G10 Forecast Revision
Q4 2019

WRITTEN BY:

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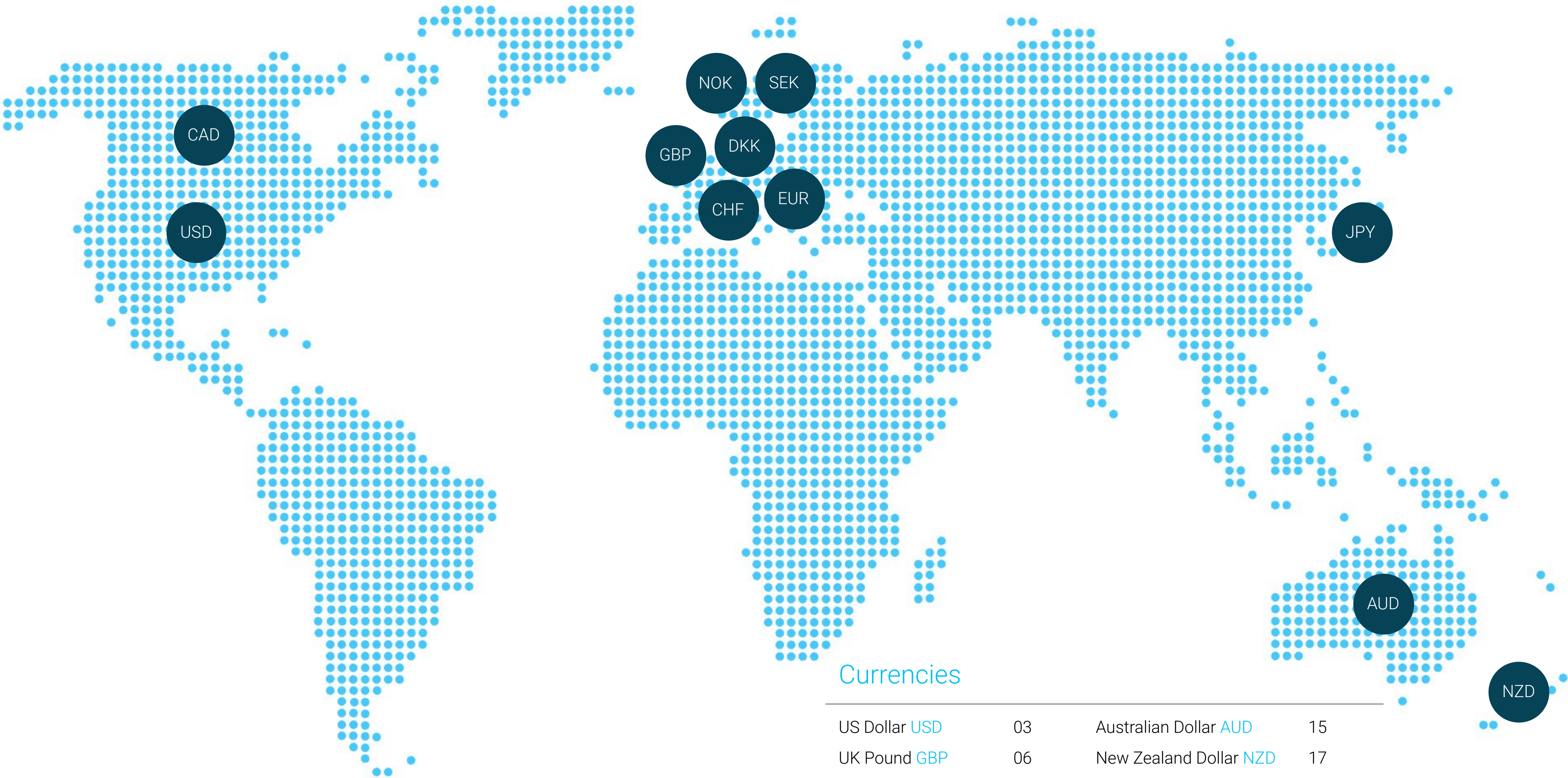
30th September 2019

Ebury What borders?

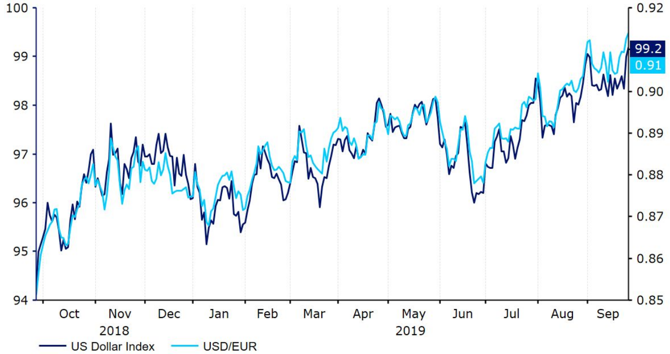


Currencies

US Dollar USD

> The US dollar (USD) has continued to remain elevated against its major peers in the past few weeks, rallying amid the ongoing flight from risk and more hawkish than expected message from the Federal Reserve's September monetary policy meeting. The currency has appreciated to its strongest position in over two years (Figure 1), despite the US central bank cutting interest rates for the second time in over a decade.

Figure 1: US Dollar Index (September '18 - September '19)



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The Federal Reserve has embarked on a drastic U-turn in policy since its most recent interest rate hike in December. Amid heightened downside risks from growing US-China trade tensions, policymakers have shifted from signalling that additional hikes are on the way to cutting rates by a total of 50 basis points so far this year. Chair of the Federal Reserve Jerome Powell has signalled that lower rates were a direct consequence of both weak domestic inflation and growing concerns among the committee regarding an escalation in the US-China trade conflict.

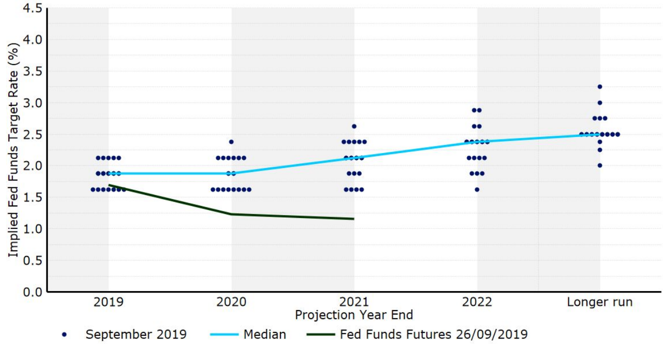
Negotiations between the US and China over trade took a turn for the worse in May, with President Trump unexpectedly hiking the existing tariffs on $200 billion worth of Chinese goods from 10% to 25%. While the G20 summit in Japan in late-June yielded a temporary ceasefire on additional tariffs and a promise of a resumption in trade talks, Trump slapped further 10% tariffs on an additional $300 billion worth of Chinese goods in early-August. These were set to take effect on 1st September, although some have been delayed. Recent comments regarding the negotiations from President Trump have been encouraging, although a resolution to the conflict is taking much longer than most market participants had anticipated.

In line with our expectations, the FOMC cut interest rates in the US for the second time in consecutive meetings in September, with all but two of the committee's voting members in favour of an immediate easing in policy. Members George and Rosengren dissent in support of no change in rates, while fellow ratesetter and notorious dove James Bullard wanted a deeper 50 basis point rate reduction. The tone of Chair Jerome Powell's accompanying press conference was, however, on the hawkish side as he talked up a strong domestic labour market and household spending. Exports had weakened according to Powell, although the additional weakness from abroad was not enough to materially alter the central bank's economic projections. The bank did, in fact, modestly upgrade its GDP growth forecast for this year to 2.2% from 2.1%.

The 'dot plot', which shows where each member of the committee expects rates to be at the end of each year, showed that the FOMC is divided regarding the need for additional action. While the median dot for 2019 signalled no additional rate cuts this year, seven of the seventeen members on the FOMC's board indicated their view that another rate reduction was needed in 2019 (Figure 2). Five members indicated that a higher Fed funds rate would be appropriate this year, although we think this merely represents the degree of opposition to Wednesday's rate cut rather than support for hikes.

US Dollar USD

Figure 2: FOMC September 2019 'Dot Plot'



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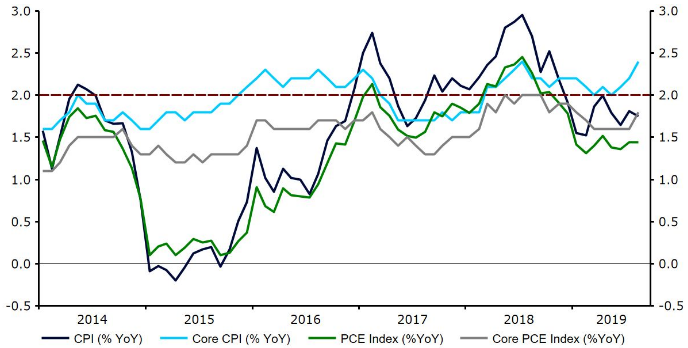
Increased appetite for cuts among the FOMC has a lot to do with the limited inflationary pressure in the US economy. The main headline rate of US consumer price growth has been below the central bank's 2% target in each of the past nine months. The Fed's preferred inflation measure, the PCE index, also came in at just 1.4% in August, while the core PCE index is now at only 1.8%, both below target (Figure 3). We note, however, that the core measure of inflation that strips out volatile food and energy components has remained at or above the 2% target. A still relatively solid labour market performance, most notably robust earnings growth, could keep prices elevated this year.

Figure 3: US Inflation Rate (2014 - 2019)



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As mentioned, the Fed has remained upbeat over the domestic economy, with its concerns largely focused on trade tensions. Much of the slowdown in the second quarter was driven by a sharp decline in business investment growth, although consumer spending picked up strongly from the beginning of the year. We continue to believe that there are no signs that an imminent recession or even a significant slowdown are on the cards. Year-on-year earnings growth remains above 3% and while the twelve month moving average job creation number has fallen, it remains at levels that do not warrant an aggressive easing cycle. Macroeconomic data on the whole has largely surprised to the upside in the past few months, with Citigroup's Economic Surprise Index now firmly back in positive territory and at its highest level since April 2018 (Figure 4).

Figure 4: Citigroup US Economic Surprise Index (2017 - 2019)

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During Powell's press conference, he stated that the Fed was not on a preset course and would be highly data-dependent, deciding on the need for action on a meeting-by-meeting basis. He did state that 'more extensive cuts may be needed' down the road and it would 'act as appropriate to sustain the expansion', although this would only be warranted if the economy takes a turn for the worse. We see this as an indication that the Fed is done with cutting interest rates for now, absent a crisis or US recession. Given that we see little chance of this materialising any time soon, we think that the Fed is now more likely than not to keep interest rates unchanged during the remainder of 2019. Our relatively optimistic opinion on global trade further supports this view.

US Dollar USD

Despite the above, we believe that the bar for Federal Reserve interest rate cuts is lower than that of the European Central Bank and indeed most other G10 central banks. In addition, the fact is that there is further room to cut there than in the Eurozone. This, in our view, should be supportive of our forecast for a broadly weaker US dollar against most major currencies. We therefore maintain our call for a gradual upward move in EUR/USD. The clear divergence in economic performance between the US and Eurozone does, however, provide a downside risk to our forecast in the near term.

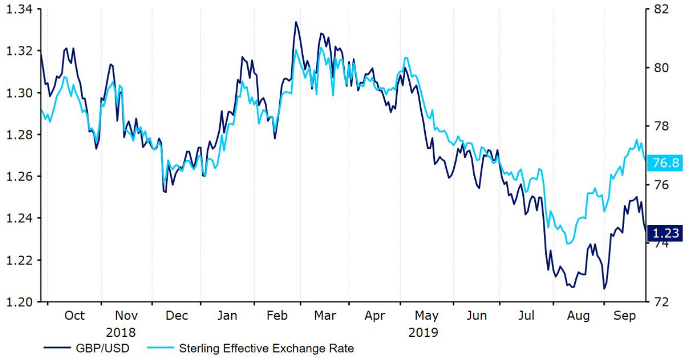
	EUR/USD	GBP/USD
E-2019	1.13	1.32
Q1-2020	1.15	1.35
Q2-2020	1.16	1.37
Q3-2020	1.17	1.38
E-2020	1.18	1.40

UK Pound GBP

> News headlines in the UK have continued to be dominated by Brexit developments in the past few months.

The failure of former Prime Minister Theresa May to force her Brexit withdrawal agreement through parliament has heightened concerns that the UK could be heading towards a 'no deal' Brexit come the delayed 31st October EU exit date. These concerns sent sterling sharply lower against its major peers since the beginning of May, with the pound sent crashing to its lowest level in three years at the beginning of September (Figure 5). The currency has, however, clawed back some of these losses in the past few weeks, with a number of political setbacks for Boris Johnson causing the market to dial back expectations for a 'no deal' Brexit.

Figure 5: GBP/USD (September '18 - September '19)



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UK Prime Minister May struck a draft deal with the European Union over a 585-page withdrawal agreement in late-November, but she was unable to force the deal through three separate parliament votes. While the margin of defeat for the third vote narrowed to 58 MPs, this was still far short of commanding a majority. The key sticking point to Brexit has been the inclusion of the so-called Northern Irish 'backstop' in the withdrawal agreement.

The backstop, a failsafe mechanism that ensures the avoidance of a hard border between Northern Ireland and the Republic of Ireland after Brexit, essentially ties the UK into the customs union for an indefinite period of time. This is something that the hard Brexiteers within the House of Commons have been firmly opposed to.

Theresa May's successor Boris Johnson has adopted a hard line stance with regards to Brexit, repeatedly stating that he would take the UK out of the European Union without a deal in place should no compromise be reached before the end of October. Johnson's Conservative Party lost their majority in parliament in early-September after he removed the whip of twenty-one party members for rebelling against his plans to keep a 'no deal' Brexit on the table. In another blow, the Supreme Court ruled that his suspension of parliament for five weeks leading up to mid-October was unlawful, effectively providing UK politicians with additional time to put in place measures that could avoid a hard exit. The Prime Minister will now be forced by law to request another extension to Brexit should no alternative solution be reached, with a general election likely to be called not long after.

Allayed concerns regarding a 'no deal' have been reflected in the latest bookmaker odds, which are now only placing an approximate 20% chance of such an outcome versus north of 40% a matter of a few weeks ago (Figure 6). It is worth noting, however, that while the House of Commons has voted in favour of rejecting a 'no deal' outright, this amendment is not legally binding and the possibility of the UK leaving the EU without a deal in place remains.

UK Pound GBP

Figure 6: Implied Probability of No Deal Brexit (Oct '18 - Sept '19)

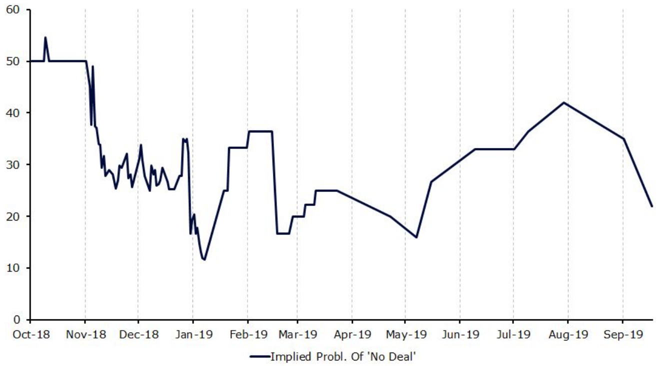

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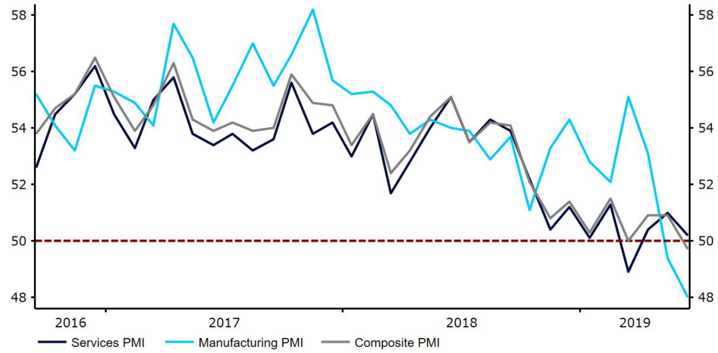
Figure 7: UK PMIs (2016 - 2019)



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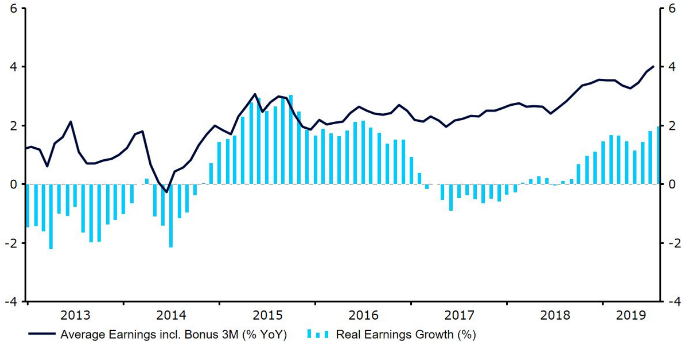
We're continuing to see the uncertainty over Brexit filter its way through to generally weaker UK consumer and business activity. The UK economy expanded at a decent pace of 0.5% quarter-on-quarter in the first three months of the year, although unexpectedly contracted by 0.2% in the second quarter. This marked the first period of negative growth since 2013. The latest indicators of economic activity ensure that growth is likely to remain weak in the coming months. Recent PMI prints have been particularly soft and are all now around or below the level of 50 that separates expansion from contraction. The composite PMI, which represents a weighted average of activity of the UK's services, manufacturing and construction sectors, came in at just 50.2 in August (Figure 7). This has been driven largely by a disastrous performance of the manufacturing index, which is currently deep in contractionary territory at 47.4.

With domestic activity slowing and the Brexit saga dragging on longer than expected, market pricing has shifted from penciling in tighter Bank of England policy commencing in early-2020 to pricing in interest rate cuts. At its most recent meeting in September, the BoE once again reaffirmed its wait-and-see stance, having revised lower its growth forecasts in August. Governor Mark Carney has stated that the perceived likelihood of a 'no deal' has increased, while noting heightened downside risks to growth. The bank has also reiterated its view that easing is possible should a Brexit deal fail to be agreed. Notorious hawk and BoE member Michael Saunders even stated in late-September that rates could be lowered regardless of whether or not the UK leaves the EU without a deal. UK inflation has also declined in the past twelve months, which may pressure the BoE to take on a more dovish stance. Core inflation came in at just 1.5% in August, its lowest level since late-2016, and is now comfortably below the central bank's 2% target.

We do stress, however, that the UK labour market remains a bright spot and has encouraged the BoE to reaffirm its view that 'gradual' and 'limited' interest rate hikes are required over the forecast horizon, provided we get a Brexit deal in the interim. The rate of UK unemployment has fallen again, declining to a fresh four decade low 3.8% in the three months to July. Earnings growth has also accelerated again to a more than one decade high 4% and in real terms is currently just above 2% (Figure 8). This is a very healthy level by recent standards and may provide support to UK growth should it filter its way through to an improvement in domestic consumer activity.

UK Pound GBP

Figure 8: UK Real Earnings Growth (2013 - 2019)



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	GBP/USD	GBP/EUR
E-2019	1.32	1.17
Q1-2020	1.35	1.17
Q2-2020	1.37	1.18
Q3-2020	1.38	1.18
E-2020	1.40	1.19

We think that sterling will continue to be driven almost entirely by Brexit developments throughout the remainder of 2019 and early-2020. We remain fairly optimistic regarding the possibility of a Brexit deal. While we acknowledge that the risk of a 'no deal' remains live, our base case scenario is for an agreement to be forced through the House of Commons at some stage. It appears that Boris Johnson simply does not have enough political muscle in order to force a 'no deal' over the line at this stage. A deal does, however, now look highly likely to require a delay to the 31st October exit date followed by a general election in order to break the impasse.

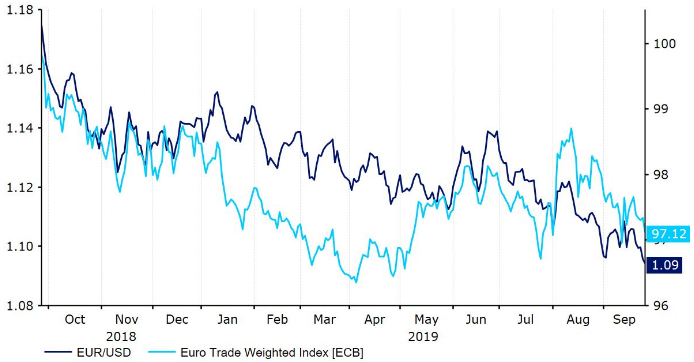
Any scenario that avoids a 'no deal' would, in our view, send the pound sharply higher and ensure that sterling ends the year as one of the best performing currencies in the G10. By contrast, a 'no deal' scenario would be the worst case for the UK currency. We would expect to see a sell-off in sterling of anywhere between 5-10% from current levels versus the US dollar.

Euro EUR

> The downward trend witnessed in the euro at the beginning of the year has recommenced itself since the end of June.

While the Federal Reserve has already cut rates on two occasions this year, the European Central Bank has also continued to strike a dovish tone, while easing policy itself at its most recent meeting in September. ECB policy action, combined with a string of generally soft domestic economic data, sent EUR/USD back below the 1.10 level in late-September. This ensures that the pair is now trading around its lowest level in two years (Figure 9).

Figure 9: EUR/USD (September '18 - September '19)



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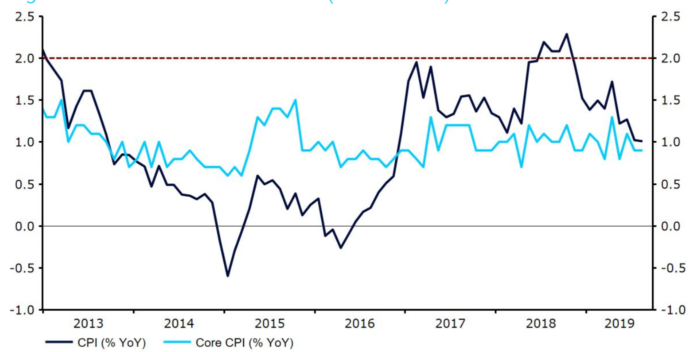
ECB President Mario Draghi caught the market off-guard during his 17th June speech in Sintra, Portugal. Draghi stated that 'lingering' downside risks were strengthening the case for policy action, giving a clear indication that extra stimulus was on the way. This stimulus came, as expected, at the bank's September meeting, with the Governing Council announcing it was cutting its deposit rate by 10 basis points to -0.5%. The bank also reintroduced its quantitative easing programme, pledging to purchase 20 billion euros a month worth of government bonds in order to stimulate the flagging Euro Area economy. The key takeaway from the press conference is that the asset purchase programme will run without an end date, i.e. it will be open-ended, reflecting the commitment of the ECB to lift inflation back to the bank's target level.

ECB President Mario Draghi struck a somewhat dovish note during the press conference, reinforcing the view that the central bank is more concerned about global trade uncertainties than the market had previously anticipated. While he touched on a few positives, mentioning 'robust' employment and wage growth, he did voice concerns over the 'protracted' weakness of the Euro Area economy, 'persistent' downside risks and 'muted' inflationary pressures. According to the bank's statement, rates will remain at their present or lower levels 'until it has seen the inflation outlook robustly converge to a level sufficiently close to, but below, 2% within its projection horizon'.

We have long reiterated that the ECB will maintain an accommodative policy stance so long as Eurozone inflation remains well short of the central bank's 'close to, but below 2%' target. Headline inflation came in at just 1.0% year-on-year in August, its lowest level since late-2016. The critical core inflation measure, the main economic data print the central bank looks at when deciding on monetary policy, has also remained stuck well short of target, coming in at just 0.9% (Figure 10). This measure has hovered around the 1% mark every month for the past five years and has, as of yet, not shown any signs of an uptrend towards the bank's target. A robust labour market should begin to filter its way to higher inflation, although this has taken much longer than the central bank (and us) initially anticipated.

Figure 10: Eurozone Inflation Rate (2013 - 2019)



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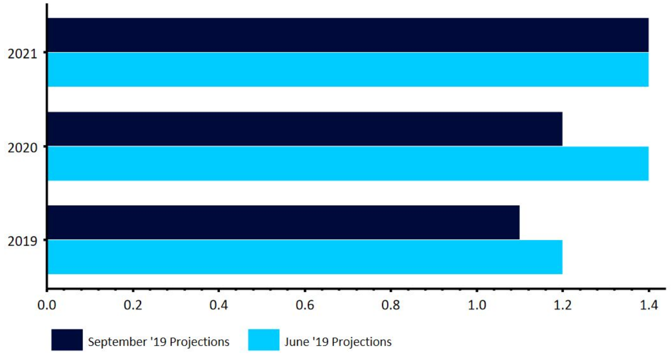
Euro EUR

Mario Draghi has recently claimed that the chances of a rebound in activity in H2 were lower than first thought, highlighting the recent downturn in manufacturing data, growing risks of protectionism and possibility of a hard Brexit. The Eurozone's economy has clearly slowed in the past year, which has helped increase speculation that ECB rate-setters will consider adopting an even more accommodative policy stance in the coming months. Growth in the second quarter of the year came in at just 0.2% QoQ and 1.2% on a year previous, its slowest pace since 2013. The ECB revised lower its growth forecast for this year in September to just 1.1% from 1.2% and 1.2% for 2020 from 1.4% (Figure 11).

Figure 11: European Central Bank Growth Forecasts (Sept '19)



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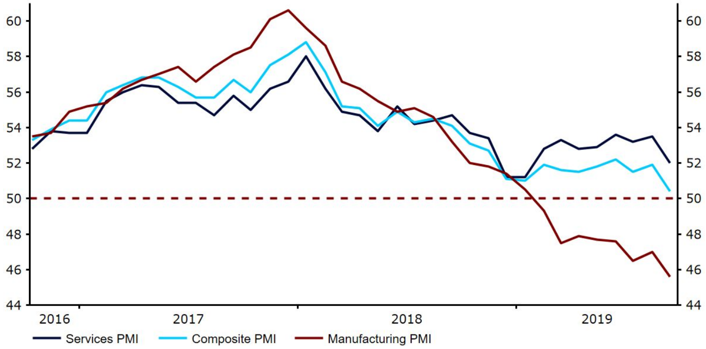
Date: 27/09/2019

The crucial composite PMI has fallen to fresh multi-year lows, declining to just 50.4 in September. This has been driven largely by a sharp contraction in the manufacturing sector, led primarily by a dismal performance in Germany. The manufacturing index slumped to 45.6, its lowest level since 2012 (Figure 12). Services activity has similarly showed signs of slowing, which is a concerning sign. Industrial production has also posted positive month-on-month growth on only two occasions since September 2018, declining by 1.4% month-on-month in June.

Figure 12: Eurozone PMIs (2016 - 2019)



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Despite recent policy easing from the ECB, we still believe that the likely path for EUR/USD in the next year is higher. With interest rates in the Eurozone already at or below zero, the Federal Reserve has much more room to lower rates than its European counterpart. This, we believe, should provide decent support for the common currency during the remainder of 2019. We therefore maintain our forecasts for a gradual appreciation in EUR/USD back towards the 1.18 level by the end of next year. A prolonged downturn in European data and the possibility of additional ECB easing in the form of an increase in the QE programme do, however, present a downside risk to this forecast.

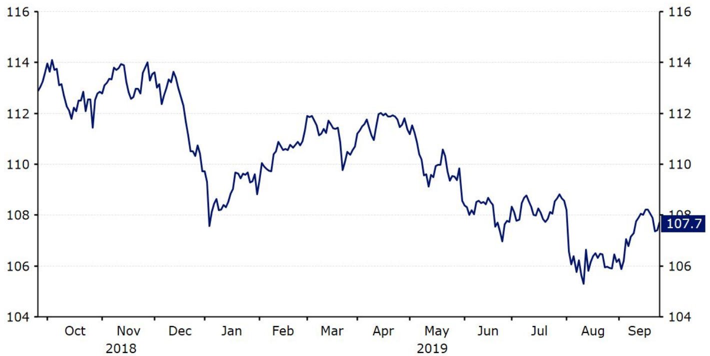
	EUR/USD	EUR/GBP
E-2019	1.13	0.86
Q1-2020	1.15	0.85
Q2-2020	1.16	0.85
Q3-2020	1.17	0.85
E-2020	1.18	0.84

Japanese Yen JPY

> The Japanese yen (JPY) has continued to benefit from growing uncertainty surrounding global trade tensions in recent weeks.

The safe-haven currency has been the favoured destination of foreign exchange traders amid the escalating US-China trade conflict, particularly after talks between the two economic superpowers took a turn for the worse in May. This rally has seen the yen appreciate by over 5% since late-April (Figure 13), with the currency by far and away the best performer in the G10 in the past twelve months.

Figure 13: USD/JPY (September '18 - September '19)



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Date: 26/09/2019

Fears regarding an escalation in the US-China trade war have caused investors to flock to the safety of the yen in the past year. President Trump has imposed and threatened to sanction a wide range of tariffs against China, including a 10% tax on $200bn worth of Chinese goods. This was unexpectedly hiked to 25% in May, causing investors to fret that a long awaited trade agreement between the two countries may not be the foregone conclusion that the market had expected. To make matters worse, Trump imposed fresh 10% tariffs on an additional $300bn worth of Chinese imports in early-August, effective 1st September.

While an eventual agreement is far from guaranteed, we have seen enough positive signs that suggest a trade deal between the two countries is more likely than not. Trump stated in late-September that 'good conversations' had been had and that a deal could happen 'sooner than you think'. We continue to believe that the Trump administration is not fundamentally serious about disturbing trade patterns, with his protectionist rhetoric largely a negotiating tactic rather than anything else. We think that an agreement between the US and China would undoubtedly lead to an unwinding of recent safe-haven flows away from the yen.

Uncertainty surrounding global trade has overshadowed recent underwhelming macroeconomic data out of Japan and the subsequent accommodative stance adopted by the Bank of Japan. A deterioration in economic conditions in the country has provided the Bank of Japan (BoJ) with very little incentive to alter its ultra-loose monetary policy stance. The BoJ kept interest rates unchanged at their latest meeting in September, having recently joined the chorus of major central banks in keeping its options open for additional policy easing should the economy take a turn for the worse.

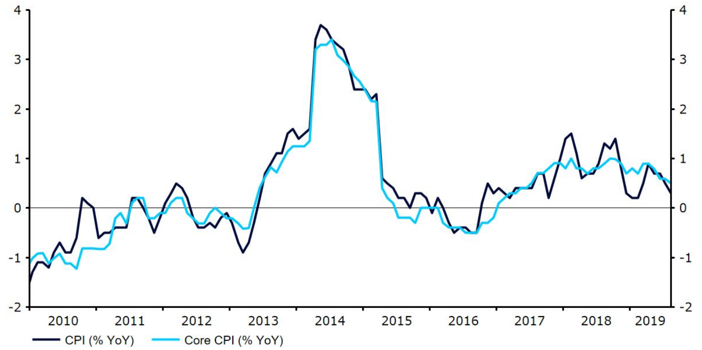
BoJ Governor Haruhiko Kuroda has reiterated the central bank's willingness to preemptively act in order to counter downside risks, stating that it would expand its stimulus programme 'without hesitation'. The BoJ has kept its main short-term interest rate negative at -0.1%, as we have anticipated, having now held it steady for more than three years. Its so-called 'quantitative and qualitative monetary easing with yield curve control' also sees the bank purchasing government bonds at an annual pace of approximately 80 trillion yen in order to maintain a 10-year government bond yield of around zero.

The BoJ's highly accommodative policy stance has had only a modest impact on domestic inflation, the main measure policymakers in Japan look at when deciding on monetary policy. Headline inflation picked up in the second quarter of the year, although remained well short of the central bank's 2% target level at 0.3% in August.

Japanese Yen JPY

Core price growth also remains stuck and has failed to breach the 1% level in every month since the removal of the effect of the sales tax hike from the index in 2015, falling to its lowest level since July 2017 (Figure 14). So long as inflation continues to show no signs whatsoever of a return back to the BoJ's target, we think that monetary policy in Japan will remain highly accommodative in 2019.

Figure 14: Japan Inflation Rate (2010 - 2019)



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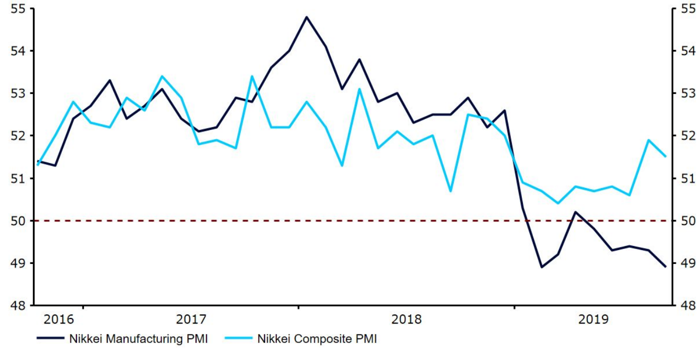
With a looming tax hike set to come into effect in October and external uncertainties clouding the global outlook, policymakers continued to sound a dovish tone on the Japanese economy in September, having revised lower their growth forecast for this fiscal year in July. The BoJ now expects the Japanese economy to expand by just 0.7% in 2019 versus its earlier 0.8% projection, largely due to its expectation for a much slower pace of expansion in exports. After picking up to 2.2% annualised in the first three months of the year, growth in Japan has eased, coming in at nearly half this rate in the second quarter. Signs for the rest of the year are not all that encouraging.

Activity indices in the country's sizable manufacturing industry have collapsed since the beginning of the year, falling below the level of 50 denoting contraction in every month but one since February (Figure 15). Industrial production also collapsed in June, which does not bode particularly well, contracting by 3.3%, although it has since rebounded somewhat.

Figure 15: Japan Manufacturing PMI (2016 - 2019)



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Despite recent doom and gloom headlines, we remain optimistic regarding the possibility of a trade deal between the US and China being struck at some point in the coming months. This, as we mentioned, should lead to an unwinding of safe-haven flows and an increase in appetite for risk. A reversal in safe-haven flows and continued dovishness on the part of the Bank of Japan, which looks set to maintain its accommodative stance for the foreseeable future should, we believe, lead to a depreciation in the Japanese yen against the dollar through to the end of 2020.

That being said, we do revise our short term forecasts for the yen higher. Heightened uncertainty surrounding the trade war has ramped up safe-haven flows into the currency and caused the yen to strengthen to a much greater degree than we had anticipated.

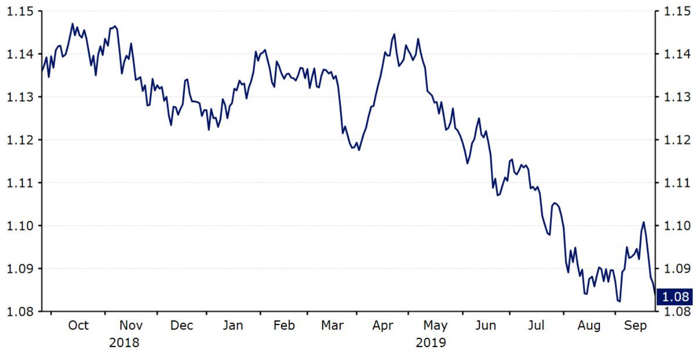
	USD/JPY	EUR/JPY	GBP/JPY
E-2019	112	127	148
Q1-2020	114	131	154
Q2-2020	115	133	158
Q3-2020	115	135	159
E-2020	116	137	162

Swiss Franc CHF

> The safe-haven Swiss Franc has continued to be driven largely by investors' changing appetite for risk in the past few quarters.

Along with the other G10 safe-haven, the Japanese yen, the franc has rallied sharply against its major peers since May, with investors flocking to the currency amid growing uncertainty surrounding the US-China trade war. These inflows allowed CHF to rally to its strongest position against the common currency in over two years in September (Figure 16), making the franc the second best performing currency in the G10 in the past year, behind the yen.

Figure 16: EUR/CHF (September '18 - September '19)



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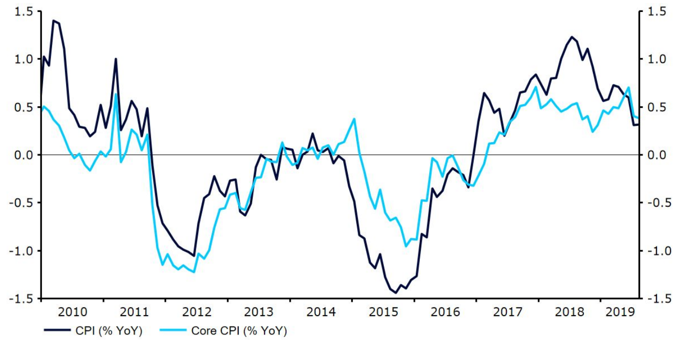
Concerns surrounding the recent escalation in trade tensions and subsequent safe-haven flows into CHF have caused the Swiss National Bank (SNB) to maintain its highly accommodative monetary policy stance and intervene in the markets in order to weaken the domestic currency. A strong CHF does not create a supportive inflationary environment for Switzerland while also hampering the country's export industry. The Swiss National Bank (SNB) has long grappled with stubbornly low inflation and has remained one of the more dovish central banks in the G10 in recent months. Interest rates have been kept deep in negative territory, with policymakers once again holding rates steady at -0.75% at the SNB's most recent monetary policy meeting in September.

SNB Chairman Thomas Jordan continued to strike a dovish tone, suggesting that the bank has room for an even more accommodative policy. He also once again expressed the bank's willingness to intervene in the FX market. Policymakers appear to have intervened in the market in late-July and early-August, buying foreign reserves and selling its domestic currency holdings in order to stem the franc's appreciation. We would expect them to continue to do so in order to prevent the currency rallying too far below the psychological 1.10 level against the Euro. Policymakers have repeatedly reiterated their desire for a weaker CHF in order to lift inflation and improve export competitiveness.

Heightened downside risks to growth from abroad, namely trade war fears and Brexit, and subdued inflationary pressure are likely to ensure that the SNB's ultra-loose policy stance remains in place for some time yet. Headline inflation has fallen further below the bank's target in the past few months, sinking to just 0.3% year-on-year in August (Figure 17), half the pace of earlier in the year and its lowest level in two years. Policymakers have stated that inflationary pressure is likely to remain moderate, with risks to their baseline scenario still to the downside. We could conceivable see the SNB lower their main interest rate even further into negative territory later this year, particularly after the European Central Bank eased policy in September. Financial markets are now placing around a 40% chance of a rate cut from the SNB by the end of the year.

Figure 17: Switzerland Inflation Rate (2010 - 2019)



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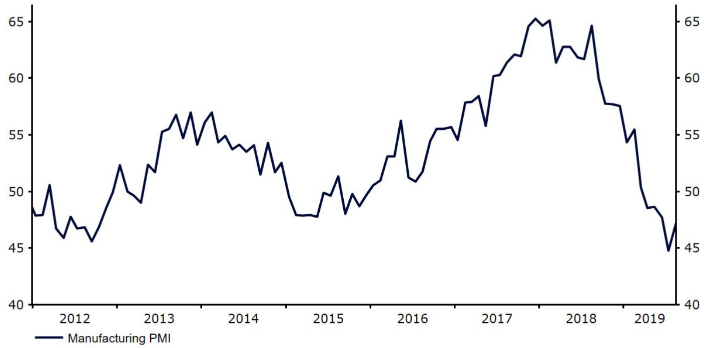
Date: 26/09/2019

Swiss Franc CHF

Growing downside risks to growth from abroad ensure that economic activity in Switzerland has been rather sluggish in the past few quarters, further encouraging the SNB to maintain its accommodative policy stance. The Swiss economy has recovered from its contraction in the second half of last year. Domestic demand has remained fragile, largely due to slow wage growth, while investment has also been sluggish. The manufacturing PMI from Markit has also nose-dived and is now deep in contractionary territory. The index sank to just 44.7 in July, its lowest level in a decade, although it has since picked up to 47.2 in August (Figure 18).

Figure 18: Switzerland Manufacturing PMI (2012 - 2019)



Refinitiv Datastream
Date: 26/09/2019

We think that recent CHF strength and the anemic levels of inflation that have followed ensure that the Swiss National Bank will maintain its highly accommodative monetary policy stance for some time yet. The SNB has continued to voice its discomfort for a stronger franc and appears committed to continue intervening in the currency markets in order to prevent a significant appreciation of the currency against the Euro.

On the other hand, Switzerland safe-haven status ensures that it remains an attractive proposition to investors in periods of unrest, albeit we expect much of these inflows to be unwound once concerns over a US-China trade war eventually abate. This, in our view, would ensure a relatively stable EUR/CHF around the 1.14 level witnessed prior to the latest blow up in trade tensions back in May.

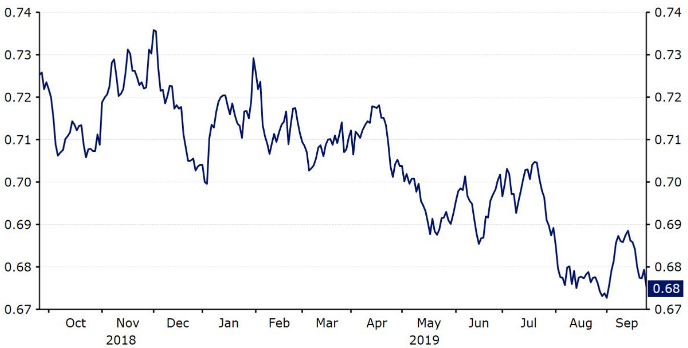
	USD/ CHF	EUR /CHF	GBP/CHF
E-2019	0.98	1.11	1.30
Q1-2020	0.98	1.13	1.33
Q2-2020	0.98	1.14	1.35
Q3-2020	0.97	1.14	1.34
E-2020	0.97	1.14	1.35

Australian Dollar AUD

> The Australian dollar (AUD) has suffered heavily in the past few months, bearing the brunt of the risk-off mode induced by an escalation in the US-China trade war and lower rates from the Reserve Bank of Australia (RBA).

The currency has now shed over 16% of its value since late-January 2018 and was sent crashing to its weakest position against the US dollar in over ten years in early-September (Figure 19). This ensures that the Australian dollar has been the second worst performing currency in the G10 since the beginning of last year.

Figure 19: AUD/USD (September '18 - September '19)



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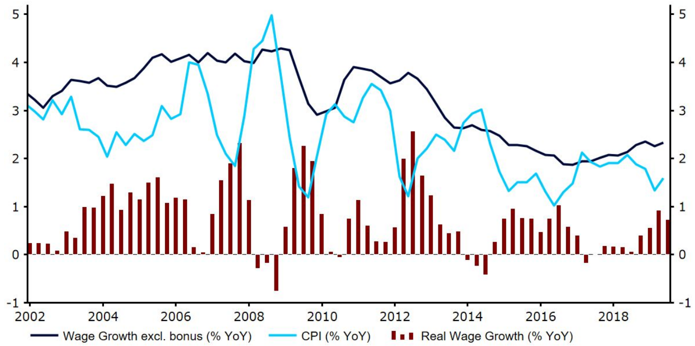
Date: 26/09/2019

AUD has suffered due to heightened uncertainty surrounding the US-China trade conflict, given that demand from China accounts for around one-third of the country's overall export revenue. This makes the Australian economy one of the more exposed within the G10 to an escalation in the trade conflict. A combination of growing uncertainty over trade, weak household spending and a cooling residential construction sector caused the Australian economy to expand by just 0.5% quarter-on-quarter in the three months to Jne and by just 1.4% on a year previous. This marked the economy's slowest pace of expansion since 2009.

In light of the rather drastic domestic growth slowdown and escalation in global trade tensions, the Reserve Bank of Australia (RBA) has embarked on a gradual process of monetary easing, cutting interest rates on two occasions already this year. The RBA cut rates by 25 basis points in June and by another 25 basis points in July to a fresh record low 1.00%. According to the RBA's July minutes, 'the Board would continue to monitor developments in the labor market closely and adjust monetary policy if needed to support sustainable growth in the economy and the achievement of the inflation target over time'. This suggests that additional interest rate reductions are on the table, though policymakers stopped short of signalling the timing of such a move. Financial markets are now placing around an 80% chance of another cut at the upcoming October meeting.

An easing in wage pressure in the past few years has capped the growth of domestic consumption and is dragging on economic activity. Labour market conditions have, however, shown signs of improvement. Earnings growth increased back up to 2.3% in Q2 (Figure 20), although this is low compared to historical standards. Unemployment declined to a seven year low 4.9% in February, though this has now increased back up to 5.3%. Record low interest rates from the RBA are expected to both help reduce unemployment and lift wages over time according to the central bank.

Figure 20: Australia Real Earnings Growth (2002 - 2019)

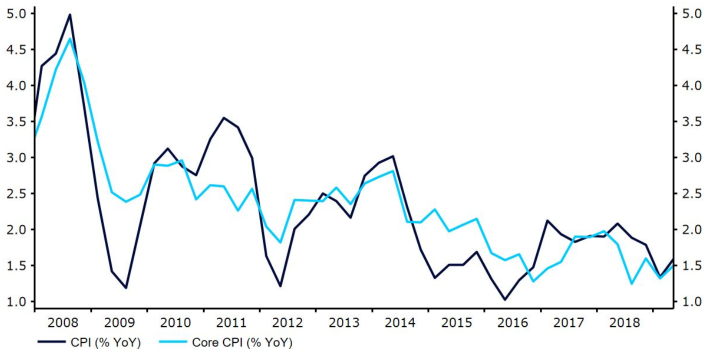


Refinitiv Datastream
Date: 26/09/2019

Australian Dollar AUD

The lack of inflationary pressure in Australia, both in the housing market and domestic consumer prices, has also contributed to the RBA's recent dovish turn. Headline inflation has remained below the central bank's 2.5% target level for some time now, with the main measure of consumer price growth coming in at 1.6% in the second quarter of the year (Figure 21). While a modest acceleration on the lowly 1.3% recorded in the first three months of the year, this is still comfortably below the RBA's target level and has not yet shown any signs of a meaningful uptrend towards the central bank's goal.

Figure 21: Australia Inflation Rate (2008 - 2019)



Refinitiv Datastream
Date: 26/09/2019

The underwhelming performance of the Australian economy in the past few quarters, namely slower growth and declining inflation, is a cause for concern, although not enough to ensure an aggressive pace of easing from the RBA. The main rationale behind the recent rate cuts is, we believe, the escalation in the US-China trade conflict. The striking of a deal between the US and China over trade, as is our base case scenario, would certainly help alleviate pressure on the bank to loosen policy further.

Because of our optimistic view over global trade we believe that the Australian currency is currently trading at rather undervalued levels and that additional losses for the Australian dollar from current levels will be limited. We do, however, revise lower our forecasts for AUD across the board in order to reflect the RBA's more dovish stance than we had anticipated.

	AUD/USD	EUR/AUD	GBP/AUD
E-2019	0.69	1.64	1.91
Q1-2020	0.70	1.64	1.93
Q2-2020	0.71	1.63	1.93
Q3-2020	0.71	1.65	1.94
E-2020	0.72	1.64	1.94

New Zealand Dollar NZD

> The New Zealand dollar (NZD) has also sold-off sharply in the past few weeks amid heightened uncertainty over global trade. This, combined with a more aggressive pace of interest rate cuts from the Reserve Bank of New Zealand (RBNZ) than the market had anticipated, has seen the currency lose more than 8% of its value since late-March alone. This ensures that NZD is currently trading at its lowest level against the dollar since early-2009 (Figure 22).

Figure 22: NZD/USD (September '18 - September '19)

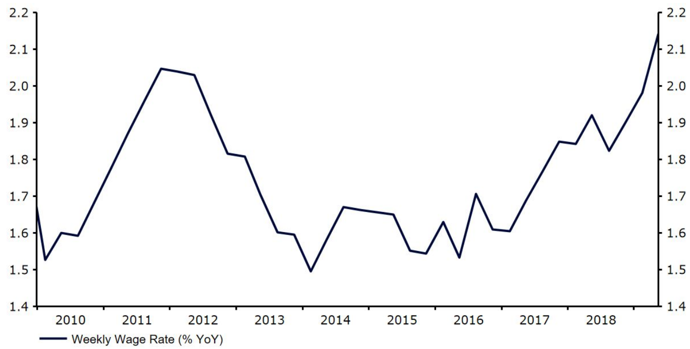
Refinitiv Datastream
Date: 26/09/2019

The Reserve Bank of New Zealand (RBNZ) was the first central bank in the G10 to begin cutting interest rates earlier in the year, lowering its main lending rate by 25 basis points for the first time since 2016. This was followed by a larger-than-expected 50 basis point rate reduction in August, with policymakers at the RBNZ stunning the market by opening the door to a very aggressive pace of policy easing. RBNZ Governor Adrian Orr stated at the time that further rate cuts were possible in the upcoming meetings, even suggesting that the bank would consider negative interest rates in order to stimulate the economy. This drastic dovish shift triggered the largest one-day drop in the dollar in over two years.

The central bank's perceived need for additional easing comes off the back of a number of downside risks to the domestic economy, predominantly the slowdown in China and uncertainty surrounding the US-China trade war. The New Zealand economy is one of the most exposed of all the major economies to a potential slowdown in China, given that the Asian country accounts for around one-quarter of New Zealand's overall export revenue. The economy has also been under pressure from falling house prices and weak business sentiment that could weigh on overall growth in the second half of the year. Growth has been on a downward trajectory in New Zealand for the past few years, coming in at 2.1% year-on-year in the second quarter of the year, its slowest pace since 2014. Recent PMI data suggests that activity got off to a rocky start to the third quarter, with the manufacturing index coming in at 48.4 in August, having slumped to its lowest level since 2012 in July. Uncertainty over global trade is likely to have played a part in the swelling of the country's trade deficit, which rose to its highest level in eleven months in August.

There are, however, reasons to be optimistic over the outlook, particularly given the recent improvements in labour market conditions in New Zealand that could begin to filter its way through to a pick-up in domestic economic activity. Earnings growth has continued to show signs of an uptrend in recent quarters and is now above 2% (Figure 23), just higher than inflation. Unemployment just below 4% is also around its lowest level in a decade.

Figure 23: New Zealand Wage Growth (2010 - 2019)



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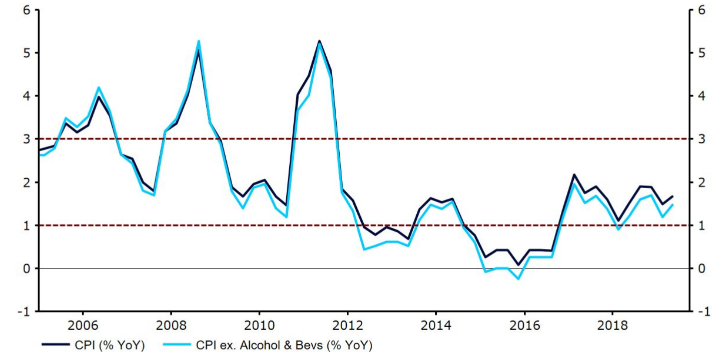
Date: 26/09/2019

New Zealand Dollar NZD

The recent strength of the job market is expected to lift inflation back to the midpoint of the bank's 1-3% target range over time, although the Q2 inflation number came in below 2% for the ninth straight quarter. Headline inflation came in at 1.7 in the three months to June (Figure 24), with the core measure only coming in at 1.5%. Softer domestic growth means that risks to inflation are tilted to the downside. Financial markets are now pricing in around a 60% implied probability of another rate cut from the RBNZ before the end of 2019.

Figure 24: New Zealand Inflation Rate (2008 - 2019)



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Date: 26/09/2019

	NZD/USD	EUR/NZD	GBP/NZD
E-2019	0.64	1.77	2.05
Q1-2020	0.65	1.77	2.08
Q2-2020	0.65	1.78	2.11
Q3-2020	0.65	1.80	2.12
E-2020	0.65	1.82	2.15

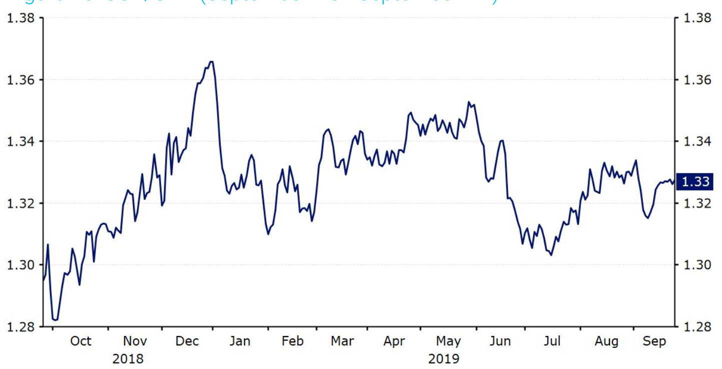
Heightened uncertainty surrounding US-China trade relations presents itself as a potentially significant downside risk to NZD, particularly should it continue to force the RBNZ to cut interest rates again at its upcoming meetings. Our optimistic view over global trade does, however, mean that we think the worst of the New Zealand dollar's losses against the US dollar are behind us.

Canadian Dollar CAD

> In line with our forecasts, the Canadian dollar (CAD) has been the best performing currency in the G10 so far in 2019, helped on its way by the Bank of Canada's less dovish stance relative to its major counterparts.

The currency fell to its lowest level in five months at the end of May (Figure 25), although rallied back to its strongest position since October 2018 in July after the BoC made it clear that it has little appetite to follow suit with the Federal Reserve in easing monetary policy this year. It has lost a bit of ground since then, although is still trading almost 3% higher year-to-date.

Figure 25: USD/CAD (September '18 - September '19)



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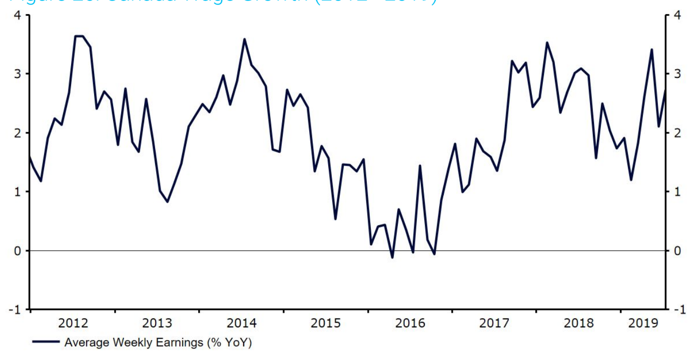
Date: 26/09/2019

The Bank of Canada has been one of the few major central banks to engage in a monetary tightening cycle in the past couple of years, raising rates by a total of 125 basis points in a little over a year starting in mid-2017. While policymakers suggested that a pause in the hiking cycle was appropriate at its March meeting, the central bank has steered clear of indicating that lower rates are on the horizon. At its September meeting, Governor Stephen Poloz continued to highlight the risks posed by recent trade uncertainty to the global economy, saying that it was 'taking a toll' on the Canadian economy. It has not yet indicated, however, that lower rates are on the cards, instead adopting a wait-and-see stance that suggests it will pause for breath before deciding on the need for action.

Poloz's comments during the press conference are very much in line with our view that the BoC will likely keep rates stable throughout 2019, provided global economic conditions do not take a significant turn for the worse. Financial markets now placing only around a one-in-four chance of a cut from the Bank of Canada during the remainder of 2019.

The shift away from rate hikes towards stable policy has come amid both global trade uncertainty and a broad slowdown in the Canadian economy. Canada's economy expanded by just 0.1% in both Q4 2018 and Q1 2019, with year-on-year growth falling to its lowest level in almost three years in the first three months of the year. The soft performance at the beginning of the year was driven chiefly by a contraction in the manufacturing sector (-0.8%) and a sharp drop in motor vehicle construction (-7.7%). That being said, consumer spending remains robust, while a solid labour market and strong wage growth (Figure 26), should help support domestic activity. Growth did indeed accelerate in the second quarter, with the economy growing by a very healthy 0.9% quarter-on-quarter.

Figure 26: Canada Wage Growth (2012 - 2019)



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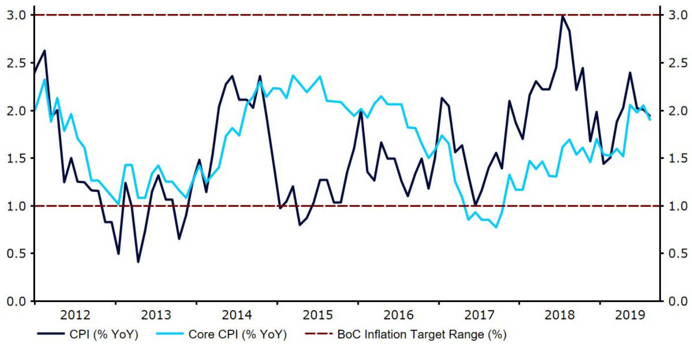
Date: 26/09/2019

Canadian Dollar CAD

It is worth noting that inflation in Canada has remained comfortably within the Bank of Canada's 1-3% target range in recent months, in itself providing policymakers with little incentive to alter its current policy stance. Headline inflation softened to 1.9% in August from 2.0% a month previous (Figure 27), although this still remains right in the middle of the bank's target range. We think that the broad recovery in global oil prices since the beginning of the year should be supportive of Canadian inflation as higher commodity prices begins to filter its way through into the consumer price index. The BoC is pencilling in a modest dip in inflation before the measure returns back to the 2% target next year.

Figure 27: Canada Inflation Rate (2012 - 2019)



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Date: 26/09/2019

Despite the above, we think that the Canadian dollar should be well supported by the recent uptick in global oil prices in 2019. CAD has historically followed a fairly similar path to that of oil prices (Figure 28), given that the commodity accounts for around a quarter of Canada's overall export revenue. Brent crude oil prices have initiated a broad recovery since falling to a near year-and-a-half low at the back end of last year, albeit prices have fallen again since April. A continued recovery during the remainder of the year, in line with the broad consensus, could filter its way through to a broadly stronger Canadian dollar.

Figure 28: CAD/USD vs. Crude Oil Prices (2014 - 2019)

Refinitiv Datastream
Date: 26/09/2019

We remain optimistic about the prospects for the Canadian dollar. While the Bank of Canada has brought its hike cycle to a temporary halt, the BoC is one of the few central banks in the G10 that has not adopted an easing bias and looks unlikely to do so during the remainder of the year. With domestic inflation right in line with the central bank's target and the Canadian labour market showing encouraging signs of improvement, we think that the BoC will keep interest rates unchanged at least through 2019. This relatively less dovish stance compared to its major peers should, in our view, lead to additional gains for CAD through the end of next year, particularly against the US dollar. Higher oil prices and our expectation for an alleviation in global trade tensions should also prove supportive, particularly given the Canadian economy's high sensitivity to external demand.

	USD/CAD	EUR/CAD	GBP/CAD
E-2019	1.30	1.47	1.72
Q1-2020	1.29	1.48	1.74
Q2-2020	1.28	1.48	1.75
Q3-2020	1.27	1.49	1.75
E-2020	1.26	1.49	1.76

Swedish Krona SEK

> The Swedish krona (SEK) has remained at very weak levels against the euro so far in 2019 and has not yet initiated the rally that we had believed was on the cards for the currency.

Weak domestic macroeconomic data and delayed expectations for Riksbank interest rate hikes has hit the currency hard this year. The krona fell to its lowest level in seventeen years in May (Figure 29). While a modest recovery followed in the three months to August, the currency has fallen again amid ongoing global trade concerns and news that the Swedish economy put in one of its worst performances in recent years in the second quarter. This ensures that the krona has been by far the worst performing currency in the G10 so far in 2019.

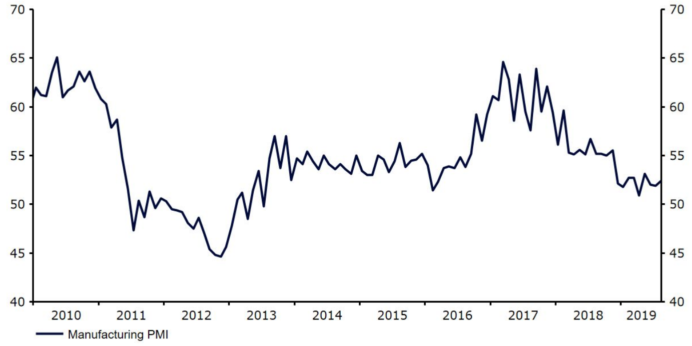
Figure 29: EUR/SEK (September '18 - September '19)

Refinitiv Datastream
Date: 26/09/2019

Sweden's central bank, the Riksbank, announced a long awaited interest rate hike in December 2018, its first in seven years. Rates were raised, somewhat unexpectedly, by 25 basis points to -0.25%, albeit this only provided very temporary assistance to the currency. Commentary out of the central bank since then has been dovish, particularly amid the blow up in US-China trade relations. The Riksbank suggested that additional hikes would be warranted in the second half of the year back in December, although this is now unlikely to take place until next year at the earliest.

A major blow to the central bank's plans to raise interest rates came in the form of an unexpected GDP contraction in the second quarter of the year. Sweden's economy contracted by 0.1% on a quarter previous, only the second time this has occurred in six years. On an annual basis, the economy only grew by 1.4%, which itself was also its worst performance since 2013. Net exports were weaker than forecast, with a decline in investment also weighing on growth. Early signs for the third quarter have been mixed, although a pick-up in the services PMI back into expansionary territory is encouraging (Figure 30).

Figure 30: Sweden Manufacturing PMI (2010 - 2019)



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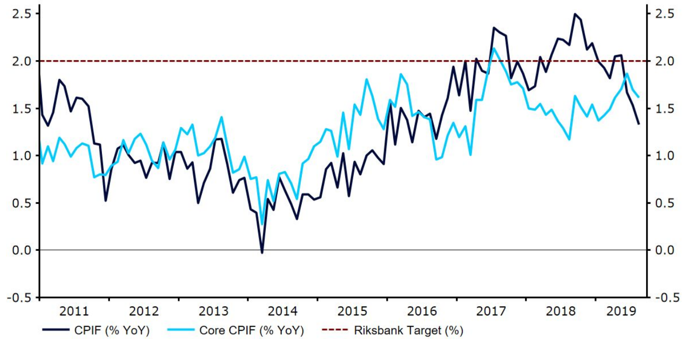
Date: 26/09/2019

Even following the recent decline in the value of SEK, Sweden's main measure of inflation has begun to lose steam again. The CPIF measure, which strips out the effect of changes to mortgage rates, has fallen back below the central bank's target, declining to just 1.3% in August. Similarly to the Eurozone, the level of core inflation has continued to remain stuck well short of target, coming in at just 1.6% (Figure 31). This provides the Riksbank with limited incentive to rush its interest rate hiking cycle. That being said, central bank chief Stefan Ingves stated that he had increased confidence that inflation is established close to target and that the need for a highly expansionary monetary policy had 'decreased slightly'.

Swedish Krona SEK

Figure 31: Sweden Inflation Rate (2011 - 2019)



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Date: 26/09/2019

Given that policy tightening from the Riksbank is still likely to come sooner than the European Central Bank, we continued to believe that the sell-off in SEK in the past few months has been excessive and left the currency at rather undervalued levels.

We therefore maintain our forecasts for an appreciation in the Krona against the Euro in 2019. The recent worsening in sentiment towards the currency does, however, mean that we have little choice but to delay our timetable for SEK appreciation.

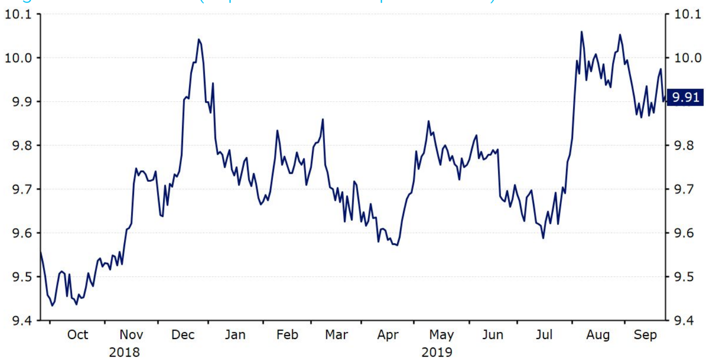
	USD/SEK	EUR/SEK	GBP/SEK
E-2019	9.40	10.60	12.40
Q1-2020	9.15	10.50	12.35
Q2-2020	8.90	10.35	12.20
Q3-2020	8.70	10.20	12.00
E-2020	8.15	9.60	11.40

Norwegian Krone NOK

> A combination of relatively low oil prices and the global flight to safety induced by the US-China trade war has hit the Norwegian krone (NOK) hard since late-July.

The krone was one of the better performers in the G10 up until mid-July, although it has since shed over 3% of its value versus the euro. This saw the currency slide to fresh post-financial crisis lows in August (Figure 32).

Figure 32: EUR/NOK (September '18 - September '19)



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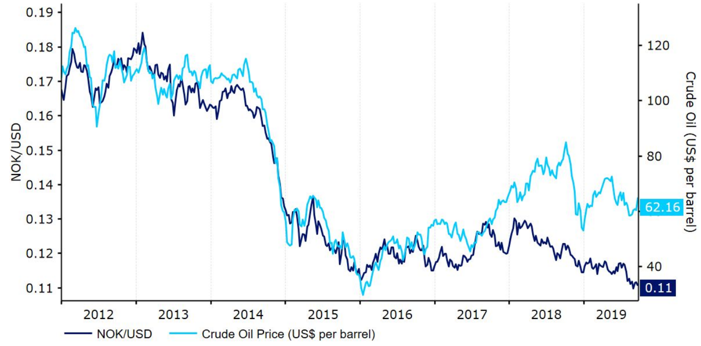
Date: 26/09/2019

Global crude oil prices fell sharply at the back end of 2018, largely due to concerns over increased oil output. The commodity lost over 40% of its value in a little over two months through to late-December. This damaged sentiment towards the krone, given that oil accounts for around two-thirds of Norway's overall export revenue. Crude oil prices have, however, been on a broad upward trend since then, firstly following ongoing supply cuts from OPEC and then following an attack on Saudi Arabia's oil facilities in September. The krone had experienced a divergence with global oil prices in late-2017, although this trend appears to have reestablished itself. We think that a continuation of the recovery in oil in the coming months should provide decent support for the Norwegian currency.

Figure 33: NOK/USD vs. Crude Oil Prices (2012 - 2019)



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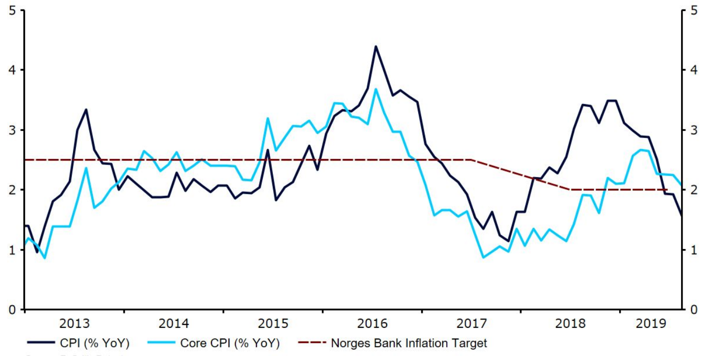
Date: 26/09/2019

The Norwegian krone has also been well supported by higher interest rate from Norway's central bank, Norges Bank, in the past year or so. Norges Bank raised rates by another 25 basis points to 1.50% at their September monetary policy meeting following their previous rate increase in June, in line with expectations. Norway is the only G10 central bank that has pushed forward with rate hikes this year, unmoved by the growing uncertainty created by US-China trade concerns. It did, however, state that further further rate hikes were now less likely amid a global economic slowdown.

Norges Bank's rationale for higher rates earlier in the year was a generally robust set of growth and inflation numbers, both of which were supported by higher oil prices. Recent economic data has, however, taken a turn for the worse in the past few months. Headline inflation spent the entirety of the second half of 2018 above the 3% mark, although this has since fallen fairly sharply and is now back below the 2% target at 1.6%. Core inflation has, at least, held firm and remains above Norges Bank's target level (Figure 34).

Norwegian Krone NOK

Figure 34: Norway Inflation Rate (2013 - 2019)



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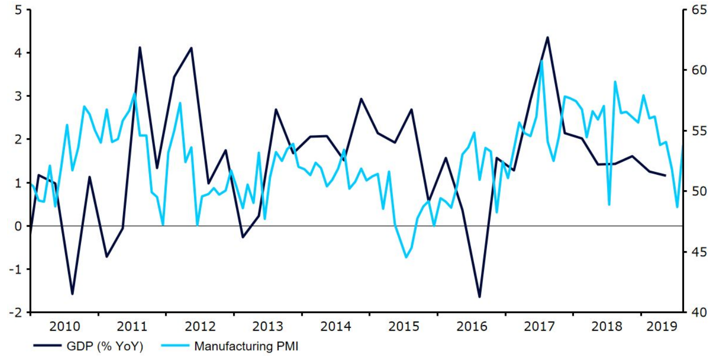
Date: 26/09/2019

Growth has slowed on an annual basis, with the economy contracting by 0.7% year-on-year in the second quarter, although quarterly growth remained at a much healthier 0.3%. Barring a one-off decline in July, the manufacturing PMI has remained above the level of 50 denoting expansion in every month for over a year (Figure 35), which bodes well for overall growth.

Figure 35: Norway Manufacturing PMI (2010 - 2019)



Refinitiv Datastream
Date: 26/09/2019

With Norges Bank one of the very few major central banks looking likely to raise interest rates this year, and with oil prices projected to rebound, we think that the Norwegian krone will be one of the better performers in the G10 this year. We therefore continue to forecast gains for NOK against both the US dollar and euro in 2019.

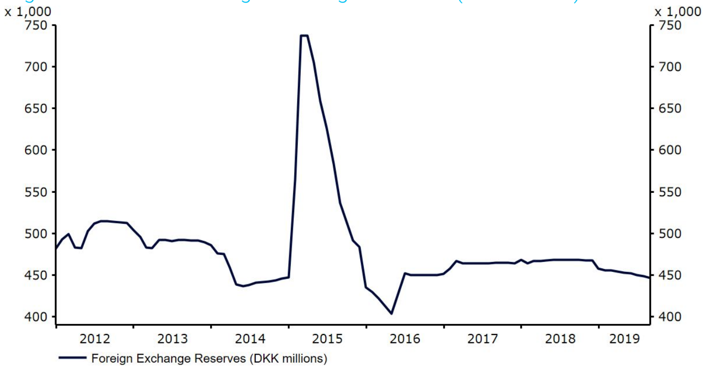
	USD/NOK	EUR/NOK	GBP/NOK
E-2019	8.50	9.60	11.20
Q1-2020	8.15	9.40	11.00
Q2-2020	7.95	9.25	10.90
Q3-2020	7.80	9.10	10.75
E-2020	7.65	9.00	10.70

Danish Krone DKK

> The Danish National Bank (DNB) has continued to have no trouble in maintaining the Danish krone's peg of 7.46 DKK to the Euro since our last G10 forecast revision. The DNB intervenes in the currency markets using its foreign exchange reserves on a regular basis in order to limit fluctuations around this rate.

Denmark's foreign exchange reserves held at the central bank have remained around the same level for over three years, suggesting that there has been very limited speculative pressure on the currency's euro peg. FX reserves declined modestly to 448 billion DKK in July, with the central bank conducting only very modest intervention so far this year. The central bank has had very little need to intervene in the foreign exchange market in order to ensure currency stability ever since the Brexit vote in June 2016 (Figure 36). Foreign exchange reserves still only equate to just 20% of Denmark's overall GDP, with reserves now 40% lower than their peak following the removal of the Swiss franc's euro cap in January 2015.

Figure 36: Denmark Foreign Exchange Reserves (2012 - 2019)



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In order to deter speculative bets and prevent an unwanted appreciation of the currency, the Danish National Bank has maintained its interest rate deep in negative territory at -0.65%, having held its policy steady since January 2016. Recent communications from the central bank suggest that rates will remain negative for the foreseeable future. The DNB's large stock of foreign exchange reserves also lessens the urgency to hike any time soon.

The Danish National Bank has continued to reiterate its desire to maintain its peg against the euro, claiming that they have limitless scope to alleviate appreciating pressure and deter another speculative attack on the currency. We think the still negative interest rate spread with the Eurozone and comfortable level of FX reserves in Denmark should allow the DNB to maintain the existing EUR/DKK peg at the 7.46 level for the foreseeable future.

	USD/DKK	EUR/DKK	GBP/DKK
E-2019	6.60	7.46	8.70
Q1-2020	6.50	7.46	8.75
Q2-2020	6.45	7.46	8.80
Q3-2020	6.40	7.46	8.80
E-2020	6.30	7.46	8.85

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