The week in review: Investors are positioning for a 'Democratic Sweep'

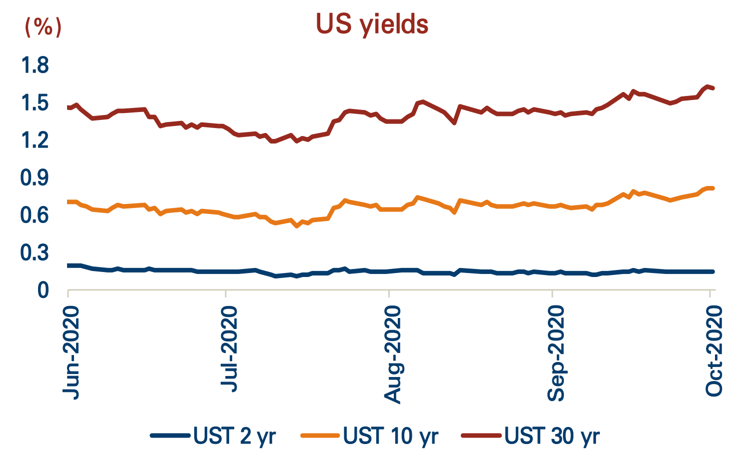
Trading environment: The USD has come under broad selling pressure primarily reflecting investors pricing in the prospect of a 'Democratic Sweep' scenario. Another positive has been news that UK-EU are set to resume talks to finalize a 'Brexit' deal by mid-November-2020, providing support to the EUR and GBP respectively. However, markets appear to be ignoring the pick-up in second wave of infections particularly in Europe that could start to weigh on economic activity in Q42020. The Republic of Ireland is set to go on a fairly stringent lock-down with substantial curbs placed on economic activity. It appears that the prospect of more policy support is negating the concerns for the time-being. **More downside in the USD cannot be ruled out in the near-term as investors position for the 'US election outcome'.** In the near-term, US fiscal stimulus negotiations and the US Presidential debate will continue to work as the primary triggers of price action.

Another significant development has been the sharp downward movement in the USD/CNY pair. China's GDP that was released for Q32020 showed that the economy will likely be the only major region to record a positive rate of growth in 2020. Improving growth has worked to attract capital inflows relative to the rest of the world. Most importantly, the expectations of a 'Democratic Sweep' is being considered slightly more favourable for US-China trade relations. Hence, the USD/CNY pair is trending sharply lower. However, strength in the CNY is not working to support other EM FX in Asia by the same degree that would reflect growing divergence in 'portfolio allocations' within EM markets.

The full-effects of the growing speculation of a 'Democratic sweep' is also working to push US bond yields at the longer-end of the curve higher. Markets appear to be positioning for substantially more fiscal expansion from the US economy over 2021. Hence, more upside cannot be ruled out at the current juncture. **Even as US bond yields have moved higher, there has not been a simultaneous uptrend seen across DM market yields.** German and French sovereign yields at the longer-end of the curve have been trending lower reflecting ongoing concerns about the outlook. Only the Japanese yields have been trending higher at the margin. However, the divergence in bond markets does not appear to have so far been reflecting in FX movements as the EUR/USD pair has rallied over the last week. We do not expect this divergence to persist on a sustained basis.

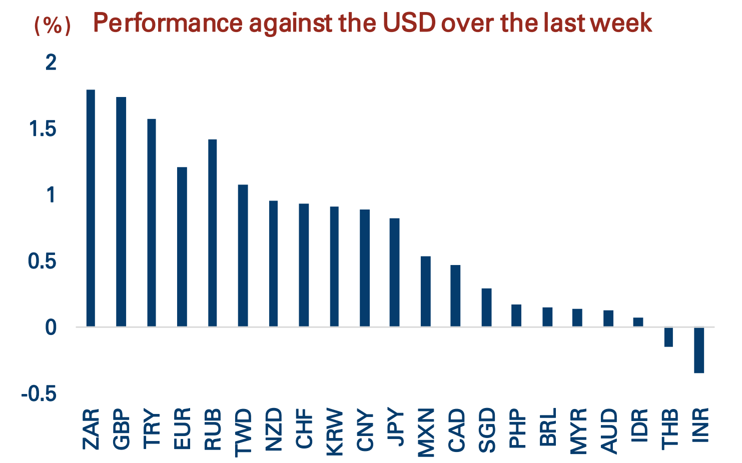
In the local markets, price action in both the FX and rates market respectively to a considerable degree is being driven implicitly by RBI actions. Fund flows in to local markets have remained fairly robust through both FDI and FPI flows. An encouraging aspect has been the pick-up in debt related FPI flows over September-October period as compared to persistent outflows that were seen over the March-August period. **However, RBI intervention has continued to persist that has ensured that the USD/INR pair does not break sharply below the 73.00 level.** We expect RBI intervention to continue given that the on an REER basis the INR has moved in to further overvaluation territory in 2020. While RBI intervention in the FX markets has continued, sentiment in the fixed income market has also improved reflecting the unconventional policy responses undertaken. Hence, local bond yields have seen ranged trading even as union government borrowings have been revised higher.

Chart 1: US yields at the longer-end are starting to trend higher



Source: Bloomberg & ICICI Bank Research

Chart 2: Most currencies have rallied against the USD with the exception of THB and INR



Source: Bloomberg & ICICI Bank Research

Shivom Chakravarti Anushri Bansal 22-October-2020

US Assets: Weakening bias could linger for a while

- The USD continues to trade on the back-foot reflecting a substantial risk-on rally that has prevailed in the global markets. Investors appear to be positioning fairly aggressively for a 'Democratic Sweep' scenario that would entail a sharp response in case the outcome is not in line with expectations. The DXY has broken below the 93 mark and a possible undershoot towards 92.30-92.50 cannot be ruled out. **In the near-term, the main trigger will be the outcome of the 'fiscal negotiations' that are expected to conclude by 23-October-2020 as well as by a lesser degree the Presidential elections.**
- While concerns about second wave of infections have intensified, private consumption in the US economy continues to show persistent strength. US retail sales came in much above expectations rising by 1.9% MoM in September that was better than the 0.7% expected and above the 0.6% increase witnessed in August. Core retail sales also showed substantial strength rising by 1.5% in September. The retail sales figures suggest that there could be upside risks for US GDP growth in Q32020. At the same time, US consumer confidence as measured by the Michigan survey increased from 80.4 in September to 81.2 in October. Initial jobless claims have also fallen sharply in the week ending 17-October-2020 to a level that has not been seen since March-2020 that was completely contrary to expectations.
- US CPI inflation remained flat with core CPI inflation coming in at 1.4% YoY in September that was unchanged from the previous month.
- The US government released its fiscal deficit figures that was last seen in 1945 of USD 3.1 tn that was ~16% of GDP. With another fiscal stimulus in the pipeline, the prospect of a structurally higher fiscal deficit remains firmly in place. Hence, US treasury yields at the longer-end of the curve have been trending with an upside bias.
- We maintain that the US 10-year sovereign yield is expected to continue to trade in the 0.60%-0.90% range with an upward break above only likely in case of a 'Democratic Sweep' scenario.

Domestic assets: Being guided by the RBI

- While the fund flows outlook remains fairly constructive and the USD is trading weaker in the global markets, the USD/INR pair remains in a tight trajectory as RBI continues to intervene fairly aggressively.
- **An emerging concern is the increase in magnitude of overvaluation of the INR** as measured by the RBI's REER 36 currency index (base-year: 2004-05) that has moved to the 117 mark. Prime facie, this would imply an overvaluation to the tune of ~17% and is much above the longer-term average of ~108-109 mark.
- A key reason for the overvaluation is down to rising local inflation rates relative to the rest of the world. This was visible in the September-2020 domestic CPI inflation reading that moved to 7.34% from 6.69% in August-2020. Inflation of the major trading partners, including the US, China and Euro-zone have all trended lower. **The upshot is that the combination of concerns about overvaluation and a BoP surplus will imply that the RBI will continue to intervene fairly aggressively to curb any sharp appreciation bias from taking place.** It is unlikely that RBI will engineer depreciation via intervention given the ample global liquidity conditions that is expected to persist. We subsequently expect the USD/INR pair to see ranged trading in the 73.00-74.00 range in the near-term.
- **India's trade position showed a further sequential improvement reflecting a fairly favourable balance of payments outlook for FY2021.** India's trade deficit narrowed from USD 6.8 bn in August-2020 to USD 2.7 bn in September on the back of a pick-up in exports that increased by 5.9% YoY in September and as imports continued to remain fairly weak falling by 19.6% YoY in September.
- Over the last fortnight, sentiment in the bond markets has been driven by 1) MPC policy 2) increase in Central Government borrowing program to fund the GST compensation cess shortfall.
- The MPC kept rates unchanged as expected while providing for the first time a forward guidance of continuing with the accommodative stance for the current fiscal year and into the next financial year.
- Moreover, while acknowledging that green shoots were visible in recent real economy data, concerns on growth took precedence over elevated inflation prints, with the statement specifying "that revival of the economy assumes the highest priority and recent inflation prints can be looked through".
- The policy also provided guidance for the financial markets, with the Governor advising the markets to collaborate with the RBI. He underscored RBI's commitment of keeping rates low for long, by introducing three measures including 1) doubling of size of OMO purchases auctions to INR 200 bn 2) extension of the recently announced HTM limit hike to March 2022 3) announcement of OMOs in SDLs. This is another unique measure, which would help build absorptive capacity for the huge supply of state paper.
- Moreover, the On Tap TLTRO scheme of INR 1 tn, would make the increased liquidity available to specific sectors, both through corporate bond markets and bank lending.
- On the other hand, the flexibility provided to banks to reverse the transactions done under the earlier TLTRO schemes, would assist in reducing the liquidity overhang in the system and provide space for the RBI to perform more durable liquidity operations such as OMOs. All together, the guidance and these measures should assure markets of RBI's commitment to keep rate low for long.

- Settling the uncertainty around the GST compensation cess fund, the Finance ministry announced that the borrowing under Option 1 (of the GST compensation cess fund) through a Special Window will be conducted by the Government of India (rather than individual state governments).
- While this increases overall central government borrowing by INR 1.1 tn, the fact that the weekly auction size would see reduction, along with lower weekly supply in duration (given the extension to mid-March), would be a positive. With this announcement, the overall general government borrowing expectations do not change as it is a transfer from state to central borrowings.
- Overall we expect gross general government borrowing of ~12% of GDP for the fiscal with H2 borrowing of ~INR 11 tn. In terms of funding the fiscal deficit, while upside risks to further slippage remain (with our estimates for central government fiscal deficit at ~8-8.5% of GDP), this deficit could be funded by higher reliance on other sources of funding.
- While currently we maintain our view of a Repo rate cut of 25 bps in the February policy, upcoming inflation prints would have to be monitored and any untoward upside risks, could lead the MPC keeping rates unchanged for the fiscal.
- **The 10-year benchmark is unlikely to see any sharp upside, assisted by RBI's action of using conventional and unconventional tools.**

EUR/USD pair: Not moving in sync with the economy

- A growing concern in the Euro-zone is the pick-up in second wave of infections that has resulted in tightening in social distancing norms and curfews being imposed. Some countries such as the Republic of Ireland have even resorted to full-scale lock-down. **Hence, the outlook has deteriorated considerably that is showing up in several sentiment indicators.**
- The ECB President has also spent a considerable period of time stressing about the growing downside risks to the economic outlook from a pick-up in second wave of infections.
- The ZEW survey fell quite sharply with the expectations component declining from 73.9 in September to 52.30 in October. The pace of Euro-zone industrial production moderated at a sequential basis from 5% MoM in July to 0.7% in August. Inflation pressures in the region remain fairly modest with German CPI inflation contracting by 0.2% YoY in September.
- In short, the outlook is weakening sharply. However, the EUR/USD pair is not showing signs of weakening on a sustained basis and has instead rallied sharply. The rally in the EUR/USD pair is primarily reflecting the pricing in of a 'Democratic Sweep' scenario. However, we are not convinced that this rally can sustain indefinitely. Hence, we maintain the trading range of 1.16-1.18 for the EUR/USD pair but acknowledge that there could be some further minor upside possibility in the near-term.

GBP/USD: Positive 'Brexit' news creates more upside

- The GBP/USD pair is ignoring local data releases but is instead being driven primarily by news on 'Brexit'.
- Media reports that a new round of negotiations between UK and EU policymakers are expected with the hope of finalizing a deal by mid-November-2020 is working to drive the pair higher in the process. The global risk-on rally is working as another positive catalyst for the pair.
- Hence, we raise our near-term projections for the GBP/USD pair and expect it to trade in the 1.29-1.32 range.

USD/JPY: Ranged trading will remain the norm for some time

- The underlying dynamics of the USD/JPY pair remains unchanged. It continues to trade in the 104-106 range responding on an intra-day basis to overall equity market performance.
- However, in recent sessions it has started to trend lower reflecting the resurgence of the 'anti-USD trade' in the global markets. 'US fiscal stimulus' negotiations and the upcoming US elections will work as the primary catalysts for the pair.

Emerging Economies: Review of the main developments

- **On the data front, the most constructive news was on the Chinese economy.** China's GDP grew by 4.9%YoY in Q32020 from 3.2% YoY in Q2020 reflecting continued growth in the industrial sector, trade, government spending and strong signs of improving private consumption growth as well. The data yet again reinforces the expectations of the Chinese economy leading the post COVID-19 recovery. High frequency indicators remained fairly robust as well.
- The PBOC provided additional liquidity in to the financial system that will work as an important support for the recovery. It injected CNY 500 bn via its one-year medium-term lending facility even as lending rates were kept unchanged.
- Meanwhile, there continued to be growing signs of most of the major EM central banks maintaining status quo that was seen in the case of Bank of Korea, Bank of Indonesia and Monetary Authority of Singapore. All of the central banks maintained status quo while keeping an accommodative stance. **Most EM central banks are also starting to move towards providing additional stimulus via unconventional methods.**
- In this regard, the Bank of Thailand extended its THB 500 bn "soft loan" program for small and medium-sized enterprises by six months to help with the effects of the lingering Covid-19 outbreak.

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