The socio-economic conditions that help determine the winner in US elections may continue to dominate FX markets.

The FX wings of the RORO spectrum should best capture any election-related issue, with ambiguous USD implications.

Many market participants are calling for a secular decline in the dollar, but we think these arguments are unconvincing.

**Summary**

**GBP:** Not only do the liquidity and portfolio channels point to weakness in the GBP when QE is increased, but structural factors along with ongoing Brexit risks remain challenging for the currency, in our view.

**JPY:** The broad sideways trend seen in recent months highlights a lack of obvious idiosyncratic drivers for the JPY.

**CHF:** We think the CHF should be positioned to outperform in a U-shaped economic recovery, but the strong presence of the Swiss National Bank in the FX market will limit significant gains from here.

**AUD:** The AUD is one of the ‘risk-on’ currencies that would capture any US economic or electoral issues, in our view.

**NZD:** We believe the global economic recovery will continue to be the driver of movements in the NZD.

**CAD:** In our view, the economic challenges remain acute in Canada, and this should weigh on the CAD.

**INR:** It is premature to extrapolate a change in the Reserve Bank of India’s current FX policy, while foreign direct investment flows will remain a key driver for the INR.

**Key upcoming events**

<table>
<thead>
<tr>
<th>Date</th>
<th>Event</th>
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<tbody>
<tr>
<td>July 15</td>
<td>Bank of Japan rate announcement</td>
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<td>July 15</td>
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<td>European Central Bank rate announcement</td>
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<td>July 28-29</td>
<td>Federal Open Market Committee meeting and rate announcement</td>
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<td>August 4</td>
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<td>Bank of England rate announcement</td>
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<tr>
<td>August 12</td>
<td>Reserve Bank of New Zealand rate announcement</td>
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Source: HSBC
US elections and FX

- The US elections may not be a dominant FX driver
- The socio-economic conditions that help determine the winner may dominate the FX market for some time to come
- The FX wings of the RORO spectrum should best capture any election-related issues, with ambiguous USD implications

With the clock ticking down to polling day in the US (3 November), it would be tempting to assume the US presidential and congressional elections are set to become the dominant driver of FX in the coming months. However, the pandemic and the associated economic lockdowns and re-openings have created heightened uncertainty around the US economic outlook. The current median forecast for US GDP in 2020 is -5.6% YoY but this includes a range that extends from -9.5% to -0.6%; and a similarly unusual spread of expectations is evident for 2021 (Source: Consensus Economics). This means the evolution of the nascent US economic recovery is likely to remain at the heart of the outlook for FX in the coming months. Indeed, the socio-economic factors that may help shape the outcome of the elections are likely to retain their grip on the FX market for a period well beyond November’s poll.

2020 has been all about ‘Risk On-Risk off’ (RORO) for the FX market, with our RORO index at close to historical highs (Chart 1). We believe any issues around the US economy or the US elections, such as rhetoric from both presidential candidates regarding the state of US-China relations, would be best played at the wings of the RORO sensitivity spectrum (Chart 2, overleaf). We see the JPY as the cleanest “safe-haven”, unencumbered by the intervention threat faced by the CHF. At the other end of the scale are the “risk-on” plays, such as the AUD and CAD.

1. RORO dominates the FX market

![Chart 1: Risk on - risk off indicator](Source: Bloomberg, HSBC)
2. Any economic or electoral issues will be captured by the FX wings of RORO spectrum *

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In our view, the RORO implications on the USD may become less clear in an environment where risk appetite is being driven by US-centric factors. For example, strong US data could be USD positive from a cyclical perspective or USD negative due to a reduced “safe-haven” bid.

This ambiguity is not to say the election is an irrelevance for the USD. **There are some direct points of influence notably around US-China relations and the US Treasury’s USD policy.** Our baseline view has been that the ‘Phase 1’ agreement will be maintained, which means the RMB’s depreciation pressures should be contained. However, we are also cognisant of not taking this line of thought too far, as there could be more uncertainty on US-China trade and other sources of friction between both sides ahead of the US elections. As for this scenario of an activist “weak USD policy” at the US Treasury to crystallize, many steps need to fall into place. So, it is a reminder that this election can have direct touch-points for the USD, and not only through RORO.

**Conclusion**

Rather than being the main focus for FX, the expected outcome of the US elections will also likely be shaped by US economic activity. We believe the socio-economic factors are likely to retain their grip on the FX market for a period well beyond November’s poll. RORO has been the framework driving FX so far in 2020 and any economic or electoral issues would be best played at the wings of the RORO sensitivity spectrum, for example in a cross like AUD-JPY.

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**FX**  | **L-T view** | **Spot** | **1mth** | **3mth** | **6mth** | **Q3 20** | **Q4 20** | **Q1 21** | **Q2 21**
---|---|---|---|---|---|---|---|---|---
AUD-USD  |  | 0.6946 | -0.73% | 9.39% | 0.65% | 0.69 | 0.70 | 0.72 | 0.75
USD-JPY  |  | 106.80 | -0.2% | -1.53% | -2.43% | 105 | 105 | 107 | 110

*Source: HSBC, Refinitiv Eikon as at 16:29 HKT on the 10/07/2020*

*L-T = long-term
NZD: Push-pull of policy

- The elimination of community transmission of COVID-19 from New Zealand suggests the economy is on track for a V-shaped recovery
- However, we believe that the global economic recovery will continue to drive movements in the NZD...
- ...as its fiscal position and monetary policy are opposite forces to the NZD

Our economists see New Zealand’s economy on track for a V-shaped recovery as community transmission of the virus has been eliminated. While some have pointed to this as a reason to expect a strong outperformance of the NZD, we still think it is the path of the global economic recovery that matters most. It is worth remembering that tourism is the country’s biggest single foreign exchange earner and even plans for a trans-Tasman “travel bubble”, originally slated to be open in July, have now been delayed indefinitely. Faced with these complex trade-offs and significant uncertainty over the future path of the virus, the FX market has chosen to largely ignore local developments and focus on global.

Policy push-pull
We believe relative fiscal positions and central bank balance sheet policy are key determinants of G10 FX performance in a drawn out recovery phase. The NZD fares well on the first with a low starting point for government debt – just 30% of GDP at the end of 2019 – allowing the government to deliver a large fiscal response. Even after the fiscal stimulus, gross government debt is expected to be below 50% of GDP by the mid-2021, relatively low by global standards.

However, monetary policy is likely to provide a check on the strength in the NZD, in our view. Unlike peers such as the Reserve Bank of Australia (RBA), who appear happy to sit tight, the Reserve Bank of New Zealand (RBNZ) has signalled that all aspects of its policy are up for review in August and has kept a range of options open including further expansion to QE (potentially including foreign assets), a negative official cash rate (OCR) and even debt monetisation. All of these options would be negative for the NZD in our view.

<table>
<thead>
<tr>
<th>FX</th>
<th>L-T view*</th>
<th>Past performance</th>
<th>Forecasts</th>
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<tbody>
<tr>
<td>NZD-USD</td>
<td>Spot, 1mth, 3mth, 6mth, Q3 20, Q4 20, Q1 21, Q2 21</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*Source: HSBC, Refinitiv Eikon
*L-T = long-term
USD: Not the time for a bear market

◆ Many market participants are calling for a secular decline in the USD. We look at the cyclical, structural and political arguments for a material decline in the USD, but do not find the evidence compelling.

◆ On the cyclical front, those expecting deep and sustained USD weakness due to rate cuts, balance sheet expansion or economic growth may be disappointed. The USD is not set to become a funding currency and other central banks are expanding their balance sheets even faster than the Federal Reserve. Our economists forecast very little growth differentiation in G10 economies. On the structural front, the US has run twin deficits for decades, but the impact on the USD has not always been clear. On the political front, the USD’s importance may gradually erode over time, but this would not be enough in itself to drive an imminent bear market for the USD.

◆ We expect greater differentiation against the USD in G10 FX, based on fiscal firepower and relative balance sheet expansions, with the AUD, and the NZD outperforming the EUR, the GBP and the CAD. In this world, and for the foreseeable future, the USD remains resilient but without a clear directional trend.

GBP: BOE QE

◆ The Bank of England (BOE) announced an increase in asset purchases on 18 June by GBP100bn, as expected by Bloomberg consensus. This sees the total amount of assets set to be purchased by the BOE rise to GBP745bn. The GBP initially popped slightly higher, as fears about an even bigger expansion or other unconventional policy were avoided. But, in our view, an overall increase in the BOE’s balance sheet will continue to create challenges for the GBP.

◆ The liquidity and portfolio channels point to the weakness in the GBP when QE is increased, in our view. Close to 30% of the UK government bond market is foreign held. As domestic investors have greater incentives to hold domestic debt, the marginal sellers of bonds to the central bank are likely to be foreign investors. The portfolio outflow impact of this would be more negative for the GBP if the scale of asset purchases were bigger.

◆ Apart from this, structural factors (such as a high debt-to-GDP ratio and large external liabilities), along with ongoing Brexit risks remain challenging for the currency, supporting our medium-term view for depreciation and for GBP-USD to head towards 1.20 this year.

GBP-USD

<table>
<thead>
<tr>
<th>FX</th>
<th>L-T view*</th>
<th>Spot</th>
<th>1mth</th>
<th>3mth</th>
<th>6mth</th>
<th>Q3 20</th>
<th>Q4 20</th>
<th>Q1 21</th>
<th>Q2 21</th>
</tr>
</thead>
<tbody>
<tr>
<td>GBP-USD</td>
<td>→</td>
<td>1.2386</td>
<td>-1.25%</td>
<td>1.08%</td>
<td>-3.62%</td>
<td>1.22</td>
<td>1.20</td>
<td>1.22</td>
<td>1.25</td>
</tr>
</tbody>
</table>

*L-T = long term
JPY: Playing it safe

- The JPY remains dominated by external factors, most notably ‘Risk On – Risk Off’ (RORO) sentiment. Diminishing risk appetite has contributed to some safe haven JPY outperformance. But in recent months the correlation between USD-JPY and the S&P 500 has diminished, suggesting this factor may be losing some importance. Meanwhile, the relationship between US rates and USD-JPY has pushed a little higher.

- The Bank of Japan (BOJ) policy remains amongst the loosest in G10, with negative rates and ongoing bond purchases. That said, the latter have been happening at a slower rate than in many other economies, as the threat (or promise) of bond intervention under the Yield Curve Control policy has been effective at keeping 10-year rates close to the 0% target. Even when the BOJ increased the auction sizes for shorter duration bonds in late June, it had negligible impact on the JPY.

- We expect USD-JPY to grind modestly lower in the medium term, but the broad sideways trend seen in recent months highlights a lack of obvious idiosyncratic drivers for the JPY.

CHF: Don’t fight the SNB

- The CHF has been the strongest G10 performer in the last month as positive risk sentiment has diminished, and the currency’s safe haven characteristics have come to the fore. However, this significant outperformance is unlikely to last, in our view.

- While we agree that the CHF should be positioned to outperform in a U-shaped economic recovery due to its low government debt levels and sizable foreign assets, the strong presence of the Swiss National Bank (SNB) in the FX market will limit significant gains from here. The central bank’s FX reserves rose by around CHF87bn in Q2, to CHF850bn, as policy makers try to mitigate the impact of currency appreciation on an economy deep in deflation and suffering negative export growth. This is the fastest rate of reserves growth since 2012, when the SNB maintained an official EUR-CHF floor at 1.20.

- Earlier this year EUR-CHF appeared to be subject to an unofficial “floor” around 1.05. With the SNB seeing the CHF as highly valued, we expect support to kick in again if these levels are threatened.
CAD: Acute economic challenges

- We expect the CAD to weaken materially during H2 2020 and into 2021. The currency has done a round-trip against the USD during the swings in risk appetite of Q2 2020, but given the likely lasting economic scarring from the COVID-19 pandemic and retreat in oil prices, this full revival seems misplaced.
- A rapid fiscal response has helped cushion the blow of the economic lockdown on the labour market, but activity is still likely to have contracted by close to 15% QoQ during Q2. The revival during the reopening could appear reassuring initially as pent-up demand is met, but our economists expect business investment to remain challenged. Social distancing requirements and oil prices still well below the levels at the start of the year will likely act as constraints.
- Our forecast of 1.45 may feel a little distant from current spot, but the pair was above that level during March 2020 and the economic challenges remain acute.

<table>
<thead>
<tr>
<th>FX</th>
<th>L-T view*</th>
<th>Spot</th>
<th>1mth</th>
<th>3mth</th>
<th>6mth</th>
<th>Q3 20</th>
<th>Q4 20</th>
<th>Q1 21</th>
<th>Q2 21</th>
</tr>
</thead>
<tbody>
<tr>
<td>USD-CAD</td>
<td></td>
<td>1.3605</td>
<td>1.45%</td>
<td>-2.49%</td>
<td>4.25%</td>
<td>1.40</td>
<td>1.45</td>
<td>1.45</td>
<td>1.45</td>
</tr>
</tbody>
</table>

Source: HSBC, Refinitiv Eikon

INR: FX policy in focus

- After being an underperformer in 2Q, the INR has had a good start in 3Q. There have been USD6bn cumulative worth of FDI inflows QTD. These cumulative inflows of USD33bn YTD alone are more than sufficient to plug this year’s estimated current account cumulative funding needs of USD26bn. As such, the Reserve Bank of India (RBI) has prudently been accumulating FX reserves to restrain excessive appreciation pressures on the INR.
- However, the recent move lower in USD-INR to below 75 has seen some market participants contemplate a change in the RBI’s current FX policy. We think it is too early to extrapolate policy changes as the magnitude of the MTD flow in itself might have been a challenge for RBI to resist FX strength. Plus, our working assumption is that the INR will remain sensitive to 30% of foreign direct investment (FDI) flows, on a full-year basis. The RBI has always been guided by the objective of containing excessive volatility in the FX market and not by any specific level of the exchange rate.

<table>
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<tr>
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<th>Spot</th>
<th>1mth</th>
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<th>Q3 20</th>
<th>Q4 20</th>
<th>Q1 21</th>
<th>Q2 21</th>
</tr>
</thead>
<tbody>
<tr>
<td>USD-INR</td>
<td></td>
<td>75.204</td>
<td>-0.54%</td>
<td>-0.88%</td>
<td>6.00%</td>
<td>75.5</td>
<td>75.0</td>
<td>75.0</td>
<td>75.0</td>
</tr>
</tbody>
</table>

Source: HSBC, Refinitiv Eikon

* L-T = long-term
Dovish refers to an economic outlook which generally supports low interest rates as a means of encouraging growth within the economy.

Hawkish is typically used to describe monetary policy which favours higher interest rates, and tighter monetary controls to keep inflation in check.

MoM, YoY: Month on month, Year on year.

Libor: A benchmark rate that some of the world's leading banks charge each other for short-term loans.

Curve: Refers to the yield curve for the respective country’s sovereign bonds.

2’s-30’s curve: Refers to the difference in yield between 2yr and 30yr sovereign bonds for the specified country.

NEER: Nominal Effective Exchange rate.

PMI: Purchasing Managers Index – an indicator of economic health of the manufacturing sector (>50 represents expansion vs. previous month).

FDI: Foreign Direct Investment is an investment made by a company or entity based in one country, into a company or entity based in another country. It typically involves the investor having a significant degree of influence and control over the company in which the investment is made.


ECB: European Central Bank (Eurozone Central Bank).


BOJ: Bank of Japan (Japan’s Central Bank).

BOC: Bank of Canada (Canada’s Central Bank).

RBA: Reserve Bank of Australia (Australia’s Central Bank).

RBNZ: Reserve Bank of New Zealand (New Zealand’s Central Bank).

SNB: Swiss National Bank (Switzerland’s Central Bank).

MAS: Monetary Authority of Singapore.

BNM: Bank Negara Malaysia (Malaysia’s Central Bank).

Lagarde: Christine Lagarde, President of the European Central Bank (ECB).

Powell: Jerome Powell, Chair of the Board of Governors of the Federal Reserve System (Fed).


Abe: Shinzo Abe, Prime Minister of Japan.

Kuroda: Haruhiko Kuroda, Governor of the Bank of Japan.

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A sideways arrow (→) indicates that the currency is expected to be at a similar level to the spot price stated in the report by the end of the last forecast period.

Note: The direction of the arrow is dictated by the difference between the spot price and the furthest forecast stated in the forecast table. Within that timeframe, it is quite possible that the currency is expected to move in an opposing direction. This is depicted both by the forecast ‘dots’ shown on the charts as well as in the forecast table.
Disclosure appendix

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