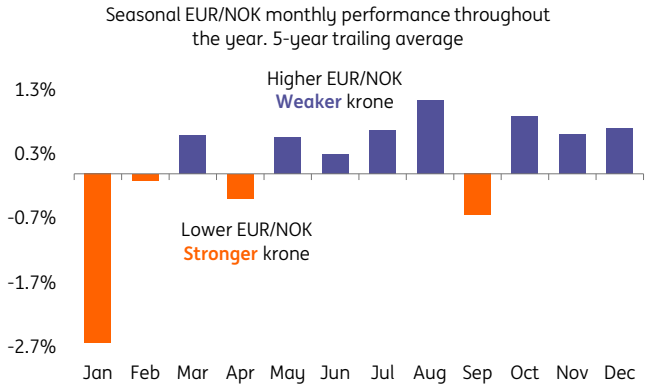
Source: ING, Bloomberg Finance L.P.

However, while the deeply negative real rate should be a limiting factor against NOK strength, it should not prevent it. The global environment should remain benign (for the reasons above) and with risk assets and equity markets likely doing well next year, so should the high beta NOK (exerting one of the highest correlations with risk in the G10 space – Figure 47). Our commodities team constructive view on the oil price (see page 36) should also support the EUR/NOK grind lower.

Scope for a shift in NB bias around the mid 2021

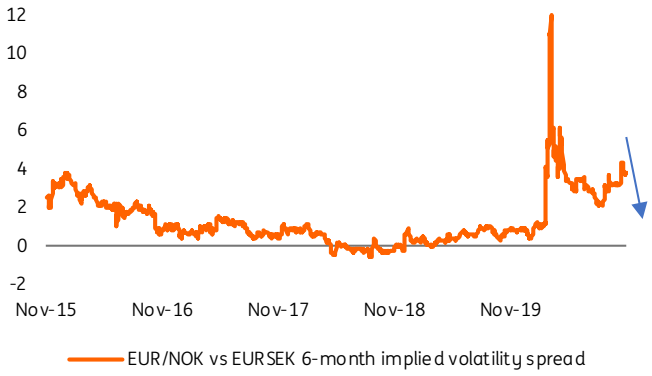
In line with its seasonality (Figure 48), we expect a portion of NOK gains vs EUR to be concentrated into the first months of 2021. While the economic data (both in Norway and in Europe) should remain soft during this period (as restrictions should remain partly in place), what will matter more for higher beta FX during the early part of the year is the market expectations of the economic rebound from Q2 onwards and the accompanying flows into cyclical currencies such as NOK. Moreover, NOK may get another boost around the mid-year if the NB moves towards hawkish bias in response to the improving economic outlook (though a rate hike in 2021 remains highly unlikely).

Fig 48 Seasonality points to stronger NOK in early 2021



Source: ING, Bloomberg Finance L.P.

Fig 49 NOK volatility should further compress vs SEK



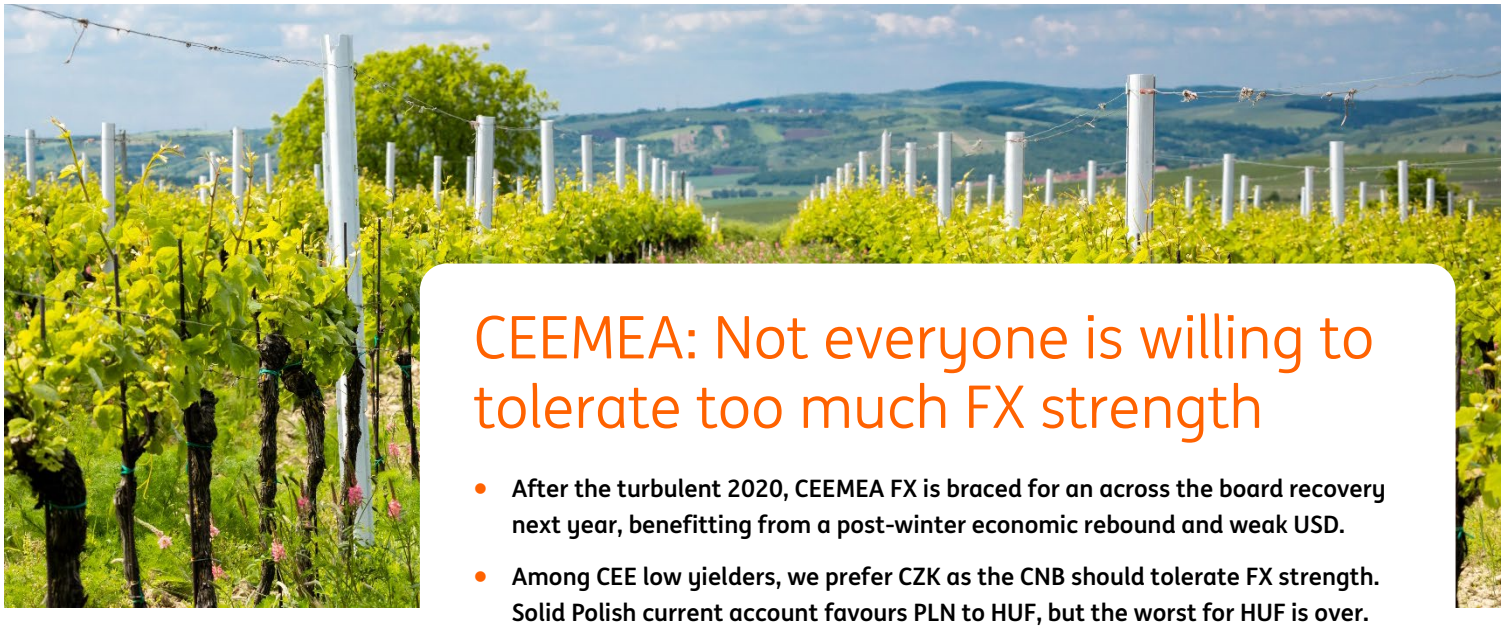
Source: ING, Bloomberg Finance L.P.

Implied volatility rather than FX spot convergence

While we don't expect much divergence between NOK and SEK next year (and both currencies to gain in the early part of the year in particular), we expect implied NOK volatility to further converge towards SEK volatility and the spread to narrow (Figure 49) as a more benign risk environment and fewer acute risk events (due to a likely change in the US administration's stance on the international relations front and the vaccine-related reduction in uncertainty with regard to the 2H21 global growth outlook) suggest further normalisation in NOK volatility.

ING FX forecasts

	Spot	4Q20	1Q21	2Q21	3Q21	4Q21
EUR/SEK	10.21	10.20	10.00	9.90	9.90	9.90
EUR/NOK	10.70	10.70	10.50	10.30	10.30	10.30



CEEMEA: Not everyone is willing to tolerate too much FX strength

- **After the turbulent 2020, CEEMEA FX is braced for an across the board recovery next year, benefitting from a post-winter economic rebound and weak USD.**
- **Among CEE low yielders, we prefer CZK as the CNB should tolerate FX strength. Solid Polish current account favours PLN to HUF, but the worst for HUF is over.**
- **Among CEEMEA higher yielders, we look for frontloaded TRY gains given the shift in CBT monetary stance and superior carry and real rate. RUB gains should be steady.**

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And the EMEA Economics Team

Forgetting 2020, bracing for a 2021 rebound in growth

While a tough winter lies ahead and local CEE economies will struggle this quarter and next, this is now largely priced in. If anything, the market-friendly outcome of the US presidential elections, the boost to the 2021 CEE and global economic outlooks received by the vaccine news and the soft USD dynamics (leading to gradually rising EUR/USD, as per our end-2021 forecast of EUR/USD 1.25) suggest that the worst for CEE FX is in the past and the local currencies should record further gains against USD.

CEE central banks point to CEE FX relative value – we favour CZK

Particularly for PLN and HUF, the upside versus the dollar should be in large part driven by a higher EUR/USD as local central banks are likely to lean against their currencies' strength versus the EUR. Hence, we strongly favour CZK versus PLN and HUF as the CNB should be more tolerant of FX strength in its quest to tighten monetary conditions. Given that the post-US election and vaccine announcements adjustment has already happened, and some of the extreme and excessive CEE FX short-term mis-valuation has closed (primarily for CZK and PLN - Figure 50), the pace of any upside should be more gradual from here, versus the price action seen during the first two weeks of November.

Agreement on the EU budget still more likely than not

Despite the current dispute over the EU budget and the recovery fund, we are inclined to think that an agreement between the EU and Poland and Hungary will be eventually reached, possibly before the end of the German EU Presidency this year. If we were to differentiate, we see an agreement with Poland more likely than with Hungary, but our base case is that none will veto the budget in the end.

While this should translate into a larger one-off recovery in PLN and HUF versus CZK (as larger risk premium was priced into the two currencies in recent days – Figure 50), we still expect CZK to outperform its CEE peers throughout 2021.

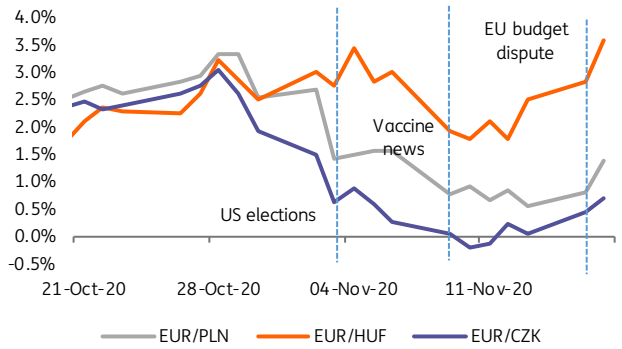
Low volatility environment favouring CEEMEA high yielders, with TRY standing out

The outlook for a post-pandemic rebound in global growth and trade in 2021 and the reduced odds of unpredictable trade wars should lead to a suppression of volatility and favour high yielding FX. Among the CEEMEA high yielders, we see the most near-term upside potential in TRY, with the lira gains likely to be frontloaded into 1Q as the currency benefits from a mix of tight monetary policy, ultra-attractive nominal and real rates (Figure 51) and an improving current account position. RUB gains should be more muted (but nonetheless in place) with the currency benefitting from a mix of solid fiscal position and a still positive real rate. Also, unlike low yielding CEE FX, the RUB remains

significantly undervalued on a short-term basis (Figure 52) as the currency did not catch up with the improvement in its short-term fair value.

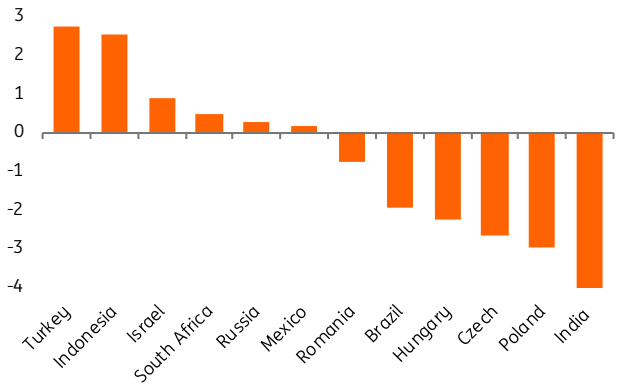
Fig 50 CEE FX short term mis-valuation

EUR/CEE crosses residuals (in %) between spot and their short-term financial fair values. The residual is a guage for the ccy risk premium



Source: ING

Fig 51 TRY benefits from very appealing real rate (%)



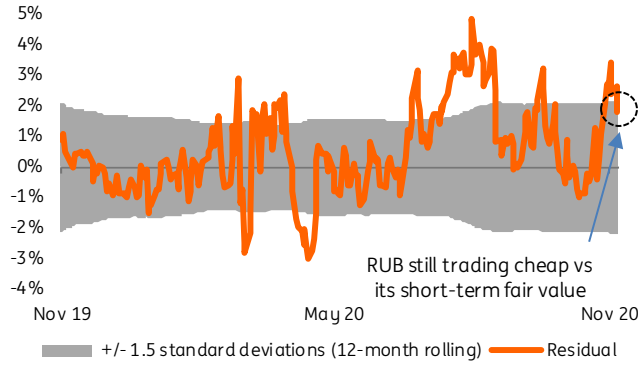
Source: ING, Bloomberg Finance L.P.

CZK: Strong CZK will be tolerated to achieve tightening of monetary conditions

CZK is the currency with the highest upside potential in the CEE region, in our view. Unlike the NBP and the NBH, the Czech National Bank (CNB) is tolerant of FX strength, with its latest forecast pencilling in a tightening of monetary conditions in 2021 via both FX and rates channels (Figure 53). While the bulk of the tightening is projected to be done via the rates channel, we think the opposite is likely to hold and the strong koruna will do the bulk of the tightening - benefitting from a mix of the supportive global environment and the most tightening prone central bank in the region.

Fig 52 RUB trades cheap on short-term basis

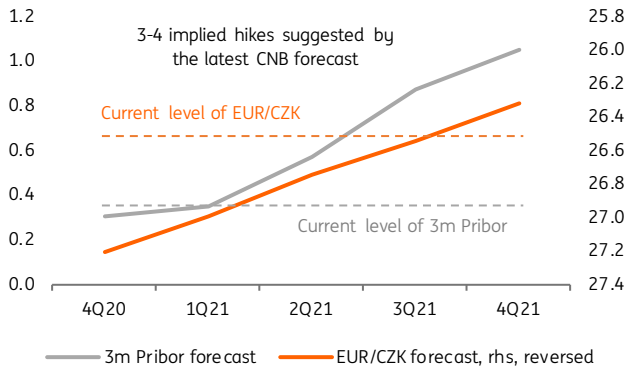
Residual between USD/RUB short-term financial fair value and spot.



Source: ING

Fig 53 CNB pencils in tightening of monetary conditions

3m Pribor and EUR/CZK CNB forecast - published on 5th November 2020



Source: ING, CNB

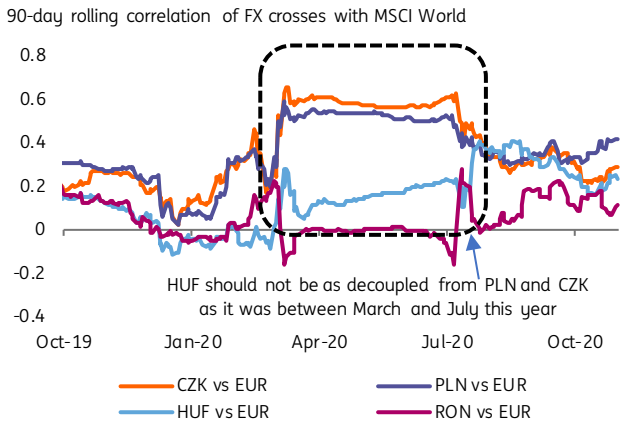
With inflation expected to dip towards the target next year, the CZK real rate should improve and exceed the real rates of PLN and HUF. Moreover, the front-end CZK IRS rate should increase the most in the CEE region given the likely build-up of market expectations related to eventual CNB tightening. We see a high probability of one 25bp hike at the end of 2021 in contrast to possible further easing measures from the central banks of Poland (NBP) and Hungary (NBH). This should support CZK and push EUR/CZK towards 25.50 next year.

While the long positions in CZK assets remain meaningful (due to the post FX floor effect), the two large washouts in CZK longs this year (associated with the two Covid-19 waves) have in our view differentiated between more sticky and less sticky money, making the positioning less crowded on the long side.

HUF: The worst is over and a more benign year is ahead

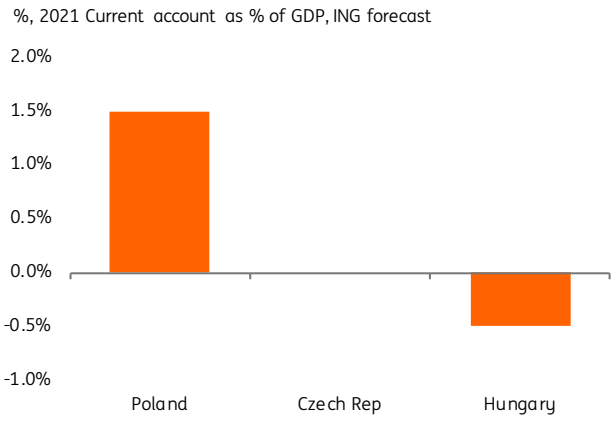
2021 should be a less disruptive year for HUF. Compared to the start of this year, HUF will enter 2021 with a higher interest rate differential than CZK and PLN. Even if we expect the NBH to cut the 1-week depo to 0.60% next month, this will still leave HUF with a higher nominal implied yield than CZK and PLN (and we don't expect NBH to go below the 0.60% level). Coupled with more stable inflation dynamics (CPI might touch 2.3% in March 2021 and average around 3% for 2021 as whole) this suggests less volatility in EUR/HUF based on idiosyncratic factors, with the forint's beta to global factors rising (versus its compressed sensitivity over a large part of 2020 – Figure 54 – particularly when compared to its free floating CEE peers).

Fig 54 HUF sensitivity to risk should normalise



Source: ING, Bloomberg Finance L.P.

Fig 55 Current account positions favour PLN vs HUF



Source: ING

Hungarian current account should see also a modest improvement from the forecast 1.3% deficit this year. We expect the deficit to decline to 0.4% in 2021 (partly because of tourism) or even move to zero at best. However, compared to the heydays of 2015-17, the current account will not be providing an active support to the currency and, in relative terms, be one of the key factors that leads to modest HUF underperformance vs PLN (Figure 55).

With the inherent NBH bias still skewed towards the dovish side, there is risk of some modest easing in 1Q (likely via more QE, but without rates dipping below 0.60%) when inflation dips further below 3% target. Coupled with what we perceive as a preference of local authorities to retain competitiveness via the exchange rate (which will appreciate in real terms just via the high inflation differential versus the eurozone), scope for lower EUR/HUF is limited in our view, even if the global environment remains benign. We thus expect EUR/HUF to stabilise in coming months around the 355-360 level (with our base case of agreement on the EU budget) with modest upside in 2H21 (to/above 365).

PLN: NBP leaning against but not preventing currency strength

The NBP tolerance for FX weakness and its unease with zloty strength is well known, but the question is how to fight the mix of: (1) the constructive risk environment for EM assets; and (2) the still solid current account surplus (albeit the surplus is expected to decline by 3% this year to 1.5-2% next year, it will still remain relatively high by Polish and CEE standards – Figure 55). The central bank has already announced its intention to continue its asset purchases (which are sterilised) and we don't rule out a cut in the reference rate to zero, but unless moving the depo rate into negative territory, it will have a limited impact on the currency. Generally, it will be difficult to lean against currency strength and if EUR/PLN goes bellow 4.40, we can expect some verbal intervention. But we believe the bias is for lower EUR/PLN.

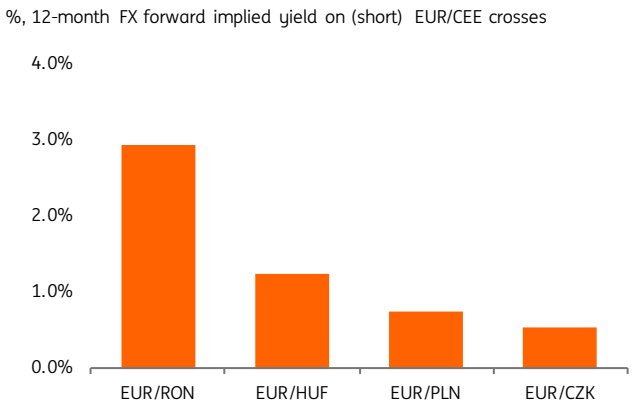
One factor that could tame PLN upside is the real rate, which should be the lowest across the region due to the mix of the low nominal rate (which might even dip

modestly if the NBP decides to cut) and the still relatively high CPI (though within the tolerance band).

RON: Status quo remains

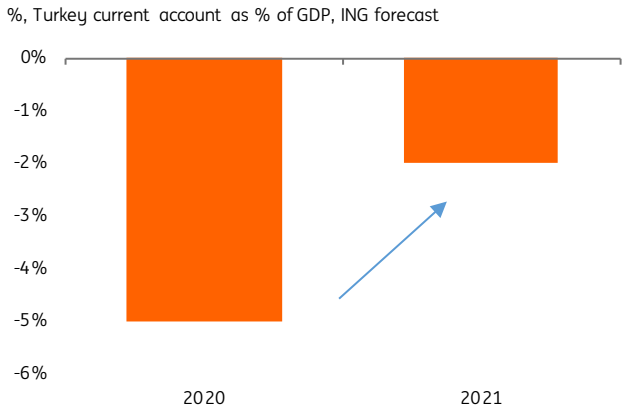
We don't expect any material change in the way the tightly managed RON trades, the NBR should continue presiding over its gradual depreciation versus the EUR which should not exceed the steep forward curve. We may see frontloaded post-election RON depreciation early next year again, but stability thereafter

Fig 56 RON still has comfortably the highest carry



Source: ING, Bloomberg Finance L.P.

Fig 57 Turkey's current account deficit to improve



Source: ING

While RON outperformed its CEE peers in 2020, this should no longer be the case in 2021 as the next year should see fewer risk events. With the threat of trade wars reduced, the Covid-19 vaccine in place and expected lower volatility ahead, the environment for RON is not ideal in relative terms to its free-floating CEE peers.

The key risks event for RON is the December 2020 Parliamentary elections. If the National Liberal Party (PNL) were to win (as projected by the polls) and the 40% pension hike is reversed (our base case), this will maintain the RON's status quo (a gradual deprecation versus EUR, but not underperforming forwards).

TRY: Frontloaded gains ahead as the game has changed (for now)

The lira outlook is upbeat for the next few months. The TRY sell-off over recent months was extreme, leaving the currency completely out of sync with its medium-term fundamentals (as gauged by our BEER model) and pointing to a profound risk premium build-up in the lira. The latest personnel changes within the Central Bank of the Republic of Turkey (CBT) and MinFin helped to halt the collapse of the lira and with the CBT delivering a profound 475bp hike on 19 November 2020, this will cement the lira's superior carry characteristics within the EM space (where TRY, exerts rather high real rate – Figure 51). As was the case after the September 2018 CBT tightening, we expect the current restrictive monetary stance to last for months and quarters ahead, making the oversold lira attractive.

With tight monetary policy in place and an improvement in tourism expected next year (given the Covid-19 vaccine), the current account position should improve and the deficit should decline from the around 5% expected this year to 1.5-2.5% next year (with the risk towards further improvement), as per Figure 57. All this should be beneficial for the lira, and coupled with the benign external environment, we look for frontloaded TRY strength to 7.20 (and even possibly 7.00) during 1Q21.

While looking for TRY gains, the large valuation gap as suggested by our BEER model should by no means fully close as: (1) investors will continue assigning some risk premium to the lira (though less extreme than at the beginning of this month); and (2) the double-digit inflation will further contribute to lira appreciation in the real terms.

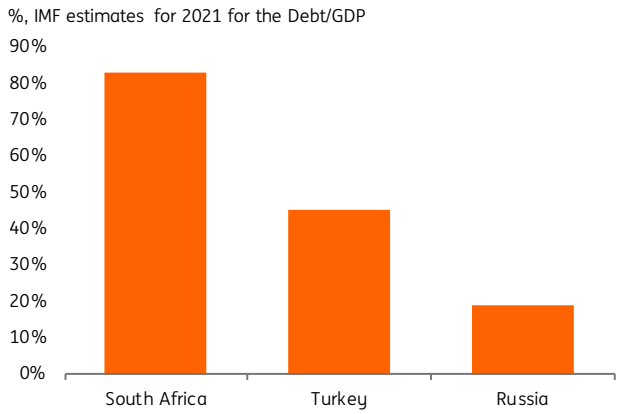
RUB: Steady gains

The low volatility environment and search for yield in the post Covid-19 low interest rate world should favour quality, high yielding FX. Given the strong fiscal position before the start of pandemic, RUB stands out on the fiscal side among the EMEA higher yielders (Figure 58), while offering an above zero real rate (similar to ZAR but lagging TRY, Figure 51). With a global 2021 economic recovery also supporting the oil price (see *Commodity Section*), this should be another positive for RUB and should help USD/RUB to move into the 70-75 region.

Although the Bank of Russia (CBR) is likely to cut interest rates further early next year, it should be of a limited nature (25-50bp cuts) and help RUB via supportive foreign inflows into local bonds (with high yielding OFZ attractive for both external – an environment favouring high yielding bonds - and domestic reasons – CBR rate cuts).

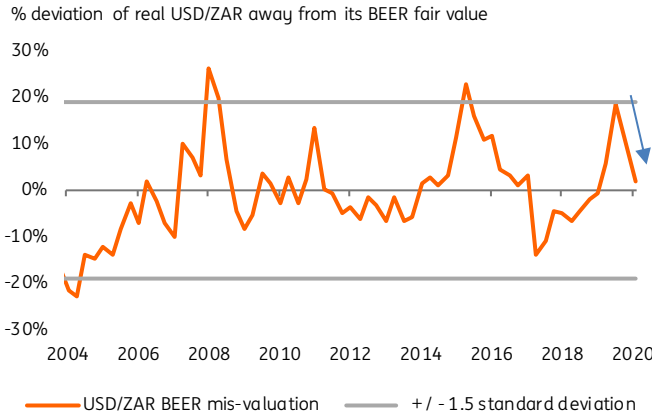
There is uncertainty stemming from the new US administration and its position on Russia and the risk of further sanctions, but this is currently an alternative risk scenario in our view rather than a base case.

Fig 58 ZAR has the worst fiscal position among its peers



Source: IMF

Fig 59 ZAR valuation gap has by and large closed



Source: ING

ZAR: Not standing out with its peers

Like other high yielders, ZAR should benefit from the mix of a benign global environment and weak USD dynamics. We look for more frontloaded ZAR strength in 1H21. Still, with ZAR suffering the worst fiscal position among the CEEMEA high yielders (Figure 58) and not exerting a superior real rate, we don't expect the currency to outperform RUB in total return terms next year. We also note that after its multi-month rally, ZAR is now fairly valued based on our medium-term BEER model (Figure 59). with the Covid-19 induced valuation gap now fully closed. This points to more modest ZAR upside, with USD/ZAR unlikely to break meaningfully below 15.00 next year.

ING FX forecasts

	Spot	4Q20	1Q21	2Q21	3Q21	4Q21
EUR/CZK	26.33	26.50	26.00	25.80	25.60	25.50
EUR/HUF	360.6	355	355	360	362	365
EUR/PLN	4.472	4.50	4.48	4.45	4.43	4.41
EUR/RON	4.87	4.87	4.92	4.92	4.92	4.92
USD/ILS	3.35	3.35	3.30	3.25	3.20	3.20
USD/RUB	76.25	72.00	71.00	72.00	75.00	73.00
USD/TRY	7.58	7.40	7.20	7.40	7.70	8.00
USD/ZAR	15.49	15.50	15.25	15.00	15.50	16.00

Emerging markets heat map

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Figure 60 provides an overview of country fundamentals for selected larger emerging market economies based on data and forecasts by the IMF, the World Bank and the World Economic Forum. We use 2020 forecasts or latest available data for stock (gross debt, NIIP, external debt, FX reserves) and 2021 forecasts for flow indicators (growth, CPI, fiscal and current account balances).

This allows a relative assessment of strengths and vulnerabilities across countries, and the identification of early warning indicators, based on a colour ranking scheme showing the strongest/most resilient in green and the most vulnerable in red (based on the 10th and 90th percentile).

Fig 60 Emerging markets heat map

	Economic Activity		Fiscal Accounts		External Accounts					Banking Sector	
	GDP	CPI	Gross Debt	Fiscal Bal	NIIP	C/A Balance	ST Ext Debt	Total Ext Deb	FX Reserves	Reg Capital	NPLs
Unit	*% yoy*	*% yoy*	*% of GDP*	*% of GDP*	*% of GDP*	*% of GDP*	*% of GDP*	*% of GDP*	*% of Ext Fin Req*	*% of RWA*	*% of Loans*
Year	*2021*	*2021*	*2020*	*2021*	*2020*	*2021*	*2020Q2*	*2020Q2*	*Latest*	*Latest*	*Latest*
Brazil	+2.8	+2.9	101	-6.5	-29	+0.0	5	45	480	16	2.8
Chile	+4.5	+2.7	33	-4.0	-16	-2.9	7	85	135	13	2.0
China	+8.2	+2.7	62	-11.8	15	+0.7	8	14	299	15	1.9
Colombia	+4.0	+2.1	68	-6.2	-61	-3.9	6	55	200	18	3.7
Czech Republic	+5.1	+2.4	39	-4.3	-13	-0.5	33	76	190	21	2.8
Egypt	+2.8	+6.2	87	-8.1	-54	-4.2	3	34	121		
Hungary	+3.9	+3.4	77	-3.9	-41	-0.9	11	138	179	18	1.3
India	+8.8	+3.7	89	-10.9	-14	-0.9	4	21	382	14	8.2
Indonesia	+6.1	+1.6	38	-5.5	-26	-2.4	4	38	175	23	2.9
Israel	+4.9	+0.2	77	-7.1	43	+3.5	10	30	699	14	1.4
Korea	+2.9	+0.9	48	-2.3	35	+3.4	10	32	421	15	0.3
Malaysia	+7.8	+2.4	68	-4.7	-3	+1.8	28	70	113	18	1.5
Mexico	+3.5	+3.3	66	-3.4	-50	-0.1	5	43	354	17	2.0
Peru	+7.3	+1.9	39	-4.3	-44	-0.3	5	34	641	15	3.5
Philippines	+7.4	+3.0	49	-7.3	-4	-1.5	3	24	507	15	2.0
Poland	+4.6	+2.3	60	-4.3	-45	+1.8	8	58	350	18	3.8
Romania	+4.6	+2.5	45	-8.1	-42	-4.5	6	51	133	23	4.4
Russia	+2.8	+3.2	19	-2.6	33	+1.8	4	33	1,325	13	9.6
Saudi Arabia	+3.1	+3.7	33	-6.0	91	-1.6	6	30	837	19	1.9
South Africa	+3.0	+3.9	79	-11.1	41	-1.8	11	55	122	16	4.0
Sri Lanka	+5.3	+4.7	98	-8.1	-55	-3.2	9	63	64	16	5.4
Thailand	+4.0	+1.8	50	-4.9	8	+4.6	10	34	861	18	3.2
Turkey	+5.0	+11.9	42	-7.9	-53	-0.9	19	65	28	20	4.2
Ukraine	+3.0	+6.0	66	-5.3	-14	-3.0	11	86	123	21	48.1
Uruguay	+4.3	+8.2	69	-4.0	-29	-3.3	11	83	210	19	2.3
Source	*IMF WEO Oct 20*	*IMF WEO Oct 20*	*IMF WEO Oct 20*	*IMF WEO Oct 20*	*IMF, ING calculations*	*IMF WEO Oct 20*	*World Bank QEDS*	*World Bank QEDS*	*ING calculations*	*IMF FSI*	*IMF FSI*
Green	*90 Percentile*		*10 Percentile*	*90 Percentile*	*90 Percentile*	*90 Percentile*	*10 Percentile*	*10 Percentile*		*90 Percentile*	*10 Percentile*
Red		*90 Percentile*	*90 Percentile*	*10 Percentile*	*10 Percentile*	*10 Percentile*	*90 Percentile*	*90 Percentile*		*10 Percentile*	*90 Percentile*

Source: IMF (World Economic Outlook October 2020, Financial Soundness Indicators), World Bank (Quarterly External Debt Statistics), World Economic Forum (Global Competitiveness Report 2019), ING

Highlights of the above show that growth will turn positive again across the board in 2021, with the strongest recovery seen in Asian economies. Inflation is set to remain low for all but a handful of economies.

A big focus in the coming years will be on public debt as the Covid-19 legacy leaves us with higher debt levels and some countries will continue to run large deficits. In the list above, Brazil, Egypt, India, South Africa and Sri Lanka have a weaker fiscal setting with large deficits in 2021 amid already higher debt/GDP levels.

When it comes to external vulnerabilities, countries with limited FX reserves in comparison to their short-term external financing needs (short-term debt and current account deficit) are most vulnerable, notably Sri Lanka and Turkey where the ratio is below 100%.

Banking system risks persist for India, Russia and Ukraine given the combination of weak capital ratios and/or weak asset quality.

LATAM: Post-pandemic challenges

- **As the Covid-19 crisis abates across LATAM, investors are eager for signs of fiscal consolidation in 2021, amid mounting post-pandemic fiscal concerns.**
- **Fiscal concerns are highest in Brazil, and much more modest in Mexico. Yield-seeking behaviour would also imply greater support for Mexican assets.**
- **2021 outlook may also hinge on post-pandemic growth-trajectories, with noted upside for Brazil and Colombia. A constructive outlook for commodity prices should also benefit Andean FX in general, but political risk is high in Chile and Peru.**

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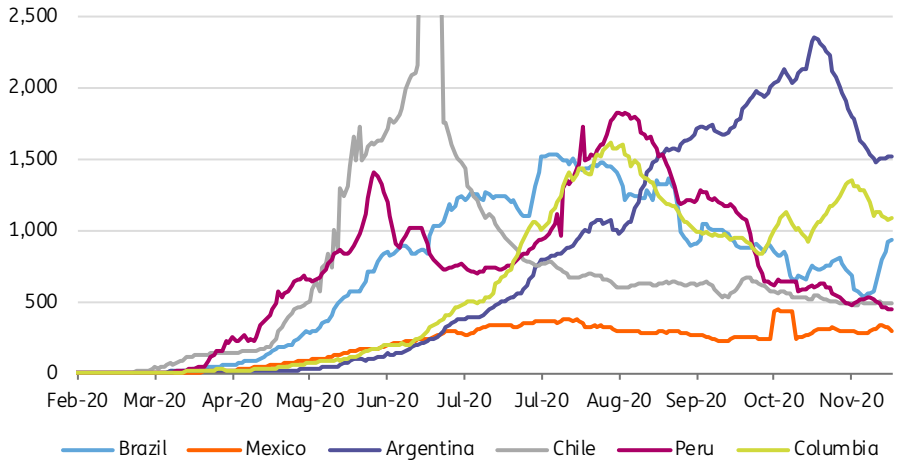
LATAM could outperform as Covid-19 subsides in the region

Latin America has largely avoided, so far, any signs of a second-wave resurgence of Covid-19 cases, as seen in much of the Northern Hemisphere. As the region reopens, its macro outlook should improve, especially in contrast to other regions where mobility restrictions have intensified.

Fig 61 No signs of a coronavirus second wave in LATAM yet (7 day increase in confirmed cases per million population)

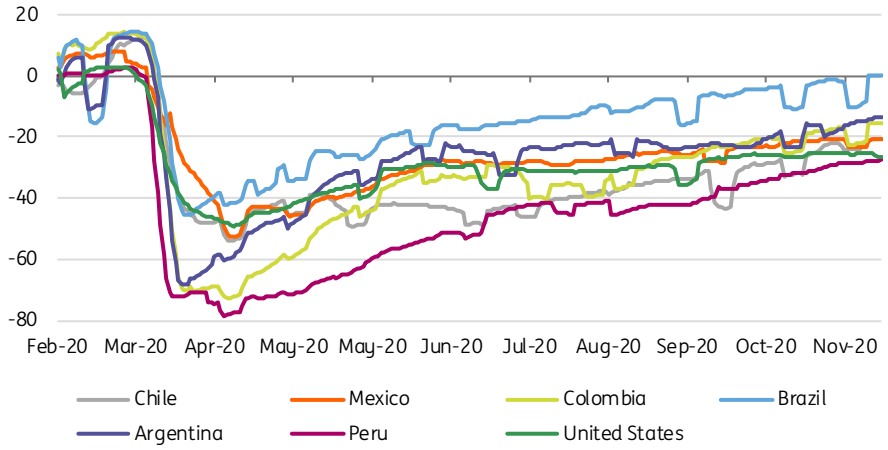


Source: Macrobond

Such an inter-regional divergence would deepen if LATAM manages to avoid a second wave, and further lockdowns, until a vaccine becomes available, possibly early in 2021. The fact that weather appears to be a factor in the spread of Covid-19 suggests that there's reason for optimism that all LATAM majors, except perhaps for their Northern peer Mexico, may be able to avoid the W-shaped growth trajectory seen elsewhere.

Despite the reduction in Covid-19 cases, mobility indicators (see Figure 62) suggest that, apart from Brazil, where evidence of a stronger-than-expected recovery is most evident, workplace visits remain much lower than pre-Covid-19 levels. This suggests that the economic recovery seen throughout the second half of the year may be insufficient to return economic activity to pre-pandemic levels.

Fig 62 Mobility indicators are gradually recovering, with Brazil standing out (7 day mobility indicator - workplace)



Source: Macrobond

Brazil is the notable exception here as 3Q activity data has already reached a touch below pre-pandemic levels. For the remaining countries, a slower recovery could possibly last until a vaccine is widely distributed.

Coping with a challenging fiscal legacy

Regardless of whether the region surprises with a faster recovery or disappoints, macro uncertainties are unlikely to dissipate quickly for the region.

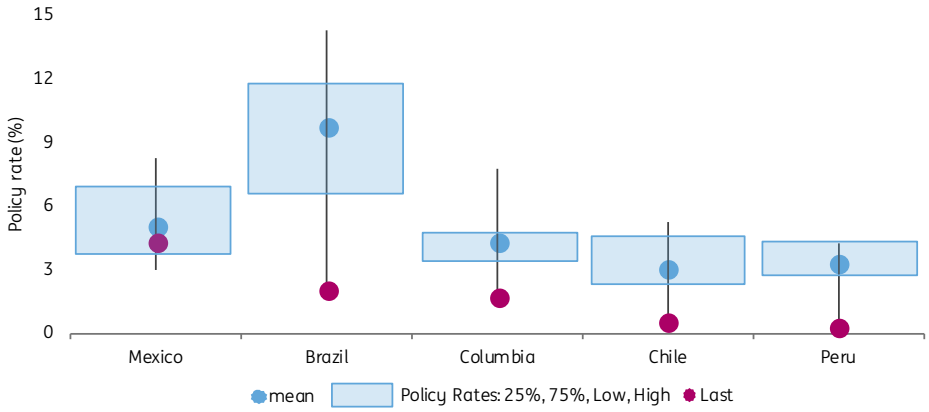
The scarring effects left behind in terms of business closures and layoffs, along with the enormous fiscal toll represented by the sharp increase in government spending and reduction in tax collection, suggest that it may take several quarters before we have a clear post-pandemic assessment of regional economies.

For now, fiscal sustainability appears to have become the primary concern for investors across the region, as it enters 2021 with much-weakened fiscal accounts.

This is best illustrated by the underperformance of Brazil's FX and FI assets relative to Mexico's, two countries that adopted vastly different strategies during the pandemic. Brazil reacted to the pandemic by announcing vigorous stimulus measures, including large fiscal transfers to households and businesses. In contrast, the Mexican administration's reaction was unusually modest, both in terms of monetary and fiscal policies.

Thanks in large part to those initiatives, Brazil's post-pandemic activity indicators are, as mentioned above, the best among major economies in the region. Mexico's recovery prospects are much weaker than Brazil's but, judging by the rally in MXN assets relative to their BRL counterparts, financial markets vastly prefer Mexico's hawkish policy stance. For FX markets, in particular, Mexico's high yield-advantage remains a crucial factor, adding support to the MXN.

Fig 63 Mexico's high yield and Brazil's massive rate drop stand out in LATAM



Source: Macrobond

Testing LATAM's ability to adapt economic policies to a new reality

In our view, faced with the pandemic, most LATAM policymakers acted correctly by implementing robust monetary and fiscal policy stimulus measures. That was the adequate course of action at the onset of the pandemic, but it's clear that, for many of the countries in the region, there's virtually no additional scope for fiscal easing.

Mounting fiscal concerns suggest that fiscal policies must, gradually, turn more hawkish, while monetary policies should remain expansionary, with the policy rate kept at or near their technical lower bounds.

In our view, the medium-term outlook for local assets should be determined, to a large extent, by each country's ability to successfully transition to a fiscally responsible stance in the coming months, while keeping the policy mix slightly expansionary.

In other words, the extraordinary set of circumstances governments faced in 2020 justified, in our view, Brazil's forceful policy stimulus. The problem that Brazil faces now is the political reluctance to firmly commit to normalize spending and/or raise taxes to help offset 2020, and re-anchor fiscal dynamics.

This difficulty in normalising fiscal spending post-pandemic, and to bolster fiscal frameworks to return fiscal trajectories to a sustainable path, is playing out in most countries in the region, including in Chile, Peru and Colombia.

Overall, even though we are optimistic about Brazil's macro outlook and expect the country to remain committed to fiscal responsibility, the fact that we also expect the policy rate to remain unchanged, at 2%, throughout 2021 suggests that the appreciation potential for the BRL is relatively limited.

The BRL's underperformance since mid-2019 was largely driven by Brazil's deep interest rate reduction. And if the central bank is able to execute its current forward guidance, which envisages no rate hikes in the foreseeable future, the BRL should remain poorly supported. Having said that, the currency's attractive valuation and prospects for an improving macro outlook lead us to adopt a gradual appreciation bias for the currency during 2021.

Mexico is, in some ways, the mirror image of Brazil. Even though we are pessimistic about the country's macro outlook, a highly supportive monetary stance for the MXN, with prospects for the benchmark rate to remain at, or near, the current 4.25% in the foreseeable future, should continue to translate into another year of strong FX performance in Mexico.

Among Andean commodity-exporters, Colombia stands out, with lower political risk

For Andean countries, politics should also be an important factor driving asset prices in 2021, with high-stakes elections taking place in Peru and Chile. Peru and Chile have already been facing tremendous political instability for a few years and, even though elections typically generate uncertainties, there's also some hope that, in these two cases, elections could pave the way for less political friction in their aftermath.

In Peru, the election of a president with a working legislative majority, in April, appears essential to end years of political dysfunction that have resulted in very unstable presidential mandates, including three presidents (and counting) in less than the (typical) 5-year mandate.

In Chile, social unrest continues to provide fertile ground for political instability, but that could also calm down following the election of a constitutional convention to rewrite the country's constitution, taking place in April, and general elections in November. Overall, while uncertainties are likely to remain elevated, the political calendar could also serve

to reset political expectations and create a more harmonious political environment afterwards.

Even though FX correlation with commodity prices has fallen somewhat, 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 remain elevated, near current levels, while the outlook for oil prices, the crucial driver for Colombia's COP, implies substantial rises from current levels. This suggests even though there is still substantial room for a catch-up correction in the CLP, which has yet to reflect the extent of the rally in copper prices seen in recent months, we see more upside for a commodity-driven rally in the COP.

For the PEN, once political risk eases, post-election, the currency could outperform, but we would not expect that outperformance to last. Following an initial post-election correction, we expect the PEN to return to its typical pattern of underperformance in a scenario of relatively benign global risk appetite, as we expect.

Overall, Colombia appears to represent the most attractive FX prospects in the Andes, with a higher benchmark rate than its neighbours, reduced political noise and large potential for appreciation if oil prices follow the appreciation trajectory we expect. Risk of a credit rating downgrade is the main risk for this call, but rating agencies appear reluctant to downgrade the credit in the shorter-term, as they wait for the government and Congress to act on their plan to re-anchor fiscal accounts.

ING FX forecasts

	Spot	4Q20	1Q21	2Q21	3Q21	4Q21
USD/BRL	5.35	5.30	5.30	5.20	5.10	5.00
USD/MXN	20.33	20.00	19.80	19.70	20.00	20.00
USD/CLP	758.4	760	770	750	760	740
USD/ARS	80.16	84.20	92.70	102.00	113.00	127.00
USD/COP	3643.4	3650	3600	3500	3450	3400
USD/PEN	3.57	3.68	3.67	3.63	3.60	3.58

International trade: Plenty of challenges, but recovery in sight

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The Covid-19 pandemic will continue to dominate all other influences on world trade in 2021, with progress towards a vaccine helping trade volumes to recover from early next year. New leadership on the world stage could start to reduce trade barriers, supporting the recovery.

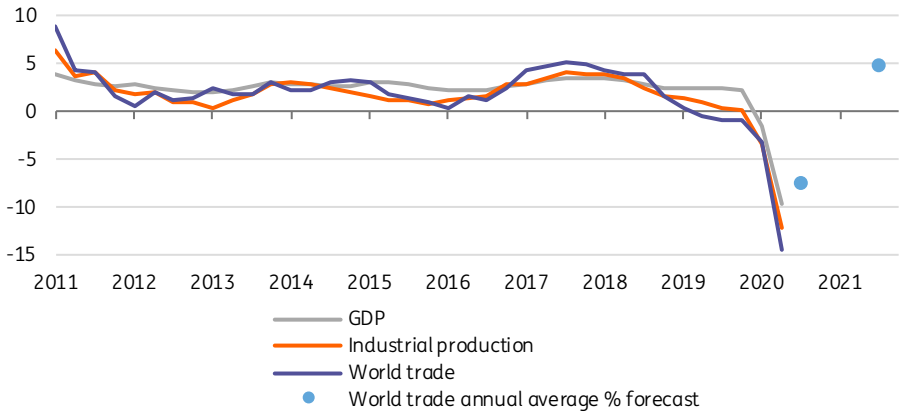
Trade will rebound with a vaccine, but second round effects will drag in 2021

Progress towards a vaccine is a key step towards restoring consumer confidence and investment over the course of 2021, helping to recover some of the ground lost in 2020 for world trade. But some Covid-19 related disruptions to transport capacity will take time to unwind, and cause a persistent drag on trade even as demand recovers.

Subsidies introduced during the pandemic pose a downside risk to the recovery in trade volumes, if they create an uneven playing field in the aftermath of the pandemic. Much of the government support introduced during the pandemic has no formal end date. If it is unwound as economies open up again, any dampening effect on trade volumes should be limited.

Overall, a rapid bounce back to pre-pandemic levels is unrealistic, and a full recovery in volumes may take until 2022. Our forecast is for a 7% fall in world trade volumes in 2020 followed by growth of around 5% in 2021.

Fig 64 Global GDP, industrial production and trade volumes



Source: Macrobond

Some tensions thawing in 2021

US trade policy under President-elect Biden looks likely to continue to build pressure and tension in US-China trade relations while de-escalating other disputes. The trade war tariffs on US-China trade flows are likely to remain in place, while the US tariffs on steel and aluminium may be rolled back, and the threat of US tariffs on EU cars forgotten.

China may redouble its efforts to lower trade costs and build up export markets closer to home through its Belt and Road connectivity projects, and develop its high-tech manufacturing capacity through the 'Made in China 2025' strategy, reducing its imports in the process.

World trade will continue to bear the scars of the trade war, and won't be far from the headlines in 2021. But cautious optimism is warranted as economies are set to recover and trade policy may be done through talks, rather than tariffs.

Asia: Better than all the rest

- **In a reflation trade, the weakest currencies in Asia could rise to the top. Determining the pace will be factors like the semi-conductor cycles and vaccines.**
- **But the tech story is a double-edged one and could weigh on certain pairs if Joe Biden ramps up the technology war with China.**
- **The pull of the CNY will also be important for some. Drawing all the themes together we present a stylised timeline for Asian FX outperformance in 2021.**

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There is more to this than a simple weak USD story

If it were just a case of figuring out if the USD will be weak or strong in 2021, our forecasting job would be very easy. But even if we take our EUR/USD forecasts at face value, which in itself is a big 'if', the Asia dollar index will not necessarily slavishly reflect what is going on with the majors.

This is roughly what has happened since August, as the US dollar index has traded between about 92 and 96, but made no lasting headway in either direction. In contrast, the Asian dollar index has shown consistent strength since the pandemic became global in March, and with few deviations, has continued to strengthen throughout the year.

The vaccine trade

One feature of Asia that is enabling this to happen, is the relative outperformance in terms of Covid-19 control in the region.

Compared to the US or European countries, Asia's worst Covid-19 country, India, looks no worse in terms of daily cases, and considerably better when adjusted for population size.

The next worst in the region, Indonesia, the Philippines and Malaysia, may be underperformers on a regional basis, but their infections statistics would be the envy of the US and most if not all of Europe right now.

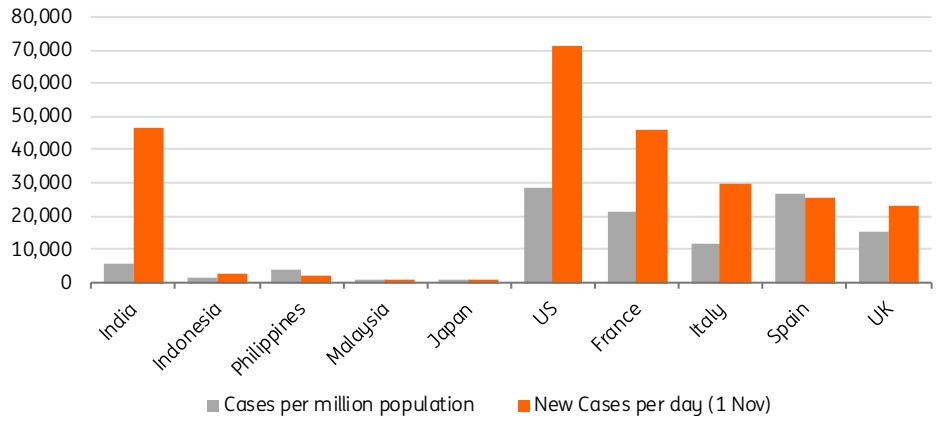
At the top end of the spectrum, a number of Asia Pacific countries have virtually no Covid-19 right now, or such small occurrences, that it can be kept controlled with existing test, trace and isolation measures and unobtrusive regulations on social distancing and mask-wearing (to which there is high adherence).

In some countries in the region, a glacial thawing of restrictions is in place, which will allow economies to breathe more freely, without unduly threatening the existing favourable Covid-19 situation. That said, some of the North Asian economies do bear close watching. Low daily numbers can become high daily numbers in just weeks, so Japan, and even Korea, are worth keeping a close eye on.

Nevertheless, compared to the US and Europe, where economies are facing second or in some cases third waves of Covid-19 and heading back into lockdown, this is as good a reason as any for supporting Asian FX versus major economies currently.

Our base assumption allows for the roll out of an effective vaccine through 2021, though perhaps not really altering the trajectory of the pandemic until 2Q21/3Q21. But at that time, we may see some slowdown, or perhaps even reversal of the Covid-19 dynamic that has supported Asian FX up until then.

Fig 65 The relatively favourable pandemic comparison for Asia



Source: Worldometer

Within the region, the vaccine trade would likely favour the INR, IDR, PHP and MYR more than currencies representing already low levels of infection, CNY, SGD, TWD, KRW, and THB. Though there are other factors that we need to consider such as the resumption of international travel, which will disproportionately help the THB, which has seen its balance of payments in services shrink abruptly during the pandemic owing to the collapse of international tourism.

Election overlay and tech war

As well as the pandemic, the other subject that has occupied much of our thinking this year has been the US election. One substantial informational benefit we have now, is that we do at least know who the next President will be (though perhaps not with 100% certainty still), which has not been the case for most of the year. That provides some helpful information that we can overlay on the Covid-19 story.

For one thing, we anticipate the US Covid-19 response to be more effective now, helping us to return to the original base global growth case, even if we have some unpleasant double-dip moments along the way.

The other factor is that relative to a Trump victory, a Biden victory is likely to deliver a less hostile trade environment, and a generally more risk tolerant environment – maybe not to the current situation, but at least relative to the counterfactual had Donald Trump won. If that had happened, we had entertained thoughts of an expanded trade war. A more tolerant trade backdrop could also set the stage for a stronger Asian FX performance.

There is still, as Iris Pang sets out in her CNY note, a meaningful risk of a technology war in 2021. But to some extent, this is an extension of the existing tension, not a brand new feature. Nonetheless, if it becomes inflamed, there are few economies in the region that would be unaffected. The economies least geared into technology are India and Indonesia, which may provide some insulation from a resumption of trade tension, though we would add that this scenario would tend to be one of risk aversion, which may more than offset any tech exposure factors for those same currencies, due to current account strains.

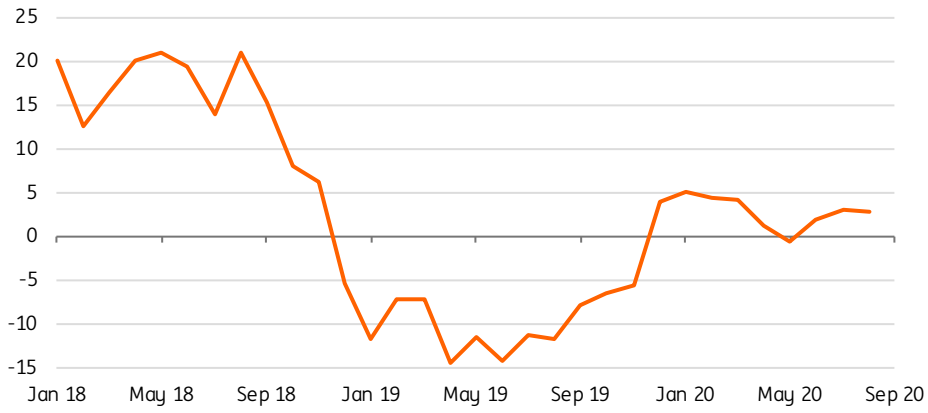
Semiconductor cycle

While the previous section discussed why being exposed to the tech sector might not be very helpful, there are also good reasons for being upbeat on this sector, not least of which is the fact that the world, and Asia in particular, seems to be experiencing one of its periodic semiconductor upcycles.

Strong demand for technology during and immediately following the lockdowns has boosted demand for components too. And the resurgence of Covid-19 waves will only reinforce the sense that working from home is not a once in a lifetime oddity, but a strong element of the new normal. Further technology expenditure should follow.

In addition to strong volume sales of technology, the prices of these items are also holding up as shortages and bottlenecks develop. Globally, container shortages are exacerbating the short supply of key chip technologies, which are being rationed out by suppliers.

Fig 66 Asia-Pacific semiconductor net billings (%YoY)



Source: CEIC

For the producers of value added in this sector, this sounds like positive news and for their currencies too. This should be a particular boost to the KRW and TWD, and to a lesser extent, the SGD and MYR, though there are relatively few currencies in the region that do not benefit. We would again cite the IDR and INR, but also the PHP where although electronics are a huge element of the export basket, they add relatively little value to the economy.

Where the CNY goes...

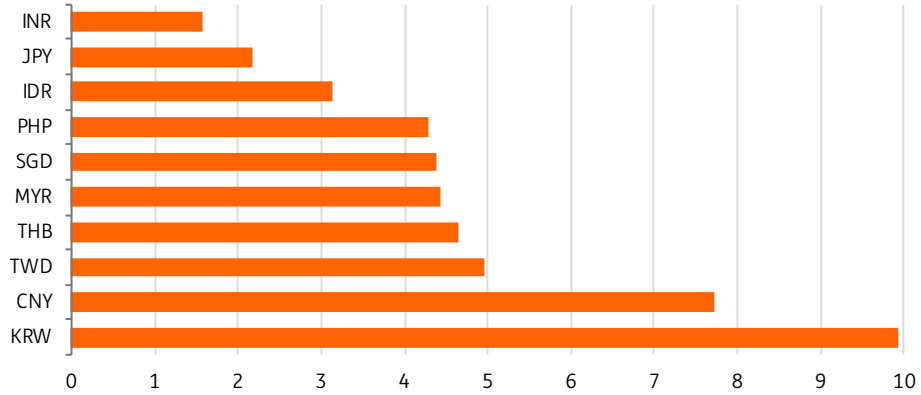
To some extent, the way currencies move in Asia resembles the way gravity operates within our solar system. At the centre of every currency system is the USD, so a weaker USD as our FX strategy team indicates is their core preference sets up Asian currencies to be stronger.

But in our local system, we also have a heavy mass currency, the CNY. And while general moves in the USD will set the tone for the Asian Pacific FX system, outsize movements by the CNY can also dominate in the short term.

What we notice is that heavily traded liquid currencies in the region, such as the KRW, tend to have a very high market coefficient, or beta, relative to big, heavy mass currencies like the CNY, and if we see USD/CNY moving to 6.30 by the end of 2021, a move of a bit more than 4%, then everything else being equal, we would anticipate the KRW moving more than this, perhaps 6%.

Most of the other currencies in the region will slightly lag the CNY performance, though not by much, with deviations described by factors that we turn to next.

Fig 67 Spot vs USD (%) (from 01/06/20)



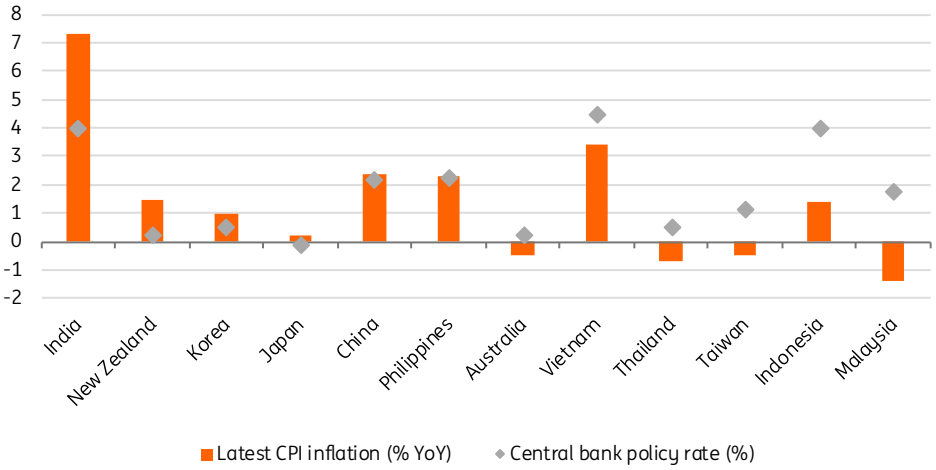
Source: CEIC

Local factors and policy influences

There are very few economies in the region where there is any significant scope for additional monetary easing, so domestic central bank policies will probably not be a substantial factor in the outlook for individual FX pairs.

Like the rest of the world, the rule book on monetary policy has been ripped up in Asia. Once unthinkable negative real rates are now common. Nominal rates are in many cases also close to zero.

Fig 68 Limited room anywhere for domestic monetary policy easing in 2021



Source: CEIC

Where there is still some physical room for rate reduction (India, Indonesia, Philippines), support for the currency and bond markets means that this is probably not going to be a big feature of 2021, and certainly not one that will determine a significant deviation from the Asian FX pack. At the same time, not one of the economies in Asia Pacific looks close to raising rates in 2021. The greatest risk comes from Korea, though we don't believe this will be seriously considered until well into 2022.

A number of central banks in our region have engaged in unorthodox monetary policies. We wrote about this at some length recently. The main offenders in this are BSP (Bangko Sentral ng Pilipinas) in the Philippines and BI (Bank Indonesia) in Indonesia. In both cases, low level quantitative easing and what looks as if it might be the thin end of the wedge in terms of direct monetary financing would normally raise concern about the currency and lead to depreciation. Markets are instead being extremely forgiving, viewing this as a supplement to otherwise weak fiscal stimulus and a necessary offset to the pandemic and associated lockdowns.

Our hope is that these policies are scaled back during 2021, and we will take a dim view of their expansion if that also accompanies a generalised pick-up in activity.

Politics will also play very little role in Asian FX in 2021. There is the possibility of snap elections early in 2021 in Malaysia, where perennially weak government means this is always a possibility. Likewise, the tense situation in Thailand where opposition forces are attempting to get PM Prayuth to resign and deliver reform to the Monarchy, politics may also weigh on the THB on and off during 2021. State elections in India in 2021 may also have a marginal effect, depending on their message for Modi's ruling BJP Party. Recent evidence is not terribly encouraging, and this as well as ineffective stimulus measures combine to make the INR our least preferred currency in the region in 2021.

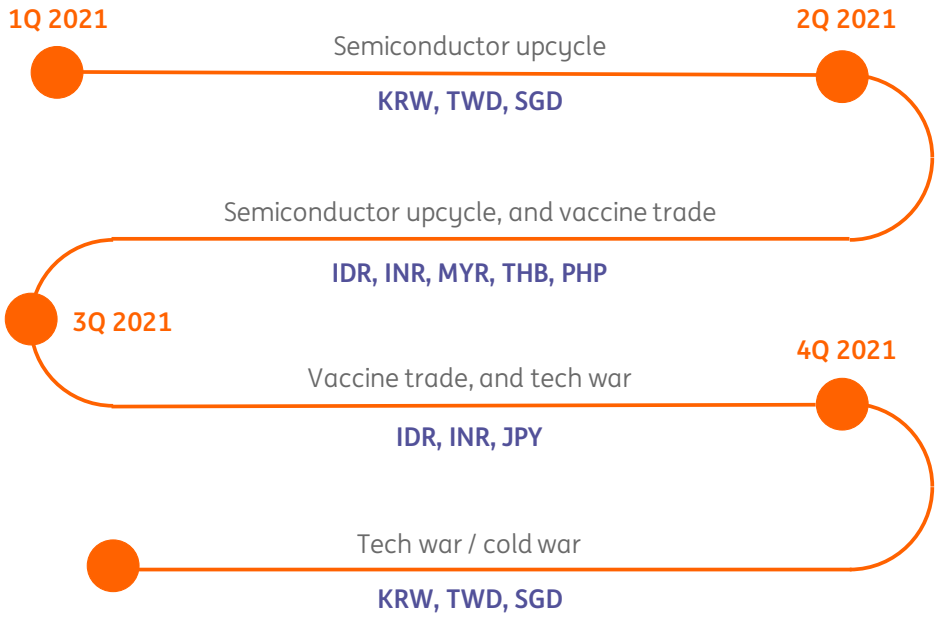
Other things to watch for will be the current account balances of the currencies which normally run deficits, but which have seen an improvement due to collapsed local demand (PHP, IDR, INR) and also whether Thailand's current account surplus begins to grow again if travel bubbles allow for some increase in international tourism.

Conclusion

If we put all this together, we can come up with a timeline that will reflect the various factors we believe will influence Asian FX over the coming 12 months, and a rough sense of which currency pairs will tend to outperform during the combination of scenarios that make up our base case view.

Unhelpfully, there is quite a lot of netting out to consider. For example, the tech war and semiconductor cycle are opposite sides of the same coin. We can also only guess at the magnitudes of the various effects or their relative timing, so aggregating all this requires some educated guesswork, which is what the timeline below has a go at in a very rough form. Our stylised chart describes which currencies might be expected to outperform the Asia pack as we move from one dominant driver to the next.

Fig 69 Stylised FX outperformance within the Asia FX pack



Source: ING

Although we will get an effective and safe vaccine before this, the time taken for distribution means that the vaccine trade is likely to be a 2H21 effect. The semiconductor cycle is already in play, and so has probably already provided some boost to the big tech giants of the region. This is likely to hold until President-Elect Biden has got his feet under the desk for a few months before he starts to pursue any tech war policies and erodes these currencies' advantage.

Which leaves us with a timeline where in the short term, KRW, TWD and SGD lead the Asia pack, before handing the running to the EM side of the currency pack with the IDR, INR, MYR, THB and PHP later in the year.

ING FX forecasts

	Spot	4Q20	1Q21	2Q21	3Q21	4Q21
USD/CNY	6.58	6.70	6.60	6.50	6.45	6.30
USD/HKD	7.75	7.75	7.75	7.75	7.76	7.76
USD/IDR	14155	14121	14195	14003	13898	13801
USD/INR	74.27	74.90	74.60	74.30	74.00	73.80
USD/KRW	1115.19	1100	1090	1080	1060	1040
USD/MYR	4.10	4.15	4.19	4.16	4.10	4.03
USD/PHP	48.31	48.45	48.09	47.87	47.51	47.38
USD/SGD	1.35	1.34	1.33	1.33	1.32	1.31
USD/TWD	28.53	28.60	28.40	28.20	28.00	27.70
USD/THB	30.40	30.30	30.50	30.30	29.90	29.50

ING foreign exchange forecasts

EUR cross rates	Spot	4Q20	1Q21	2Q21	3Q21	4Q21	USD cross rates	Spot	4Q20	1Q21	2Q21	3Q21	4Q21
Developed FX													
EUR/USD	1.183	1.20	1.20	1.22	1.23	1.25	EUR/USD		1.20	1.20	1.22	1.23	1.25
EUR/JPY	123.1	122	122	124	125	128	USD/JPY	103.99	102	102	102	102	102
EUR/GBP	0.89	0.88	0.88	0.88	0.88	0.88	GBP/USD	1.324	1.36	1.36	1.39	1.40	1.42
EUR/CHF	1.08	1.08	1.08	1.10	1.12	1.15	USD/CHF	0.91	0.90	0.90	0.90	0.91	0.92
EUR/NOK	10.70	10.70	10.50	10.30	10.30	10.30	USD/NOK	9.04	8.92	8.75	8.44	8.37	8.24
EUR/SEK	10.21	10.20	10.00	9.90	9.90	9.90	USD/SEK	8.63	8.50	8.33	8.11	8.05	7.92
EUR/DKK	7.450	7.44	7.45	7.45	7.45	7.45	USD/DKK	6.29	6.20	6.21	6.11	6.06	5.96
EUR/CAD	1.55	1.56	1.52	1.53	1.53	1.54	USD/CAD	1.310	1.30	1.27	1.25	1.24	1.23
EUR/AUD	1.63	1.64	1.60	1.61	1.62	1.62	AUD/USD	0.73	0.73	0.75	0.76	0.76	0.77
EUR/NZD	1.72	1.76	1.71	1.69	1.71	1.71	NZD/USD	0.69	0.68	0.70	0.72	0.72	0.73
EMEA													
EUR/PLN	4.472	4.50	4.48	4.45	4.43	4.41	USD/PLN	3.78	3.75	3.73	3.65	3.60	3.53
EUR/HUF	360.6	355	355	360	362	365	USD/HUF	304.7	296	296	295	294	292
EUR/CZK	26.33	26.50	26.00	25.80	25.60	25.50	USD/CZK	22.25	22.08	21.67	21.15	20.81	20.40
EUR/RON	4.87	4.87	4.92	4.92	4.92	4.92	USD/RON	4.12	4.06	4.10	4.03	4.00	3.94
EUR/HRK	7.57	7.54	7.53	7.52	7.51	7.53	USD/HRK	6.39	6.28	6.28	6.16	6.11	6.02
EUR/RSD	117.6	117.6	117.6	117.6	117.6	117.5	USD/RSD	99.4	98.0	98.0	96.4	95.6	94.0
EUR/RUB	90.25	86.4	85.2	87.8	92.3	91.3	USD/RUB	76.25	72.0	71.0	72.0	75.0	73.0
EUR/UAH	33.55	34.2	33.8	34.0	34.3	35.0	USD/UAH	28.35	28.5	28.2	27.9	27.9	28.0
EUR/KZT	507.1	504	503	508	511	517	USD/KZT	428	420	419	416	416	413
EUR/TRY	8.98	8.88	8.64	9.03	9.47	10.00	USD/TRY	7.58	7.40	7.20	7.40	7.70	8.00
EUR/ZAR	18.33	18.60	18.30	18.30	19.07	20.00	USD/ZAR	15.49	15.50	15.25	15.00	15.50	16.00
EUR/ILS	3.96	4.02	3.96	3.97	3.94	4.00	USD/ILS	3.35	3.35	3.30	3.25	3.20	3.20
EUR/AZN	2.011	2.04	2.04	2.07	2.09	2.13	USD/AZN	1.700	1.70	1.70	1.70	1.70	1.70
LATAM													
EUR/BRL	6.34	6.360	6.360	6.344	6.273	6.250	USD/BRL	5.35	5.30	5.30	5.20	5.10	5.00
EUR/MXN	24.06	24.00	23.76	24.03	24.60	25.00	USD/MXN	20.33	20.00	19.80	19.70	20.00	20.00
EUR/CLP	897.70	912	924	915	935	925	USD/CLP	758.4	760.0	770.0	750.0	760.0	740.0
EUR/ARS	95.15	101.04	111.24	124.44	138.99	158.75	USD/ARS	80.16	84.20	92.70	102.00	113.00	127.00
EUR/COP	4327.0	4380	4320	4270	4244	4250	USD/COP	3643.4	3650.0	3600.0	3500.0	3450.0	3400.0
EUR/PEN	4.237	4.416	4.404	4.429	4.428	4.475	USD/PEN	3.57	3.68	3.67	3.63	3.60	3.58
Asia													
EUR/CNY	7.79	8.04	7.92	7.93	7.93	7.88	USD/CNY	6.58	6.70	6.60	6.50	6.45	6.30
EUR/HKD	9.18	9.30	9.30	9.46	9.54	9.70	USD/HKD	7.75	7.75	7.75	7.75	7.76	7.76
EUR/IDR	16739	16945	17034	17084	17095	17251	USD/IDR	14155	14121	14195	14003	13898	13801
EUR/INR	87.85	89.88	89.52	90.65	91.02	92.25	USD/INR	74.27	74.90	74.60	74.30	74.00	73.80
EUR/KRW	1322.21	1320	1308	1318	1304	1300	USD/KRW	1115.19	1100	1090	1080	1060	1040
EUR/MYR	4.85	4.98	5.03	5.08	5.04	5.04	USD/MYR	4.10	4.15	4.19	4.16	4.10	4.03
EUR/PHP	57.25	58.14	57.71	58.40	58.44	59.23	USD/PHP	48.31	48.45	48.09	47.87	47.51	47.38
EUR/SGD	1.59	1.61	1.60	1.62	1.62	1.64	USD/SGD	1.35	1.34	1.33	1.33	1.32	1.31
EUR/TWD	33.95	34.32	34.08	34.40	34.44	34.63	USD/TWD	28.53	28.60	28.40	28.20	28.00	27.70
EUR/THB	35.98	36.36	36.60	36.97	36.78	36.88	USD/THB	30.40	30.30	30.50	30.30	29.90	29.50

Source: Bloomberg Finance L.P., ING

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