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US & EU take important steps – ingredients for further USD selling

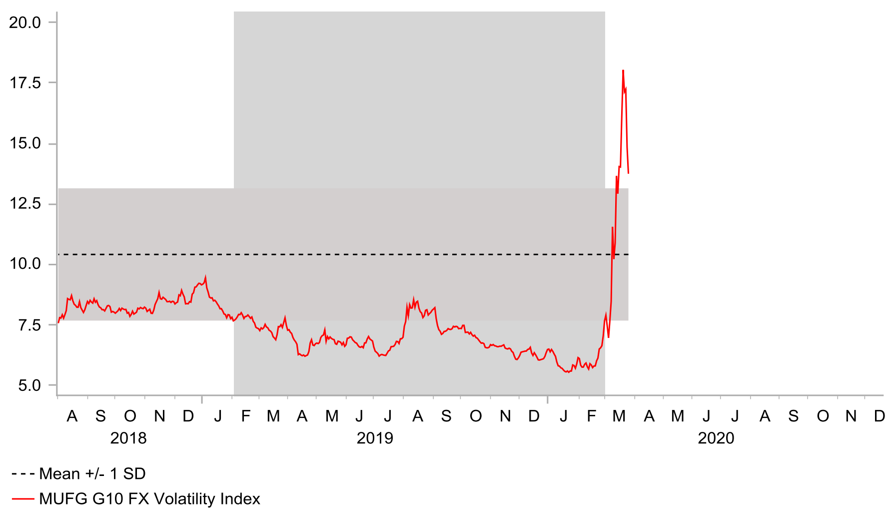
25th March 2020

USD& EUR: More policy progress as FX vol subsides further

There were two important developments on the policymaking front last night that will help maintain the current degree of positive market sentiment – first, a deal was reached between the White House and the Senate on the now widely known USD 2trn fiscal stimulus package and second, the Eurogroup reached a deal on utilising the ESM to provide further fiscal stimulus – a potentially far more important development.

On the US deal, a vote is now expected in the Senate today with the House expected to follow shortly after. We are assuming Nancy Pelosi is on board with this deal and hence expect it to be passed. The details appear close to what we already know – USD 500bn for support to the corporate sector; cheques of USD 1,200 to individuals (*perhaps less than previously reported*), and additional funds to boost unemployment insurance and other support measures. This package was widely expected to pass and certainly the near 10% gain for the S&P 500 last night reflects expectations of that – so an important step but certainly well priced by the markets at this stage.

G10 FX VOL SET TO DECLINE FURTHER ON POLICY RESPONSES



Source: Bloomberg, Macrobond & MUFG GMR

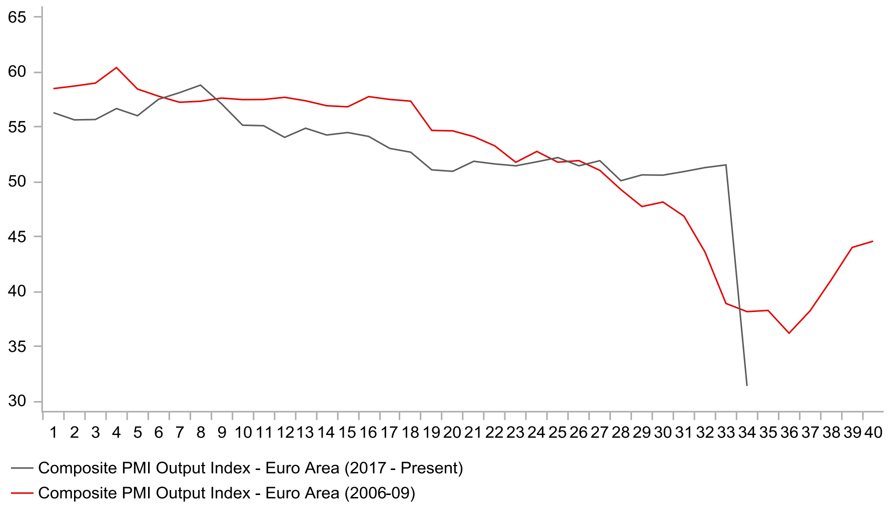
The policy step taken in Europe could prove more important. The deal reached last night by the Eurogroup means euro-zone countries will now be permitted to use the European Stability Mechanism to finance fiscal spending in response to COVID-19 equal to 2% of each country's GDP. The deal will need formal sign-off at the European Council meeting scheduled for tomorrow. This we believe is very significant in that it is a clear step toward a joint fiscal response. The ESM is funded as a joint liability and is the first clear step in the direction of a shared fiscal response. While not the same as a new "coronabond" that has been spoken of, it is a step in that direction. There are no reports on conditionality but we assume if being rolled out across the euro-zone, conditionality will not be an issue.

So further important steps have been taken in terms of policy response and we are seeing the benefits of this in terms of declining levels of volatility with our G10 FX Volatility Index declining further. This index broke into double-digits on 3rd March and peaked at 18% on 19th March and today is back below 14%. We expect further declines in line with falling VIX and bond market volatility. These moves are important ingredients for further USD depreciation. Further near-term USD depreciation is possible now with policy responses buying time to gauge whether economic lockdowns are helping curtail the spread of COVID-19. More on that below.

EUR: The horrible data begins

There are now a deluge of forecasts in the financial markets over what is heading our way in terms of the dire economic data for March and the second quarter. We are finalising our MUFG estimates to be confirmed very soon, but the arrival of the first most timely data in PMIs across Europe and the US are certainly consistent with the potential for large single-digit contractions in Q/Q in Q2.

EURO AREA COMPOSITE PMI NOW VERSUS GFC PERIOD



Source: Macrobond & MUFG GMR

The worst moment of contraction during the Global Financial Crisis for the euro-zone came in Q1 2009 when GDP contracted by -3.2% Q/Q after a -1.7% Q/Q print in Q4 2008. At the scale of GDP contraction, the Euro-zone PMI Composite Index had fallen to 36.2 in February 2009. On a 3mth average basis (perhaps a better reflection of GDP), the index dropped to 37.6 in Feb 2009 – below the current 3mth average of 44.8, following the record low one-month print yesterday of 31.4. Markit reported yesterday that the March reading "*is indicative of GDP slumping at a quarterly rate of* *around 2%*". Of course it will be the April print that will help provide further clarity on Q2 GDP but suffice to say with the March advance PMI yesterday not yet capturing the full impact of the COVID-19 hit, the April reading will be worse. Furthermore, whether current lockdowns extend beyond April will obviously be key for the Q2 print as well. Certainly an overall contraction in GDP over Q1 and Q2 or -5% or more now looks realistic and fast becoming consensus.

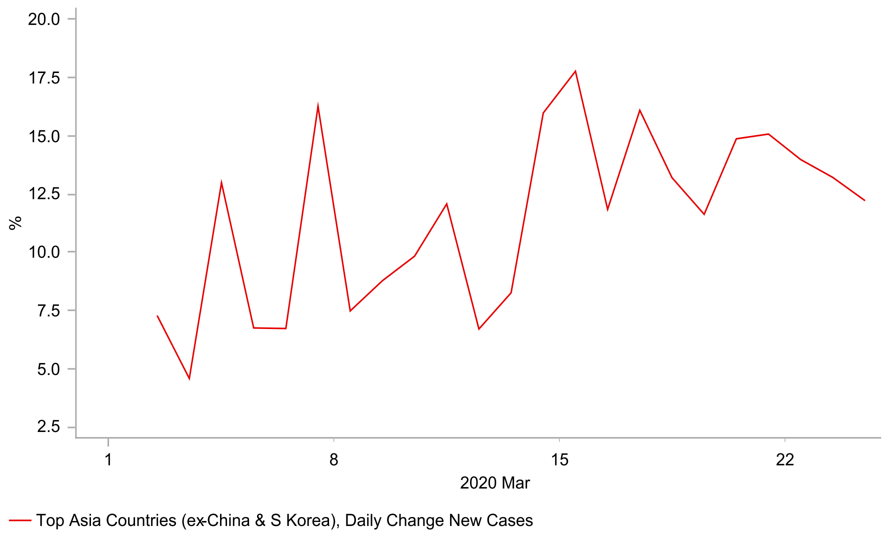
We would argue though that horrible economic data over the March to say May period will not necessarily fuel further market panic. Markets have quickly adjusted to the prospect of record falls in GDP over the coming months. Fed President Bullard mentioned the possibility of -50% Q/Q annualised GDP and other banks have released deep record contractions. The crux to market sentiment remains credibility in the policy response to protect the economy as much as possible from substantial job losses and the day to day data on the spread of COVID-19.

The substantial bounce in risk appetite yesterday on the day when these terrible PMI figures were released is evidence that the focus is not necessarily about the terrible data to come but the central bank and government policy responses to deal with the economic fallout. We are not suggesting strong risk appetite can coincide with plunging economic data – but the bad news will not necessarily prompt renewed selling.

COVID Update: Asia remains a risk to monitor

The last thing the market needs now is evidence of re-infections in China or South Korea – the two Asian economies to suffer the most initially and which COID-19 data of late had suggested were through the worst. Yesterday, Singapore announced a more pronounced lockdown while Thailand announced a state of emergency for a month to contain the spread of the virus. While China announced an end to lockdown restrictions in Hubei province (not Wuhan), it also announced more restrictions on entry into China to curtail imported cases. The data from Asia show numbers remain relatively small – but as we have seen elsewhere, compounding changes the total size quickly and any sign of further escalation in COVID-19 in Asia would be very damaging to prospects of getting through the worst of this in Q2.

ASIA (X CHINA & KOREA) COVID NEW CASES DAILY % CHANGE



Source: Bloomberg & Macrobond

Thailand's 5-day average daily percentage change is currently at +25%; Hong Kong is at 13.3% and Singapore is at 12.4% - all levels notably higher than a week or so ago. Data from China will also be important following the ending of the lockdown in Hubei province.

The good news remains the continued evidence of a slower pace of new cases of COVID-19 in Europe. The 5-day average in Italy hit another new low yesterday (11.0%) as it did in France (15.3%) and Spain (19.7%) also. In the US the picture is far less positive. The 5-day average is far higher at 32% and not yet showing a peak while the death rate jumped yesterday by 40.5%. President Trump's idea of ending lockdowns in time for Easter appears detached from reality.

KEY RELEASES AND EVENTS

Country	GMT	Indicator/Event	Period	Consensus	Previous	Mkt Moving
UK	07:00	CPI YoY	Feb	1.7%	1.8%	!!
UK	07:00	PPI Output NSA YoY	Feb	0.9%	1.1%	!!
NO	07:00	Unemployment Rate AKU	Jan	3.9%	3.9%	!!
GE	09:00	IFO Business Climate	Mar F	--	87.7	!!!
UK	11:00	CBI Retailing Reported Sales	Mar	-15.0	1.0	!!!
US	12:30	Durable Goods Orders	Feb P	-1.0%	-0.2%	!!
US	13:00	FHFA House Price Index MoM	Jan	0.4%	0.6%	!!

Source: Bloomberg

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