Infinity
International Foreign Exchange

Economic Outlook Q1 2021

A return to the old normal?

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2020 Recap

Last year didn't really go to plan. The first case of COVID-19 was identified in Wuhan, China in December 2019, but nobody could have predicted the global impact that this would have on economies, nor the political and social impact.

For the currency markets it was a year of two halves, in large driven by the US Dollar. The first phase saw large scale Dollar strength as the market deciphered the COVID pandemic, resulting in a bout of risk aversion and subsequent US Dollar strength.

The second phase was a prolonged bout of US Dollar weakness as the market determined the Federal Reserve's change in inflation policy, and the dawn of a new administration as opinion polls turned sour for President Trump.

UK/EU trade talks continued to ebb and flow and, in some cases, provided a thorn in the side of Sterling. However, a deal was struck at the end of 2020 and passed by the respective UK and 27 nations of the Eurozone.

UK – Political issues remain but could early vaccine approval pay dividends?

- 4.5 years later a UK/EU trade deal is agreed.
- Less uncertainty means lower GBP implied volatility.
- Early vaccine rollout and weak US Dollar could spur GBPUSD higher.

The UK/EU trade deal agreed on Christmas eve ends close to 4.5 years of uncertainty about how the UK will be transacting with its biggest trading partner, post the transition agreement. However, a degree of uncertainty does remain regarding the actual impact to growth.

The nature of the trade agreement may cause some permanent damage to the UK economy and will limit its scope for material outperformance. This has been reflected in several economists' suggestion that growth could be circa 4% lower in comparison to if the UK had remained in the EU. The next few years will be watched to articulate the accuracy of these forecasts.

Since the Brexit referendum, Sterling has been vulnerable as political uncertainty escalated on the unknowns of the UK's trading relationship beyond the end of the transition agreement. It can be argued that now a deal has been agreed and ratified, this unknown factor is removed, reducing volatility and fragility of the currency, only time will tell. However, whilst the political focus will diminish, it is unlikely to go away and will still play its role on the direction of Sterling.

The Scottish Parliamentary elections in May 2021 are likely to focus on another Scottish independence referendum which could impact Sterling during Q221. However, the potential negative impact is likely to be only modest given that the second Scottish referendum is unlikely for several years, (could Labour copy the Conservatives approach to combat UKIP and offer a Scotland independence referendum to win votes?).

The UK unemployment rate shot up to the highest level since 2016. In addition, the Bank of England sees unemployment peaking above 2.5 million even with a Brexit deal.

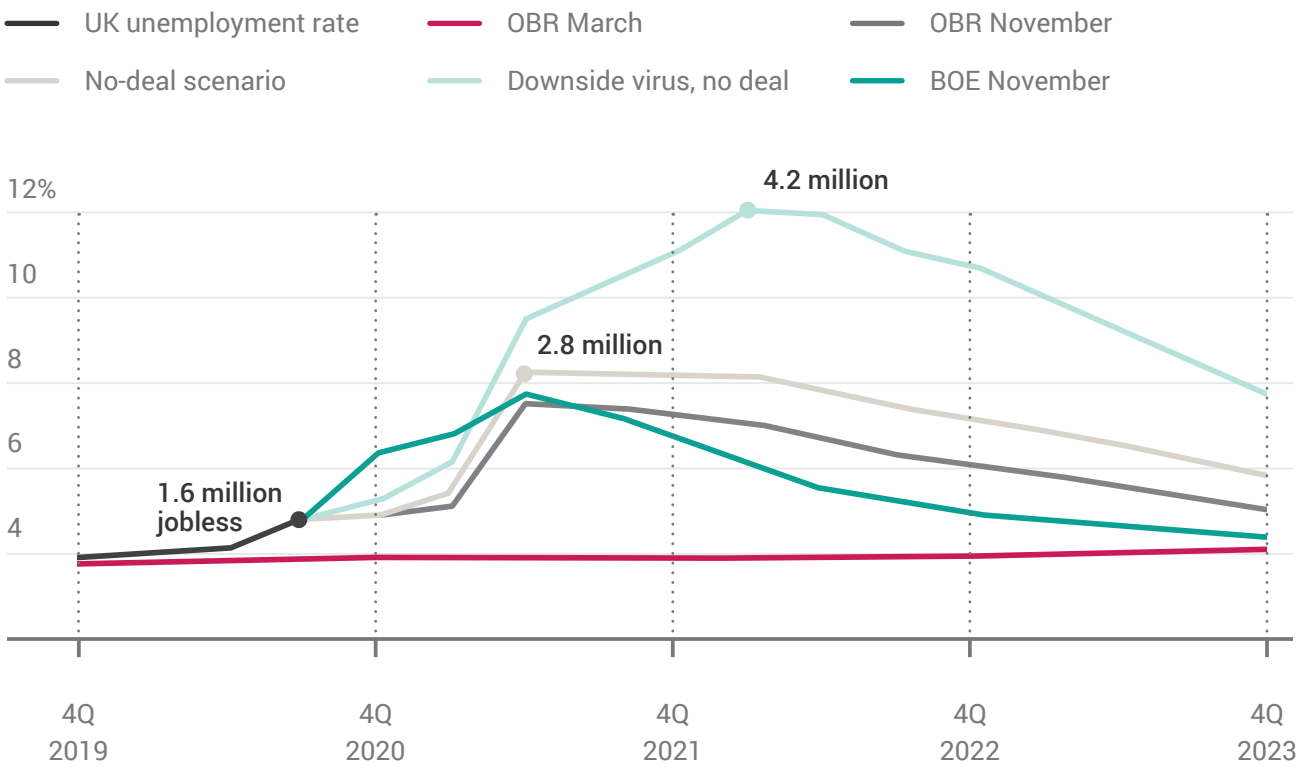
The below graph shows the various forecast and how they changed during the pandemic and Brexit dilemma during the second half of 2020.

The UK was the first nation to not only approve Pfizer-BioNTech vaccine, but also the AstraZeneca Plc and the University of Oxford's one. This puts the UK a step ahead in potentially returning to the "old normal".

Approval of the Oxford AstraZeneca vaccine means that immunisation can be dramatically sped up across the UK. This was echoed by UK Health Secretary Matt Hancock as he stated:

"What I can tell you is whereas previously I've said that I hope we can be out of this by the spring, I've now got a very high degree of confidence that we can be out of this by the spring."

The rollout of the vaccine in the UK is likely to be a simpler operation than that of the US and the Eurozone. If we do see Hancock's statement materialise the UK could be one of, if not the first G10 country to return back to normal and start repairing the damage done to the economy.



Source: Office for Budget Responsibility, Bank of England, Office for National Statistics

US – Will regime change unwind 2018/19 Dollar gains?

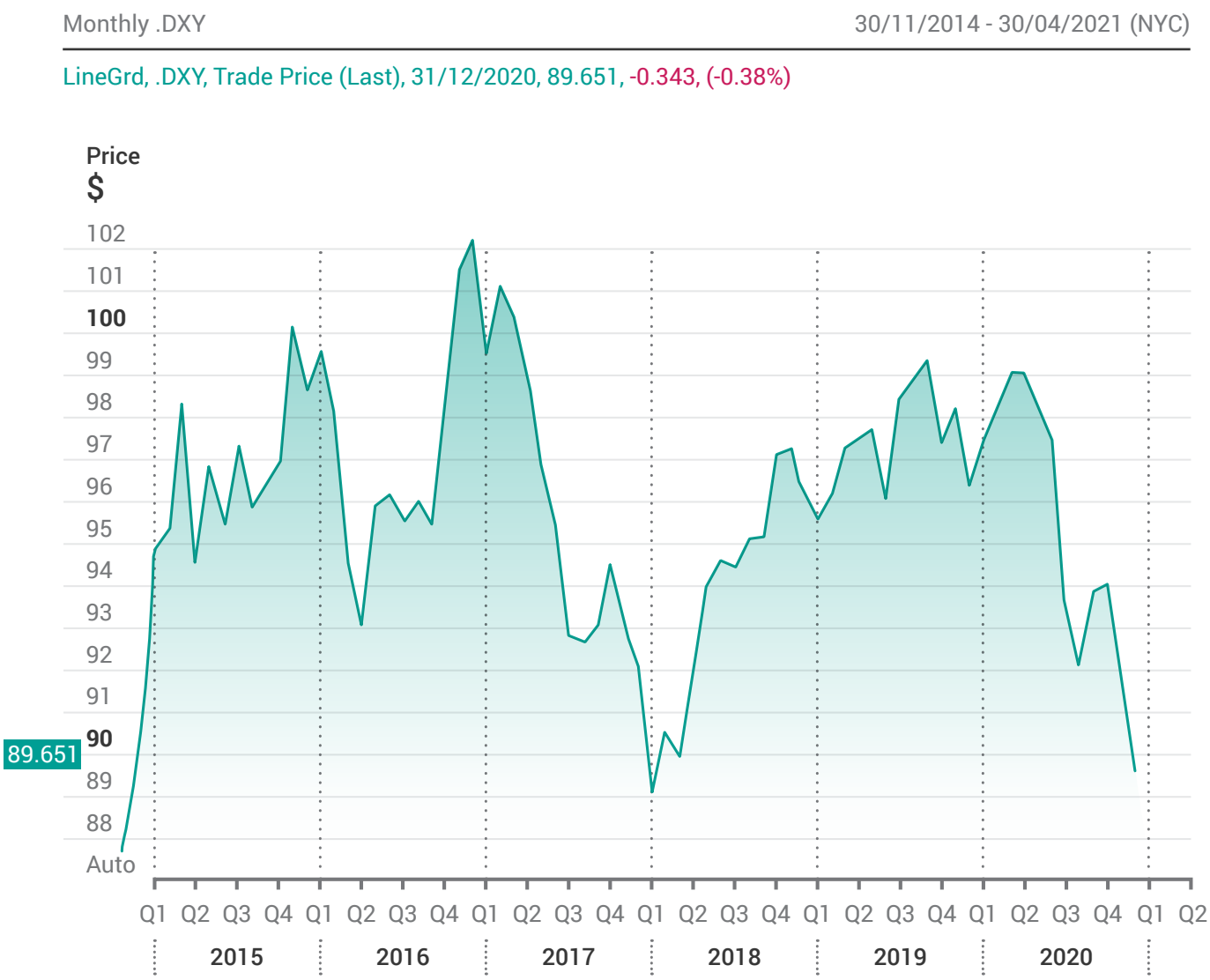
- The regime change at the White House suggests a further reversal of the 2018/19-dollar strength seen under Trump's reign.
- Federal Reserve Shifts to average inflation; what does this mean for the US Dollar in 2021?

Whilst 2020 will be remembered for the havoc that COVID-19 spread across the globe, it will also be remembered for the year that President Trump lost the race for the White House, making him the first one term President since George Bush in 1993.

Whilst the focus will remain on the economic recovery following the release of various vaccines, it cannot be ignored that there has been a seismic change in the administration, which could have implications for the US Dollar. Reflecting on President Trump's tenure it is important to understand the background of the US Dollar movement.

- 2017 - Trump inauguration and US Dollar weakness on a quiet White House and Eurozone revival.
- 2018/19 - The dollar strengthened once the White House announced 2017 tax cut and launched protectionism from March 2018 onwards.

It is likely that we will see a return to a rules-based (and conventional) system of trade under a Biden administration and perhaps less exceptionalism on the fiscal front. This could open the way for Dollar weakness moving into 2021. A less protectionist White House and a recovery in the world economy are two additional key ingredients in a Dollar decline.



Source: Reuters Eikon US Dollar Index 30/12/20

Last year the Federal Reserve decided to shift its inflation focus from absolute value to focus on average inflation targeting. When this was announced it created a weaker US Dollar environment, however it could have additional impacts in 2021.

Most analysts believe the global economy is moving out of recession and into an early recovery stage.

Assuming COVID-19 can be contained, combined with a vaccine rollout, a sustainable recovery and inflation expectations will rise.

However, as a result of inflation rising and the measuring of inflation on the new averaging metric, it is plausible real interest rates will be negative territory in comparison to the real economy. This conundrum could result in a weaker US Dollar.

EU – Can the single currency continue its rise?

- ECB and EU lay foundations for stable environment and growth.
- Can the ECB hold the single currency back?

On reflection the Euro was one of the big movers in 2020 breaching the key psychological level of 1.20 against the US Dollar. The Euro rose by over 15% from the lows following the snap reaction to the COVID pandemic hitting the Western economies. This was a result of a weak US Dollar environment but also coupled with moves from both the ECB and EU.

The EU has introduced new fiscal measures that involve significant joint bond issuance. The new measures reduce EU break-up risk, something that has been a concern following Brexit. In the meantime, the ECB introduce further quantitative measures to further support the shared economy.

Looking at 2021, the region at first glance does not look that appealing. The economy has been hit by the second wave of COVID-19 and the related restrictive measures, growth prospects look fragile and is likely to impact Q420 and Q121; whilst the inflation outlook looks bleak.

However, whilst the picture does not look great, changing of the administration in the US could play a large part in the single currency's direction and ultimately improves the prospects of the region.

Since 2018, the EU has been on the defensive as personalities clashed over protectionist measures executed by the Trump administration. The administration under President Biden is likely to be less hostile and repair relationships whilst reducing protectionist policies, installing greater confidence in the Eurozone manufacturing sector. Combined with a Brexit trade deal the prospects are much improved.

It is also plausible that the roll out of the vaccine in the EU will be less complicated than the US and potentially easier to implement, meaning we could see a post winter boost to the economic block. The Eurozone is a large open economy levered to global growth, as a result the currency should benefit from the recovery in global trade after a tough winter.

Last year, the ECB actively tried to intervene and reduce the strength of the single currency. However, its attempts were in vain as the currency continued to appreciate.

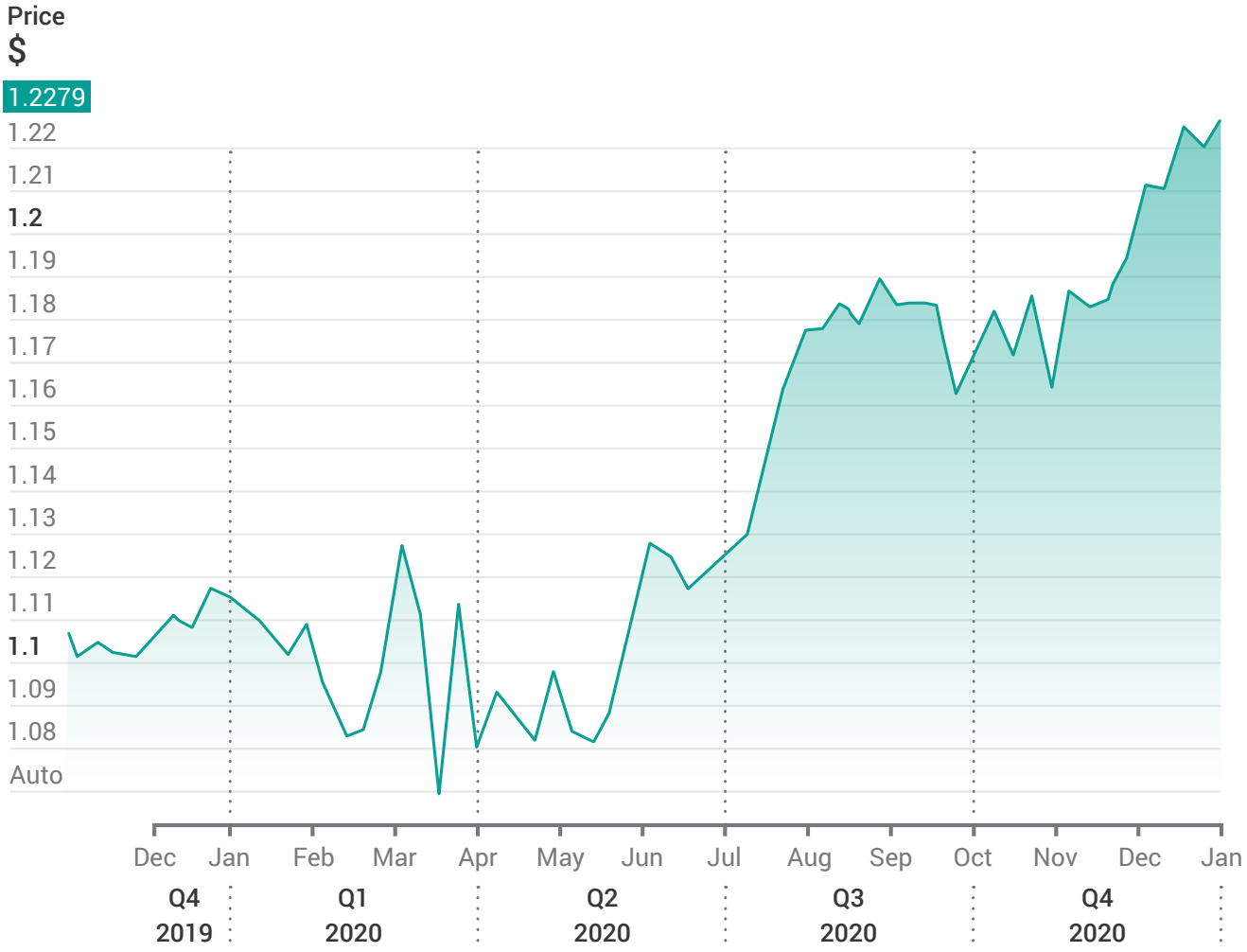
Intervention from the ECB may come down to the speed of the move for the currency. During the summer of 2020, EURUSD appreciated close to 10 cents over a 3-month period.

A gradual strengthening of the currency in an orderly manner, coupled with an environment of improving economic growth outlook, would mean the ECB is less likely to intervene.

The reality is that there is little the ECB can do as it is already implementing a QE programme and interest rates are already at record lows.

Weekly EUR= 08/11/2019 - 21/01/2021 (GMT)

LineGrd, EUR=, Bid(Last), 01/10/2021, 1.2279, +0.0032, (+0.26%)



Source: Reuters Eikon EURUSD 30/12/20

FX Forecast

As highlighted, the path of GBPUSD, EURUSD and GBPEUR will be circumstantial depending on various outcomes, some political and some dependent on the global economy. This means that there is a variety of contrasting views from respected institutions, which only highlights the difficulty in trying to call the markets.

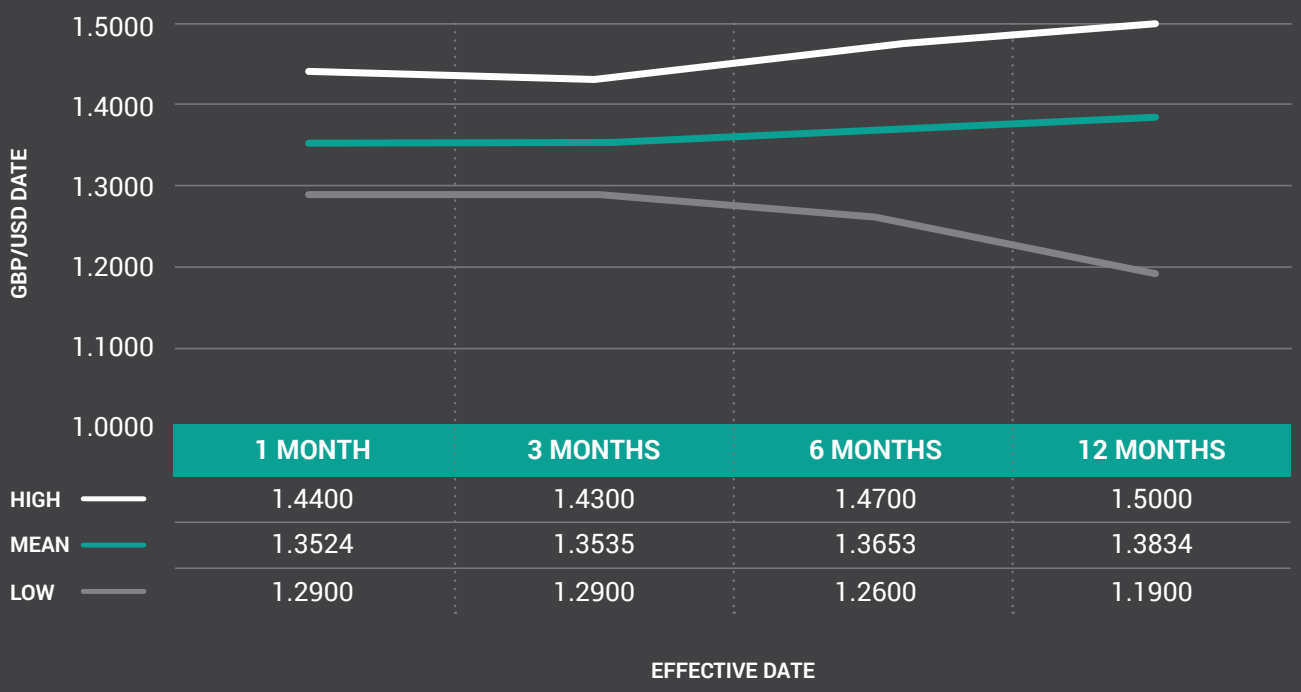
This following data has been taken from Reuters and interpreted from forecasts from over 40 financial institutions.

Rather than showing individual forecasts, we have taken the high, the low and the mean. The data is taken from the latest updated forecast posted on 7 January 2021.

Whilst the data is subjective, it does highlight the vast divergence of views based on the current environment.

GBPUSD

The average forecast (over 40 contributors) shows upward trend with the average forecast for 31/12/21 = 1.3834.



	1 MONTH	3 MONTHS	6 MONTHS	12 MONTHS
HIGH	1.4400	1.4300	1.4700	1.5000
MEAN	1.3524	1.3535	1.3653	1.3834
LOW	1.2900	1.2900	1.2600	1.1900

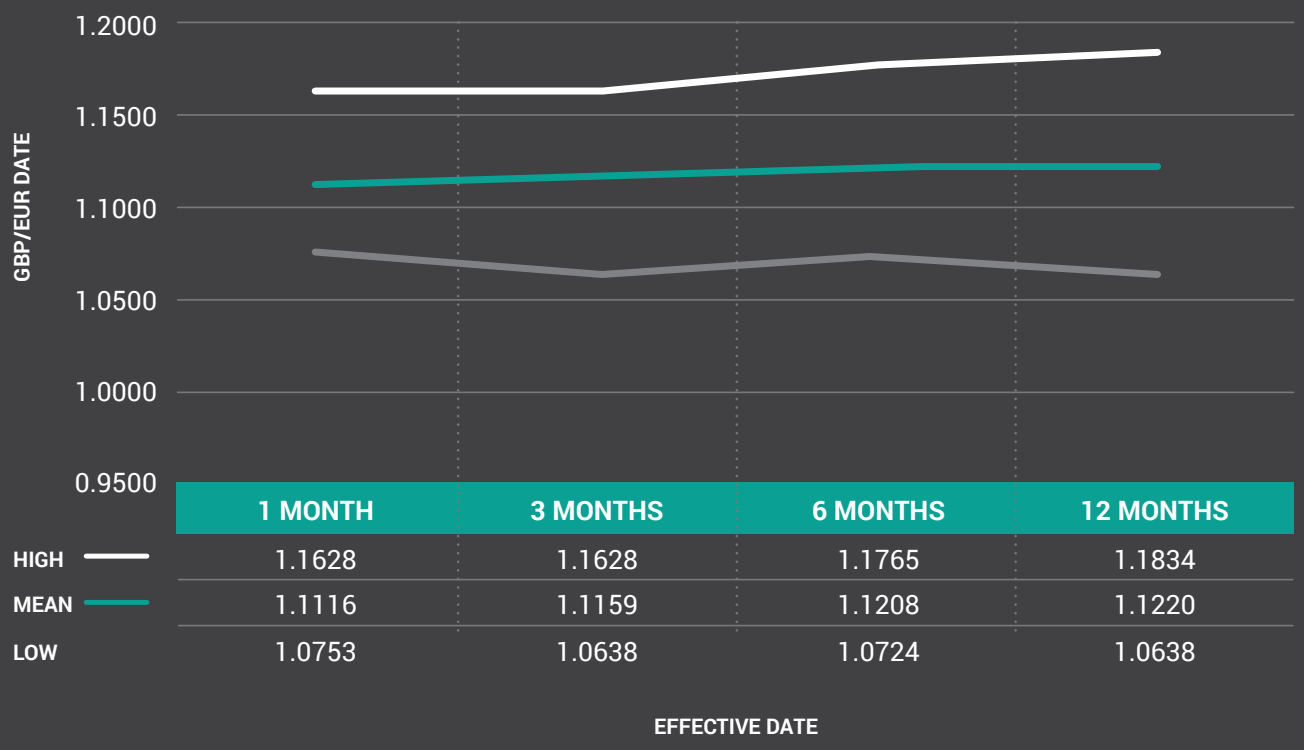
FORECAST WEIGHTING

6-month forecast
Out of 55 forecast only 18 are below 1.3500.

12-month forecast
Out of 56 forecast only 16 are below 1.3500.

GBPEUR

The average forecast (over 40 contributors) shows a tepid rise with the average forecast for 31/12/21 = 1.1220.



	1 MONTH	3 MONTHS	6 MONTHS	12 MONTHS
HIGH	1.1628	1.1628	1.1765	1.1834
MEAN	1.1116	1.1159	1.1208	1.1220
LOW	1.0753	1.0638	1.0724	1.0638

FORECAST WEIGHTING

6-month forecast

Out of 41 forecast only 12 are below 1.1111. (EURGBP 0.9000 – big psychological level)

12-month forecast

Out of 42 forecast only 14 are below 1.1111. (EURGBP 0.9000 – big psychological level)

EURUSD

The average forecast (over 50 contributors) shows a tepid rise with the average forecast for 31/12/21 = 1.2358.

	1 MONTH	3 MONTHS	6 MONTHS	12 MONTHS
HIGH	1.2400	1.2500	1.2700	1.3000
MEAN	1.2191	1.2145	1.2242	1.2358
LOW	1.1900	1.1500	1.1500	1.1400

FORECAST WEIGHTING

6-month forecast
Out of 66 forecast only 11 are below 1.2000.

12-month forecast
Out of 71 forecast only 9 are below 1.2000.

Summary

There can be no doubt that 2020 was anything but normal, however some key uncertainties were significantly reduced, namely Brexit and the US Presidential Election. Headline uncertainty remains in the form of COVID despite the creation of various vaccines.

Sterling still faces economic headwinds as pointed out by the Bank of England in its forecasts for unemployment to rise to 7.5% whilst highlighting that the Brexit deal could lower GDP by 4% in the long term. Despite this, the average forecasts for Sterling predicts a rise against both the US Dollar and Euro. The reduction of political uncertainty that has been weighing on the currency since 2016 has been removed and deployment of the vaccine has so far been more extensive than Europe's and the USA.

Based on the forecast, it appears that the majority are suggesting a weaker US Dollar environment as a new administration takes over the White House. A combination of a less protectionist regime (in comparison to the Trump era) and the prospect of negative real interest as a by product of the Federal Reserve's amended approach to tackling inflation.

Whilst the forecast and the current economic backdrop suggest that the majority believe we could see a weak US Dollar, it should not be overlooked that the world's reserve currency price action has correlated to global risk trends. With the biggest uncertainty, namely COVID, still prominent, the forecasts (compiled monthly) could change on any new information.