Market update: A not so quiet end to 2020!

- **The FOMC provided further assurances that US monetary policy will remain accommodative for a considerable period of time by changing the forward guidance on its QE purchases program, even as it opted not to lengthen the maturity profile of its purchases**
- **The tone was dovish and economic projections were altered to take in to consideration the possibility of herd immunity building up by Q32021 as vaccines start to get distributed to the US population**
- **However, inflation projections were left unchanged with core PCE expected to only hit 2% level by end-2023. Hence, the dot plot signaled that no rate hikes are likely till end-2023**
- **The FOMC outcome met market expectations and supported the risk-on trade in the global markets. However, price action will now be driven by: (a) US fiscal negotiations and (b) 'Brexit developments**
- **The USD continues to get beaten down as global reflation remains in place and investors position for a UK-EU trade deal. We see sharp volatility in the near-term contingent on the manner in which 'Brexit' pans out**
- **We think the 'Brexit' outcome will have a binary effect on the GBP and we maintain our scenarios. EUR will also respond to 'Brexit' developments with a favourable outcome expected to provide more support**
- **The outlook for EM FX remains favourable and we do not rule out more downside in the USD/INR pair. RBI intervention could moderate given that the US Treasury has placed India on its 'monitoring list' as part of its currency manipulation report**
- **On the other hand, US fixed income markets will continue to be driven by US fiscal negotiations. We maintain our call of a steepening bias in the sovereign yield curve over the medium-term**

FOMC reiterates its message of an accommodative framework: The FOMC maintained status quo on its accommodative framework that was on expected lines. Key highlights from the FOMC were the following:

- **QE program:** While the size of the QE program was left unchanged at USD 120 bn per month, the FOMC made an important change about the length of time that it plans to keep its asset purchases program in place. The guidance was changed from 'these purchases will continue for the coming months' to 'these purchases will continue until substantial further progress has been made in meeting the committee's maximum employment and price stability goal'. **In other words, the QE program has been explicitly linked with economic outcomes implying that it will remain in place for a considerable period of time.** However, the FOMC did not lengthen the maturity profile of its QE purchases that was contrary to our expectations. We suspect that lengthening the maturity profile could be done at a later date in 2021.

- **Policy rates:** Policy rates were kept unchanged and forward guidance of keeping them at current levels until economic outcomes on inflation and the labour market are met was maintained.

- **Economic projections:** Economic projections were altered to take in to account a strong Q32020 and possible 'herd immunity' building up by mid-2021 to Q32021. GDP growth projections were revised higher for 2020 reflecting a strong Q32020 figures while projections for 2021-2022 were raised as well. However, we see a slower pace of growth in Q42020 than the Fed has currently assumed and subsequently have a lower GDP target for the US economy in 2020.

  Unemployment rate projections were revised lower as well over the forecast horizon.

  The flat trajectory on PCE inflation was maintained over the forecast horizon. PCE inflation was only expected to move towards the 2% mark by end-2023 signaling that US monetary policy will maintain an accommodative bias for a considerable period of time.

  The 'dot plot' showed that the FOMC will keep policy rates at the zero lower bound until end 2023. One member voted for a rate hike in 2022 and five members voted for a rate hike in 2023 but the median was for status quo throughout the forecast horizon.

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17-December-2020

Chart 1: FOMC's projections have been revised considerably over the course of 2020

Median Fed macro-economic projections					
	2020	2021	2022	2023	Long term
GDP (%YoY)					
Dec 2020	-2.4	4.2	3.2	2.4	1.8
Sep 2020	-3.7	4.0	3.0	2.5	1.9
Jun 2020	-6.5	5.0	3.5		1.8
Unemployment Rate (%)					
Dec 2020	6.7	5.0	4.2	3.7	4.1
Sep 2020	7.6	5.5	4.6	4.0	4.1
Jun 2020	9.3	6.5	5.5		4,1
PCE inflation (%YoY)					
Dec 2020	1.2	1.8	1.9	2	2.0
Sep 2020	1.2	1.7	1.8	2.0	2.0
Jun 2020	0.8	1.6	1.7		2.0
Core PCE inflation (%YoY)					
Dec 2020	1.4	1.8	1.9	2.0	
Sep 2020	1.5	1.7	1.8	2.0	
Jun 2020	1.0	1.5	1.7		
Median Fed funds rate (%)					
Dec 2020	0.1	0.1	0.1	0.1	2.5
Sep 2020	0.1	0.1	0.1	0.1	2.5
Jun 2020	0.1	0.1	0.1	0.1	2.5

Source: FOMC & ICICI Bank Research

- **Importance of emergency programs emphasized:** The FOMC also extended its USD swap facility in to September-2021. The Fed Chair emphasized that while several of the credit programs are set to wind down by end-2020 but they could be re-started if required next year with Treasury backing.

- **A dovish message:** The Fed Chair continued to emphasize the need for more fiscal support and that it will take a considerable period of accommodation to lift inflation higher. He continued to indicate that the FOMC has 'lending powers' not 'spending powers'. The Fed Chair also added that interest rate sensitive sectors are performing well but service sector activity that entails greater human to human contact was weakening as the second wave of infections is picking up. **Hence, focus shifts to the need for greater fiscal support, especially as considerable labour market slack remains in place.** The post policy statement was also relatively unchanged with the outlook of the economy continuing to get linked to the manner in which the pandemic evolves.

Review of the trading environment: The conclusion of the FOMC meeting provided further assurances to the market that the global liquidity environment will remain favourable, subsequently encouraging global reflation trades to continue. Market response was modest given that the outcome was priced in but the risk-on rally sustained. However, we reiterate that two key event risks will work to drive price action over the remainder of 2020:

- **US fiscal stimulus:** US policymakers appear to have set a deadline for 18-December-2020 to reach a consensus on the next round of fiscal spending. We reiterate that the effect of the fiscal stimulus that was introduced back in March-April-2020 has worn out. The second-wave of infection and sharp deterioration in the US labour market makes it imperative for a deal to get agreed upon. The upshot is that US households and businesses need another life-line. Hence, at this stage members of Congress are negotiating ~USD 900 bn fiscal deal. **The passage of this deal will prove critical to provide another leg-up to overall risk sentiment.**

- **'Brexit': An end at last: But how will it end?:** Finally, it appears that UK-EU are poised to conclude negotiations to agree upon a longer-term relationship. Media reports indicate that a deal is close and that several of the sticking points could get resolved very soon. The main areas of contention relate to fisheries and how to create a level playing field after the UK departs from the EU. **For the markets, a 'No-Deal' will work as another explicit growth shock given the strong trade and financial linkages between the two respective blocks. A UK-EU deal will be viewed very favourably and continue to support global reflation trades that remain firmly in place.**

US assets: Swayed by risk and fiscal negotiations:

- We maintain that the DXY will continue to trade as the primary anti-cyclical currency in the global markets. It has already broken below a key technical resistance level of 90.00 as investors position for a favourable 'Brexit' outcome. We maintain our near-term trading range of 89.50-91.50. However, a 'No-Deal' outcome could push the DXY to the 93.00-94.00 range.
- While global reflation trades are remaining in place as focus remains on liquidity and progress with regards to the vaccine, US economic indicators are showing a weakening trend reflecting the build-up of second wave of infections. US retail sales fell quite sharply by 1.1% MoM in November reflecting a pick-up in second wave of infections and initial jobless claims have moved up quite sharply.
- We maintain our call of a steepening bias in the US yield curve. In the near-term, momentum will be driven by US fiscal negotiations. We maintain our trading range for the US 10-year yield at the 0.7% to 1.00% range with a possibility of a break above 1% in case a fiscal deal is agreed upon.

Domestic assets: INR supported by global reflation:

- Perhaps the most significant development has been that the US Treasury has placed India on its 'monitoring list' as part of its currency manipulation report. Our understanding was that the decision was taken after the massive amount of intervention undertaken by the RBI over the last year.
- While we do not anticipate India to be branded as a 'currency manipulator' anytime soon, it could curtail the ability of the RBI to intervene fairly aggressively in the market. Hence, the weaker global USD and ample global liquidity conditions could continue to lend a sharp downside bias in the USD/INR pair. We see a range of 73.00-74.00 in the pair. We expect overall 'Brexit' to have a fairly limited effect on the EM FX such as INR with the exception of a very short knee-jerk reaction depending on the outcome. Global reflation will work as the more prominent drivers for EM FX such as the INR.
- It also needs to be kept in mind that this is not the first time that India has entered the US Treasury's 'monitor list'. Back in 2017, India was placed on this list but was removed from this list in 2018.

EUR/USD: trending higher but 'Brexit' uncertainty still looms

- The EUR/USD pair has been trending higher reflecting the global reflation trade and the anti-USD sentiment. However, we expect the pair to move in sync with the final 'Brexit' development. We see a near-term range of 1.19-1.23 with a possible downside of 1.16 in case of a 'No-Deal' outcome.
- There also appear to be some encouraging signs with respect to high frequency indicators as PMI surveys showed a sequential improvement in December. Overall economic activity appears to have improved as the scale of lockdowns have eased considerably. Service sector activity is showing signs of reviving.

GBP/USD: 'Brexit': The final countdown has set in

- The GBP/USD pair has been trending higher as investors position for a favourable 'Brexit' outcome implying that the scope for disappointment in the near-term remains fairly high. We maintain that a UK-EU deal could push the pair to the 135-1.40 range but a 'No-deal' outcome could open up downside to 1.25 level.
- Similar to what is being seen in the EU, UK economic indicators have also shown a sequential improving trend. However, one area of concern pertains to visible signs of deterioration in the labour market that could intensify as the government supported furlough scheme will come to an end by March-2021.
- After having raised the size of its QE program in the last policy meeting by GBP 150 bn in November, we expect the BoE to maintain status quo in its policy meeting due later today. However, we expect an underlying dovish message with concerns being expressed about 'Brexit'. In case of an adverse 'Brexit' outcome, we think that the BoE could consider easing policy as early as in January-2021.

USD/JPY: Moving lower on back of the anti-USD trade

- We see the USD/JPY pair trending lower reflecting investor positioning as the anti-USD trade has intensified. The correlation between global equity markets and the USD/JPY pair also appears to have broken down. We see a range of 102.50-104.50 for the pair.
- Japanese economic indicators are showing a mixed trend but on balance it appears that a pick-up in second wave of infections is hitting near-term economic activity.

EM markets: A quick review of the main developments

- Most USD/EM pairs have been trending lower reflecting the very favourable global liquidity environment with both the ECB and FOMC re-affirming that their accommodative framework will remain in place for a considerable period of time.
- The USD/CNY pair in particular continues to see strong interest as the local economy is showing strong signs of rebounding. High frequency monthly indicators showed a broad-based expansion with sequential improvements seen in industrial production, retail sales and fixed asset investment (excluding rural sector). Labour market also showed an improvement with the unemployment rate drifting lower.
- The Central Banks of Indonesia and Philippines maintained status quo on expected lines after the surprise rate cuts that were delivered in the previous policy meetings. The Central Bank of Taiwan also maintained status quo.

Appendix: US Treasury's currency manipulation report: Key findings explained:

In setting this report, the US Treasury examines the currencies of 20 bilateral trading nations that trade with the US of USD 40 bn annually. After identifying these countries, three sets of criteria are used to assess the status of a country on whether it is a currency manipulator:

(1) A significant bilateral trade surplus with the United States is one that is at least $20 billion over a 12-month period. This threshold captures a group of trading partners that represented three fourths of the value of all trade surpluses with the United States in 2018. It also captures all trading partners with a trade surplus with the United States that is larger than about 0.1 percent of U.S. GDP.

(2) A material current account surplus is one that is at least 2 percent of gross domestic product (GDP) over a 12-month period. This threshold captures a group of economies that accounted for more than 90 percent of the nominal value of current account surpluses globally in 2018.

(3) Persistent, one-sided intervention occurs when net purchases of foreign currency are conducted repeatedly, in at least 6 out of 12 months, and these net purchases total at least 2 percent of an economy's GDP over a 12-month period. Looking over the last two decades, this quantitative threshold would capture all significant instances of sustained, asymmetric foreign exchange purchases by major U.S. trading partners.

Key findings of this report:

- The US Treasury determined that, under the Omnibus Trade and Competitiveness Act of 1988 (the 1988 Act), both Vietnam and Switzerland are currency manipulators. Both countries met this criteria over a four quarter period.

- Treasury found that ten economies warrant placement on Treasury's "Monitoring List" of major trading partners that merit close attention to their currency practices: China, Japan, Korea, Germany, Italy, Singapore, Malaysia, Taiwan, Thailand, and India, the last three being added in this Report.

Note: The content in the appendix has been taken directly from the US Treasury report on Currency Manipulation

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