The week in review: A rude awakening!

Trading environment: In our previous publication, we warned that investors were not paying adequate attention to the sharp rise in second-wave of infections in Europe and the US. However, all of that has changed in dramatic fashion after several European countries have opted to impose partial lockdowns and tightened social distancing norms considerably. Hence, the growth outlook in Q42020 has weakened considerably. Some disappointment was also apparent after US fiscal stimulus was delayed till after the outcome of the US election season. We would not rule out a further intensification of the risk-off rally that could take the USD higher on a trade-weighted basis in the process. **Recent price action with concerns about the scale of the pandemic intensifying makes the backdrop of the US elections week a fairly challenging one.**

Investor focus will also shift to the outcome of US election season. We reiterate that the focus for investors will not be solely on the outcome of the Presidential election but also be on the results of the Senate and House respectively at the conclusion of voting that is due to take place on 3-November-2020. We see three following scenarios that could influence markets:

- **A delay in the result is possible:** Unlike past elections, in the current round there has been a substantial pick-up in 'mail-in ballot' votes. This could in turn imply possible delays in counting and subsequently in the outcome of the vote. Hence, the results may not come out on election day itself but might take the entire week. We see substantial volatility in the interim period.

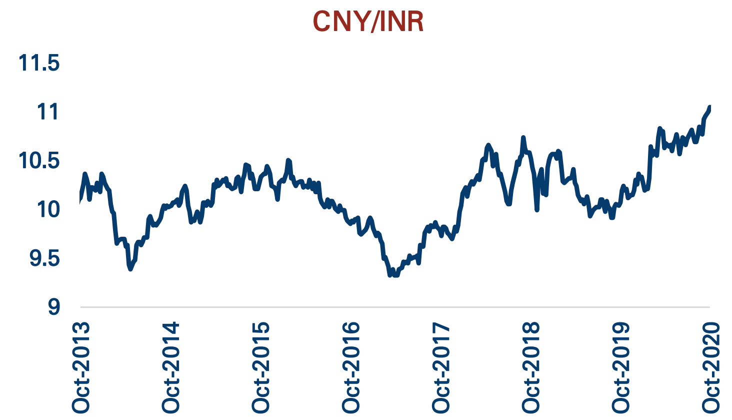
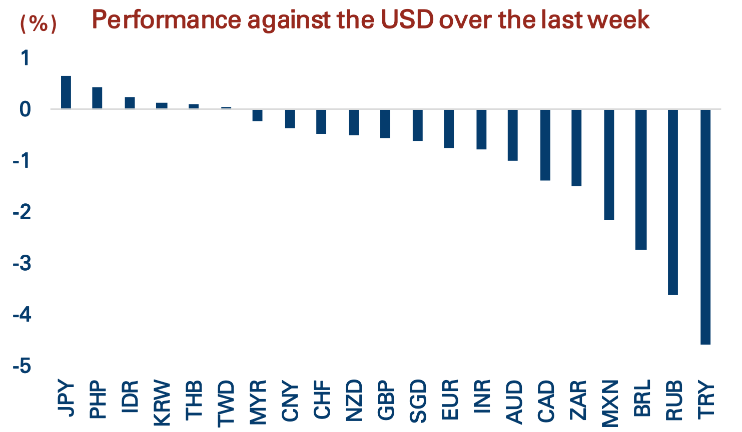
- **Close election outcome followed by a legal challenge is the worst case scenario:** Even if there are delays, investor focus will remain on the outcome of the vote. A close election outcome could result in possible legal challenges and move to recount the votes in several states. In such a scenario, uncertainty could prolong for a long period of time similar to what was seen post the outcome of the 2000 elections in which equity markets fell sharply over a two-month period.

- **A clear winner but legal challenges cannot be ruled out:** This would be the best case-outcome, even if there are delays in counting all the votes. A winner to emerge with a substantial margin particularly in the 'battle-ground' states will reduce the uncertainty premium going forward. It is quite possible that legal challenges are made to the result but that is unlikely to influence price action by a great degree. If there is a decisive winner, the effect on the market will remain limited. Investors will then respond to the next political configuration and the implications for policymaking.

Global investors have been positioning for a 'Democratic Sweep'. Hence, any outcome that is not in sync with expectations could result in a violent sell-off and a re-positioning within the FX and global rates market respectively. The USD will continue to trade as a 'safe-haven' asset trading inversely with overall risk sentiment. One surprising development has been the break-down in relation between US yields at the longer-end and risk sentiment. Given the scale of equity market sell-off in the previous week, US yields should have been trending sharply lower. However, that was not the case as investors position for the next political configuration to deliver record fiscal stimulus. **We think that among all asset classes, US bond markets are most vulnerable to a re-pricing if the outcome is not in line with expectations.**

In the local markets, price action has been fairly divergent in both the FX and rates market respectively. The USD/INR pair has been trending with an upside bias reflecting adverse global risk sentiment. Besides, the fact that the RBI has been intervening aggressively in the 73.00 to 73.40 range has limited a sharp break below these levels. Hence, the USD/INR pair has broken above the 74 mark. The INR has also emerged as an underperforming EM FX that is visible in the sharp rise in the CNY/INR pair that has broken above the 11 mark that was last seen in 2013 during the peak of the 'taper tantrum'. The uptrend in the CNY/INR pair also reflects the growing divergence in sentiment towards Chinese assets and other EM asset classes. RBI intervention has also worked to restrain sharp appreciation bias in the INR. Going forward, global risk sentiment will work as the pre-dominant driving factor for the USD/INR pair. On the other hand, persistent expectations of the RBI resorting to unconventional monetary easing is working to restrain sharp upside in bond yields at the longer-end of the curve.

Shivom Chakravarti Anushri Bansal 29-October-2020

Chart 1: CNY/INR pair has been trading with a sharp upside bias	Chart 2: The USD has staged a sharp comeback over the past week
 Source: Bloomberg & ICICI Bank Research	 Source: Bloomberg & ICICI Bank Research

US Assets: More volatility in store

- **The USD has rebounded primarily against the EUR and by a lesser degree against EM currencies reflecting an increase in concerns about the effect of the pandemic on global growth prospects.** However, the impact of extreme risk aversion as seen in global equity market performance on the USD has been somewhat modest. An important reason for this is that investors are also waiting for the outcome of the Presidential elections before fresh positions are taken.
- We think that the USD could trade lower only in case of a 'Democratic Sweep' scenario. Possible delays in the counting could also result in more support for the USD. We maintain our near-term trading range of 92.00-95.00 for the DXY.
- On the data front, there continued to be strong further indication of a 'V' shaped recovery pattern taking hold in the US economy. US initial jobless claims fell sharply from 898K for week ending 10-October-2020 to 787K for week ending 17-October-2020. The US Housing market continued to show strength that was visible in the NAHB housing market index, new home sales and existing home sales.
- We forecast US GDP for Q32020 to increase by 30% QoQsaar after the 31.4% contraction that was witnessed in Q22020.
- Even as risk sentiment has deteriorated, US yields at the longer-end of the curve are not trading with a downside bias as investors position for a US election outcome. A further sharp break higher is only likely in case of a 'Democratic Sweep' outcome.

Domestic Assets: Vulnerable to developments in the global markets

- **We raise our near-term USD/INR projections reflecting a much sharp deterioration in global risk sentiment than we anticipated at this point in time. We see the USD/INR pair trading in the 73.50-74.50 range in the near-term with global risk sentiment expected to work as the primary driver.** The main event risk is likely to come from the US election outcome.
- The INR will trade in sync with its EM peer group. However, sharp outperformance is not expected given that RBI will continue to intervene.
- Sentiment in the bond markets has been driven by the MPC minutes released last Friday. Overall the minutes could be deciphered as dovish, with growth concerns taking precedence over 'transient' elevated inflation prints. The proclivities of the new external members seem to be more towards the dove/neutral camp, tilting the entire committee towards focusing on growth, given the expectations of moderation in inflation over the second half of the fiscal. Explicit mention by members on concerns around elevated term-premia and forward guidance aimed to reduce spreads would be welcome by the markets.
- Given this backdrop, we expect continued support by the RBI to maintain easing financial conditions, aiding monetary policy transmission and keeping costs of capital low.
- Overall we expect current pace of OMO purchases (G-sec and SDL), forward guidance, other measures (extension of HTM limit hike, On-tap TLTROs) and our expectations of additional ~INR 2.5 tn OMO purchases, to aid overall sentiment in bond markets and counter the borrowing pressure.
- **In the background, there are growing reports about a possible another round of fiscal support that the government could be considering delivering shortly.**

EUR/USD pair: More downside is possible

- **The EUR/USD pair finally succumbed to the pick-up in second wave of infections and subsequent lockdowns that have been implemented across the region with German and France announcing partial lockdowns.** The growth outlook for Q42020 is likely to get revised lower. We see a range of 1.15-1.18 for the EUR/USD pair in the near-term.
- The majority of economic indicators reinforce the fact that underlying growth momentum is slowing particularly in the services sector that entails a greater degree of human to human contact.
- Euro-zone PMI surveys showed a mixed trend but the effect of the rise in second-wave of infections that has resulted in tightening of social stringent measures. The services PMI fell more than expected in October to 46.2 from 48.0 coming in lower than expectations of 47. However, the manufacturing PMI rose to 54.4 in October from 53.7 in September coming in above expectations of 53.1. The net result was the Euro-zone PMI composite moving from 50.4 in September to 49.4 in October back in to contractionary territory.
- The German IFO survey that was released also came in weaker than expected illustrating the deterioration in growth outlook that has taken place.
- **We expect the ECB to maintain status quo in its policy meeting due later on today but provide a dovish guidance reflecting the build-up of 'downside risks' to the growth outlook.** We see a strong case for a further EUR 500-700 bn increase in the Pandemic Emergency Purchases Program that could come in the December-2020 policy meeting along with the revised projections on the economy.
- One favourable development from a medium-term perspective was the European Commission on behalf of the EU launching its first intra-European sovereign bond issuance. This was issued under the 'SURE (Support to Mitigate Unemployment Risks in an Emergency) Fund.' Around EUR 17 bn was issued under this scheme and proceeds raised was given to Italy, Spain and Poland. It is a medium to longer-term structural positive for the EUR/USD pair given that it is a step towards a more homogenous bond market as well as in the region. Given the quality of the paper, it can also compete directly with the US Treasury market as a 'safe-haven' instrument that could take place over a period of time but probably not in the near-term.

GBP/USD; Some favourable progress on 'Brexit'

- **While risk aversion has intensified, the downtrend in the GBP/USD pair has been much more moderate reflecting media reports that indicate credible progress has been made with regards to 'Brexit'.** However, there has been no official confirmation of this. More negotiations are expected going forward. We see the GBP/USD pair trading in the 1.28-1.32 range in the near-term.
- Even as the spread of COVID-19 appears to ticking higher, UK retail sales accelerated from 2.7% YoY in August to 4.7% YoY in September. However, UK PMI surveys weakened sharply in October with the composite PMI falling from 56.5 in September to 52.9 in October reflecting a simultaneous fall in PMI manufacturing and PMI services. Unlike the Euro-zone, all of the surveys remained above the expansionary level of 50.
- Media reports indicate that there could be stringent social distancing norms or partial lockdowns that could get imposed by the UK government. This would work as a substantial headwind for the region.

USD/JPY: More downside potential is in store

- **We are lowering our USD/JPY projections in the near-term and see an equilibrium range of 103.50-105.50 in the near-term.** The downward revision primarily reflects an increased possibility of more volatility in the near-term that could favour 'safe-haven' assets such as the JPY.
- The BoJ maintained status quo on expected lines but made downgrades to growth expectations for 2020. Service sector activity is expected to be weaker than previously assumed that has resulted in lower growth profile.
- Japanese economic indicators continue to show a flattening trend over August-September after the improvement that was seen over April-July reinforcing a 'U' shaped recovery pattern going forward. PMI surveys, retail sales and industrial production seem to corroborate that view.

Emerging Economies: Review of the main developments

- A growing source of concern is the sharp upward move that is being seen in the USD/TRY pair that has come on the back of the Central Bank of Turkey unexpectedly maintaining status quo. The central bank was expected to hike interest rates to support the currency. However, continued currency depreciation given the external liability profile of Turkey could have a cascading effect for other EM FX as well.
- The US Presidential elections will work as a substantial event risk for EM Assets and FX given the different external policy approaches of Biden and Trump. A 'Biden-led' administration will be considered as a more favourable alternative for EM FX than a 'Trump-led' administration as we have indicated in previous research notes.

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