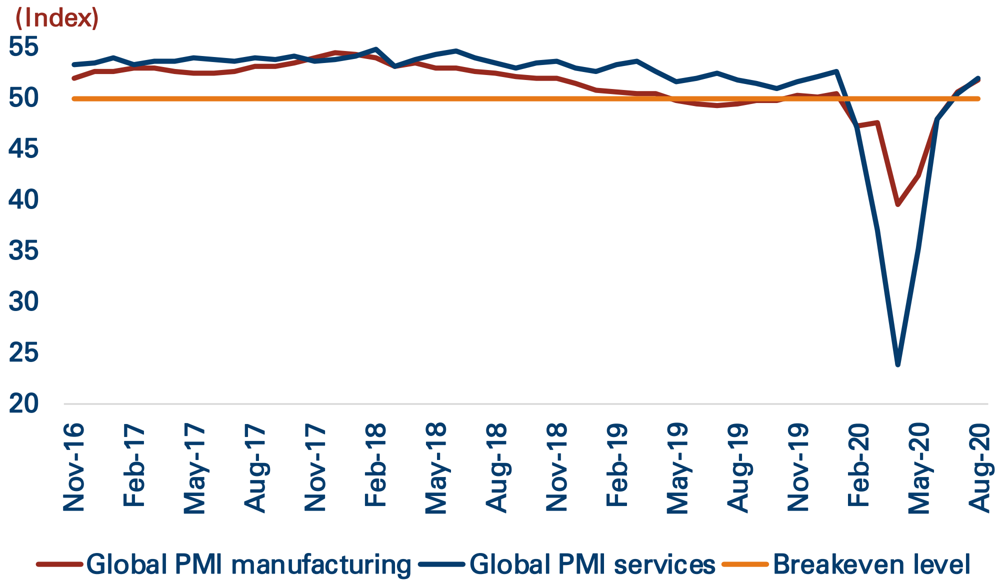
The week in review: The return of 'Brexit' and volatility

Trading environment: Global markets have become more volatile responding to conflicting factors. The only encouraging aspect is that global growth momentum is still holding up, even as the pace of growth is moderating on a sequential basis. This was the message that was visible in the global PMI surveys that were released with both global PMI manufacturing and services remaining in the expansionary territory in August. The shape of the recovery resembles more of a 'U' than a 'V'. Besides, so far the recovery appears to be more of an inventory re-stocking cycle and some pent-up demand reflected in the fact that the manufacturing PMIs are rebounding at a much sharper rate than service sector PMIs.

Investors continue to respond to news on the vaccine with some concerns building up after a leading vaccine produce appeared to have stopped its phase three trail after one of the respondents showed an adverse response. However, trials appear to have resumed and assurances are being provided that a vaccine could be in place by end-2020. Hence, risk sentiment has recovered. The other adverse development has been on the 'Brexit' front. It appears that 'Brexit' negotiations are unlikely to be smooth with the UK PM wanting to renege on some parts related to North Ireland border that was agreed upon as part of the withdrawal agreement. Hence, **uncertainty about the road ahead with regards to 'Brexit' has intensified that has provided some support to the USD.** We see some consolidation in the FX markets up ahead with a bias towards USD strength in the near-term. Global bond yields are expected to continue trading fairly range bound with a downside bias reflecting risk aversion and an accommodative global monetary policy framework. On the other hand, USD/EM pairs are likely to be influenced less by 'Brexit' but more by overall liquidity and investor perception about the strength of the recovery. A further downside bias across the USD/EM pairs cannot be ruled out in the near-term.

In the local markets, some degree of stability appears to have returned to the USD/INR pair after the sharp move lower that was seen in the previous week as RBI appears to have lowered the overall quantum of intervention in the foreign exchange market. We see a flat trading trajectory for the USD/INR pair in the week ahead. Fixed income markets remain volatile, as the sharp surge in local bond yields has been capped to some degree by RBI action through OTs and raising of HTM limits. However, fiscal concerns in local fixed income markets will continue to drive price action in the coming weeks.

Chart 1: Global growth momentum is accelerating



Source: Bloomberg & ICICI Bank

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US Assets: A new lease of life?

- The return of risk aversion has meant that the USD has appreciated on a trade-weighted basis that has been concentrated primarily against DM FX. The bulk of the gains has come against the GBP reflecting increased 'Brexit' uncertainty.
- Going forward, given our expectations of an increase in risk aversion as investors fret about the state of the global economy could result in the DXY trading with an upside bias. We maintain our range of 92.00-94.00 with a possible upside of 94.20 emerging in the near-term.
- On the data front, US economic indicators continue to show a fairly robust trend that was visible in the sharp fall in the unemployment rate even as the pace of payroll growth moderated by a degree for the month of August. The US ISM PMI manufacturing accelerated from 54.2 in July to 56.0 in August while ISM PMI services sector slowed from 58.1 in July to 56.9 in August. Both surveys suggest that growth remains fairly firm in the US economy. US CPI inflation has picked up but that has had a very limited effect given the change in the FOMC's framework to an average inflation targeting regime.
- However, near-term risks to the US economic outlook have also increased as US policymakers fail to reach an agreement over the fiscal stimulus package.
- The combination of ongoing concerns about the state of global growth and an accommodative monetary policy framework of the Federal Reserve will likely cap any sharp upside in US yields. We maintain our near-term target range of 0.55%-0.75% for the US 10-year treasury yield.
- The FOMC meeting that is due next week is unlikely to invoke a sharp response given that investors have already started to price in the new monetary policy framework of a flexible average inflation targeting regime. The FOMC could move towards a data dependent forward guidance, although we assign higher odds of that happening later in 2020 or in early 2021. Economic projections are unlikely to change considerably with the 'dot plot' reinforcing the fact that policy rates will remain low for an extended period of time.

Domestic assets: Global liquidity versus local fiscal concerns

- **We expect some degree of divergence between the FX and bond market to continue.** A favourable global liquidity outlook will continue to work to ensure that the USD/INR pair trades with a downside bias. 'Brexit' related uncertainty is unlikely to have a significant impact on EM FX such as the INR. Only if the UK actually crashes out of the EU will it have a pronounced negative impact via a risk sentiment perspective.
- We have lowered our near-term trading range for the USD/INR pair and see it trading in the 73.00-74.00 range in the near—term. RBI intervention appears to have moderated by a degree that has been the primary reason for the lower trading trajectory.
- The bond markets have witnessed a fair degree of volatility in the past few weeks and we expect this trend to continue going ahead. After the high inflation print and the hawkish MPC minutes, RBIs circular on aiding orderly market conditions including:
    1. INR 200 bn OT announcements (in addition to the INR 200 bn OT announcement done last week), with a commitment to conduct more such operations if required
    2. Term Repo Operations of INR 1 tn at floating rates in middle of September "to assuage pressures on the market on account of advance tax outflows", along with the option to Banks of reversing the LTRO operations done in March, before maturity. This will help banks reduce their interest liability
    3. HTM limit hike from 19.5% to 22% of NDTL, surprised the markets and led to a knee-jerk reaction of 10-year benchmark moving below the 6.0% handle.
- However after the keen-jerk reaction, concerns on 1) continued supply of Government paper, impasse on GST compensation fund with increasing risks of it translating into higher borrowing, expectations of a higher borrowing number to be announced in the H2 borrowing calendar due to be released later in the month, 2) high and elevated inflation prints (with our expectations of August CPI to be ~6.9% YoY), 3) recent rise in geopolitical tensions and 4) volatile oil markets has been driving sentiment. On the other hand, mixed reviews coming from global growth and development of the vaccine could be partly positive for safe-assets. We expect this sort of volatility to continue in the near-term, with risks to the downside for the bond markets.
- The next main event risk for bond markets is likely to be the CPI inflation release that is due later on today.
- Market response to the weakest GDP reading on record in Q1FY2021 was fairly modest given that the release was priced in by investors. Moreover, a sequential improvement in the IIP reading for July was also largely priced in. Instead, local investors are more concerned about the fiscal position of both the centre and states.

EUR/USD pair: Not breaking the range

- Investor concerns about possible ECB intervention to stem the pace of appreciation in the EUR/USD pair proved to be short-lived given the messaging provided at the conclusion of the policy meeting.
- The fact that the central bank did not express concerns about the level of the EUR will in turn imply that price action will be driven primarily by 'Brexit' developments in the near-term.
- However, sharp upside for the EUR/USD pair will not be restrained only by 'Brexit' uncertainty but also by the fact that the spread of COVID-19 across the Euro-zone appears to be increasing. Hence, we suspect that there could be a further imposition of social distancing norms that might start to weigh on activity. In this regard, Euro-zone PMI surveys show that the momentum of growth is slowing. The composite PMI fell from 54.9 in July to 51.9 in August reflecting a sharp fall in services PMI. Retail sales also showed signs of moderating on a sequential basis in July. The upshot is that concerns about the pace of recovery for the Euro-zone is likely to increase by a few notches going forward that will get reflected in the price action in the EUR/USD pair. Hence, we see the EUR/USD pair trading in the 1.1750-1.1950 range in the near-term.

GBP/USD: Volatility with downside bias as 'Brexit' uncertainty intensifies

- After the passage of the Withdrawal Agreement in January-2020, markets had priced out the prospect of a 'No-Deal Brexit' or 'Hard-Brexit' scenario. However, in the interim period several complications have arisen.
- For one, the UK government introduced an 'Internal Market Bill' with the intent of protecting the UK in case negotiations with the EU break-down'. The problem is that the new bill violates several provisions that was agreed upon as part of the 'Withdrawal Agreement'. Hence, risks of a break-down in negotiations have increased considerably. The EU Chief Brexit negotiator has indicated that the region is preparing for a 'Hard-Brexit' outcome. There might also be legal ramifications for the UK if this bill is passed that will now go through UK Parliament.
- Given the hit that COVID-19 has already provided to the UK economy, it cannot afford a hard break-up with the EU that moves trading relations back to WTO norms.
- Hence, ongoing 'Brexit' concerns will likely drive the GBP/USD pair lower ensuring that it trades with a downside bias. We see a range of 1.26-1.30 for the pair in the week ahead.
- Several BoE MPC members have struck a fairly dovish tone with the Governor highlighting that the central bank can use a variety of its toolkit to accommodate any slowdown that takes place. The toolkit comprises of QE, forward guidance, sector-wise targeted lending programs and possible negative rates. The BoE should reinforce this dovish message at the conclusion of the policy meeting due on 17-September-2020 that could in turn work as another bearish catalyst for the GBP/USD pair.

USD/JPY: Guided by risk sentiment and the USD

- The trajectory of the USD/JPY pair remains unchanged for the time being as it is being driven by: (a) overall risk sentiment and (b) USD trajectory in the global markets. We see this range trading environment for the pair to continue to remain in place of 105-107.
- Even as there is likely to be a leadership change with the PM Abe having resigned from his post, the impact on the JPY and Japanese markets is likely to remain minimal as the policy framework will not change.
- The voting within the ruling LDP Party will take place today with the leading candidate Chief Cabinet Secretary Suga expected to carry forward the fiscal and monetary agenda of the previous administration.
- The Japanese economy was confirmed to have slowed by a record quantum in Q22020 and PMI surveys are not showing signs of accelerating. The outlook for the region will remain contingent on the manner in which the spread of COVID-19 pans out. Industrial production did show some sequential improvement of 8% MoM in July but that primarily reflects a restocking cycle.
- The BoJ policy meeting (17-September-2020) is unlikely to be eventful. The accommodative policy framework is likely to be maintained. The net effect on the market should be limited.

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