FX Focus

Four key themes for 2020

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Theme 1: The US Presidential Election: Implications for 2020

- Impeachment unlikely to have a major impact on election
- Trump will not stand still ahead of the election
- A rise in support for Sanders or Warren is a downside USD risk

Election shapes all US policy

Although the outcome remains uncertain, the 2020 election will be the key driver of political jockeying and decision-making in Washington DC this year. Regardless of Democrats' choice of nominee to challenge President Trump, the campaign will likely be the ugliest in living memory in the US, with insults, mud-slinging, and accusations of cheating by both parties. It is unclear how this dynamic will impact voter preferences come 3rd November, but record voter turnout is possible. While much of the attention is on which party will secure the presidency, it is important to bear in mind that Americans will also determine the outcomes of all 435 seats in the House of Representatives, 35 of 100 seats in the Senate, 13 state and territorial governorships, and myriad local elections—with major short and long term ramifications. Buckle your safety belts and prepare for a bumpy ride.

Impeachment unlikely to have major effect on 2020 outcome

The exact path of Trump's impeachment's remaining steps is uncertain, but the outcome is not. Having been impeached almost entirely along party lines by the House of Representatives on 18th December, Trump will not be convicted by the Senate. This will play out in the context of rising polarization between Republicans and Democrats, which has been further exacerbated under Trump. Record numbers of Republicans support the president, while record numbers of Democrats oppose him. Impeachment has added poison to this well, but it remains a symptom of the trend, not its cause. For this reason, impeachment is unlikely to be a major factor in the 2020 elections, although it may impact a few highly competitive congressional elections. If anything, impeachment has further entrenched Democrats and Republicans within their respective camps. Polling data also indicate support for impeachment is ebbing. RealClearPolitics for the first time on 16th December revealed opposition to Trump's removal from office surpassed support since polling on this began on 1st October.

Election year impact on US policy

There is little room for political compromise in any election year, and with a divided US Congress, 2020 will be no different. The US-Mexico-Canada Trade Agreement (USMCA) may be one of the only bipartisan agreements that Trump signs into law in

2020. Democrats have thrown support behind the relatively protectionist agreement after negotiating changes on progressive priorities. Politically, the move also helps shield vulnerable members from the charge that they have eschewed advancing the US economy by opposing Trump's presidency and supporting impeachment. It is unlikely that the circumstances that led to bipartisan support for the USMCA will be replicated for other major legislation; infrastructure, pharmaceuticals, or other key priorities are likely off the table in 2020.

Foreign policy a key area to watch

Despite the fact that Congress will be at a political standstill, President Trump will not stand still. He will use the powers at his disposal to energize the coalition that elected him in 2016, focusing on his "promises made, promises kept" doctrine. Returning to his "America First" agenda, he will label his Democratic opponents as globalists who seek to undermine US sovereignty. Handcuffed by Congress, expect Trump to turn his attention to foreign policy, where he will have more freedom to act without input or approval from Congress. It is unclear how this will manifest itself, but in 2020's earliest days we have already seen dramatically increased tensions between the US and Iran and renewed sabre-rattling from North Korea.

Trade frictions remain a risk, but reduced in 2020

On trade, Trump will seek to balance competing priorities: the desire to demonstrate he is standing up for American workers who feel left behind by past trade deals, with the reality that he needs to avoid new trade wars that could undermine a resilient US economy. Trump could announce new tariffs targeting Asia, Europe, or Latin America, with the risk of him doing so increasing should he feel protected by strong economic numbers. Nonetheless, the likelihood of major escalation across any of these fronts should remain contained.

Who wins the Democrat ticket matters for the markets

As of 5th January, Joe Biden remains the frontrunner to win the Democratic Party nomination. He leads Bernie Sanders by 9.4ppts. Elizabeth Warren is 3rd, 14.9ppts behind. Sanders has outperformed Warren since October when Warren was on a par with Biden. Certainly a Sanders or Warren victory in the primaries followed by outperforming Trump in the polls heading into the election would be the scenario that would spark most financial market volatility. The extreme left policies of Sanders or Warren are not priced and risk-off USD depreciation would certainly follow.

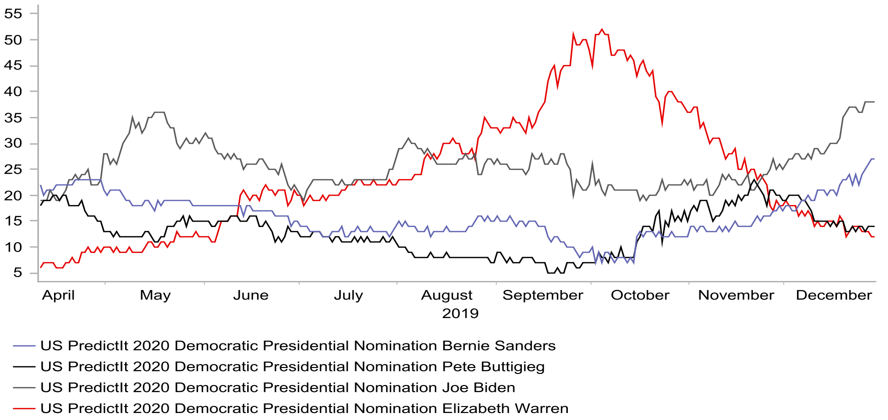
It's Biden versus Trump – which implies less USD volatility

While that's a risk for this year our core assumption incorporated into our FX forecasts is that Biden wins the ticket to run against Trump in the election. Key to that assumption is that he has consistently led polls both nationally and in swing states. In the key swing states like Ohio, Michigan, Wisconsin and Florida Biden consistently out-polls Trump unlike Sanders and Warren. However, when it comes to Trump versus Biden we are not convinced the current polling will be realised. We see a greater risk of Trump defeating Biden – that's our current assumption although we fully acknowledge the outcome is extremely fragile and a close call!

Politics will be important for the dollar but other factors key also

As always, the outcome of the election will be extremely important and will immediately shape expectations on growth with implications for FX and rates. President Trump is likely to campaign this year on a promise of more stimulus but assuming the House remains in Democratic control after 2020, more stimulus is very unlikely. But certainly the markets will likely speculate that Trump, emboldened by another election victory, will aggressively pursue his trade policies in order to complete what he started in his first term. Phase 2 negotiations with China could easily result in a re-escalation in trade conflicts, not just with China but attention could also turn to Europe. Certainly Trump will care less about US economic damage in 2021 than he obviously does in 2020. A Trump victory coupled with a Democrat-held House will likely have the least impact on US dollar direction but we assume that with the US economy weakening further this year, expectations of an escalation in trade tensions in 2021 on a Trump victory would be more harmful for the US dollar than the escalation of trade tension was in 2018 and 2019.

BIDEN OUT IN FRONT WITH SANDERS A CLEAR SECOND



Source: Macrobond & MUFG GMR

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Theme 2: Monetary policy frameworks – what are the implications for USD?

- The close proximity of the effective lower bound (ELB) is increasing pressure on the ECB and Fed to alter their monetary policy approach.
- A shift to a "makeup" inflation strategy has been touted for the Fed associated with "lower for longer" & posing downside risks for the USD.
- Expectations for ECB policy review are more muted even as ECB remains closer to the ELB. A potential trigger for higher euro volatility.

Higher risk policy rate will fall to effective lower bound prompts need for more serious re-think of Fed & ECB policy

One of the important themes for 2020 will be the outcome from the upcoming ECB and Fed monetary policy reviews. Fed Vice Chair Richard Clarida noted that "in light of unprecedented events of the past decade, we believe it is good time to step back and assess whether, and in what possible ways, we can refine our strategy, tools, and communication practices to achieve and maintain their goals consistently and robustly as possible". Of particular concern is that the neutral level of the policy rate, the level that keeps the economy on an even keel when employment and inflation are close to their objectives, appears to have fallen in the US and abroad. The decline in the neutral policy rate likely reflects several factors including aging populations, changes in risk-taking behaviour, and a slowdown in technology growth. It increases the risk that the central bank policy rate will fall to its effective lower bound (ELB), and thereby constrain central banks' ability to counter future downturns. In addition, inflation appears less responsive to resource slack in recent decades. The flatter Phillips curve makes it all the more important that longer-run inflation expectations remain close to levels consistent with the inflation target.

"Makeup" inflation strategies under consideration to more effectively address current policy constraints

In the Federal Reserve Act, Congress has assigned the Federal Reserve the responsibility to conduct monetary policy "*so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates*". The review takes this statutory mandate as given and that an inflation rate of 2 percent is most consistent over the longer run with the congressional mandate. Their flexible and balanced approach attaches an equal footing to the employment and inflation objectives. Under the current policy framework, persistent shortfalls of inflation from the target are treated as "*bygones*". It means that policy is not adjusted to offset past inflation shortfalls with future inflation overshoots of the inflation target, and vice versa. It poses the risk that longer-term inflation expectations could become poorly anchored or anchored below the inflation goal during persistent inflation shortfalls, and it has encouraged some economists to advocate "*makeup strategies*".

Makeup strategies lead to better outcomes in theory but needs to be understood by public as credible commitment

These strategies include: i) targeting average inflation over a multi-year period and ii) price-level targeting – to be implemented on either a permanent or temporary basis. According to many models that incorporate the ELB, these makeup strategies lead to better average performance on both legs of the dual employment and inflation mandate, although their benefits rest heavily on households and firms believing in advance that the "*makeup stimulus*" will be delivered. Therefore it is vitally important that it is understood by the public as a credible commitment.

Price-level targeting would commit to reversing temporary deviations of inflation from target. Policy rate would remain lower for longer.

Former Fed Chairman Ben Bernanke has strongly advocated the adoption of a temporary price-level target in recent years. A price-level-targeting central bank would try to keep the level of prices on a steady growth path, rising by say 2 percent per year. In contrast to the current inflation target regime, the price-level targeter would commit to reversing temporary deviations of inflation from target rather than "*looking through*" and treating as "*bygones*". A price-level targeter can be still be flexible and take into account output and employment considerations as well. One of the advantages of price-level targeting at the ELB is that it provides automatic stimulus. If the promise of keeping rates "*lower for longer*" is credible, it should help to ease financial conditions and reduce the adverse effects on output and employment. In addition, it should help to lift inflation expectations and lower real rates in anticipation that higher inflation will be tolerated in the future as an offset.

Temporary price-level target would only be applied to periods around the ELB

The "*temporary*" price-level target and the associated "*lower for longer*" principle would "*only be applied to periods around the ELB*", and would retain the current inflation targeting framework including 2% target at other times. It should still help to make encounters with the ELB shorter, less severe and less frequent, but would not require a major shift away from the existing policy framework thereby making easier to communicate. A potential example of updated policy communication was put forward by Ben Bernanke as follows "*The Committee agrees that in future situations in which the Fed funds rate is at or near zero, a necessary conditions for raising the Fed funds rate will be that average inflation since the date at which the Fed funds rate first hit 0% be at least 2 percent.*".

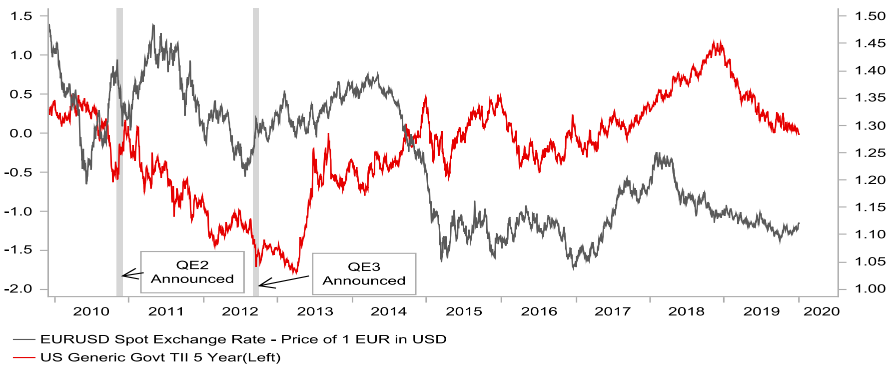
The Fed adopting a makeup inflation strategy would increase downside risks for the USD

The FT recently reported that the Federal Reserve is considering adopting a '*makeup inflation*' strategy. In September, Fed staff economists presented make-up strategy options to the FOMC. The outcome from the monetary policy review is scheduled to be concluded during the 1H 2020, and has the potential to be a market moving event. If the Fed decides to adopt a "*makeup*" inflation strategy, market participants are likely to see it as negative for the US dollar to begin with. Under a makeup inflation strategy, the Fed would effectively commit to keeping looser policy in place for longer to encourage higher inflation further down the line. If credible, the commitment would also help to raise inflation expectations and lower real yields proving more stimulus and undermining the US dollar. For comparison, QE2 and QE3 also both helped to push down US real yields between 2010 and 2012. During that period the US dollar was much weaker. EUR/USD averaged around 1.3350 and even briefly traded above 1.4500. However, the immediate negative impact on the US dollar will depend upon when the make-up strategy is implemented. If the Fed chooses to wait until the policy rate moves closer to the ELB, then the negative US dollar impact will be delayed until the US economy slows more abruptly and requires further rate cuts.

Expectations for ECB policy review are more muted. Low expectations create more room for policy surprise which could lift low euro volatility.

Market expectations for the ECB's upcoming policy review are surprisingly more muted (click here) even though the ECB remains closer to the ELB. According to a poll conducted by the FT, more than half of the economists polled expect the ECB to amend their current inflation target of "below but close to 2 per cent". A shift to a simpler "symmetric" target of 2 percent over the medium-term is viewed as most likely. It would more clearly signal that the ECB was as worried about inflation being too low as being too high, although it would not be as significant a policy shift as adopting a makeup inflation strategy. If the ECB only tweaks their monetary policy approach, the impact on the euro should be more limited. Low expectations do though create more room for a policy surprise and higher euro volatility.

FALLING US REAL YIELDS & A WEAKER USD



Source: Bloomberg, Macrobond & MUFG GMR

Theme 3: China – As the Supply Chain Shifts

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- As the Supply Chain Shifts means major MNC production lines moving out of China in 2020
- We do not think phase 1 will remove major trade uncertainties
- As a consequence, MNCs must develop flexibility away from China
- Which is a big, necessary but inherently difficult process

Each year we offer a tagline for the state of play of the Trump Trade War

In the 3+ years since we began to analyze the Trump Trade Wars in notes, each year we've given a tagline to the state of play:

- In 2017, it was **Threat of a Trade War**
- In 2018, it was **A Live-Fire Trade War**

In 2019, it was **The Year When Macro Effects Become Obvious**.

In 2020, we propose **As the Supply Chain Shifts**

In 2020, we propose: As the Supply Chain Shifts. The main idea is that after assessing, studying, lobbying and occasionally cringing, many of the world's major multinationals will noticeably shift a part of their supply chains out of China. Now we don't mean a wholesale abandonment of China, such as what some proponents of decoupling might wish for, but a number of MNCs will begin to move a major line of production or a major product out of China and redeploy it elsewhere around the world. No one will leave China altogether - it's simply too big a part of future growth to be ignored. But especially in the part of China that is the final stop for a product before it is shipped to the US, it makes sense to shift now.

We think a part of the 2019 melt-up rally is a view Trump is neutered on trade in 2020

A good part of the market melt-up rally that ended 2019 seemed predicated on a notion that even if Trump has not entirely caved in his Trade War as widely thought earlier in the year, at least he is neutered when it comes to trade mischief in 2020. That once the phase 1 agreement between the US and China is signed on 15 January 2020, Trump will be on his best behavior when it comes to trade, a pussycat and not a lion, domesticated and not a wild boy around town. In this scenario, Robert Lighthizer can conceivably look forward to a quiet year with not much to do.

We disagree; for one thing, disputes over phase 1 can pop up quickly

We have taken issue with this view. Our judgment is phase 1 will not put an end to Trump Trade Wars. Phase 1 itself has a number of issues that can go wrong, beginning with, most prominently, the Trump-ballyhooed Chinese "commitment" to buy USD40-50bn of US agricultural goods in 2020 and 2021. We have had questions from the get-go over whether the supply curve of US agriculture at low levels of agricultural goods prices can deliver anything close to the USD40-50bn of US agricultural exports implied by phase 1. As we have written before, disagreements before phase 1 imply disagreements after phase 1, and that's not even discussing phase 1 as a DINO (Deal In Name Only).

For another, the Trump Trade Train has further stops to make

Besides disputes connected to phase 1, we have long said that though the Trump Trade Train will make its first stop at China, it won't be its last stop. That significant trade tensions with China will persist beyond phase 1 may be a surprise to markets, but pivoting onto a next stage of trade disputes with Europe, in autos, with Taiwan, etc. could be a bigger shock. The fundamental framework we adopted at the outset was to take account of Trump's bedrock instincts as a mercantilist to gauge how far he will go as Tariff Man. We believe USTR Lighthizer will be plenty busy in 2020.

As a consequence, global MNCs must develop flexibility outside of China

Even after phase 1 is signed, the global economy will be more protectionist than it was three years earlier, and we think enough of planning, MNCs have to adjust. Though we are convinced free traders, we recognize current world politics do not seem configured to support free trade outcomes, so CEOs worldwide have to adjust. The idea is to create flexibility outside of China.

To summarize, we highlight two ideas

Within the space constraints of the monthly it won't be possible to fully flesh out our thoughts (so consider this a summary), but there are two major ideas we'd emphasize:

- **This won't be a process that starts small**
- **Though necessary to hedge, redeploying production out of China will be difficult.**

Global MNCs relocating major production lines is big, and gets bigger

It will start big and get bigger. Economists can be fond of processes that begin small before building up gradually till they become, using that dreaded word, modest. This is *not* what we are thinking. Though we've already seen some FDI redeployment in 2019, those were moves by small- and medium-size exporters desperate to avoid Trump Tariffs and shifting final production to places like Vietnam, Mexico and Taiwan. In aggregate, those represented billions of USD. The sort of change we are thinking about will be an order of magnitude larger, into the tens of billions of USD. As one Swedish client said to us, "If my customer moves, then of course I have to move." The intricacy of the global supply chain means if one major line at a global

MNC shifts, 100 suppliers will shift. So if it's only 10 major MNCs in 2020, we are thinking about 1,000 companies. Initially MNCs will be tight-lipped about this, for fear of offending either governments in China or in the US or in both.

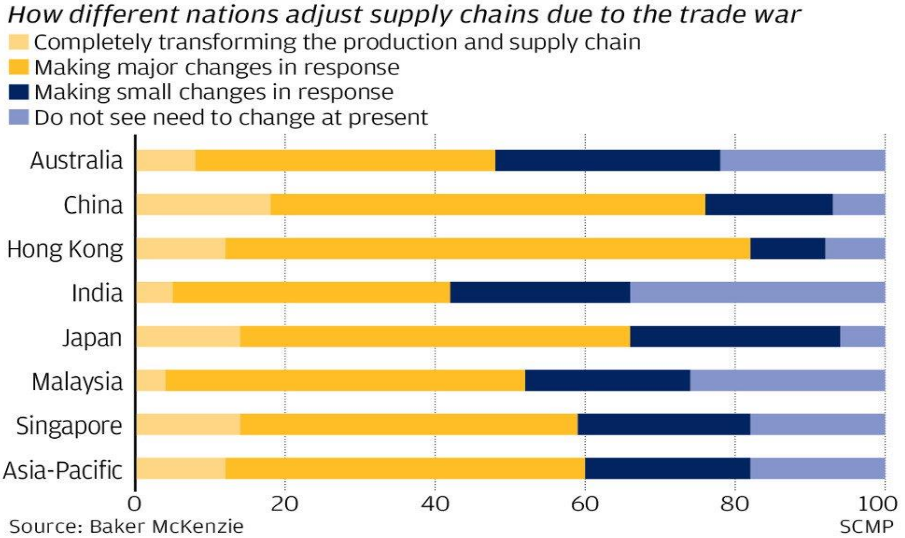
Even if necessary, moving out of China is inherently difficult

No one is happy about the divorce. This is a good juncture to re-emphasize there are no winners in a Trade War. We use Mexico as an example. Mexico's bilateral trade surplus with the US has burgeoned due to the Trade War, so that must mean Mexico has "won," no?

Moving out is difficult and no miracle cure; there's a cost to be paid

Not really. Past academic studies put value-added in exports for Mexico at a number around 25%. In China today, the same # is North of 50%. So shifting from China to Mexico means moving from a far higher value-added exporting economy to a lower one. Where Mexico and other countries competing with China have to compete is really with the economic infrastructure China painstakingly built over two decades. In China, you may find all of the 50 other companies you need to work with on the supply chain are already there, only a few miles away. In Mexico, maybe only 7-8 of them are there. You then need to forge new contractual relationships with the other companies outside of Mexico. So, hypothetically, you might need to go to Paraguay, or to Chile, or even to the United States. This explains why when some companies shift out of China, they don't go onto a single new destination (eg, Vietnam) but often to a number of countries. You go to a less efficient place, it costs you more to do so. Replicated 10,000 times, costlier production reduces potential growth, and either profit margin shrinks or consumers pay higher prices!

SUPPLY CHAIN SHIFTS



Theme 4: Oil at a crossroads – fundamentals, geopolitics and energy transition will drive markets in 2020

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- Demand optimism but a mixed supply outlook will keep oil prices in check with forward curves anchored near cost support in 2020
- Geopolitical pressures may unfold but events are price risk symmetrical
- Environmental, social and governance (ESG) investing pertaining to

climate change is moving front of mind, even if bearings are medium-term

Oil markets remain mired in supply abundance with the energy transition threatening long-term demand

The search for a new oil market equilibrium continues. Oil markets notched up a number of milestones in 2019 that echoed the new oil order of the past decade: the world has shifted from an era of supply tightness to plenty, with the energy transition into renewables threatening long-term demand. Despite the dramas of the last decade, oil closed out 2019 well below its 10 year average, as inexorable US output and concerns surrounding the health of the global economy, weighed on prices. Yet towards the end of 2019, forces were aligning to support prices again. This is likely to prove short-lived. Distinguishing cyclical bullish momentum with long-term structural bearish shifts in oil markets signals that price upside remains capped in 2020.

De-carbonisation will be a key theme limiting the call on oil this decade

At the dawn of a new decade, many challenges facing oil markets look similar to those in the last: ever present geopolitical uncertainties, supply abundance and peak demand concerns. What is different is that markets are becoming serious about de-carbonisation – climate change, a deeper presence of renewables, ESG investing and the rising penetration of electric vehicles, are all limiting the overall call on oil.

A benign global economic outlook puts oil demand prospects on a more studier footing in 2020

On the demand-side of the oil equation, growth disappointed in 2019, increasing at half the rate forecast at the start of the year. We are becoming more sanguine about global economic growth and expect oil demand to bounce back in 2020, growing by 1.1m b/d, nearly double the tepid 0.6m b/d growth in 2019 (lowest since 2011). Global GDP growth will accelerate in 2020, reflecting policy clarity (US-China and USMCA), a more positive impulse from financial conditions, easier fiscal policy in Europe, a stabilisation in manufacturing activity and an end to the inventory adjustment. One-offs depressed oil demand in 2019 – sanctions-related demand destruction in Venezuela and Iran, plus warm weather in Europe – all of which will not feature in 2020. Also, oil demand will be boosted by marine gasoil as bunker volumes move in line with IMO 2020 low-sulphur regulations on shipping fuels.

Composition of supply is changing but overall abundance will keep markets oversupplied in 2020

Meanwhile, oil markets are dealing with a confluence of trajectories on the supply-side – crucially, overall oil supply growth will rise robustly in 2020, increasing in net by 1.4m b/d, up from 0.1m b/d in 2019. What's changing is supply's composition. First, the US won't dominate as much, with signs that the shale industry, which has transformed the oil market in the past decade, is finally slowing. Recurring negative free cash flow generation, high accumulated leverage, tighter capital access, stalling productivity and accelerated decline rates are forcing shale companies to scale back their expansion plans. Slowing growth does not signal no growth however, with the US set to become a consistent net oil exporter in 2020 – a testament of the country's outstanding crude transformation. Second, and the most significant, pertains to long-cycle non-OPEC supply away from the US. The large, and delayed concurrent legacy projects ramp-up in Brazil, Canada and Norway as well as new promising producer Guyana, will collectively deliver 0.9m b/d of supply in 2020. Third, OPEC+ members have been forced to revert to a quota system of production since 2017, but even with significant (voluntary and involuntary) volumes taken off the market, Brent crude has failed to increase above a core range of USD60-70/b. Without iterative cuts, prices would be much lower. Yet, a lack of an coherent exit strategy implies that the group will be confronted with its long-term dilemma – defend prices or defend market share.

Oil prices to remain in check based on a broadly balanced 2020 global oil market government finances

From an oil price perspective, absent growth or geopolitical tensions escalating into material shocks, we mark-to-market our Brent spot average forecasts at USD62.3/b in 2020, based on our models which signal a moderately balanced global oil market (0.4m b/d surplus). Our forecast for one year forward Brent futures is USD56.6/b with a long-term anchor near the industry's marginal cost of production and support of ~USD55/b, and persistent levels of backwardation (given low-to-normal inventories) across the curve. Our WTI 2020 average price forecast is USD56.7/b, with the one year forward forecast of USD52.1/b, and a long-term anchor at ~USD50/b.

Markets remain sensitive to geopolitical events but uncertainties are balanced and price risk symmetrical

Risks to oil prices are balanced with both bullish and bearish skews. The impact of the September 2019 Saudi oil infrastructure attacks has largely ebbed away, but the story is unfinished. The announcement of the targeted killing of the top Iranian commander on 3rd January 2020 inherently puts short-term upward pressure on oil prices, with prospects of a wider conflagration, a material geopolitical uncertainty hanging over oil markets. We live in an age of plenty when it comes to energy supply, but that does not mean energy security is guaranteed. Dependence on areas of the world mired by conflict remains a significant risk. Critically though, unlike recent years, geopolitical supply risks are no longer only oil price bullish. The sheer magnitude of Iranian and Venezuelan output losses makes such disruptions, price risk symmetrical, as breakthroughs could transpire that enables output to return.

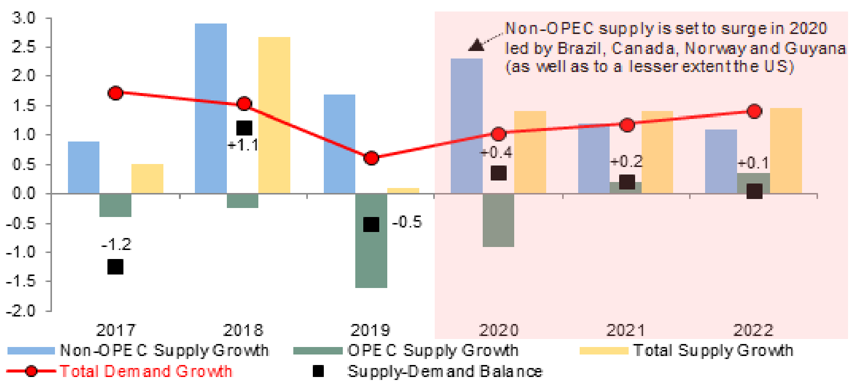
Energy transition is moving front of mind but oil will remain an integral part of the energy mix for a few years yet

Climate change became top of mind in 2019. The 2020s may be the decade when oil consumption finally peaks, with the transition into renewables fostering momentum. The substance of the issue has not altered. The salience of the issue, however, has not been matched by material progress towards a solution. Public interest in climate change still remains intermittent. For the oil industry, the difficulty is that public policy and market realities are still not moving in concurrence. The investment required to meet growing demand is being jeopardised by uncertainty over the policies that will be in place by the time such outlays begin to produce a return. Succinctly put, the increasing importance of cleaner energy threatens to curb long-term oil demand and lower prices. However, before the transition to renewables is complete, oil will remain an integral part of the global energy mix for some years yet

Structurally bearish oil market outlook signals price upside remains capped

Looking ahead, chasing rallies in the oil price remains a risky strategy, and there are strong reasons to anticipate a crude correction in 2020. First, President Trump will be in no mood to entertain a sustained period of higher oil prices in an election year, given he has made lower gasoline prices a central part of his manifesto. Second, higher oil prices incentivises higher cost marginal producers, who are unlikely to stay on the back foot if crude keeps strengthening. Third, a sustained period of higher oil prices would merely lead to demand destruction becoming more likely, through a combination of enhanced efficiency and a slowdown in the global economy. Oil's fortunes might have cyclically brightened, but the game has not structurally changed.

OIL FUNDAMENTALS: DEMAND, SUPPLY AND OVERALL BALANCE, MILLION B/D



Source: Bloomberg, IEA, EIA, OPEC, MUFG MENA Research

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