

Third Quarter, 2020

July 7, 2020 - HotForex Market Analyst Team

UNITED STATES

The first half and particularly Q2 of 2020 has had a more significant impact on the US economy than anything in living memory. The Great Financial Crash of 2008/9, the Dot-com bubble burst of 2000 and the October market sell-off of 1987 all had a less of an impact than the spread of the coronavirus and COVID-19. Over 125,000 US lives have been lost during its spread and as we enter Q3 the big fear is the spike in infections, hospitalizations and deaths from the combined impact of early relaxation of lockdowns particularly in the south and west of the country and the ongoing rallies and protests over economic and racial inequality following the death of George Floyd. Over 47 million new unemployment claims have been registered in the first half of 2020 with over 30 million of those in Q2. Unemployment soared to 14.75% and remains elevated at 11.1%.

The May and June non-farm payroll data suggests a strong V-shaped recovery may be attainable with 2.5 million and 4.8 million jobs being created respectively, however the dichotomy of a continued rise in unemployment claims on a weekly basis and a rise in new jobs on a monthly basis will have to be resolved during Q3.

Q1 GDP growth was confirmed at -5%, and expectations for Q2 are for a record decline to -32%. The Q2 Earnings season kicks off July 15 and is expected to see a huge squeeze on corporate profits and growth rates. The real question remains as to the type and style of the recovery. The two-quarter collapse caps the longest expansion in US history, and sets the base for what will likely prove to be the sharpest rebound in history in Q3 and Q4 too.

While economic activity will remain sluggish as the COVID-19 crisis persists, the truce with China may also come under scrutiny again and could suggest a deeper pullback, however, after some initial exchange of negative rhetoric, both sides appear to have stepped back from the brink. Adding to the less dire outlook is the continued accommodative policy stance from the Federal Reserve and the federal government.

The **Dollar** was in demand as a safe haven currency during Q2 but as global economies continue to recover that demand could cool over the coming months if the economic outlook fails to pick up as expected. The USDIndex rallied to 101.00 in April before closing Q2 down 3.6%, below 97.35. The prospects for the **Dollar** are mixed as lower growth and lower future interest rate differentials weigh against it, however, with all central banks moving in dovish unison, the Dollar retains its appeal and is likely to pivot around current 97.00 levels. Trump comments are likely to also cause short-term turbulence, especially if the Covid-19 crisis deepens and the trade war truce stumbles.

The **USD10YR** bond yield has been struggling as a result of the expectations for lower rates for longer, further amplified by the fact that the slowdown is becoming more visible, with the jobs market also showing these conflicting signs. Q2 saw the huge decline in yields from Q1 consolidate under 0.7000 with the exception of the early June spike to over 0.9000 with 12 consecutive weeks of falls driven by weakening economic outlook. Any rise in geopolitical tensions, particularly in the Middle East, would all but extinguish investor confidence.

The **USA100** recovered sharply to new all-time highs during Q2, as the major technology companies drove the recovery from Q1 lows. The **USA30** and **USA500** followed in the wake of the USA100 but with flatter-based recoveries and remain below all-time highs. Lower rates are beneficial to the stock market as it creates room for both price-based and volume-based gains. Earnings reports during Q2 also helped to buoy equity markets, with 74% of reporting companies in the USA500 beating expectations even as the economic data cratered in April and recovered in May and June. However, it is expected that the Q2 reporting season will be significantly disappointing with expectations getting ahead of the reality of the data. Q2 was certainly volatile and Q3 is likely to continue in that vein.

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EURO AREA

The **Euro** area saw its second quarter economic performance being better than expected as economic confidence bounced, and while officials are trying to rein in market exuberance, it seems even central bankers are seeing some light at the end of the tunnel. However, the contraction seen in Q1, with GDP to -3.6% q/q from -3.8% q/q reported initially, still left the annual rate at -3.1% y/y and doesn't change the fact that with Q2 GDP certainly going to be worse the Eurozone is effectively in recession now. The forecast for Eurozone GDP is expected to contract by 7.1% for all of 2020, then turn positive in 2021, with full-year growth of 4.5% — the largest increase since 1976. At the same time, the annual inflation rate stood around 0.3% and the core figure is showing signs of weakening at 0.8%, much lower than the 2% ECB target. Much will depend on when and how quickly the services and tourism sector can resume and if the uptick in jobless numbers becomes sufficiently entrenched to lead to clear downward pressure on wages. For now data is expected to justify the ECB's very accommodative stance.

The **ECB** has over-delivered by so far extending the size of the PEPP asset purchase program by a further EUR 600 bln -- bringing it to EUR 1.35 trillion. The length of the program was extended from December this year to June next year. The ECB stressed that the purchases will be conducted in a "flexible manner over time, across asset classes and among jurisdiction," and clarified that maturing bonds will be reinvested at least until the end of 2022, which means there will be no need for the central bank to sell its holdings until 2023 at the earliest.

In **Q3**, with improved market conditions, the ECB may be able to slow down the pace of asset purchases and may not actually have to use the full envelope provided by the PEPP program. However currently we have seen reports stating that a broad majority of German MPs will back a parliament set to back the ECB's QE program. This would potentially end the standoff with the German constitutional court, in regards to the boundary between monetary and fiscal policy that was part of the original agreements on the establishment of the ECB. Nonetheless, the bank looks eager to stress that the measures will remain in place as long as needed and that the ECB does in fact continue to stand ready to tweak all its instruments if needed to address the fallout from the pandemic. The decision clearly reflected the more pessimistic outlook on the economy, with the central scenario no longer including the previous best case scenario.

Germany, the largest EU economy, is **better off than most other Eurozone countries** and likely to see less of a contraction in overall growth than the Eurozone as a whole, but that doesn't mean it will be plain sailing and that it won't take a long time to recover. At the same time, the medium term risks including to financial stability are piling up. Ultimately it could prove costly to gloss over Italy's spiraling debt with the help of more German funds, if it risks creating similar financial threats in the Eurozone's largest economy further out. Germany's export oriented business model may need an overhaul, but the EU as a whole also needs to ensure that its stimulus projects foster the type of investment in innovation that lays the ground for a more sustainable long term recovery.

Nonetheless, another major political issue is still the EU-UK trade negotiations, which remain in deadlock, with the latest round of talks having ended a day earlier than planned, with the EU's chief negotiator Barnier saying, "after four days of discussions, serious divergences remain." The next round of trade discussions will be in the week of July 20th. The issue is likely go down to the wire, which will be in October, the deadline for an agreement to be made before the UK's access to the single market terminates at year end. Critics in the EU say the UK is trying to have its cake and eat it, wanting access to the single market while not being obliged to follow the EU's so-called level-playing-field rules, which would be untenable for many paid-up EU member nations. The domestic politics of Brexit in the UK demand that the British government has to play hard ball, though there is a real risk that the UK wins only a narrow trade deal or even no deal at all, which would put a large part of UK trade on less favourable WTO terms. Deals with commonwealth nations, such as Australia, are already in the pipeline, though things are not going so smoothly with other potential partners, such as Japan. When the UK leaves the single market, it will not just be leaving free trade with the EU but also the 40 free trade deals the EU has across the globe.

Against that background, maintaining the integrity of the single market and the EU's framework is even more important. Allowing concessions that violate the bloc's overriding principles are even less of an option than last year. What that means is that unless London changes tactics, the risk that the transition period ends without a deal remains very real -- but some in Westminster may welcome that.

Clearly the balance of risk remains tilted to the downside, but the ECB may not need to fully use up the flexibility of the PEPP. The services sector in particular continues to face ongoing restrictions, with travel, holiday and hospitality still hit hard by the fallout from Covid-19 and in countries such as Italy, Spain, Greece, which disproportionately rely on tourism, it will be a difficult comeback for many companies, despite temporary government support measures. Borders have re-opened and the EU published a list of countries deemed

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to be sufficiently safe to allow travel to, but weaker than expected rebounds in the headline data continue to act as a reminder that it will be a long way back to pre-crisis activity levels for many countries. On the other hand, Covid-19 hasn't gone away as new regional lockdowns across several European countries show, and as Germany prepares to take over the rotating EU presidency, the talks with the UK over the future trade relationship still have yielded no major progress so far.

As such, there should be no fundamental change to the **Euro** from an interest rate differential point of view, while it could benefit if a second wave of the virus is avoided and a recovery is sustained. On the stock market front, the **GER30** has been following the overall upwards trend and volatility in June but could also register some idiosyncratic effects if the weakening in the German economy continues. The **NETH25** and **FRA40** followed a similar path as the **GER30**, with large rallies at levels last seen in early March - i.e before lockdowns.

JAPAN

The **Yen** ended Q2 flat even though it made significant moves, with 106 and 109 levels key support and resistance. **JPN225** improved 6% in June and had a remarkable 23% rally on a quarterly basis. Japan's economy remains under pressure from the coronavirus containment measures and dampening of global trade. However, high frequency indicators suggest that activity picked up in June even though activity remains well short of the levels seen last year. Most export activity of the country is based on Vehicles, Machinery including computers, Electrical machinery equipment, and Optical, technical, medical apparatus, and based on changes that happened after the pandemic, they have better opportunities to rebuild than many countries which depend on Tourism, Agriculture, Oil products and so on. However, uncertainty among households, unemployment and business remains elevated. Some improvement in sentiment is evident as lockdown restrictions have been eased, with all domestic travel restrictions now removed.

Meanwhile, the **BoJ** is expecting a gradual recovery from the pandemic, after it expanded the special lending program in order to provide sufficient liquidity (90 trillion yen) to get the economy through the slump. The BoJ is signalling ongoing readiness to pump not just Yen, but also Dollars (via dollar-funding operations) into the economy and hence the key **USDJPY** 108.50 and 106.00 levels will be watched. The **JPN225** closed Q2 in line with all the major stock markets in the world, leaving a 36% climb from March lows. As expectations of further monetary and fiscal easing measures have evaporated, the Japanese economy is not expected to turn quickly in the near future as exports are expected to continue to suffer, while the fear of a second wave of the pandemic is rising and given its safe haven status, the Yen could potentially be at a disadvantage in the longer term.

UNITED KINGDOM

Sterling continues to struggle with respect to both the Euro and the Dollar as the United Kingdom has been hit hard by the COVID-19 crisis. It has recorded the highest infection and death rates as compared to other European Countries (311k confirmed cases and 43.5k deaths as of 29th June), which is delaying the easing process of the lockdown. The fear of the rise of a second wave of Covid-19 infections in the United States and the United Kingdom continues to hamper investor appetite towards Sterling. GBPUSD is struggling to remain above 1.2300 after surging as high as 1.2800. EURGBP continues to press higher above 0.9100 and keeps on rising as EURO regains its status as safe-haven currency. The current coronavirus issue has been reflected in the **UK100 index**, which has been the worst performer of the major developed stock indices.

The UK economic uncertainty is compounded by the Brexit transition negotiations. The disagreement over the future trading arrangements between the EU and UK is keeping the smoother Brexit transition in jeopardy. Even though Prime Minister Boris Johnson has said that there is a good possibility that the Brexit deal can be sealed by summer, the President of the EU council, Charles Michel, emphasized that they will never accept an agreement that goes against the interests of the union. This shows a significant sign that the tension between both parties remains high. Increased risk aversion in the UK and global markets has also pushed the **UK Gilt** higher, thus lowering the yield.

The **Brexit** transition uncertainty and the slow decline in virus cases could have negative consequences for both **Sterling** and the UK economy, as it would likely hamper the hope of V-shape recoveries as anticipated by investors, which will harm both profits and future potential.

AUSTRALIA & NEW ZEALAND

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The Covid-19 pandemic has hit the housing sector in Australia, the major source of wealth for most local households. The Australia House Price Index (HPI) for Q1 slowed from 3.9% to 1.6%. A study has forecasted that residential property prices across all capital cities will continue declining until the end of Q3. Housing values could come into further headwinds when government wage subsidies and borrower 6-month repayment holidays expire. To date, a fresh government stimulus plan has allowed buyers of newly constructed homes to receive grants of minimum \$20,000.

In New Zealand, the RBNZ has almost doubled its bond-purchase program, from NZ\$33 billion to NZ\$60 billion. Despite the country exiting the lockdown on May 14, unemployment is projected to peak at 8% while 23.8% economy recovery is expected in Q3. On the flipside, Australia is set to remove all domestic restrictions by July 2020, with 850k jobs expected to be restored.

On the geopolitical front, tension between Australia and China escalated regarding debates on the origins of Covid-19. China retaliated with several tariffs on Australian barley, while the introduction of new inspection guidelines on iron ore could prevent Chinese power stations from importing Australian coal. Research showed that about 62% of China's iron ore imports (total 1.07 billion tons) in 2019 came from Australia. Chinese citizens have been told to avoid studying in or making a trip abroad to Australia. Combining all the factors above, Australia's economy could further deteriorate in Q3 2020.

Likewise, New Zealand stoked tensions with China as the former alleged that China attempted to dissuade New Zealand from going into lockdown to suppress the virus. Meanwhile, for the remainder of the year, a failure of New Zealand to include Huawei without justifications as it builds its national 5G network could worsen the two countries' trade relationship. However, New Zealand's refusal to join the Five Eyes (FVEY) in condemning the Hong Kong security law is a positive indication of the government's determination to not bind to the de facto US ally.

The **Aussie** has been traded higher against nearly all major currencies, with a strong yearly rally against **Dollar**, **Pound** and **Euro**. The bullish correction against the Dollar capped within 0.6900- 0.7000 handle. Similarly, the **AUS200** has displayed a bullish appreciation since March, with a rebound from its 8-year lows at 4,399, to 6,199. Similarly, the **Kiwi** has posted a bullish reversal in Q2 as it has been traded relatively stronger against the Dollar, leaving its session highs at 0.6584 printed on June 10. The pair has experienced a strong plunge since the beginning of the year towards the 0.55 handle seen on March 19, before extending strong bullish gains and recouping nearly 90% of prior losses.

CANADA

Stephen S. Poloz stepped down as the governor of the BoC after holding this position since June 2013, replaced by Tiff Macklem. In his first public appearance, the new BoC governor stated that interest rates will remain low to support the Canadian economy's recovery from the COVID-19 pandemic, after the bank slashed its key interest rate three times in March by a total of 150 bps to a record-low of 0.25%. Canada's inflation slowed to a -0.4% y/y rate in May, following the -0.2% contraction in the previous month. That was the biggest decline since September 2009. Meanwhile, the Q1 GDP revealed a -8.2% pandemic driven drop, the sharpest contraction since Q1 2009. That said and after Deputy Governor Lawrence Schembri's statement "Cautious spending behavior on the part of households will likely continue until a vaccine becomes available. While the outlook for the second half of 2020 and beyond remains heavily clouded, the Bank expects the economy to resume growth in the third quarter." tracked expectations for a hefty decline in Q2 GDP, a 25% bounce in GDP is penciled in for Q3. The BoC will provide an updated outlook for output and inflation in its July 15 rate decision.

The **Loonie** recovered significantly in Q2 against the Dollar after seeing a multiyear high in March. **USDCAD** lost over 600 pips over Q2. Regarding oil prices, which have continued to be the principal driver of **Canadian dollar** direction, bullish momentum has been waning, with markets having gone some way in pricing-in reopening global economies and the associated demand stimulus this is bringing, although oil prices remain somewhat below pre-crisis levels. Supply still remains tight, with the **OPEC+** group maintaining reduced output for a third month in July and with relatively cost intensive US production continuing to slide. As such, the **USDCAD** is more likely to remain to the downside, assuming that global economies are able to keep a lid on new coronavirus inflections until such time as there is a vaccine or effective treatment of the SARS Cov-2 virus. This view also assumes that the OPEC+ group won't discipline over supply quotas too early in the recovery.

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EMERGING ECONOMIES

The emerging countries have been in the spotlight this year as they registered record lows against the US dollar due to its perceived safe-haven status. Emerging market currencies and economies have been hit hard by the coronavirus, and they are also a claimed victim of the global slowdown and cratering oil prices as the virus weighed on demand, as most of them export raw materials to China. The MSCI Emerging Markets Currency Index recorded a 24% decline in Q1 while it has seen the strongest advance since 2016 in Q2, with improving economic data and government and central bank stimulus measures helping revive investor confidence. The surge to the US Dollar given its perceived safe-haven status has driven several EM currencies to record lows against the Greenback, with the **South African Rand (ZAR)** and **Peso (MXN)** posting declines of more than 25%. Risk appetites are also evident among emerging market currencies.

The **Peso (MXN)** also weakened due to the lack of proper pandemic management by the government, as it is still unable to flatten the contagion curve and is showing weak measures, which is delaying economic recovery and with it the economical ability to maintain quarantine. In Q1 2020, the Mexican economy contracted 1.2% which marks the fifth quarter in contraction, and the biggest since 2009. Mexico had a historical drop in industrial production during April and growth in Mexico is expected to drop 10.5% by the end of 2020. The country's economy has been slowing since mid-2018. Mexico is heading for the most prolonged economic recession in 90 years, which will slow down business expansion plans, limit job creation, and restrict wage increases. Additionally, the Kearney 2020 FDI Confidence Index stated that Mexico is no longer among the top 25 priority destinations to receive foreign investment worldwide. Investors in Mexico are deteriorating and the 13% recovery in the **Mexican Peso** against the **Dollar** does not reflect an improvement in its economy, but rather the expansionary policy in the US. A continuous rate drop is anticipated, and a contraction in the economy greater than expected.

In Asia, the **Yuan** recorded a high equivalent to the peak price of 2019. The latest economic data for May continued to disappoint, suggesting the government's soft reboot of economic activity will result in a slow recovery. Retail sales and fixed asset investment out of China fell short of expectations, extending monthly contractions. Industrial production increased, but at a slower pace than expected. Meanwhile China is planning to sell Yuan 1 trillion of specific Treasury bonds to partially fund the economic stimulus in response to the Covid-19 pandemic in contrast with the huge volumes of stimulus seen in the United States and Europe. The continued rapid issuance of government bonds means that infrastructure spending should remain strong and help keep the recovery on track. However, despite the latter, the **Yuan** could be seen supported in Q3 amid a steady Chinese economy (also seen in June) and by a softer Dollar in Q3, as safe haven demand is unlikely return to the pinnacle reached earlier this year even with a second wave of coronavirus infections or further trade threats from US.

Following other major central banks, **SARB** increased its QE program, but on a much smaller scale so far. An expansion of ZAR 25 billion will increase the bond portfolio by only 0.6% of GDP compared to pre-COVID-19 levels. Small and medium businesses have access to ZAR 100 billion credit facilities, which can be expanded to ZAR 200 billion if needed.

South Africa's Q1 GDP for 2020 contracted 2.0% following another contraction of 1.4% in the final quarter of last year when the economy **entered recession**. A key economic metric for the country is its labor market which has one of the highest rates of unemployment in the world, a situation complicated by the near collapse of industrial activity due to continued power cuts by Eskom. The **ZAR** weakened sharply in the first quarter, however as the pandemic began to spread globally and the globe entered lockdown, ZAR strengthened against the USD by 15.63%, calculated from the April high up-to-date. The global spread of the coronavirus pandemic sent investors flocking to the Greenback in March and hammered emerging market currencies. The biggest contributors recently to the strengthening of the **Rand** are the South African reopening, the massive stimulus packages and the uptick in global risk sentiment. **Rand** has retraced nearly 38.2% of the 2020 losses seen against the **Dollar**. The **Rand** is expected to strengthen modestly in the year ahead as domestic bond liquidation looks to have slowed, helping to ease downward pressure on the **Rand** after the heavy capital outflows in March when foreign investors sold a net ZAR55.6 billion of **South African bonds**.

The last of the emerging markets is the **Turkish Lira**, which has also been caught up in the emerging market rally. The Turkish currency is the worst-performing major emerging market currency against the Dollar so far this year despite recovering slightly in the second quarter of 2020, like most of its counterparts. However for **TRY**, it is not just about stronger USD due to its safe-haven demand and the pandemic but also the fact that investors are fretting over the fragility of the Turkish financial system and its dependence on foreign portfolio flows. From the economic side, Turkey is also highly dependent on the country's Tourism and Textile industry and export of

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agricultural products, and all of them have been hit hard by the pandemic, with inflation and unemployment rising. The underperformance of Lira this year was also aided by investment restrictions. In May, the country's banking regulator moved to restrict foreign investor access to lira-denominated transactions in an effort to prevent speculation and short-selling, while Turkey's central bank drew down millions of dollars from its foreign currency reserves to buy Lira. For Q3, fundamentally TRY is expected to continue falling despite the start of international travels, as the Turkish Lira was under pressure nearly 2 years prior to the pandemic amid the high debt and high unemployment but crucially as investors question the credibility of the central bank and its ability to defend the currency. An additional issue is the geopolitical tension in the Middle East, which caused several sanctions to be applied by the United States and played the role of an elevator for pairing.

COMMODITIES

Commodities performance has gained significantly in Q2, and after seeing a turbulent first half of 2020 the second half of the year is starting quite muted.

Gold was definitely the standout winner in the first half of the year, extending its upward trend since 2018 to 12-year highs and moving around 3,600 pips up from March lows. Its safe-haven characteristic boosted the demand higher amid the ongoing global crisis and the unlimited quantitative easing especially from the FED. Interestingly, metals in general are supported by the FED as increasing monetary stimulus tends to back gold as a hedge against low US interest rates, but not by physical demand. **Physical consumption shrank** and the recovery is expected to be slow as well as gold prices could ease as haven demand ebbs. However, it is widely expected that prices could hit a record above \$1,900 in the second half of the year.

Silver, after a sharp drop in the first quarter of the year, had a remarkable recovery as it reached 3-year high territory, up to \$18.40. Silver soared over 24% in May to post its biggest monthly gain since 2011. In addition to the commodity factors that boosted gold, silver was also impacted by the **growth of industrial extraction** and by the demand of the electrical and electronic sector since it is a fundamental part of the infrastructure of **5G technology** that is growing globally. Also, the grey metal is considered an alternative or addition to gold due to their close correlation, encouraging more money flow in silver. **In contrast with gold**, despite its 33% rally from the Covid drift, silver remains at 11-year lows. Hence based on its correlation with gold and its industrial use silver could be boosted higher in Q3 due to the reopening tourism industry and the 5G plans. In the longterm, **silver** could post record demand due to its potential from investors as a solid inflation hedge (tool against the forces of hyperinflation and inflation).

The price of **oil** has rebounded from its historic fall, supported by the combination of inventory drawdowns in the US, along with **OPEC+** production cuts and an improving demand picture as economies have reopened. **USOIL** reached \$40/barrel, largely ignoring the US-China tensions, forming a monthly morning star pattern at the end of May and closing the gap seen on March panic. As OPEC+ is considering extending the production cuts until the end of 2020, along with the closure of hundreds of US shale wells, and as China and India are said to be increasing imports, **USOIL** is expected to be supported in the medium term. Apart from the US-China tensions downside risk, in the bigger picture, as long as the nascent recovery isn't scuttled by the pandemic, oil price risk going forward would appear to be to the upside. All this is based on the assumption that OPEC+ will remain disciplined in keeping output restrained. Ongoing positive economic data which could underpin hopes for a V-shaped economic recovery could also support crude prices further.

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