FX – MARKET OUTLOOK

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September 2020
G10 FX Volumes have reverted to pre-Covid levels

Crisis Over?
Not quite yet
Spreads remain elevated especially in EM FX
Significant drop in realised volatility, but still higher than pre-Covid levels
The USD has weakened broadly

While the USD has weakened in 2020, the move was not large relative to history and the USD remains broadly overvalued.
The alleviation of USD funding stress removed a bullish USD catalyst

The USD sell-off represents a delayed reaction to a shift in fundamentals

The bank for a changing world
EU recovery fund – gross receipts, gross contributions and net receipts (% GDP)

Tighter peripheral spreads provide positive backdrop for EUR

Eurozone peripheral spreads tightened in anticipation of the EU recovery fund, keeping EUR supported.
US real yields continue to move against the USD

Cost to hedge away USD FX risk at 5y lows

Real yields and tight nominal spreads both weighed on the USD
Japanese investor debt outflows have kept USDJPY supported.

Stretched EURUSD positioning creates risks of short-term positioning squeezes.
US accumulated portfolio flows, since Q4 2014, excluding US corporate retained earnings

- Foreign investor buying US debt (less US corporate retained earnings)
- Foreign investor buying US equity
- US investor buying foreign debt
- US investor buying foreign equity

USD, trillion


Source: BNP Paribas, Macrobond, Federal Reserve

Eurozone accumulated portfolio flows, since Q4 2014

- Foreign investor buying EZ equities
- EZ investor buying foreign equities
- Foreign investor buying EZ debt
- EZ investor buying foreign debt

USD, trillion


Source: BNP Paribas, Macrobond, ECB

Foreign investor buying of USD fixed income, less corporate retained earnings, totals over USD 1 trn since Q4 2014.
Eurozone foreign debt purchases: approximately USD 550bn to the US.

Sources: BNP Paribas, ECB

Japanese Life Insurer Hedge Ratios*

Sources: BNP Paribas, Macrobond, Bloomberg, Japanese MoF

*Average of 9 of the largest life insurance firms that report hedge ratios in annual reports.  Bloomberg CIX: .JINSFXHR G Index
Spot skew correlation re-normalises, back to multi-year highs
**Forward Volatility Risk Premium (1m1m vs 1m realised, 3m3m vs 1y realised, 6m6m vs 5y realised)**

<table>
<thead>
<tr>
<th>Tenor</th>
<th>1M Implied</th>
<th>1M Realised</th>
<th>3M Implied</th>
<th>3M Realised</th>
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Options market pricing a significant increase in volatility in the near term
Implied volatility higher due to focus on specific events rather than a general increase
FX investors are neutral on GBP heading into Q4

GBPUSD has converged towards its CLEER. The ‘no deal’ fair value of 1.20 suggests no deal risk premium in FX is light.
The narrowing in the Biden-Trump lead has coincided with election vol premium rising.

Sources: Bloomberg, BNP Paribas
US election impact on EM

A Biden victory could boost support for NATO and thus strengthen the alliance with some Eastern European countries like Ukraine, although possibly leading to issues with administrations in Poland and Hungary, both of which have been particularly close to the Trump administration.

Biden himself is seen as a long-time hawk on Russia, which could boost the odds of the DASKA sanctions bill being approved in the Senate – particularly if the Democrats also gain control of the house.

Regarding China, albeit a Biden victory could arguably entail less trade volatility than a Trump win, both political parties in the US have shown a hawkish stance towards China.

Biden has pledged to re-join the Iranian nuclear deal, which could ease tensions in the Middle East, but may also review alliances with Israel and Saudi Arabia.

Under Biden, Brazil’s Bolsonaro administration could face hurdles in negotiating an anticipated trade deal with the US, given Democrat quibbles about Bolsonaro’s environmental and social track record.

India’s prime minister Narendra Modi has enjoyed cordial relations with Trump. A sharp reversal seems unlikely, but a Biden victory could heighten concerns over a controversial citizenship law.

For debt-stricken nations such as Argentina, Lebanon and South Africa, a strengthening of multilateral institutions – as hinted by Biden – such as the IMF, the IADB and the World Bank could be of particular help.

Biden = bullish EM?
Trump = bearish EM?
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