GLOBAL MACRO AY2019/2020 SEMESTER 2 RESEARCH REPORT

GLOBAL MACRO RESEARCH TEAM – AY2019/2020 SEMESTER 2

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[All information accurate as of 28th June 2020]

UNITED STATES (Underweight)

The U.S. economy entered 2020 looking strong with U.S. equity prices supported at a record level of 3393, U.S.-China trade war risk seemingly down after the Phase I completion, unemployment at record low of 3.5% and the macroeconomic focus mainly on the November presidential election. That was before COVID-19, which dragged the global economy, including the U.S. economy, to a pandemic-led recession. A recession that has come near the depth of the 1930's Great Depression. It has changed the trajectory of the U.S.-China relationship, the election dynamics as well as the macro fundamentals.

The nature of this recession is unique as the unprecedented nature, sheer magnitude and tremendous speed that COVID-19 impacted the economy makes it hard to analyse. Considering that, we will cover the impact of the COVID-19 on the U.S. economy together with the fiscal and monetary measures that have been in place and how we think they will help the economy to recover. On top of that, we will also explain our views on other macro themes such as the U.S.-China relationship, U.S. Election, and how they will come together to shape our structural bearish-bias on broad USD-Index for the next half of 2020.

U.S. Fiscal Policy: Short Term vs. Long Term Dilemma

From the period between March to April, the Congress has passed various fiscal packages that amount to roughly USD 3 trillion to help the U.S. economy from a possibly far worse recession due to the COVID-19. These packages broadly cover a wide range of social safety net, stimulus and support for medical needs, local governments, and workers affected by the pandemic. The key fiscal policy responses are:

Phase 1: USD 8.3 billion Coronavirus Preparedness and Response Supplemental Appropriation Act.
Phase 2: USD 192 billion Families First Coronavirus Response Act
Phase 3: USD 2.3 trillion Coronavirus Aid, Relief and Economic Security Act (CARES Act)
Phase 3.5: USD 483 billion Paycheck Protection Program and Health Care Enhancement Act

Phase 1 and Phase 2 together provide for virus testing and vaccine development, paid sick leaves, food assistance, expansion of Small Business Administration loan subsidies and international assistance to prevent the spread of COVID-19 overseas.

Phase 3 (CARES Act), which is by far the largest single relief package in the U.S. history appropriated at USD 2.3 trillion. The Act includes (1) USD 510 billion to prevent corporates from going bankrupt by providing loans and guarantees, (2) USD 349 billion in forgivable Small Business Administration (SBA) loans and help them to retain workers, (3) USD 293 billion to provide one-time tax rebates for individuals, (4) USD 268 billion for unemployment benefits, (5) USD 150 billion in transfers to state and local governments, (6) USD 100 billion for hospitals, (7) USD 50 billion for international assistance and (8) USD 25 billion to provide food safety for the most vulnerable.

Phase 3.5 is a supplementary stimulus package mostly to replenish the PPP and EIDL, it includes (1) additional USD 321 billion for forgivable SBA loans and guarantees, (2) USD 75 billion for hospitals, (3) USD 62 billion for the SBA to provide grants and loans to assist small businesses, and (4) USD 25 billion for additional virus testing.

While the fiscal policy is undoubtedly huge (at around 11% of GDP), we believe that the positive growth impulse of the fiscal stimulus may be short of the initial expectations as not all parts of the fiscal stimuli are actually achieving their objectives and the multiplier effect on the economy is unknown. Therefore, we believe that the recovery in the markets or at least the cheerful hope for recovery that has been priced in (at the time of writing, the U.S. equities retraced around 88% of the March low) so far was mainly a response to the Fed's monetary stimulus. This makes the need of the next fiscal stimulus (Phase 4) even more debatable since the economy is faced with a short-term versus long-term dilemma.

The proposed Phase 4 amounts to USD 3 trillion and was passed by House Democrats. The decision by the Congress whether to pass the bill will be out in coming weeks. This puts the U.S. in a tricky situation because the U.S. is facing short-term nationwide healthcare issues currently, yet a stimulus that will bear long-term consequences of rising debt which will haunt the economy when the pandemic is over. There are also concerns that the fiscal stance pursued is deviating away from the sustainable fiscal path.

We acknowledge the danger of additional debt taken to tackle the COVID-19 crisis, but it is evident that a deeper and longer recession tends to leave a long-term damage to the productive capacity of the economy which will risk the economy to fall into an extended period of low productivity growth and stagnant income. In addition, a sustainable fiscal path is something that should be considered when the economy is doing well and unemployment is low, whereas the situation now is far from that. As the Fed has used up all the ammunition to prevent the economy from liquidity crisis and clearly expressed the reluctance of negative interest rate policy (NIRP), we think that an additional fiscal policy – despite the possible consequences – is necessary to smoothen the economic recovery that is well under way.

If the congress passes the bill in coming weeks, it will help to boost the risk sentiments as the final USD 3 trillion package will complement the recovering economy and gradual reopening across the 50 states. This is in line with our structural bearish view on the broad United States Dollar index (DXY) as increasing risk appetite will reduce the demand for the safe-haven dollar. This behaviour of DXY being a function of risk sentiment is very apparent in recent DXY rally on the back of fears of a more damaging COVID-19 second wave, the reverse is also true.

U.S. Monetary Policy: Will Fed Consider Negative Rates?

When the financial markets were buckling in March because of the terror about the COVID-19, the Fed committed to use its “full range of authorities” to prevent the financial markets from a liquidity crisis. The Fed has taken some extraordinary measures to cushion the economic shock – some are from the 2008 playbook and the others went well beyond. The unlimited support, despite the sudden stop in economic activity, manages to stabilize the markets and backstop the financial system. The Fed’s stimulus can be categorised into: (1) interest rate cut, (2) loans and asset purchases and (3) regulatory changes.

The Fed cut its benchmark fed funds rate twice in March 2020, the first time by 50 basis points and the second time by 100 basis points, effectivity lowering the fed funds rate from 1.50%-1.75% to 0.00%-0.25%. In addition, the Fed also cut its discount rate, which lower the cost of discount window lending, by 150 basis points down to 0.25%. In addition, the Fed also reduced the cost of swap lines with major central banks and extended the maturity of FX operations and extended more USD swap lines to more central banks.

On top of interest rate cut, the Fed expanded their balance sheet. The scale of the program is open-ended or sometimes called the unlimited QE, though the Fed has been hesitant to call these measures a QE. It instituted an unlimited bond purchasing program, increased repo market operations, created new emergency lending facilities (Figure 1). The Fed’s balance sheet has increased to more than USD 7 trillion with some forecasts predicting it could reach USD 9-10 trillion.

Facilities	Description
Commercial Paper Funding Facility	*Facilitates the issuance of commercial paper by companies and municipal issuers*
Primary Dealer Credit Facility	*Provides financing to the Fed's 24 primary dealers collateralized by a wide range of investment grade securities*
Money Market Mutual Fund Liquidity Facility *(MMLF)*	*Provides loans to depository institutions to purchase assets from prime money market funds*
Primary Market Corporate Credit Facility	*Purchases new bonds and loans from companies*
Secondary Market Corporate Credit Facility	*Provides liquidity for outstanding corporate bonds*
Term Asset-Backed Securities Loan Facility	*Enables the issuance of asset-backed securities backed by student loans, auto loans, credit-card loans, loans guaranteed by the Small Business Administration*
Paycheck Protection Program Liquidity Facility (PPPLF)	*Provides liquidity to financial institutions that originate loans under the SBA's Paycheck Protection Program (PPP)*
Main Street Lending Program	*Purchases new or expanded loans to small and mid-sized businesses*
Municipal Liquidity Facility	*Purchases short term notes directly from state and eligible local governments.*

Figure 1: The Fed's Facilities in Response to COVID-19

On the regulatory changes, the Fed made a number of technical changes to hold on to less capital so that they can lend more to those borrowers affected by COVID-19.

The Fed has very clear dual mandates, which are inflation and unemployment. While unemployment is very high currently, it is mainly because of the economic standstill due to the COVID-19 lockdown. We think that inflation is more concerning as a risk that can result from such a dramatic loosening of monetary policy. There is much evidence of countries who turned to printing money in difficult times and ended up in high inflation. We do not think that the U.S. will end up in high inflation. In macroeconomic theory, an increase in money supply should increase the levels of inflation. However, money supply is not the only driver of the general price level. Another key driver is the speed at which money moves in the financial system – otherwise known as the velocity of money. A low velocity of money allows money supply to increase significantly without causing a high-level inflation. While money supply is high in the U.S., the velocity of money is at record low. While there are many explanations for the low velocity of money, the reasons are all very structural in nature and it all revolves around the idea of more savings rather than spending. The inflationary pick up is more likely through USD weakening as a result of narrowing rates differential between USD and the rest of the world.

Another interesting topic is about negative rates and their likelihood in the near future. Ever since the 150bps cut, the Fed has touched the zero-lower bound (ZLB) and there are increasingly more talks about negative rates. For what it's worth, the market is pricing a 20% probability of a cut in 2021. The latest round of Trump vs. the Fed also involved negative rates, although Jay Powell has repeatedly made it clear that NIRP is not one of the policy tools that the Fed will consider. We understand that due to COVID-19, governments around the world have announced tons of fiscal stimuli and the government spending is one of the key drivers that will help economies to weather COVID-19. Considering that, there is a benefit of negative rates because it reduces the relative borrowing cost further - this is our view on what we think Trump wants. Historically high rates disparity between USD and the rest of the world is structurally bullish for USD. The lack of fundamental support (weaker U.S. growth) since 2019 has been accelerated by the COVID-19-led 150 basis points cuts in March, USD has been moving lower (see below for USD analysis) since. If the Fed chooses to pursue NIRP, USD will weaken further and the relationship between weaker dollar and higher inflation will materialise. This will in turn erode the nominal value of debt repayment for the COVID-19 packages, which is a valid concern by Trump.

U.S. Elections: Two Horses No Longer Running on a Pedestal

Little did the markets predict what was thought to be the highlight of this year, the November presidential election, to look more like a reactionary event to the black swan of 2020, the pandemic. After a long race of bipartisanship within the Democratic party itself, Biden won by a comfortable margin over Sanders, winning 10 out of 14 states on Super Tuesday, including Michigan and Florida, 2 perennial swing states as seen in 2016's elections. Earlier in the primaries' rounds, Trump still had an optimistic chance of being re-elected, but upon his sweeping statements about the severity of COVID-19 and poor responses to the virus, the people's sentiment and confidence in him has shifted. America became the epicentre with more than 127,000 deaths and 2.5 million people infected as of the time of writing, and some of that was attributable to his dismissive attitude when the virus first hit the U.S. With that, gone too was the chance to increase his approval rating drastically. This is especially so as historically, American presidents' approval ratings shot up upon a catastrophic event. For example, Bush's approval ratings shot up after the 9/11 attacks, from 54% to 88.1% whereas Trump's stood from 42.8% to 43.3% within similar time intervals, which has been consistent, instead of improving significantly as per seen in previous presidents, throughout his 3+ years of presidency.

This has called for more attention to the kinds of policies that the president hopefuls are bringing to the table, for the key to winning the election is in a comprehensive economic plan. We believe that winning sets of policies regardless of the party leanings are those that promise employment to the 38.6 million Americans who were unemployed because of COVID-19, stimulate domestic demand in the short and long terms, as well as one that could iron out the postponed trade war with China. Here is a table comparing key policies by Trump and Biden as of the time of writing.

	Trump	**Biden**
Infrastructure	· USD 2 trillion infrastructure bill for "very big and bold plan" to rebuild America while providing jobs	· A 10-year USD1.3 trillion infrastructure plan aiming for a net-zero greenhouse gas emissions while providing jobs
Taxes	· Extend the current Tax Cuts and Jobs Act set to expire in 2025 · Repeal renewable energy tax credits · Offer tax credits for Education Freedom Scholarship Program	· Tax capital gains as ordinary income for those who make > USD 1million / year · Raise corporate tax rate from 21% to 28% · Apply payroll tax to income over USD 400,000

Healthcare	· Spending cuts of USD 900 billion and USD 450 billion to Medicaid and Medicare respectively · 10% decrease from 2020's level to Department of Health and Human Services	· Protect and expand the Affordable Care Act · Eliminate 400% income cap on tax credit eligibility · Lower the limit on the cost of coverage to 8.5% of the income · No Medicare for all, more like an insurance option
Trade	· No clear deal on a Phase 2 talk yet, but deteriorating relationship with China due to COVID19 · Treats Hong Kong no longer as an autonomous entity from China, but no long-lasting policies discussed yet	· No concrete trade policies with China yet, but emphasized that Trump has ostracised American economy; wants to end the "America alone" narrative

Figure 2: Key Policies Comparison between Trump and Biden

To sum it up, both Trump and Biden are similar in their infrastructure and trade policies to a certain extent. They have ambitious plans for infrastructure bills as they plan on using those to increase employment. Biden is also more willing to give an "immediate set of ambitious and progressive economic measures" such as emergency paid leaves to those affected by the outbreak than Trump's relying on resuming the economy without any extra fiscal stimuli to the people. Besides, trade talks with China will most likely resume, with Trump possibly taking a harder stance after blaming China for the pandemic, condemning its bill that reduces Hong Kong's autonomy and resorting to protectionist policies, and Biden a more collaborative effort with other allies in opposition against China. However, there has not been any concrete plans yet as to how this will roll out; there have only been negative speculations in terms of collaborations with China to minimise U.S.' trade deficits.

The biggest pain points will be in the healthcare bills and tax changes. Trump has officially announced a cease in WHO funding due to its concealment of the "extent of virus threat in China", a move the markets are not shocked to hear following his cut in spending to the WHO a month ago when the pandemic was ravaging American lives. As such, there was not much reaction in the market, with the greenback seeing a meagre change from its previous position then. However, what is highly contested and is most immediately hitting the economy during recovery is in the tax reforms that Biden is going for. He wants to get the top 20% household by income to be accountable for the 93% increase in tax returns. This is a whopping number following the details of the higher corporate tax hikes – a move he claims necessary to uplift the lives of middle-class Americans.

We believe that although Biden's leading in the popular vote, the electoral college vote is just as important – and there is no clear winning candidate yet. As the second wave of the virus looms in North America and Europe still, testing capacities will be key in ensuring the re-opening of the economy. This is especially so as Trump's early mishandling of the crisis will have a domino-effect on public trust and consumer confidence has dropped significantly, proving that most Americans are going to be cautious in their spending activities at least for the rest of 2020 until a vaccine is found. More details on the stimulus package that Biden is more likely to hand out to the large public is important to tip over those voters to him, especially since his tax hikes are disadvantageous for many corporates who have been bleeding through this pandemic. This is a downside risk to a Biden presidency, and corporates would most likely be on Trump's side.

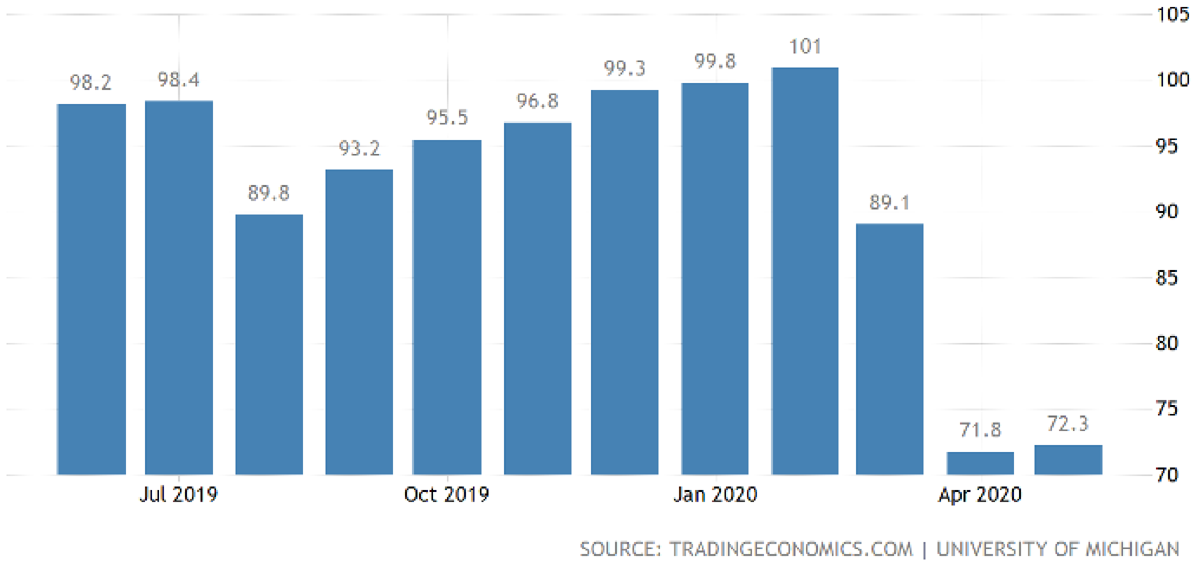

Figure 3: Consumer Consumption Index in the U.S. (*Source: Trading Economics*)

Further, we need to look at how the current virus situation has impacted Trump's chance at re-election, for it has reached the end of the first phase and the second phase of the virus has taken off. Unfortunately, ever since the relaxation of quarantine measures from late May to June onwards depending on the states, there have been upticks in cases in several states alongside increased testing capacities. For example, seven states (including California, Texas, Arizona, etc.) are reporting new highs from current COVID-19 hospitalisations, according to the data tracked by The Washington Post. Some highlighted numbers are that in Texas and California, more than 5,000 new cases over a 24-hour span were recorded as of 24th June, with overall 33 states and U.S. territories having a rolling average of new cases higher than that of the week before. This meant that Trump's narrative of pushing the blame on China for being the source of the pandemic or worse, for not alerting the rest of the world on the deadly pandemic is no longer as effective as previously. Before the second wave of COVID-19 was a reality, as of March, negative views on China among Americans have grown by 20% since Trump took office, and this animosity against China has proven to be useful to keep his voter base given the time lags he needs in order to get a vaccine for the virus. However, the current situation post-relaxation of quarantine order is that he is still not handling the crisis as well as other countries did, as seen in the uptick of cases in many states. Besides that, according to the Washington Post, the federal government plans to end support of testing sites on 30th June, including seven sites in Texas, which is one of the states where the uptick in cases is most deadly - and this could exacerbate the downside risk of Trump being re-elected as it may erode his predominantly strong voter base of baby boomers and the elderly, who are critically affected by COVID-19. The relaxation of quarantine order period is a key period for him: the public are looking closely into how he could handle the crisis that had been warned by public health officials ahead of time, especially since there have been both successful and unsuccessful cases of containing the second wave of COVID-19 from hitting from Asian countries which lifted the restrictions earlier than the U.S., yet Trump's actions have been less than satisfactory in keeping COVID-19 at bay.

Besides those discussed above, there is another unexpected event that lasted for more than a week in June that could affect the November elections' results: the mass protests in the U.S. due to the killing of George Floyd in Minneapolis. Floyd is a black man who allegedly committed a petty crime of buying a pack of cigarettes with a fake USD 20 bill was arrested by a white police officer, Derek Chauvin, and was brutally killed on the scene there and then. This sparked rage and protests across many states in the U.S., to which Trump threatened a military crackdown to forcefully stop the rampant protests all over the country. This happened due to his series of missteps in handling the protest situation which fueled even more anger in Americans, which includes getting a photo-op at a Church near the White House after asking the police to unleashed tear gas on peaceful protesters there and calling peaceful protesters as "thugs" on Twitter, among the many divisive comments he made. The effect of mass protests in the midst of a pandemic that was not fully contained hurt his approval ratings. According to NPR poll, his approval rating is 41% in the poll, down 2 points since March (latest poll), but his overall disapproval rating increased by 5% to 55%

upon the mass protests in the U.S. This brings a golden chance for Biden to rack up his voter base, in which he led Trump 88% to 9% with black voters in the poll, very near the margin Clinton received in 2016. This boils down to how much could Biden make a difference in the eyes of suburban voters, whites, independents and men, and although currently he is beating Trump by a wider margin than Clinton did in 2016, considering that this is a one-off event that although has left many Americans more aware of racial injustice within the system and the importance of passing on real change and real bills through a government that support equality, Biden still needs to tread the current popular public's trust in him carefully to maintain lead by a big enough margin in November.

At the end of the day, we believe that the current situation for a Biden or Trump presidency is still unclear. It is fascinating to note that despite the unclear policies that Trump is proposing for his second term, his approval rating has only wavered around the low 40% all throughout his presidency period, despite his many poor handlings of matters in 2020 alone. Markets-wise, we expect the volatility to increase nearing the elections, as seen from how it has the ability to diverge from the Main Street in as much as the dive into risk-on sentiment once news on relaxation of quarantine orders and drug testing for COVID-19 were released, despite their short-lived highs and the turbulence and decline that followed right after. Considering all circumstances, we believe that the markets are slightly tipping over for a Trump re-election as opposed to Biden's presidency due to the stickiness of his voter base who are pro-Republican and the corporates who favor lower corporate taxes as many Americans are looking at economic recovery as the most important factor above all in the current climate. Hence, if Trump can resolve his dispute and better talks on trade war nearing the elections, it will be beneficial for him in voters' eyes.

U.S.-China Relationship: No Longer Lukewarm and Cordial

By the end of 2019, the U.S.-China relationship has become better, given their truce in trade war was followed by a 3-phased agreement, with Phase one already in place in January. However, with the pandemic storming off with no caution, Phase 2 and Phase 3 talks have long been forgotten, if not postponed. Moreover, their relationship has soured over the course of the pandemic, with Trump's accusations of the pandemic as a "Chinese virus" the start of his narrative to blame China over the origin of the virus. He also believed that COVID-19 was deliberately concealed by China from the rest of the world. Trump spurted a litany of complaints on China's role in causing this global pandemic and supported his accusations with cutting U.S.' ties with the WHO (which includes its funding) for the possibility of the WHO being complicit with China on this matter.

Political accusations aside, the original timeline of the rollout of Phase 1 deal is as follow:

Dates	United States	China
15th January 2020	• Trump and Xi signed the phase one trade deal at the White House • Reaffirmed the commitment to reduce duties from 15% to 7.5% on USD 120 billion worth of Chinese products • The USD 250 billion tariffs on Chinese products are still in place	• Trump and Xi signed the phase one trade deal at the White House • Purchase an additional USD 200 billion worth of U.S. goods and services over the next 2 years (on top of the USD 186 billion purchases in 2017, including manufactured goods, energy, farm products, and services)
7th February 2020	N/A	• China will have tariffs on USD 75 billion worth of U.S. goods, including crude oil from 10% to 5% and others from 5% to 2.5% (in response to the halving of tariffs the U.S. did in January) • Soybean and meats also see a reduction in tariff to a smaller degree, from 30% to 27.5% and from 35% to 30% respectively
17th February 2020	• From 2nd March, the Tariff Commission will accept applications from Chinese companies that intend to sign contracts to purchase and import related goods from the U.S.	• 696 U.S. commodities will be exempted from Chinese additional tariffs including meats, soybeans, liquefied natural gas, crude oil, medical equipment, etc
8th May 2020	• Reps from both sides reaffirmed their Phase 1 deal	• Reps from both sides reaffirmed their Phase 1 deal • Reinstated that Beijing will keep up to its promise of buying extra USD 200 billion worth of U.S. products • Significantly increased its imports for U.S. pork at 40,200 tons of meat in early May (especially since the U.S. meat output has dropped by more than 30% due to slaughterhouse closures)
12th May 2020	N/A	• A new list of 79 U.S. products exempt from the tariffs including U.S. imports of medical disinfectants, rare earth ores, silver, gold, etc.

1st June 2020	• Eliminated special treatment towards Hong Kong as a move to punish Beijing	• State-owned Chinese firms bought at least three cargoes of U.S. soybeans • The purchases totaled at least 180,000 tonnes of the oilseed for shipment in October or November, which is the peak U.S. soy export season (when American soybeans are usually the cheapest in the world) • Chinese importers canceled 10,000 to 20,000 tonnes of American pork shipments (equivalent to one week's orders) in response to Trump's comment on Hong Kong and China's relationship

Figure 4: Timeline of U.S.-China Trade Dispute

Ignoring the vacuum from February to May due to respective countries' efforts to control the pandemic and re-open their economies progressively, the highlight of the table is that China needed to repeatedly reinstate their commitment of additional USD 200 billion imports from the U.S. According to CSIS (Centre for Strategic and International Studies), at the time of writing, the projected exports of U.S. goods to China may only be at USD 60 billion for the entire 2020, just a couple hundred billion shy of what was promised – triggering outcry from the U.S. This is attributable to China's poor performance in the first quarter as the pre-first virus wave started in China in itself. However, they quickly responded by lifting tariffs on certain U.S. goods such as gold and silver, as well as pledged to buy pork from the U.S. despite a recent accusation by Trump and Secretary of State Pompeo of the virus originating in Wuhan and demanding an investigation on it then.

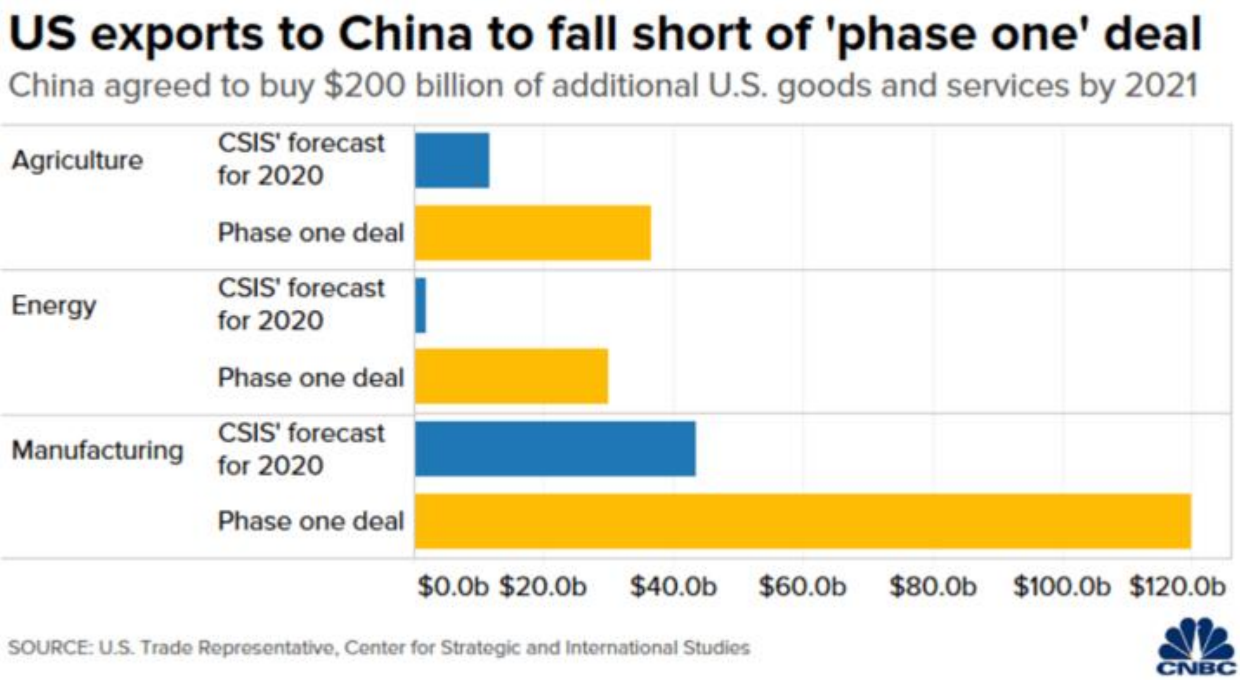

Figure 5: Worst-Case Scenario Projection of Unfulfillment of Chinese Imports (*Source: CNBC*)

China's inability to keep to its supposed amount of U.S. imports will be detrimental to the U.S.-China relationship. Although both countries' officials have spoken over the phone a few weeks back to ensure that the Phase 1 agreement will keep to its schedule, the talks on the next phases seem dimmer. This is because Trump has tweeted that the U.S. will "do a termination [of the deal] and we'll do what I can do better than anybody." With this hostile tone and knowing Trump's aggressive tone throughout the years, this may not just be a fake threat, but rather a very real one. However, if Trump were to follow through with his threat, it is going to hurt both economies badly, especially looking at their high degree of codependency.

As for China, it will lose its largest source of foreign demand, especially considering that exports contribute to 20% of its GDP. Whereas for the U.S., the consequences are that there will be a loss of low-cost goods that the lower to middle class Americans may have relied on all this while. Foreign demands for U.S. products will also be deeply hurt if the trade war continues, especially since China is the U.S.' third biggest source of U.S. goods importers. Most importantly, China is the largest source of foreign demand for Treasury securities, and if the U.S. loses this, the road to economic recovery (both from the deficit in consumer spending as well as the very tight government spending budget left) will be an arduous one. What is up on the table is the consideration about the mounting public debt-to-GDP ratio which is projected to go up to 106% from 79% in 2019 with the current interest rate already at the zero to 0.25% range.

This trade war may be a race between how long the Fed can put up with the meagre interest rate (assuming NIRP will not happen as Powell repeatedly mentioned) and U.S.-China's bettering relationship followed by real increasing numbers of U.S. and China imports and exports to each other. However, we believe that the U.S. is in a more severe growth-starved economy than China is, especially considering its uncertainty in handling the re-opening of the economy, therefore the chances of the deal falling through carry more risks to the U.S. and its mounting indebtedness and low spending capacity.

Besides the trade deals, China's legislature's approval of the controversial national security laws for Hong Kong has caused another major blow to its relationship with the U.S. Pompeo has stated that with the new bill, the U.S. can no longer "assert today that Hong Kong maintains a high degree of autonomy from China" Although the U.S.' responses to this new bill forward, be it tariff, visa status, etc. is still unclear, putting Hong Kong in the same light as China will have negative implications to both the U.S. and Hong Kong. Although this has brought the HKSE to see its lowest levels in the month yet, the DXY did not move much following that. However, Hong Kong is still of considerable concern to the U.S., as it is one of the few territories that still maintains a trade surplus with the U.S. (~USD 26.4 billion in 2019). With its ballooning balance sheet, we feel that the U.S. is trying to insinuate a better deal with China by leveraging on the unrest that HK is having with China to allow them to reconsider the passing of the bill.

However, as the U.S. was overwhelmed by the concurrently ongoing mass protests and second wave COVID-19 crisis amid China's effort to pass the bill, the U.S. failed to incite a big enough threat to stop the bill from being passed. China has successfully passed the bill despite the rampant protests that happened in Hong Kong, to which the U.S. was scrambling to find other aspects to weaponize it against China's bold move despite the U.S.' strong warning. In response to the passing of the bill, the U.S. Secretary of State Mike Pompeo announced restrictions on U.S. visas for serving and former Communist Party officials, who have been "believed to be responsible for, or complicit in" undermining Hong Kong's autonomy, rights and freedoms. To this China's foreign ministry office in Hong Kong strongly replied that U.S.' claims of China undercutting Hong Kong's semi-autonomous status as a "slander" and warned the U.S. to stop its "bullying actions" regarding its newest visa restrictions which could be extended to the families of those selected officials. Chinese analysts said Beijing was unlikely to take immediate action in response to the U.S. visa restrictions. A bigger concern, they said, was the passage of a bill last week in the U.S. Senate to sanction Chinese officials and freeze their assets over repressive actions in Hong Kong. Cui Lei, an associate research fellow on China-U.S. relations at the China Institute of International Studies, said high-level dialogue between the two countries had pretty much come to a standstill, so the direct impact of visa controls was not that significant.

In retrospect, we are still optimistic that the trade talks between U.S. and China will continue in the future, although we are starting to see China getting riled up and using harsher words in response to the U.S. now. This is especially so considering that in Q12020, there is still a total of USD 2.3 billion in new projects (by American companies to China) announced, from USD 2.8 billion in 2019. However, we do not expect "bullying actions" from Trump towards China to end, but rather escalate as we near the elections. If talks were to continue and Trump can convince Xi to follow through the Phase 1 deal of USD 200 billion U.S. imports (and make it a priority above all other trade partners), this will improve U.S.'s trade deficits in

2020 alone. Right now the two sides have one trump card each which poses as downside risk to a better relationship: China's tough stance on limiting Hong Kong's autonomy progressively since the bill has been passed and U.S.' threat (which has been passed by the Senate) of delisting public Chinese companies from the NYSE after the accounting fraud of Luckin Coffee, a Chinese company listed on the NYSE on top of the possibility of freezing Chinese officials' assets over repressive actions in Hong Kong (which was talked about, but not in terms of its possibility and feasibility, therefore not counting it as a reliable trump card as of yet). We believe that the best scenario for the two countries in the coming months is for such a compensation: China to increase its U.S. imports in a faster rate in exchange with the U.S. dropping its investigation on more Chinese companies listed on the NYSE (and stop or reverse its 'petty' visa restrictions) with a signed deal of sustainable increase in China taking in U.S. imports until 2021. As such, the dollar will maintain its strength and Trump may well get an additional boost on his approval ratings, all set for November and possibly strengthening the DXY, as it will discount another uncertainty in prior to the highly contested election in November.

FX TRADE IDEA: SHORT DXY

Since the beginning of 2019, we started to see an eroding fundamental support for DXY due to a relatively sluggish U.S. economic growth compared to the rest of the world. However, it did not translate to a weak broad Dollar index as the high interest rate differential then fundamentally prohibited speculative short USD positions. However, due to COVID-19 which forced the Fed to cut back into zero-lower bound (ZLB), the rate differential has narrowed significantly. On top of that, there is ample USD liquidity globally as we see a normalizing LIBOR-OIS and the Fed is persistent in preventing USD shortages.

Figure 6: DXY Daily Chart (*Source: TradingView*)

Entry: 98.3
Stop loss: 100
Take profit: 95.5
Risk to reward ratio: 1.65

We analyze the technicals for DXY using multi timeframe analysis. When we look at the weekly chat, we rely on Ichimoku with EMA as our main analysis. As seen from the chart, the lagging span of the indicator has crossed the price, and this gives the first bearish signal. This bearish signal will be completed (we believe that it has high probability) when the short 9EMA cross below the long 26EMA and the price manages to break the cloud. This will be in line with our structurally bearish-biased view on DXY.

Figure 7: DXY Weekly Chart (*Source: TradingView*)

Moving on to the daily charts, we can observe that the DXY has been range bound around 98.3 on the downside and 100.94 on the topside for the past few months. In addition, we have seen a completion of Triple Top as the price broke a key support at 98.3 and more importantly the price has broken the 200DMA. This price action can open the price action all the way down to 95.6 region.

MEXICO (Overweight)

Mexico entered 2020 carrying the weight of 2019's economic contraction brought about by a series of conditions: unfavorable foreign investment climate, President Andrés Manuel López Obrador (AMLO)'s unpopular policies, and control over key sectors in the economy, and an economy bogged down by debt. With an already grim economic prospect, the pandemic hit a sweet spot in the already struggling Mexican economy. With supply chain disrupted, manufacturing plants closed for operations, and the U.S., being the biggest trading partner, as one of the deadliest hotbeds of the virus, 2020 really is set to mark the first year of full contraction ever since the 2009 Global Financial Crisis for Mexico.

Coupling with the Saudis and Russians' feud over oil supply that sent the WTI to negative levels in April amid a pandemic, Mexico's oil refineries suffered major losses correspondingly. However, on a whole, Mexico's 2020's Q1's GDP declined by 1.2% as opposed to the predicted 1.6% in April (although the real rock-bottom should be reflected in Q2 figures). As such, we will look closely into Pemex and its oil refineries and revenues, Banxico's (almost) no fiscal stimuli, and Mexico's indebtedness to determine the outlook of the peso for the rest of 2020. All three themes will be discussed with respect to the effects of COVID-19, especially since the second wave risk is pertinent in Mexico and Latin American countries.

Pemex: Still Drilling Oil, Señor?

Petróleos Mexicanos, or more commonly known as Pemex, has been downgraded twice this year to junk level. In January, Fitch assigned Pemex's long credit ratings at BB+, but further lowered it in April to a BB- due to oil's negative outlook and pessimism surrounding Pemex's debt issuance. With this rating, it effectively means that Pemex bonds are below investment grade – it carries a higher risk of default than most bonds issued by corporations and governments. This comes about as Pemex comes into 2020 with ~USD 99 billion debt, in response to which it issued for the first time ever, a 40-year maturity bond with a coupon of 6.95% and another 11-year maturity bond at a coupon of 5.95% in order to salvage it. Pemex said that these bonds will be used to repurchase dollar-denominated debt maturing in 2020 and other refinancing purposes. Indeed, Mexico is stacking bonds upon bonds in hopes of reviving its then national hero Pemex, or so AMLO believes.

Upon his election, AMLO emphasized that he wanted to focus on Pemex and make it a bigger contributor to the Mexican economy (it currently contributes ~15% to the government revenue) – thus his move to resist OPEC+'s supply cut of 400,000 barrels per day in order to curb sluggish oil demand from the pandemic restrictions in April. Then, the WTI crude price for the contract maturing in May was trading at negatives, yet AMLO still held strongly to his goal of producing 1m barrels per day by May, despite data showing that it would hurt the Mexican economy. Although his resistance proved successful with the U.S. taking some of Mexico's supply cut quota, AMLO's move of opening a new USD 8 billion refinery in his home state on top of keeping Pemex running for the duration of the volatile oil prices is highly contested against.

At that period where crude was only running at low USD 20s per barrel for weeks in April-early May, the upstream business of keeping Pemex running resulted in a USD 23 billion quarterly loss in Q12020, up from USD 17.7 billion last year. This is due to the fall in demand for fuels by ~72% in April as compared to last year due to complete shutdowns of manufacturing plants for fear of the virus. Moreover, at that price of oil, Pemex was making a loss both at its main drilling wells and at its refineries by simply operating. Indeed, Pemex struggled with cash flows just to maintain its operational and financial cost.

However, it seems like the global outlook on oil demand has weathered its toughest storm. Optimism surged in early June for a number of reasons: OPEC+ extended its global supply cuts for another month at ~9.7bn barrels/day, stricter rules on countries that still over-supplied oil despite their commitments, and reopening of cities in the U.S., Europe and Asia. However, we would still maintain a cautious outlook on oil demand globally, and we maintain the stand that demand in oil will not pick back up as early as Mexico did in ceasing all measures of social distancing (social distancing ended on 18th May when virus death hit 10,000, and the count has increased to 25,000+ deaths as of the time of writing). This is largely due to the uptick in cases in the U.S., Mexico's largest trading partner, and a quasi-second wave hitting Latin American countries who were struck with the virus late during the first wave of virus yet have highest death tolls globally.

Fascinatingly, given the many headwinds to pre-pandemic demand levels and the cost of running Pemex, AMLO is still unfazed. In the latest OPEC+ meeting, Mexico was the only country who did not agree to the extended supply cut of crude oil, stating that it would only commit to its April numbers, as AMLO wanted to continue with its plan to revive both the wellheads as well as the refineries. Given his stubbornness and the early re-opening of Mexico despite multiple public health warnings, AMLO could be planning to focus its efforts of organically creating demand for both crude oil and its downstream products, leveraging on the lower levels of imports at this period and the quick reopening of Mexico. Moreover, through his series of protecting Pemex, we believe that he has another agenda of using his successful resistance against the international community to get the renewables energy leaders to cede their effort in replacing fossil fuels in Mexico. In May, he did so by halting all deals surrounding renewables, such that he could maintain the Federal Electricity Commission (CFE)'s share of electricity generation at 54% such that oil and gas remain the top energy source as per his wishes. Indeed, if he could risk causing friction with the Saudis in order to win national control over Pemex's activity, he is serious about rebuilding what was once a great economic icon.

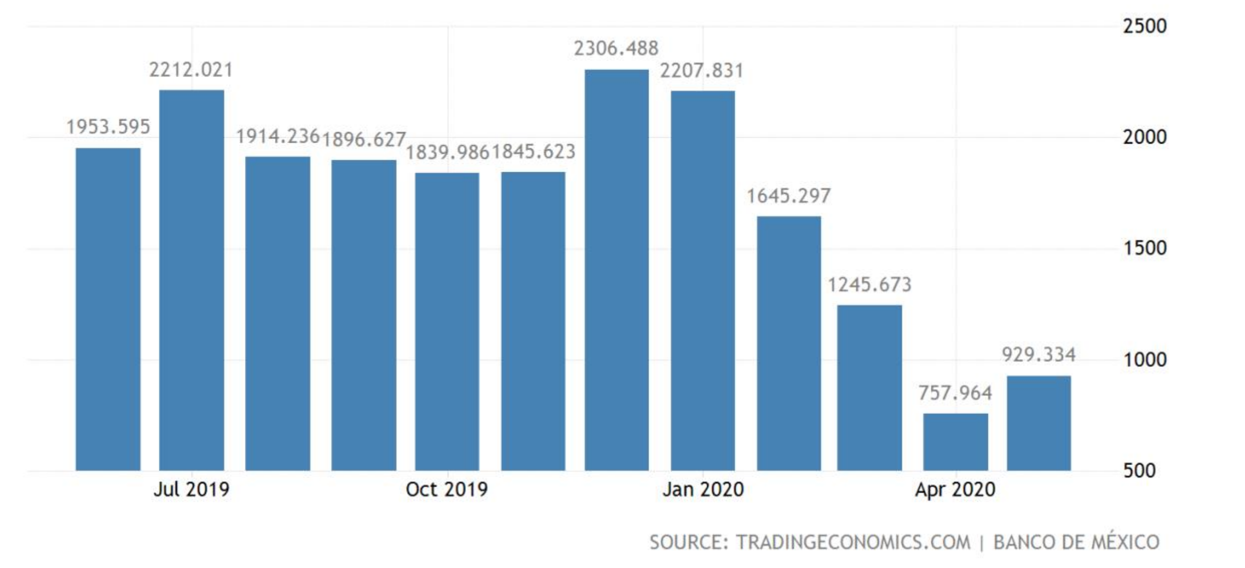

Figure 8: Oil Exports in Mexico (*Source: Trading Economics*)

As such, it is expected that there will be a decline in FDI in the coming months, leaving Mexico to deal with its debt through domestic financing via bonds issuance and tax revenues to curb its losses, especially in April where complete shutdowns were rampant. Indeed, with AMLO's stubbornness in keeping Pemex running and his action of dismantling the energy reform carry both upside and downside risks. The former ensures that Pemex will keep running at its highest possible capacity, for AMLO's backing and his move to make it the preferred energy will boost its revenue to cover its major losses in Q1 and keep it from defaulting. But the latter, the renewables plan, was supposedly key to new FDIs which could alleviate some burden from the indebted economy through injection in new infrastructure and alternative energy which cuts costs for the Mexican economy overall.

In summary, this is an epitome of when political belief clashes with the economic needs of a country: AMLO's demand is chosen over the efficacy of his policy simply due to his rigid belief coming into the office. As such we believe that despite USDMXN's big shift to safe-haven USD once the pandemic took over, it has been and will continue to be favoring the market's risk-on sentiments, as long as AMLO keeps supporting Pemex through its debt refinancing and stimulate demands even if it meant that a second wave COVID-19 scare is the reality in Mexico.

Monetary Policy: Snip Snip, Banxico

Banco de México, more commonly known as Banxico, has one of the highest interest rates in the EM landscape coming into 2020 at 7.25%, but it has already seen 4 times of rate cuts from the start of 2020 to the time of writing. Out of these, the most unexpected one was a 50 basis points cut to 6.5% in March in an unscheduled meeting. It was decided urgently due to dwindling oil prices as the Saudi-Arab feud soured which caused an overnight oversupply in the oil market amid the sluggish global demand from COVID-19. The last cut in May was another 50 basis points cut which according to many analysts was not enough, yet the markets expected it to go to that level anyway. As such, looking at how the virus is rampaging the Central and South America later than other hard-hit regions like Asia, Europe, and North America, and AMLO's reluctance to give direct monetary relief to businesses or increase domestic spending, it is expected that Banxico will adopt a more dovish stance and continue cutting rates until the end of 2020 while trying to keep its target inflation rate at 3.0%.

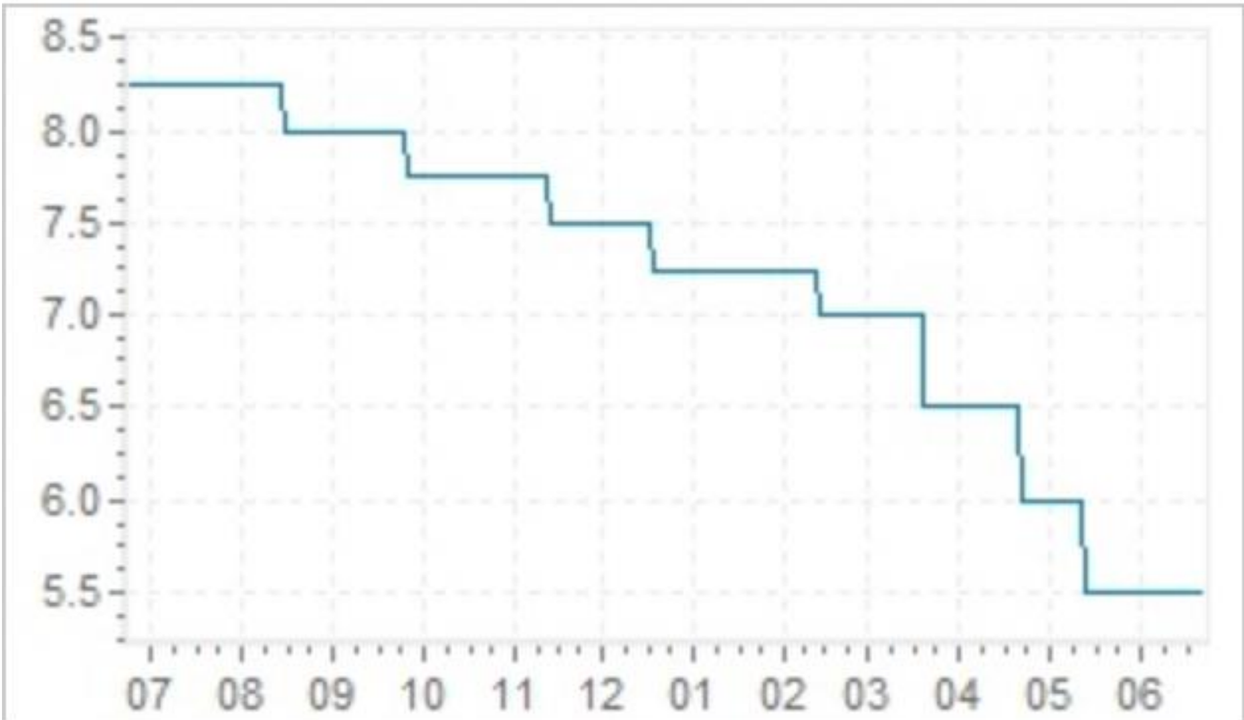

Figure 9: Banxico's Interest Rate (*Source: Global Rates*)

Although the current rate at 5.5% is already Banxico's lowest since 2015, comparing Banxico's rate to other neighboring countries' such as Brazil's at 3% and Columbia's at 2.75%, there is still plenty of room to cut as Mexico adjusts with the evolving situation. The current situation is a battle of who is the worst at handling the pandemic - in which Mexico's death rate and infection rate are still lower than the aforementioned two countries. As such, Mexico still offers one of the highest and most lucrative carry trades across the EM landscape. Focusing on the carry of the USDMXN pair, we believe that since the Fed has firmly reinstated that they will keep its current interest rate at 0.25% and will not go for a negative interest rate for fears of uncertain returns, Mexico's unchanging interest rate at 5.5% in June brought optimistic returns to U.S. carry traders. Besides the interest rate, as of the time of writing, the dollar also posted a weekly loss as bearish bets have soared to a 2+ year high: according to Reuters, the value of net short dollar position rose to USD 16.83 billion last week, compared to a net short of USD 15.69 billion the previous week. The exchange rate is working in favor of Mexico despite its government downplaying the severity of the virus: the whole world is focusing on the second wave in the U.S. way more than it does to Mexico, and risk-aversion sentiments have strengthened the peso. As such, Banxico is probably trying to hold out at its current interest rate before easing it further in 2020 as COVID-19 wanes, if it does.

Looking into Mexico's inflation rate, as to the data released recently, the annual inflation in Mexico slowed to 2.15% in April from 3.25% in March due to the pandemic. However, this is most likely just a short-term outlook, for the production and manufacturing has been forced to have reached bottom in April. Evidently, May's inflation rate has picked up, currently nearing December 2019's level at 2.84%. However, since the inflation rate is closely related to domestic spending and business activities, although the inflation rate has increased in May, this level may not hold out, unless there is a big spending directly by the government to increase employment. This is further supported by the fact that there was rampant unemployment (>550,000 formal jobs lost in April, while the informal sectors most likely also lost sizable numbers), signaling weak domestic spending and low business confidence in the coming months without any economic stimuli and poor handling of the crisis.

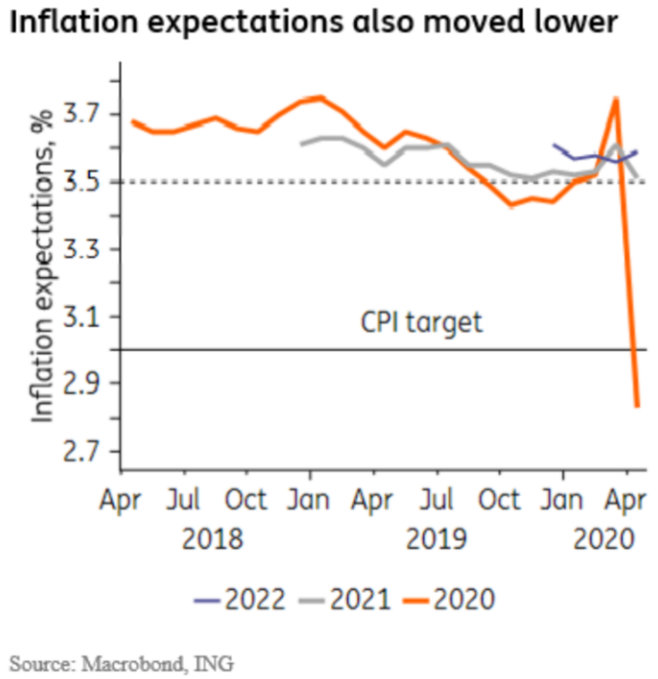

Figure 10: Consumer Price Index Expectations up to April 2020 (*Source: ING*)

Besides interest rate cuts, Banxico also has an additional measure to free up liquidity in the financial markets by reducing the monetary regulation deposit that banks are required to hold by MXN 50 billion. These two were enacted on top of offering to banks credit auctions in USD by making use of the swap line that the Fed has ramped up earlier in the year such that market makers are able to support the functionality of the government bond market, especially since Mexico freshly issued bonds for Pemex earlier in the year. Paradoxically, Mexico is not buying back any major assets for itself, but rather bets on businesses' increased borrowing given the expected interest rate cuts throughout the year.

Overall, Banxico's current interest rate is an outlier in the EM landscape, and it will most likely remain so despite the rate cuts throughout 2020. Looking at the 3 consecutive 50bps cut, it is possible that the trend will continue. However, if the core inflation rate picks up, a 25bps cut is still not out of the table. Over the next six months, inflation will most likely not pick up if there are no additional benefits or fiscal stimuli given by the government, It is possible that Banxico is looking at carry trade (especially with the U.S.) to tide through its securities over stimulating the domestic economy in the second half of the year, but that depends highly if there are any portfolio outflows: currently the risks are how badly the second-wave will hit its major trading partners especially the U.S. vs the virus situation in Mexico itself, which still did not have it under control despite reopening. Although we are cautiously optimistic about the pandemic situation in Mexico, we believe that while monetary easing should continue at its current rate, fiscal-side policies need to be employed to ensure the Peso will maintain its appreciation in the coming 6 months.

FX TRADE IDEA: LONG USDMXN

Figure 11: USDMXN Daily Chart (*Source: Investing.com*)

We are going to use multi-timeframe charts for the technical analysis of the USDMXN pair. From the daily chart above, there was a strong bullish rally from March onwards, as seen in the momentum that is at the overbought level for nearly a month at a Stochastic of above 80 for most of that rally period. After such strong bullish momentum, the pairs moved down south for 3 days in March, only to pick back up to retest the resistance at 25.43 price level, showing that the move down was only a retracement instead of a reversal. The pair followed a similar pattern again in April, as markets were unsure of the COVID-19 containment in the U.S. given the anticipation for an economy re-opening.

After retesting the resistance and failing to reach it for the third time in a row, there is a clear bullish pennant pattern that has formed. However, the pattern broke exactly on 18th May (when Mexico announced its lockdown was officially over) to show a bear on the USD coupled with a bull on the MXN as one of the most attractive EM currencies taking over the market as risk-on sentiments across EM currencies returned. With the markets itching for good news from the whole pandemic slump, the optimistic outlook was evident in the short-term rally. However, if we look at the pair from 8th June onwards, the movements were even more erratic than previously, as the Stochastic level surged from an oversold to an overbought area only in a couple of days; a bounce back from the overly optimistic outlook was due.

There is a similar pattern in June as that of the March-May period, but in smaller movements -- currently the pair is retesting its resistance at around 23.05, which failed to break through twice before now advancing to test the support level in the March-May area at 23.4 to decide whether it will be another reversal back to the bull market on the greenback again. This movement in June is largely due to global cautiousness, which came back after a series of second wave figures in the number of cases around the world, largely from the U.S.' reopening and some fears over in Asia (South Korea, Singapore, for example), sending people to flee the risky EM assets, ending a bull rally for EM currencies which was diverging from the Main Street reality of the virus lurking still, especially in Mexico and the Latin American space.

Looking at the Ichimoku indicator, there is no clear direction of the pair yet, as the green cloud has just turned red, but its lagging span is on course to cross the pair to be above it, and the 9-days EMA just crossed the 26 days EMA too. With 2 out of 3 signals on the Ichimoku suggesting that there is going to be a reversal back to the bull market on the greenback as well as the pair moving beyond the 100 days EMA, we are of the view that the pair will stay on the overbought area for about a month or so as global containment of the virus will be clearer after more time. We believe that although there are no strongly bullish indicators on the pair currently, the markets is playing a sentiment game largely controlled by the U.S.' containment of the virus as the Peso is also holding out at its current levels with limited support from Mexican government to stimulate domestic demand in the coming months.

Figure 12: USDMXN Weekly Chart (*Source: Investing.com*)

Entry: 23.260
Stop loss: 22.723
Take profit: 25.424
Risk to reward ratio: 1.21

Looking at the weekly chart to support our view, there is a three black crows' pattern in May which showed that indeed, the bear has taken over the market post March rally - a reversal to the bearish trend. If we draw up the trend line following March rallies and look at the Stochastic, it was on course to continue the bearish trend as it dived nearing the 30 soon after. However, three weeks after what were considered as strong bearish indicators, the pairs returned with dizzying bullish patterns: a bullish engulfing followed by candlesticks with longer bottom wicks, ending off the third week with a hammer pattern. A hammer shows that although there is selling pressure, in the end of the day, the buying pressure was stronger, and it drove the price up instead. As such, there is a possibility that another reversal is what the markets is heading towards.

On the other side, when we look at the dollar, it has seen a massive depreciation with respect to Mexican Peso, especially in the first week of June. But the bearish DXY is also testing key resistance levels currently, hence showing 2 bullish hammers followed by one bearish hammer afterwards, suggesting that the bear on the greenback may not be here to stay. At the time of writing, although the dollar has evidently weakened across the board, Mexico's struggle with containment of the virus made it seem that the U.S' situation is the better one out the 2 bad bets, which causes the carry trade with Mexico to resist only for a short while, since Banxico is expected to cut rates further in the year to stimulate domestic economy. Therefore, our view is that we need to be cautious in trading this pair given how volatile their movements are, but as of the time of writing, it is expected that traders will be more careful in trading EM currencies and would prefer to have a hold of the greenback in the coming months, much less an EM currency like the Mexican Peso which has not seen the end of the virus containment in any near term. As such, we would enter the long trade once the price breaks through the previous support level at 23.260 and putting a stop loss at

22.723 at the 61.8% level. We are taking profit once the price shoots up to the previous high in the March rally at 25.424. This is due to our belief that there is a high chance Mexico will experience a second wave scare after its failure in containing the first wave (which according to the government has passed yet the number of cases has increased ever since the declaration) as it has not ramped up testing capacities unlike the U.S.

CANADA (Underweight)

Canada is the world's 10th largest economy (in nominal terms) and ranks third globally in terms of natural resources. The country's gross domestic product (GDP) was worth USD 1.74 trillion in 2019, growing 1.79% from the previous year. The key industries which drive the company's growth are real estate, manufacturing, and oil and gas extraction, which make up over 30% of the country's GDP collectively.

Canada has the third-largest oil reserves in the world, naturally making the oil and gas industry the backbone of the economy. Crude oil also makes up the largest proportion of Canada's total exports – up to 22% of total exports in 2019. This also makes the Canadian Dollar (CAD/'loonie') highly correlated with the oil market (correlation coefficient of -0.96 with USDCAD pair).

Things were looking optimistic at the end of 2019 as trade tensions between the two superpowers eased. The new and improved United States-Mexico-Canada Agreement (USMCA) brought hope to the economy as GDP growth humbled to a mere 0.3% in the fourth quarter. The CAD was also one of the best-performing currencies out of the G10 countries; and stable interest rates attracted investors. In our previous report, we were optimistic about a better-performing Canadian economy due to the aforementioned points - rightfully so. Consumer confidence was strong, the unemployment level was at a historic low, and the resurgence of the housing market was imminent as the Canadian Finance Minister relaxed mortgage qualification rules.

However, the unexpected emergence of one of the worst pandemics in human history altered growth trajectories of countries all over the world dramatically. Hope and optimism were short-lived as the global economy plunged into a recession within a mere three months since the virus first surfaced in China.

Dual Demand Shocks Throws Canada Off the Cliff

While Canada appeared to be shielded from the impacts initially due to their relatively weak trade links with China, the country soon found itself plunging into a recession after a devastating blow by the combination of the COVID-19 outbreak and plummeting oil prices. The global pandemic roiled global markets, forcing people and cities into lockdowns, and businesses to face one of the greatest crises in history. Nonessential businesses had closed and soon the country found itself under lockdown. The entire Canadian economy came to a standstill within just weeks of the virus outbreak.

Canadian retail sales plunged 10% on March month-on-month. April's data is expected to be much worse at about a consensus estimate of 16%. PMI data is far more worrying – April's IHS Canada manufacturing PMI plunged to 33 compared to 46.1 a month before. This latest reading pointed to a historic contraction in factory activity. Unemployment accelerated to an all-time high as affected companies resorted to layoffs to cut costs so they could weather this devastating storm. On the price front, consumer prices in Canada fell 0.2% year-on-year in April as consumers halted spending to preserve cash and maintain liquidity. Housing starts in Canada fell 12.4%, albeit still beating market expectations. The housing market – one of the economy's biggest drivers – is also facing a crisis as deflationary pressures weigh heavily on home prices. According to the Canadian Real Estate Association (CREA), the average home price in Canada in April is around 10% lower than the average home price in February.

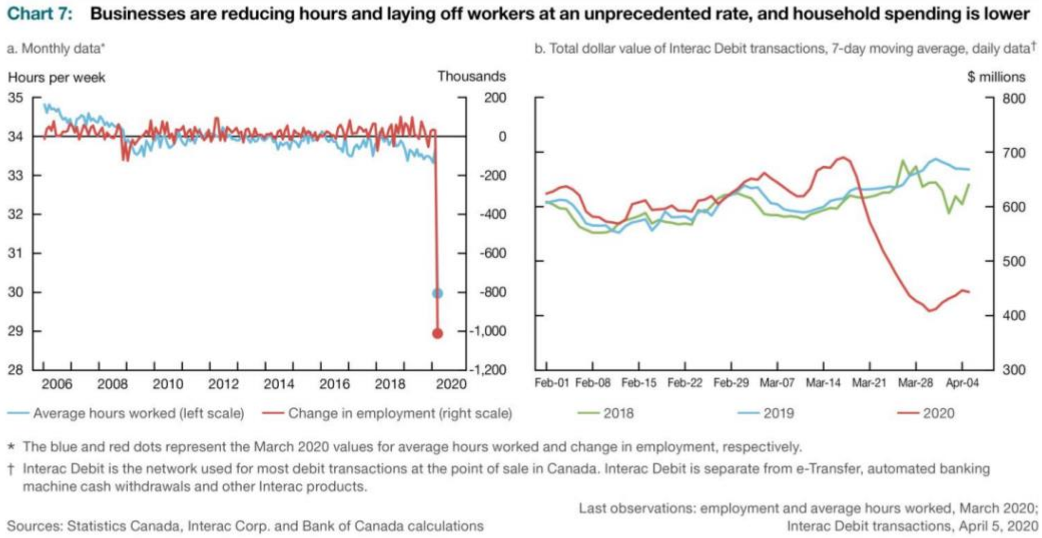

Figure 13: Working Hours and Transaction Values in Canada (*Source: Bank of Canada*)

The Bank of Canada (BoC) took swift actions and provided monetary stimulus as well as huge fiscal stimulus – slashing overnight interest rates to zero and preparing massive asset purchases to support the economy in this unprecedented crisis. The government spared no effort and unveiled plans to inject billions into the economy through asset purchases – with a minimum target of CAD 5 billion worth of debt per week. Due to the nature of the current health crisis, fiscal policy is prioritized to support the economy. The Canadian government managed to accurately identify the two pressing issues to address – depleting household income and liquidity issues for businesses. The federal government announced a 75% wage subsidy under the Employment Insurance (EI) program to discourage lay offs to prevent drastic spikes in unemployment levels. The government also announced large-scale tax deferrals to ease tax burdens on both companies and individuals amidst lower cash flows, especially those from hard-hit sectors like oil and gas. The country's total fiscal stimulus is likely to be an estimated 13% of GDP.

Soaring Sovereign Debt Levels: A Cause for Concern

The unprecedented pandemic has induced governments globally to boost spending significantly to support businesses and individuals who had been adversely affected. Heading into the crisis, Canada's federal debt-to-GDP ratio was 30.9%. As of 24th April 2020, Canada's fiscal results included CAD 146 billion in federal budgetary measures. In mere weeks of combating the pandemic, the parliamentary budget officer announced that rising budgetary deficits and sharply lower nominal GDP boosted federal debt-to-GDP to 48.4%. However, Canada's balance sheet has always been highly leveraged, with gross government debt-to-GDP ratio standing at 88% in 2019. Given the severity of the impacts of the pandemic, huge fiscal stimulus is unavoidable and considered essential for the country to be able to weather this storm.

The last time the federal debt-to-GDP ratio was above 48.4% was in 1999-2000. While it is still well below the peak of 66.6% in 1995-1996, increased spending on interest payments is worrying because this means that the government can afford to spend less on rebuilding the economy due to the interest payment taking up a larger proportion of government spending. Interest payments now represent a considerable annual expense for the federal government. For provinces like Newfoundland and Labrador, the signs are worrying as the provincial governments are spending more on interest payments (CAD 1.4 billion) than other essential aspects of the economy like education (CAD 0.8 billion).

The problem and solution are, unfortunately, one and the same - the government will have to continue borrowing to resolve the problem of soaring debt. Finance Minister Bill Morneau announced the Canadian government's plans to shift towards longer-term borrowings to finance the soaring budget deficit due to immense fiscal measures. Massive government spending and a historically leveraged balance sheet have recently induced Fitch ratings to downgrade Canada's top-tier credit rating from AAA to AA+. Fitch also expects gross government debt-to-GDP ratio to peak at around 115% by the end of 2020 as the government continues to roll out fiscal support to keep the economy afloat.

Uncertainty in the developments of the pandemic still looms as recent spikes in infection rates in the U.S. are reigniting scepticism amongst investors. Regardless, the soaring debt levels are a growing cause of concern as it determines the recovery trajectory of the Canadian economy.

Poor Oil Prices Weighing Heavily on Canada's Recovery Plans

Global demand shocks and oversupply have placed extreme downward pressure on oil prices, thus damping on the Canadian economy which is heavily reliant on the oil market. The price war between the two largest producers of oil in the world – Saudi Arabia and Russia – exacerbated the oil collapse. The price war was triggered as Saudi responded to Russia's refusal to cut oil production to curb falling oil prices. Global land and sea oil inventories started to fill up as supply far exceeded the slumping demand for crude. Oil futures took a historic plunge to negative USD 40 a barrel, largely driven by the United States Oil Fund (USO) – an oil ETF – due to a long squeeze as investors started to realize the severity of the impacts from the pandemic. Production and investment in the sector have declined sharply (Figure 14) and will remain low, which could deteriorate further based on pandemic developments.

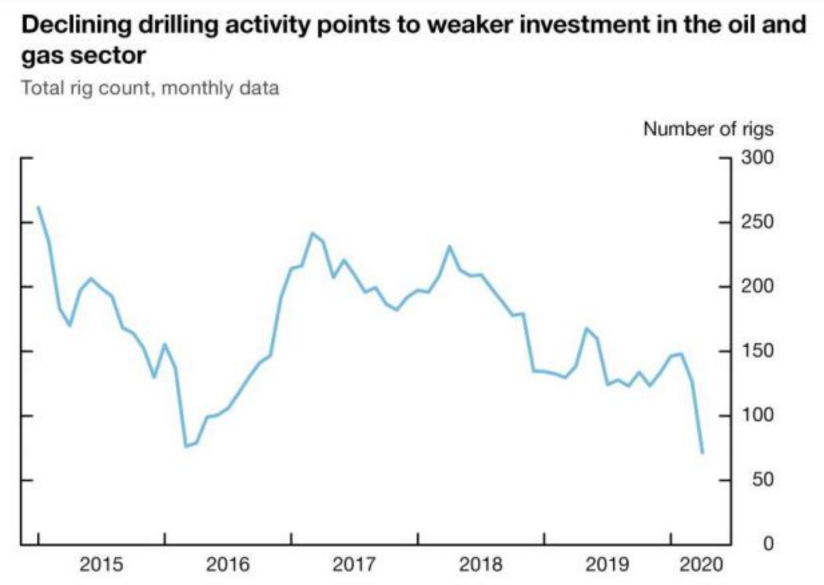

Figure 14: Drilling Activity in Canada's Oil and Gas Sector (*Source: Bank of Canada*)

The oil and gas industry is one of the major drivers of the Canadian economy, which accounted for 5.6% of Canadian GDP in 2019. The oil price collapse, driven largely by severe demand and supply shocks, is detrimental to the Canadian economy. According to a recent BoC Business Outlook Survey, sentiments within the sector are now even more pessimistic about its prospects than it was during the 2008 recession or right after the previous major oil price crash of 2014.

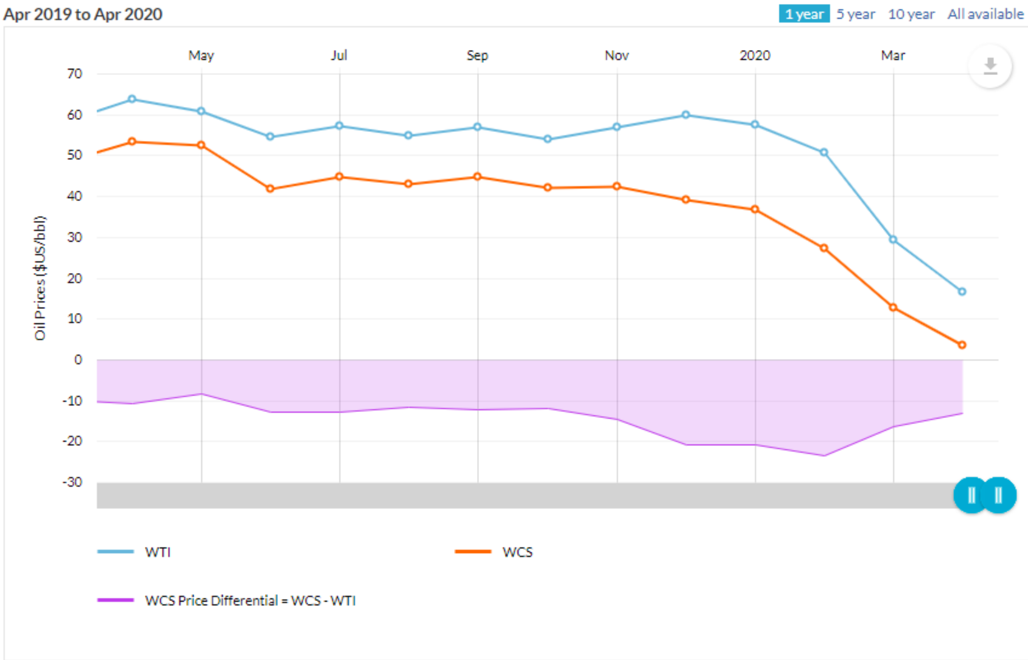

Figure 15: WTI and WCS Prices from April 2019-20 (*Source: Government of Alberta*)

Oil prices have since recovered as the markets have since largely priced in a mild recovery due to vaccine hopes rising; and oil futures appear to be in contango at the moment - an indication that investors are currently optimistic about the recovery of oil prices in the near future. However, the oil market's performance still largely hinges on the developments of the pandemic and tensions between Russia and Saudi Arabia. The relationship between Russia and the rest of the OPEC+ members remains fragile as Russia signalled intentions of ramping up production in July as crude demand improves.

In essence, we expect the Canadian economy to underperform due to sluggish recovery in the oil market. Firstly, Canadian oil production cuts are limiting the recovery of the Canadian economy. Oil production in Canada is down roughly 10% this year as major oil producers cut back on production in attempts to save oil prices from further collapse. Prices of oil futures with expiry one year from the present are currently priced at USD 38-42, still way below pre-COVID levels (Figure 16). Much damage has already been done to oil companies which are currently going through a liquidity crisis. Some Canadian energy companies have a breakeven price of USD 30-40 per barrel. At current price levels, extended periods of loss-making are unsustainable. As the backbone of the Canadian economy, the federal government is forced to extend further aid – a USD 717 million funding program to keep the oil industry afloat, thus placing further strain on government debt and spending leading up to recovery.

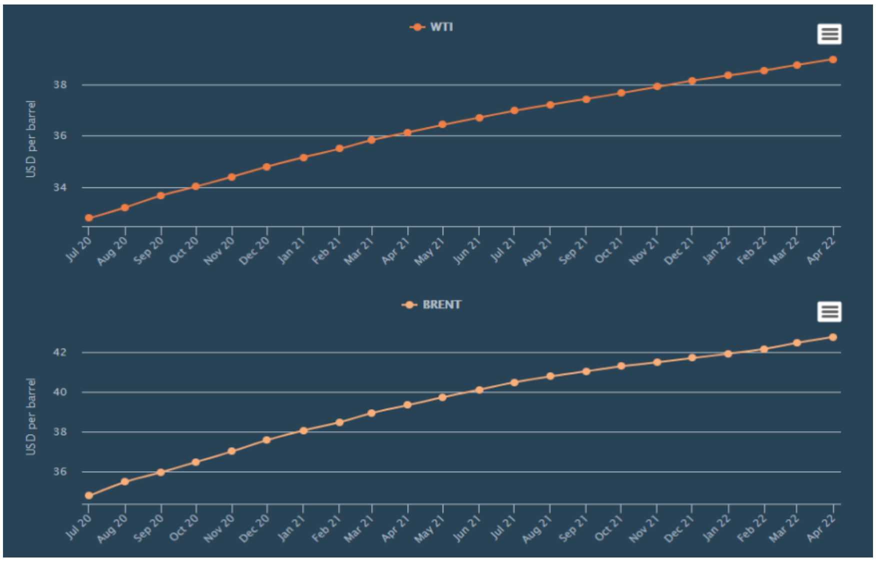

Figure 16: Brent and WTI Futures Curve (*Source: CME Group, ICE, Bluegold Research*)

Secondly, oil prices are unlikely to return to pre-COVID levels despite current optimism in the markets. In recent weeks, investors have been pricing in optimism as hopes of a vaccine discovery by the end of 2020 lifted spirits. However, as mentioned before, the second wave of infections could eclipse this period of bullish movements. In the recent weeks after the U.S. declared the reopening of their economy, there has been a sudden spike in infection cases, highlighting the undesired threat of a second wave of infections.

Moreover, it is crucial to understand the extent to which this virus has instilled trauma amongst consumers. We believe it is unlikely that major industries like the airlines and shipping – which are major demand drivers for oil – will recover to pre-COVID levels any time soon. The discovery of a vaccine also does not equate to immediate, rapid recovery of business activity. We expect a gradual ramping up on economic activity as a significant amount of time is required to validate safety in workplaces and communities.

Strong Fundamentals the Key to a Swift Recovery

The future is, unfortunately, still an enormous uncertainty. However, looking at the current state of situations, we foresee a slow recovery for Canada (as compared to other developed countries) as the federal government attempts to rebuild the economy with increased debt burdens, and a battered oil and gas market. After witnessing a sudden resurgence of infections in the U.S. shortly after the reopening of the American economy, it is undeniable that there exists a strong threat of a second wave of infections if the relaxation of restrictions occurs too rapidly. We can expect the pace of growth to be slow as economies deal with the repercussions of heavy fiscal stimulus.

Nevertheless, Canada's fiscal stimulus has proven to be rather effective in supporting the economy. Despite a historically leveraged balance sheet, Canada has dealt with it adequately and has one of the best net-debt-to-GDP ratios among the G7. In light of the spark of a new 'Cold War' between the U.S. and China, Canada seems to be relatively shielded as it is mostly dependent on the U.S. for trade. Canadian authorities have been proactive and decisive in testing, business shutdowns and enforcing social distancing. The result of such measures proved to be largely efficient and thus helped to slightly ease government debt burdens of healthcare costs and monetary support. As such, we remain Neutral on Canada's outlook.

FX TRADE IDEA: LONG CADJPY

The loonie has rebounded from April's lows after the historic oil crash. The recovery of Canada's Western Canadian Select oil prices has allowed the loonie to recover some lost ground in the past few weeks. The BoC announced that it will maintain overnight rates at 0.25% in the latest policy statement, signalling commitment in rebooting the economy through growth in output and employment. The recent surge can also be attributed to some optimistic developments within the oil market - positive developments in Russia-Saudi relations and agreements to cut production. The recent string of pessimistic news regarding inflated hopes of demand recovery and creditworthiness has induced some bearish price movement. Nevertheless, we believe that Canada has put in place effective measures to curb the spread of the virus, thus paving the way for recovery to take place. Moving forward, we are expecting the loonie to continue trending upwards as nations are exiting lockdowns and factories are starting to reopen.

Figure 17: Canadian Dollar Index (XDC) YTD Performance (*Source: TradingView*)

On the other hand, the Japanese economy has been especially hard hit by the pandemic. While Japan has lifted the state of emergency in 39 out of its 47 prefectures, the economic outlook remains gloomy due to the dual impact of the pandemic and a sales tax hike to 10% in October last year. Japan's economy has been stagnant for decades when compared to other major economies. Tourism - which has been a significant contributor to the Japanese economy - has also taken a huge hit as a result of the health crisis. The pandemic has also taken a huge toll on the manufacturing and services sector, which is exacerbated by the cancellation of the 2020 Olympics which was supposed to be held in Tokyo. Analysts are currently expecting a near 5% contraction this year.

Japan's swelling mountain of debt - currently more than twice the size of the economy - is continuing to grow, placing immense pressure on government budgets despite ultra-low yields. Creditworthiness also comes into question as debt balloons, compelling investors to consider the higher probability of default risks, thus lowering the demand for Japanese debt and hence currency. We believe that Japan's fiscal position will likely remain weak in the upcoming years, as the central bank incurs huge interest payments.

Figure 18: CADJPY Daily Chart (*Source: TradingView*)

Entry: 78.311
Stop loss: 76.553
Take profit: 83.350
Risk to reward ratio: 2.56

From a technical standpoint, the CAD has appreciated against the yen since the oil collapse in April and seems to have started a rally from May. Prices are currently pulling back towards 0.5 to 0.618 Fibonacci levels. Based on the above-mentioned fundamentals, we recommend taking a long position once price movement has rebounded off the 0.618 level and surpasses the 0.5 level. Taking a look at the MACD, it is currently signalling potential bullish reversal as the moving averages converge. We recommend taking a tighter stop loss on this pair at the moment due to uncertainties in the oil market which could be detrimental to the CAD.

BRAZIL (Underweight)

Brazil is Latin America's largest economy, with a total GDP of USD 1.84 trillion in 2019. As a country rich with natural resources, it's mineral mining industry is one of the world's giants, as well as the country's major economic driver. It is a leading producer of a basket of minerals, including exotic metals, gems, as well as fuels like crude oil. Brazil is also the world's primary source of agricultural products such as coffee, soy and cassava.

Things were not looking so great for Brazil at the end of 2019 as the global trade tensions and manufacturing slumps weighed heavily on the country's path to recovery. However, things started looking incredibly grim as the COVID-19 pandemic plagued the global economy. Brazil soon became a hotspot for the pandemic, being the second-most infected country in the world, just behind the U.S.

We held a pessimistic stance in our previous review due to poor fundamental economic drivers within the Brazilian economy. Tariffs imposed by the U.S. as well as the poor relationship with Argentina is deterring potential investments into the economy. As expected, economic indicators across the board highlighted Brazil's underperformance in the following months before the pandemic hit the country - GDP growth slowed from 0.6% to 0.4% QoQ in 4Q19, total exports plunged to 27%, and total exports slowed 30% just one month after cases in China (Brazil's largest trading partner) started emerging.

<u>Economy in Shambles Despite Record-Low Selic Rates</u>

As with the rest of the world, Brazil took an especially hard hit from this pandemic. It lost billions in trade due to China's shutdown; combined with poor leadership and living conditions, it became the hotspot for infections in Latin America. This year, the Banco central do Brasil (BCB) has already slashed interest rates from 4.5% to 2.25%, a historic low for the country. (Figure 19).

Figure 19: Selic Interest Rate (*Source: Trading Economics*)

Brazil's retail sales plunged a record of 16.8% in April as social-distancing restrictions prohibited spending. Services activity slumped a record 11.7% in April and overall consumer spending fell 6.2% QoQ. As a result, the country failed to achieve inflation targets of 4%. Annual inflation is currently under 2%, even lower than the 2.5% floor allowed for by a 1.5% margin. Analysts are also forecasting lower-than-expected inflation figures in the upcoming year as the extended period of this pandemic takes a massive toll on the economy.

Despite much fiscal stimulus and leveraging their balance sheets, we believe that the BCB will be forced to test the so-called 'lower bound' interest rates to further support the economy. Analysts are now projecting a sub-2% selic rate by the end of 2020. Considering the extent of this health crisis and low inflation figures, further monetary stimulus is required to support the economy.

Brazil in Danger, With or Without QE

In May, Brazil's Congress approved a constitutional amendment that will enable the BCB to implement quantitative easing (QE) in the country to increase the money supply in the economy. However, the BCB chief Roberto Campos Neto is reluctant to exercise QE powers which will further worsen Brazil's budget deficit. The BCB is adopting a more

The economy is on track to a 6% contraction this year as the pandemic situation in Brazil erodes consumers' and investors' confidence. Economic indicators across the board are painting an extremely depressing picture for the economy with huge risks of a debt crisis.

Industrial output crashed 27.2% YoY in April, manufacturing PMI crashed to 36 in April, from 48.4 the previous month – the lowest in more than a decade. May's figure shows a slight improvement in optimism, though still well-below 50. The BCB said its economic activity index for April, which is seen as a proxy for GDP, slumped 15% YoY.

At the time of writing, Brazil's infection curve is still showing no signs of flattening and infection numbers are still continuing to climb rapidly. Looking at the current state of things, the BCB will most likely have to use all available weapons in its arsenal to prevent the economy from falling into a depression. Despite the BCB's reluctance to expand debt burdens, the businesses and individuals will need more support as this health crisis continues to worsen in Brazil.

This pandemic has exposed many underlying structural issues of inequality and unequal access to healthcare, which are impeding the country's path to recovery. Highly cluttered communities concentrated in poor neighbourhoods with relatively poor access to healthcare makes social distancing measures more difficult to implement. Even with the discovery of a vaccine, significant amounts of time would be required to grant people access to these vaccines. In general, the solution to this immediate health crisis in Brazil is far more tedious than that of other countries. As a result, we believe there is still yet to be light at the end of the tunnel for Brazil.

Death Toll Exceeding China's? "So What?"

President Bolsonaro has been widely criticised for his handling of the pandemic outbreak in Brazil. The federal system in Brazil allows the government to easily implement lockdowns and social distancing measures to curb the spread of the virus. However, President Bolsonaro openly disregarded and discouraged such measures, causing the country to lose two important and influential ministers. The well-liked and respected Health Minister Luiz Henrique Mandetta was fired after openly criticising President Bolsonaro's actions. Within a month, Brazil lost its second health minister, Nelson Teich, after President Bolsonaro demanded the use of unproven antimalarial drugs to combat the virus. Moreover, he has called for the reopening of the economy, essentially dismissing the severity of the virus.

President Bolsonaro's insouciant attitude towards the virus seems to be affecting Brazil's containment of the virus, thus impeding its recovery. He openly criticized quarantines imposed by state governors as part of efforts to slow the spread of COVID-19, saying that such restrictions will cause more harm to the economy than the virus itself. Despite more than 1000 deaths daily, politicians are opening the country back up. While governments of other major economies in the EU or Asia have implemented strict social-distancing measures, Brazil shows little signs of social-distancing. Local isolation orders have been largely ineffective as the lack of harsh punishment has failed to deter individuals from adhering to government rules. A released tape of the cabinet's meeting revealed a remarkably worrying attitude towards solving this health crisis, triggering a public outcry. The current health crisis has catalysed the already unstable political environment within Brazil.

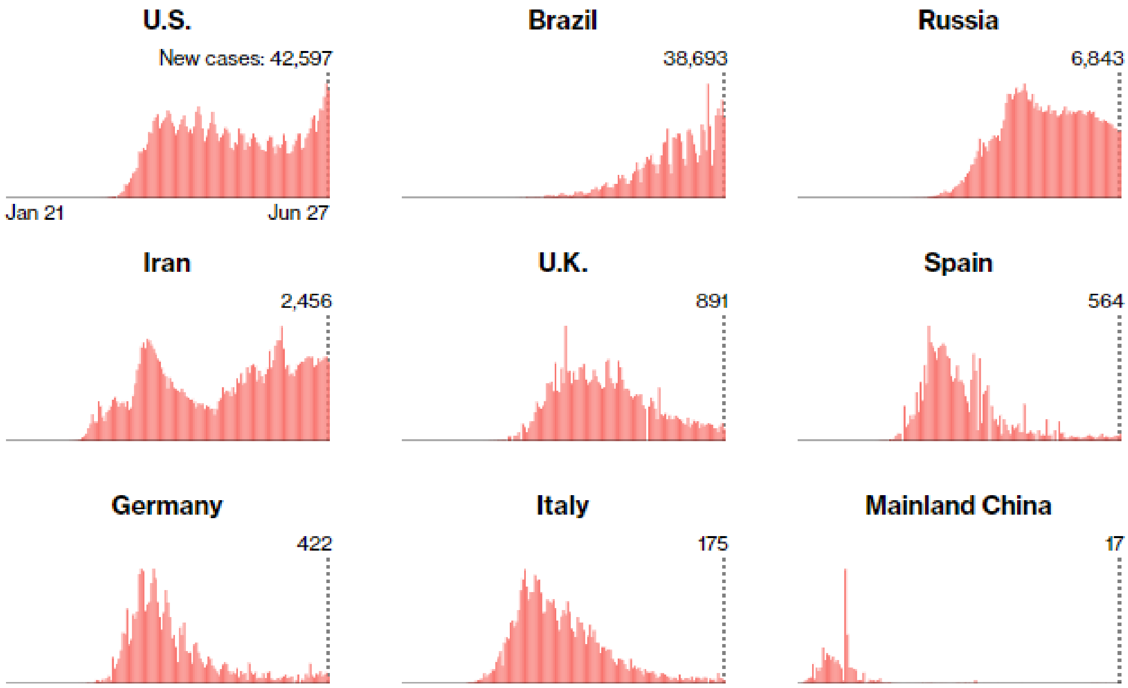

Figure 20: Cases Added per Day by Country (*Source: Bloomberg*)

We believe that the political spats involving President Bolsonaro are preventing the economy from making a speedy and efficient recovery. The unrest also serves as a major deterrence for foreign investors – of course, coupled with the high number of infections within the country. Moving forward, unless President Bolsonaro can garner sufficient investor and domestic support, Brazil will likely underperform its peers in the upcoming months.

Looming Latin American Debt Crisis as Argentina Becomes the First to Fall

Globally, central banks sprang into action implementing both monetary and fiscal stimulus to cushion the impacts of the pandemic. The BCB pledged to spare no effort in assisting the economy to weather this storm. Brazil announced USD 30 billion in fiscal stimulus in March, though it is not new spending. It is more of a range of measures to ease burdens on business owners and individuals – tax deferrals, cash aid to the poorest families. The government also declared a state of calamity, thus allowing them to spend past its previously set spending limits. The federal government also unveiled an USD 8.7 billion plan to support municipalities which included the funding of health services.

With more spending, comes a heavier burden on the government in future. Government debt to GDP stood at a whopping 75.8% in 2019. With aggressive fiscal stimulus in place, the Economy Ministry expects the ratio to surge past 90% by the end of 2020. Consequently, the central government budget deficit excluding interest payments could balloon to 9.4% of GDP. Moreover, tax revenue figures are showing a 29% decline MoM in April, lowest since records began in 2007. The market is already pricing in a large amount of pessimism with regards to a potential debt crisis, as highlighted in the more than 30% plunge in the Brazilian real (BRL) this year (Figure 21).

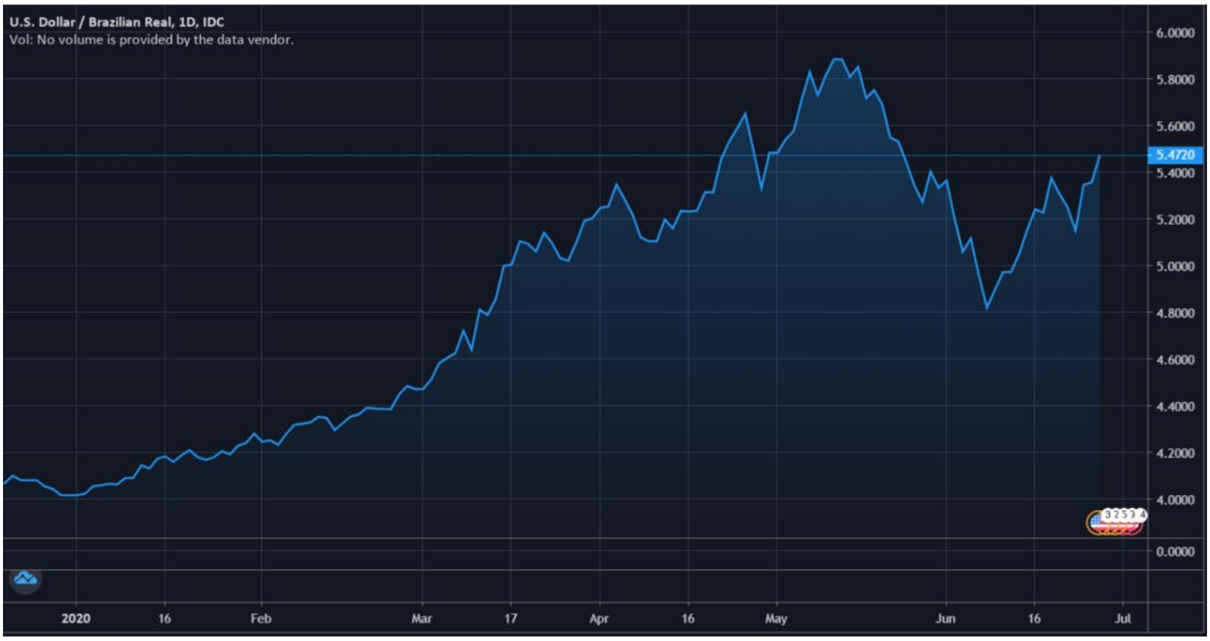

Figure 21: USDBRL Spot Price (*Source: TradingView*)

The pandemic has also stalled the once hopeful pension reforms. Brazil's pension system has been a major contributor towards the big budget deficit - Brazilians are retiring too early and with too many benefits, thus relying heavily on pensions to support their lifestyle in their later stages in life. President Bolsonaro made promises to push for major pension reforms, which initially gave investors some hope of change in the economy. Unfortunately, this pandemic has stalled these reforms and is further deteriorating the government's budget deficit.

We foresee the BRL to further depreciate in value as investments into the country continue to decrease as investors avoid higher-risk investments in this period of heightened volatility.

Real: Worst Performing EM Currency

The BRL hit highs of over 6.0000 per dollar in early May, making it the worst-performing EM currency this year - having depreciated 36% against the dollar this year. This can be primarily attributed to constant Selic rate cuts, as well as capital flight from the country as investors seek safe-haven currencies and assets and avoid the tumultuous political environment within Brazil.

In April, Brazil has witnessed the sharpest decline of foreign direct investments (FDI) in three years. Investors are increasingly worried about the severity of the pandemic within the country due to the lack of government efforts to combat the virus. Contractionary monetary policy is simply not an option. As short-term outlook remains grim, the BCB simply could not afford an interest rate hike at this point in time to attract investors as the country tries its best to stay afloat. Meanwhile, with government debt piling higher, a sudden rate hike would almost certainly lead to a default.

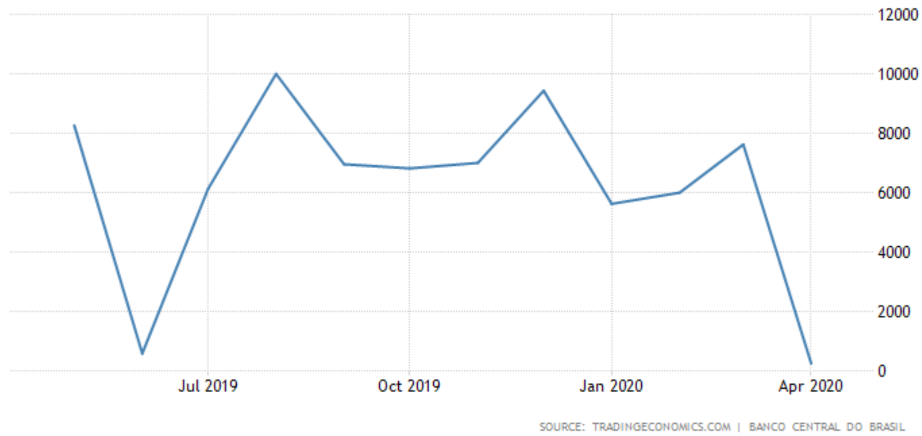

Figure 22: Brazil FDI (*Source: Trading Economics*)

China's significant shutdown, along with lower commodity prices, has placed extreme downward pressure on Brazil's exports and hence the currency. Price for Brazil's major exports - iron ore, crude, soybeans, sugar etc. - plunged double-digits as demand crashed. Prices have since made a significant recovery, especially iron ore prices, as China's demand starts to pick up in light of a flattening infection curve. Nevertheless, low prices persist thus weighing heavily on hopes of a recovery.

Figure 23: Soybeans, Sugar, Iron Ore, Brazilian Oil Prices (*Source: Trading Economics and Oilprice.com*)

Nevertheless, the future remains uncertain as countries are now fearing the second wave of infections which might cause further harm to the economies. Beijing's sudden spike of new cases has left investors sceptical about the increasing risk-on sentiment evident in the markets.

Figure 24: Brazil Export Figures (*Source: Trading Economics*)

Consumer spending in the first quarter of the year plunged 6.2%. However, the result from the second quarter is likely to be worse. Unemployment in Brazil is on a consistent rise since the start of this year to 12.6% in April. Unlike other major economies like the U.S. and Canada, the BCB cannot afford to extend as much economic aid due to their highly leveraged balance sheets. As mentioned above, the risk of a growing debt crisis is certainly on the minds of policymakers as the BCB adopts a more "defensive" stance towards heavy usage of QE.

We believe unemployment figures will continue to rise as companies continue to furlough workers to cut costs. Even if people were allowed to roam freely and make purchases, it is unlikely to spur much spending as consumer hoard cash to tide through the health crisis. Other than on the trade front, the BRL is unlikely to see any optimism in the near future.

Brazil to Face More Turbulence Before Entering Recovery Phase

Brazil's economy is still in shambles despite recovering demand for its largest trading partner. Poor living conditions and densely populated areas are continuing to catalyse the spread of the virus. The government is obliged to continue to ramp up support plans to prevent a potential depression. As we have yet to witness a peak in the health crisis, we expect Brazil to continue to underperform other EMs in the short-term.

A prolonged, gruelling road to recovery is expected for Brazil. Essentially, Brazil is lacking the basic components required for a speedy and efficient recovery at the moment. The health crisis has catalysed the erosion of government political authority as President Bolsonaro fails to recognise the severity of this pandemic. With the high number of infected individuals and the lack of a vaccine, his push for the reopening of the economy will likely backfire and result in more serious repercussions in future.

Sky-high government debt is also likely to impede the country's recovery as the government struggles to repay interest on debt. Stalled pension reforms - which have been a major contributor to poor budget deficits - have also failed to relieve the high fiscal pressure faced by the government. We believe economic recovery will take a significant amount of time as interest payments take up a larger proportion of government spending. With these major headwinds, it is difficult to picture a smooth and swift recovery for Brazil.

FX TRADE IDEA: LONG USDBRL

We suggest taking a long position on USDBRL based on the following conditions.

The greenback has always been a safe haven currency during times of crisis as companies hoard onto cash to meet short-term obligations. Over the past two weeks, the DXY has seen bearish movement, hitting a new two-month low. This is mainly brought about by vaccine hopes and the gradual reopening of the U.S. economy. However, uncertainty still lurks as tensions with China remain high as President Trumps adopts an increasingly hostile stance towards China, blaming them for allowing the virus to transform into a global pandemic.

Figure 25: DXY Daily Chart (*Source: TradingView*)

On the other hand, Brazil's economy might not have seen a bottom just yet. Domestically, the economy is incredibly fragile, primarily attributed to the factors mentioned above. Looking at the larger picture, low oil prices are placing strain on the mineral giant's trade balance. China, Brazil's largest trading partner, is starting to ramp up its factories and is entering the recovery phase. This might provide some consolation to Brazilian businesses which rely on these Chinese imports. However, we are expecting the internal chaos within Brazil to be a large obstacle the country must overcome before things start to take a turn for the better. As long as the infection rates are not slowing, coupled with the absence of a vaccine, it is unlikely that Brazil can return to pre-COVID levels of production. Furthermore, we expect more selic rate cuts to come as the government's deteriorating fiscal deficit is a cause for concern – therefore, triggering the need for further monetary stimulus instead.

Figure 26: USDBRL Daily Chart (*Source: TradingView*)

Entry: 5.3090
Stop loss: 5.0950
Take profit: 6.0000
Risk to reward ratio: 3.23

From a technical standpoint, the USDBRL has been on a bullish run since last year. Constant Selic rate cuts and high demand for the greenback has pushed the pair to 6.0000 in early May. Prices have since pulled back towards more reasonable levels as risk-on sentiments start to emerge. Looking at the Fibonacci retracement levels, prices seemed to have rebounded off the .382 level as of 28 May as evident with a bullish engulfing candle. RSI levels are currently near oversold territory and looking to rebound off the 30 level. The MACD indicator is also showing signs of bullish reversal with the flattening of the moving averages.

Based on the above-mentioned factors, we are expecting the BRL to further underperform against the dollar.

EUROPEAN UNION (Overweight)

<u>The Dreaded 'R-Word'</u>

The eurozone's economy shrank by the fastest rate on record in 1Q2020 by 3.8% QoQ, with the continent set to enter a deep recession as measures to contain the COVID-19 pandemic froze business and household activity. Germany, France and Italy entered into a technical recession with GDP dropping 2.2%, 5.8% and 4.7% QoQ respectively, following a GDP contraction in 4Q2019. Spain's GDP shrank 5.2% in the first quarter, ending more than six years of uninterrupted growth. While the record-breaking numbers and the dreaded 'R-word' may serve as attention-grabbing headlines, it is not all doom and gloom. Latest economic indicators revealed signs of a gradual rebounding and recovery of the economy, with country-wide lockdowns beginning to ease, and the engines of the industrial sector warming up again. Regardless, the labour market remains under considerable pressure, and would be the determinant for the speed of recovery in the months ahead.

The eurozone composite PMI rebounded significantly in June to 47.5, up from April's low of 13.6, albeit remaining in contractionary territory.

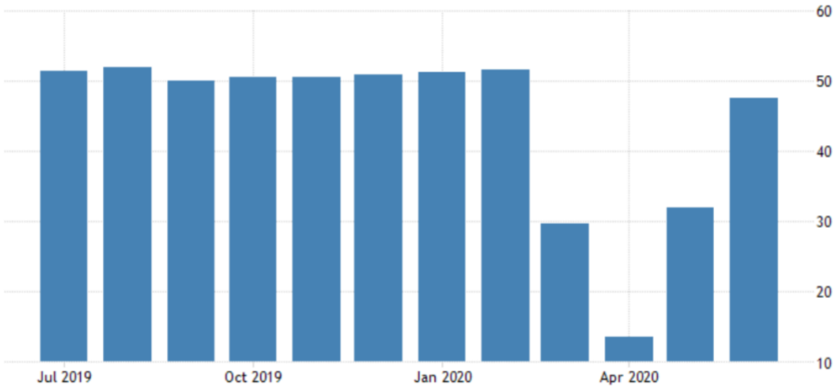

Figure 27: Eurozone Composite PMI (*Source: Trading Economics*)

Reopening of businesses has led to output growth again, but the majority of businesses are still experiencing a contraction. The restrictions that have been lifted so far across Europe, albeit modest, have caused daily activity at retail and grocery shops to recover a fair bit according to Google's mobility data and other high-frequency data, painting a more positive picture than the PMI, leading us to believe that the bottom has most probably been reached. The unemployment rate for April exceeded expectations, rebounding back to November 2019 levels of 6.6%.

Regardless, the Euro Area Economic Sentiment Indicator (ESI) has been trailing expectations, rising to 67.5 in May and 75.5 in June (against a consensus of 70.3 and 80 respectively). With the reopening of economies and the resumption of factory activity, a large improvement in sentiment was to be expected after the historic drop in April. In reality, firms remain pessimistic about the near future, even as lockdowns are lifted.

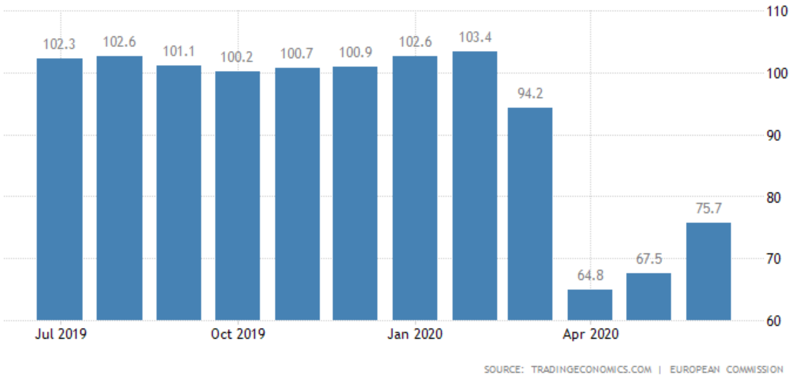

Figure 28: Eurozone Economic Sentiment Indicator (*Source: Trading Economics*)

By country, France saw a further deterioration in May before rising in June as the lockdown continued, while countries like Germany and the Netherlands saw above average improvements. Austria, which was the first to ease measures and announce an exit path out of lockdown, saw a marked improvement in economic sentiment from 61.9 to 68.8. This suggests that domestic lockdowns continue to dominate the economic situation at the moment.

Industry saw sentiment bounce back from April lows of -32.5 to -21.7 in June, while services showed signs of bottoming out - from -43.6 to -35.5 in June. The staggered recovery of the services sentiment suggests that the gradual easing of measures may have a delayed effect on the recovery of output. While service sector businesses are becoming more optimistic about demand, they may remain pessimistic about employment expectations.

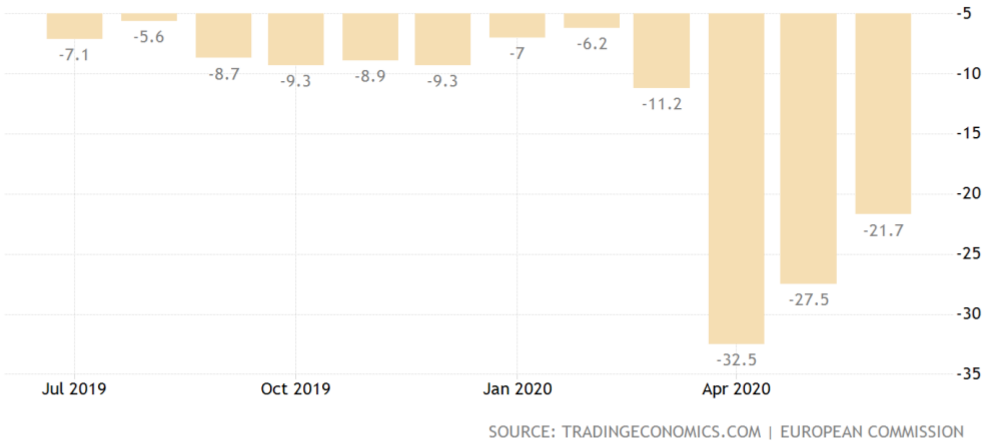

Figure 29: Eurozone Industrial Sentiment (*Source: Trading Economics*)

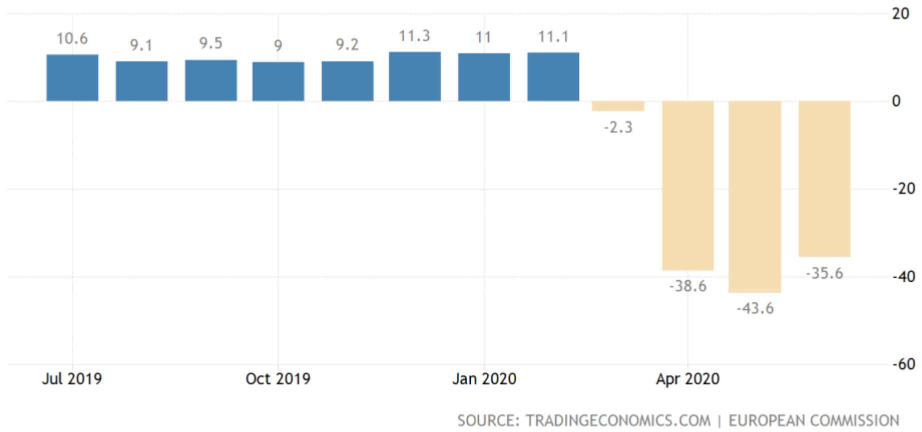

Figure 30: Eurozone Services Sentiment (*Source: Trading Economics*)

The simultaneous slowdown of both the industry and services sector eradicated whatever little optimism that remained of the resilient services sector spearheading the rebound of the eurozone economy, after signs of a bottoming out of the sluggish industry sector were seen in the first two months of the year.

The overarching theme is that the economy is not going to go through a V-shaped recovery, and higher unemployment will only drag out the recovery phase. At the same time, businesses are indicating very weak price pressures at the moment, making deflation in the short-run and more deflationary pressures in the medium-term a likely scenario.

Inflation in the Euro area showed early signs of recovery, up from 0.1% in May to 0.3% in June, as the lingering impact of a decline in oil prices tapered off. Whereas, core inflation ticked down to 0.8%, painting a more accurate picture of the deflationary forces from the economic damage of the pandemic. We believe inflation will continue to be depressed, providing room and setting the stage for the ECB to act "rapidly and powerfully", as put by Banque de France's Villeroy.

Figure 31: Eurozone YoY Inflation Rate (*Source: Trading Economics*)

Figure 32: Eurozone YoY Core Inflation Rate (*Source: Trading Economics*)

ECB's 'Whatever It Takes'

In the ECB's March meeting, the bank had unveiled plans to buy an extra EUR 750 billion of bonds and issued a "no limits" commitment to defend the eurozone, as a response to the worsening economic and financial turmoil caused by the pandemic. The plan, dubbed as the "Pandemic Emergency Purchase Plan" or PEPP, is set to carry out the extra asset purchases in 2020. In addition, the ECB had also decided to expand the range of assets eligible for purchase to non-financial commercial paper, and to ease its collateral standards to allow banks to raise money against more of their assets, including corporate finance claims. The PEPP is on top of additional net asset purchase of EUR 120 billion until the end of the year.

For the April meeting, ECB staff had prepared three different scenarios, with real GDP in 2020 dropping by around 5%, 8% and 12% under the mild, medium, and severe scenarios respectively. The shape of the recovery highly depends on assumptions of epidemiology of the virus, effectiveness of containment measures and lifting of the measures, as well as permanent damage caused by the measures.

April data for the ECB revealed another massive month for bank lending, with non-financial corporates seeing an inflow of EUR 70 billion, after March's record month of EUR 117 billion. The massive take-up of liquidity suggests that bank lending support through Targeted Longer-Term Refinancing Operations (TLTROs) remains a key part of the emergency support delivered, along with the PEPP and PSPP, in boosting money supply to keep conditions as loose as possible. The ECB had eased the conditions of its TLTRO III earlier in April, by 25bps from a -0.25%/-0.75% range to -0.50%/-1.0% range and loosened the criteria for banks to benefit from the lower rate, in addition to introducing the Pandemic Emergency Longer-Term Refinancing Operations (PELTRO), providing potentially unlimited liquidity to banks at an interest rate of -0.25% for one year.

Figure 33: ECB Liquidity Injections Through Time (*Source: ECB, ING*)

In an unprecedented move, the German Constitutional Court on 5th May 2020 ruled that the ECB's quantitative easing (QE) programme, or Public Sector Purchase Programme (PSPP), did not respect the "principle of proportionality", failing to "conduct the necessary balancing of the monetary policy objective against the economy policy effects, exceeding the monetary policy mandate", requiring the ECB to explain why the government purchases were needed. The Court asked the Bundesbank, Germany's central bank, to stop buying government bonds under the ECB's stimulus programme in the next three months. Such a decision by the Court, as well as the possible exhaustion of the EUR 750 billion envelope of the PEPP programme by October will demand an intense discussion on a possible increase to the programme. The ECB will also have to decide how to continue the PSPP without Bundesbank participation.

With the German Court's ruling, it gives the ECB freedom to act in any event-driven action, but not so much in a general "the economy still needs monetary stimulus" sense, which could motivate the ECB to increase the PEPP while the eurozone is still dealing with the pandemic, rather than when the worst is over.

Sure enough, the ECB in its June meeting decided to increase the size of its PEPP by EUR 600 billion (exceeding market expectations of EUR 500 billion) to a total of EUR 1350 billion, with the purchases set to last at least until the end of June 2021, versus the original end date of end-2020. In addition, the ECB will reinvest the proceeds from the PEPP purchases until at least 2022. The ECB also largely disregarded the German Court's ruling, emphasizing that the ECB falls under the jurisdiction of the European Court of Justice, which had judged that its QE has been in line with the ECB's policy mandate. The ECB's decisions make it clear that the central bank has little tolerance for any increase in European bond yields and are focused on providing additional room for regional governments to continue to ramp up fiscal spending to support their domestic economies.

European Commission Lends a EUR 750 Billion Helping Hand

The European Commission (EC) on 27th May 2020 proposed a EUR 750 billion fund to help Europe recover from the pandemic. The fund would be made up of EUR 500 billion in grants and EUR 250 billion in loans and is set to be spent on measures over 2021 to 2024. The EC aims to raise the capital through issuance of 3Y to 30Y bonds, and the debt would be repaid out of future EU budgets (aka future member state contributions or EU-wide taxes) from 2028 to 2058.

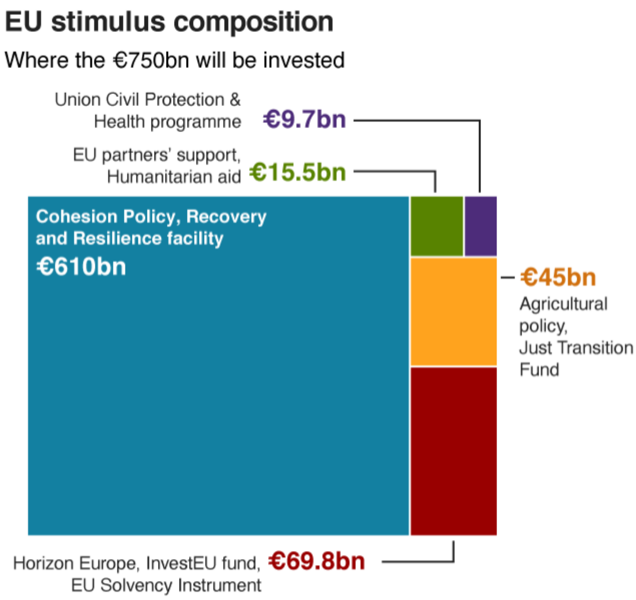

Figure 34: Composition of the EC's 750b Stimulus Package (*Source: European Commission*)

Italy and Spain, both hit hard by the pandemic, would be the main beneficiaries of the fund, being eligible for EUR 172 billion and EUR 140 billion respectively. Germany and France, along with the Frugal Four (Austria, Sweden, Denmark and the Netherlands) are set to be the main contributors to the fund.

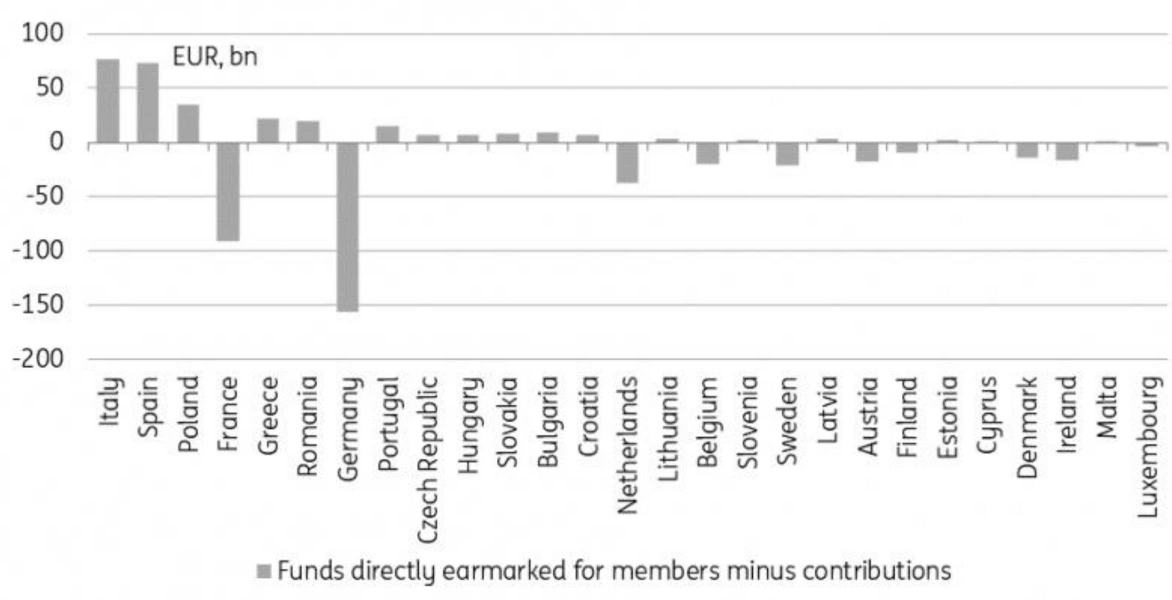

Figure 35: Net Allocation of EU Recovery Funds (*Source: ING*)

However, fierce negotiations are set to lie ahead as member states have yet to unanimously agree on the fund, with crucial points including whether the money disbursed will be as grants or loans. In addition, the Frugal Four remain sceptical of the plan and raised their own proposal for a fund including just conditional loans.

Worst May Be Over for Germany, but Growth Ahead Set to Remain Subdued

Germany had narrowly avoided a technical recession in 2019 with a growth of 0.3% QoQ in Q3 after shrinking 0.2% QoQ in Q2. However, reality quickly set back in when the economy went back into contraction territory in Q4, ending off the year on a disappointing note. Plagued with a slowdown in its manufacturing sector threatening to spill over to its then-resilient labour market, the nation entered 2020 on hopes of a rebound.

However, the COVID-19 pandemic pulled the rug out from under the feet of the German economy, registering a decline of 2.2% QoQ in 1Q2020 – the sharpest rate of decline since the height of the Great Financial Crisis in 1Q2009. With this, 2.5 years of cumulative GDP growth was wiped out and the German economic output fell back to levels last seen in mid-2017, even though the pandemic restrictions only took full effect in the last two weeks of March.

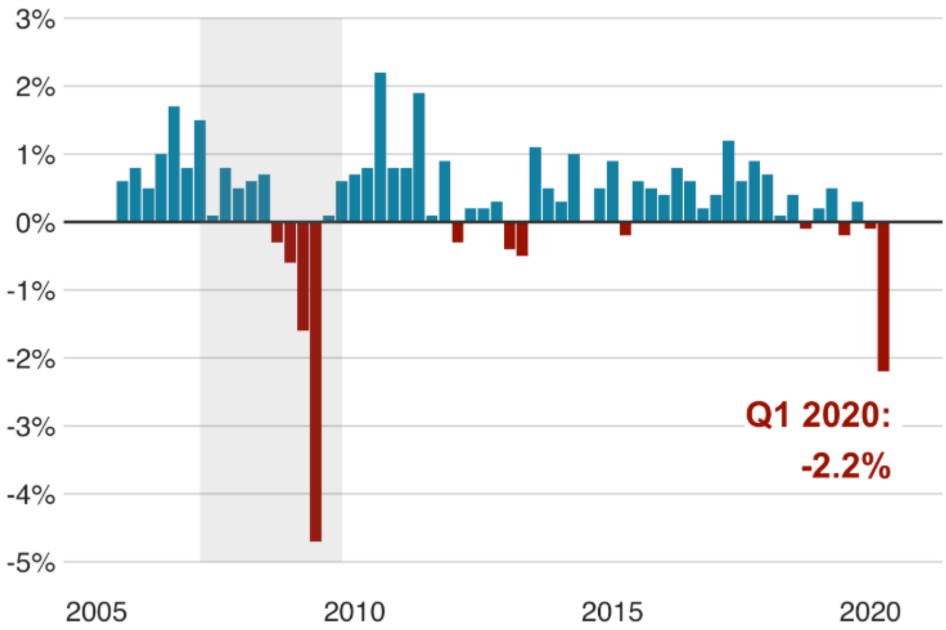

Figure 36: Germany's QoQ GDP Growth (*Source: German Federal Statistics Office, BBC*)

The drop in its economic activity, however, was not nearly as bad as the other European powerhouses such as France and Italy which saw staggering declines of 5.8% and 4.7% respectively. Both nations were more heavily affected by the virus, necessitating a stricter and longer lockdown, alongside the fact that their services sector (tourism in particular) contributed to larger proportions of GDP (79% and 74%) as compared to Germany (68.6%). In addition, Germany's decision to allow factories and construction sites to stay open, with estimates showing that German manufacturers are running at as much as 80% capacity, may have further cushioned the impact relatively.

Regardless, the impacts of the slowdown were hard-hitting, with German industrial production plummeting 9.2% MoM in March and 17.2% MoM in April, marking the steepest declines on record. Manufacturing PMI however painted a rosier picture of recovery, rising from April lows of 34.5, before rebounding to 45.2 in June. Services PMI told a similar story, cratering to 16.2 in April before rebounding back to 45.8 in June.

The country's industrial sector had already been mired in recession for six quarters before COVID-19 broke out, beginning back in 3Q2018. There had however been signs of a potential recovery in German industrial activity, where order intake stabilised in the second half of 2019, and the downtrend in the order backlog faded.

Figure 37: German Manufacturing Output and Orders, 2015=100 (*Source: Federal Statistics Office, Deutsche Bank Research*)

With the onset of the effects of COVID-19 however, business expectations cratered and the rise in both domestic production and industrial orders in January and February are set to be reversed.

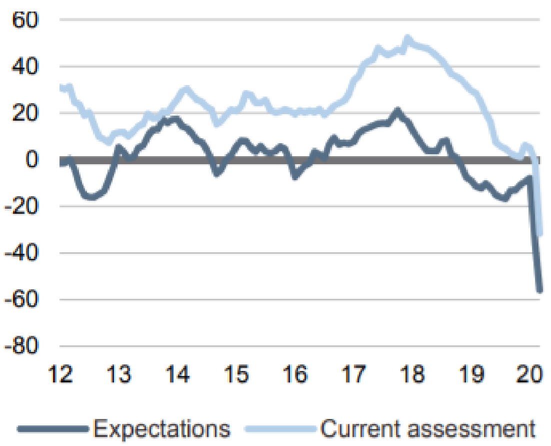

Figure 38: Manufacturing Industry Business Expectations Experiencing a Sharp Decline (*Source: Ifo Institute, Deutsche Bank Research*)

Moving forward, in 2H2020, we may expect some catch-up effects as containment measures gradually ease, although certain restrictions may still continue to apply such as the ban on major events. We may also begin to see the impacts of the German government's EUR 1.1 trillion rescue package, which was greenlighted on 1st April 2020. The massive package includes state-backed loan guarantees, support for businesses and the health system, and schemes to put millions of workers on reduced hours to avoid layoffs. Workers forced to stay at home due to the pandemic and government measures would also stand to receive close to three quarters of their net salary. Plans for tax cuts and heavy rebates for businesses are also currently in consideration. In addition, Germany's coalition government announced in early June an additional EUR 130 billion stimulus package for 2020 to 2021, including a temporary drop in VAT, electric vehicles incentives and more financing for corporations. With its focus on consumption incentives and government spending, the stimulus is also set to have knock-on effects on imports from other EU countries.

With China's industrial production gradually getting back underway and seeing a mere 1% fall YoY in March, Germany should start feeling a positive stimulus from demand in the near future. International demand for industrial goods is also set to pick up as individual economies return to work, and the German economy stands to benefit from this revival in activity more than other European countries.

The key downside risk would be a sluggish recovery in German domestic demand due to lingering economic uncertainty and widespread job fears prompting consumers to hold back on major purchases for the time being. In addition, for an export-oriented German industrial sector, the asynchronous global economic recovery and the resulting subdued recovery in global trade is also likely to weigh on prospects for German exports in the upcoming quarters. With close to 20% of German value-add being generated via international supply chains, and with the rest of the EU being their largest trading partners, the uneven economic recovery in Europe could thus delay the supply chain restart of an "early opener" like Germany. Such a scenario would stifle the recovery in German production and provide headwinds in the months ahead.

Italy's Debt Crisis Back in Focus

Italy stepped into 2020 on unstable footing off the back of a government reshuffle after its political shake-out in August and September 2019, still reeling from the resignation of Five Star leader Luigi Di Maio. The January 2020 regional elections continued to put pressure on its volatile political landscape, before the pandemic swiftly diverted the markets' attention away from its politics and placed it under global spotlight as the first nation outside of Asia to be hit hard by COVID-19. Already facing a contraction in economy activity in 4Q2019 on the back of poor domestic demand, the pandemic dealt a brutal blow to the nation's economy, with tourism which accounts for at least 13% of the nation's GDP being the first domino to fall.

The Italian government was swift to act, implementing lockdowns and restrictive measures to curb the spread of the virus, alongside EUR 25 billion worth of measures to tackle short-term emergencies and to cushion the shock of the immediate economic consequences of measures, in addition to rollouts of further economic support for enterprises and employees.

Regardless, the brunt of the economic impacts has already begun to manifest. Italy slipped into a technical recession with a 4.7% QoQ fall in GDP in 1Q2020, with consumption and gross fixed capital driving a steep contraction. The outlook for 2Q2020 is likely to be even weaker, as lockdowns only began to ease on 4th May 2020, with retailers opening on 18th May 2020, and bars and restaurants on 1st June 2020. Industrial production plunged by an eye-watering 28.4% MoM in March, and a further 19.4% MoM in April. The story is not that bleak however, with manufacturing PMI indicating a strong rebound back to 47.5 in June, up from April's low of 31.1.

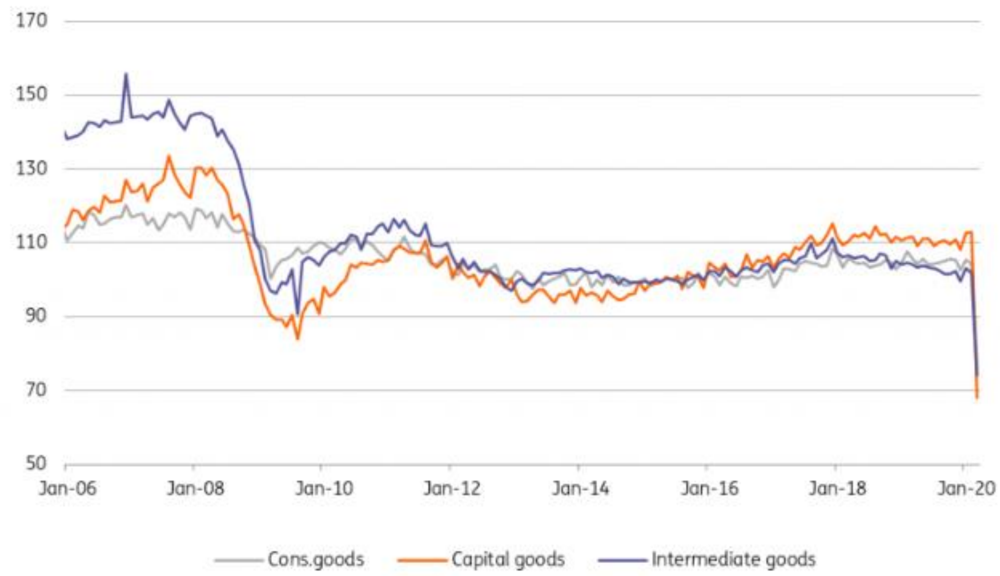

Figure 39: Visualisation of the Extent of Fall in Consumer, Capital and Intermediate Goods (*Source: Refinitiv Datastream, ING*)

While the slowing infection rates offer a brighter outlook that lockdown measures are helping and the economy is primed for a rebound, it has also shifted the longer-term outlook back into focus, which in Italy's case involves a highly indebted government amid a politically fraught environment, painting a much bleaker future. As it stands, Italy's public debt to GDP ratio is at 135%, higher than it was in 2012 while its banks' balance sheets were clogged with non-performing loans and Italian government bonds.

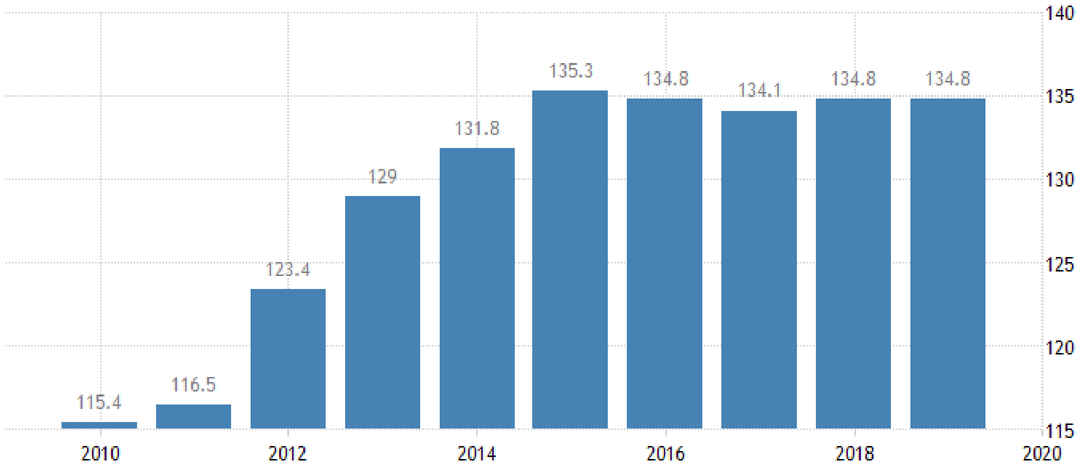

Figure 40: Italy's Government Debt to GDP (*Source: Trading Economics*)

At current forecasts of the euro area's nominal GDP shrinking by 10 percent as compared to 2019, and budget deficits to worsen by 10 percent, Italy's debt, currently the largest in Europe at EUR 1.7 trillion, would rise to 158% of GDP, the highest level since World War II. This inevitably re-raises questions on the sustainability of the public finances and health of the banking system of a country that was already in a precarious balance between high debt and no growth before the pandemic.

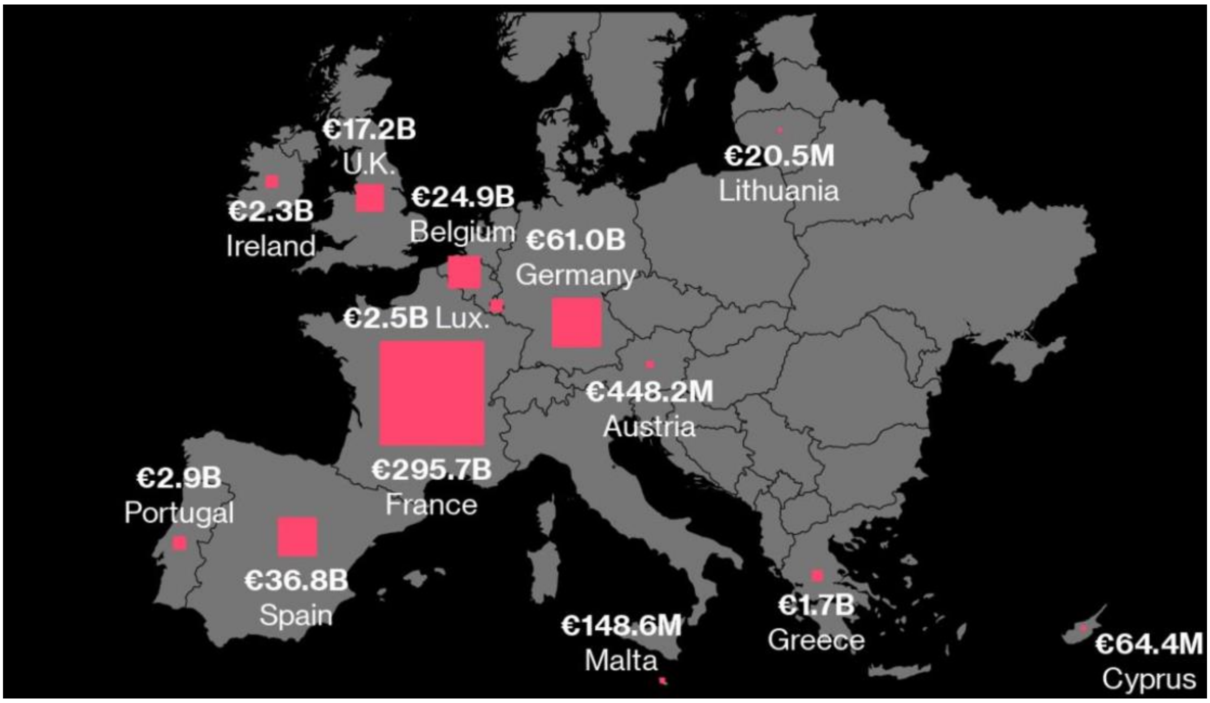

Figure 41: Total Credit Exposure to Italy Among Non-Italian EU Banks, as of June 2019 (*Source: Bloomberg*)

Former ECB President Mario Draghi had argued in a recent piece in the Financial Times that high sovereign debt/GDP ratios would become the norm at least for the time being and called for full mobilisation of entire financial systems to stymie its possible collapse and its ripple effects through financial contagion.

As of now, the bold EU recovery plans along with the prospects of expansions in the ECB's purchase capacity have provided a decent tailwind to Italian bonds, with Italian debt making up a third of the ECB's asset purchases in March. The country's ever-increasing debt-to-GDP burden has to be resolved permanently at some point in the future, and that can only come from sustained growth, but in the short-term, the ECB's monetary response has proved to quell calamity in the bond markets for the time being.

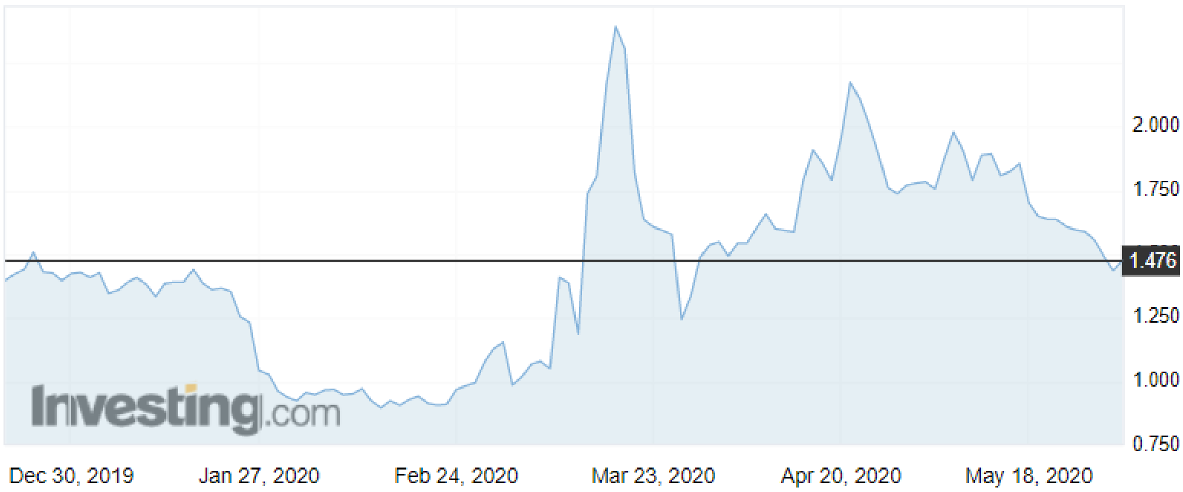

Figure 42: Italy's 10-Year Bond Yield Rising Sharply at the Peak of COVID-19, Before Showing Signs of Recovery (*Source: Investing.com*)

Sovereign spreads have also been on a tightening path as a result, driven by the return of carry-oriented investors now that volatility in rates have eased.

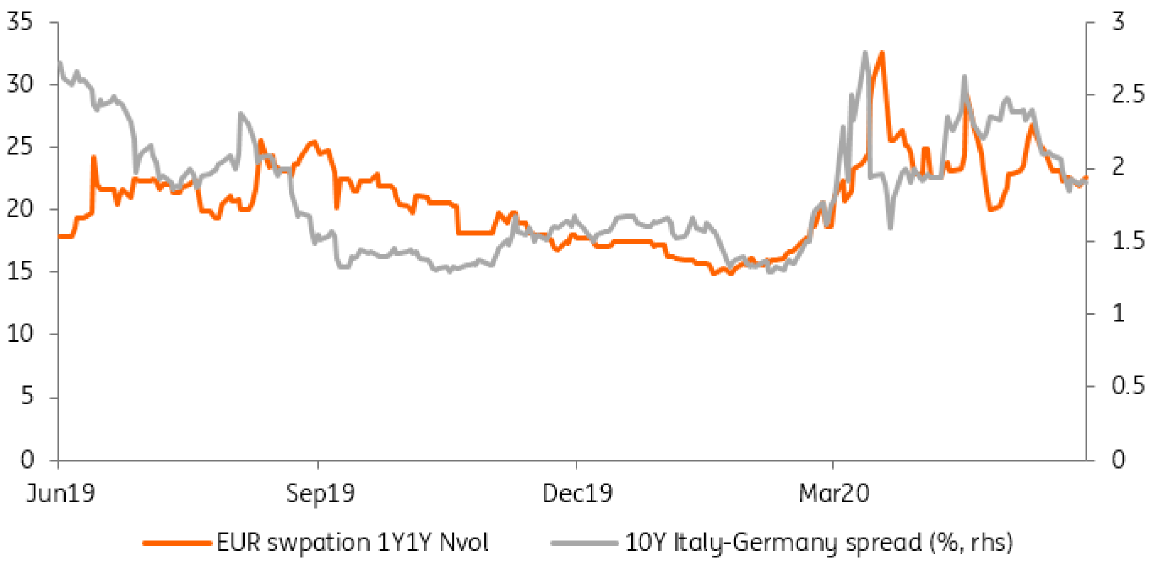

Figure 43: The BTP-Bund Spread Tightens After Strong Fiscal Action from the ECB and a Gradual Shift Back into a Risk-On Sentiment (*Source: Bloomberg, ING*)

Moving forward, medium-term risks are skewed to the downside with the threat of a second wave later in the year remaining real, but fiscal support from the ECB for now continues to provide a strong bastion for Italy, with spreads pointing to a gradual recovery in sentiment.

Significant Contraction in France Caused by Trouble After Trouble

France was expected to outperform with higher quarterly growth rate as a result of strong business growth and positive consumer sentiment rebounding. Moreover, with President Emmanuel Macron's reforms, 2020 was supposed to be the new era for France as the economy has experienced economic growth towards the end of 2019, with timely tax cuts and less reliance on exports.

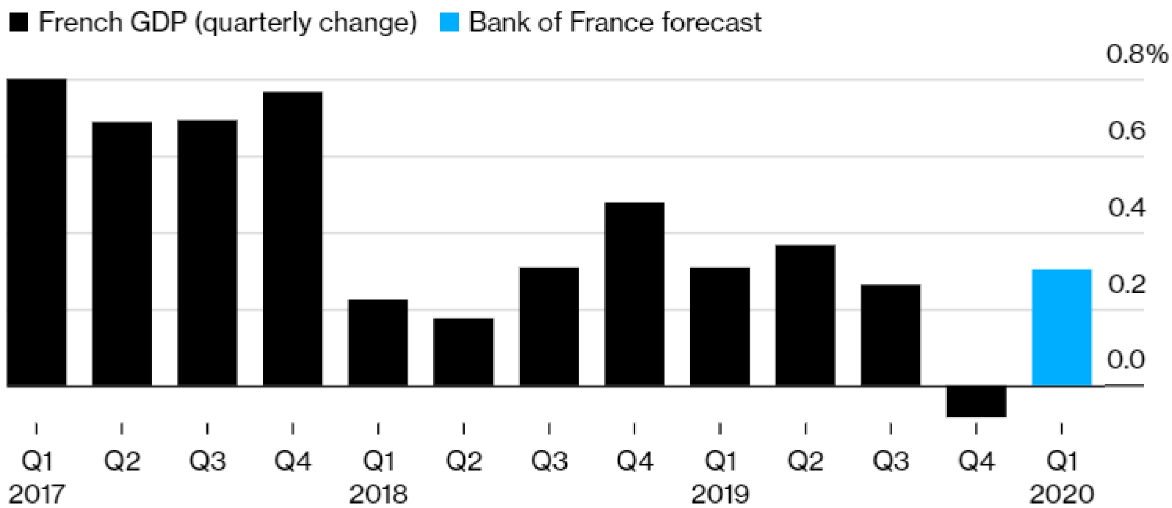

Figure 44: France's Quarterly GDP Change (*Source: Bloomberg*)

Unfortunately, France made headlines globally at the end of 2019 as public transit workers went on a strike amidst the festive season of Christmas. Compared to a year ago, sales in France had fallen by about 10%. According to France's General Confederation of Labour, more than 1.5 million workers had taken part in the demonstration. This had largely contributed to the fall in GDP in Q4 as France's GDP slipped by -0.1% (Figure 44), as retailers and restaurants bore the brunt of the loss in activity from the crucial year-end holiday season. The optimism that the French economy is expected to rebound quickly had been quickly destroyed as fast as the COVID-19 pandemic took the nation.

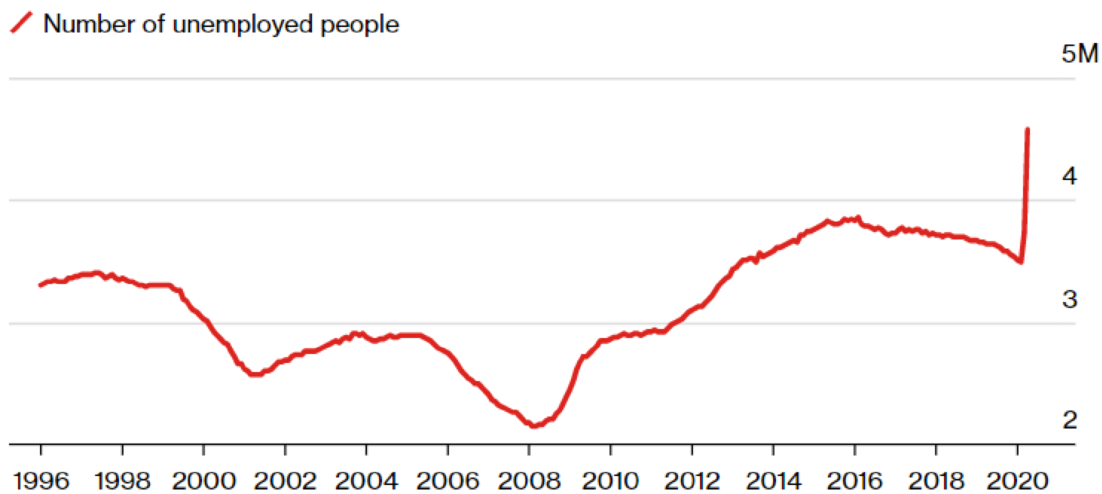

Figure 45: Number of Unemployed People in France (*Source: Bloomberg*)

Again, France took headlines globally early this year for the wrong reasons, as France became one of the hot spots for the COVID-19 pandemic as early complacency and negligence caused a rapid increase in infection cases. As recession begins to loom in France, the French unemployment rate has also been increasing significantly as the French unemployment claims jumped 22% in April, with 843,000 more people seeking work and companies not actively hiring, and the total number of unemployed people is nearing 5 million.

French GDP fell by a striking 5.8% in the first quarter and is the biggest drop since 1949 as the National Institute of Statistics and Economic Studies unveiled in its first estimate. This is in stark contrast to the previous recession in the first quarter of 2009, which saw a relatively small contraction of 1.6%. This sharp fall in GDP is linked to the necessary evil of shutting down 'non-essential' activities in the implementation of the lockdown.

Bruno Le Maire, the Minister of the Economy and Finance, said that France is expected to spend around EUR 24 billion on unemployment benefits and the total emergency spending could exceed EUR 100 billion if necessary.

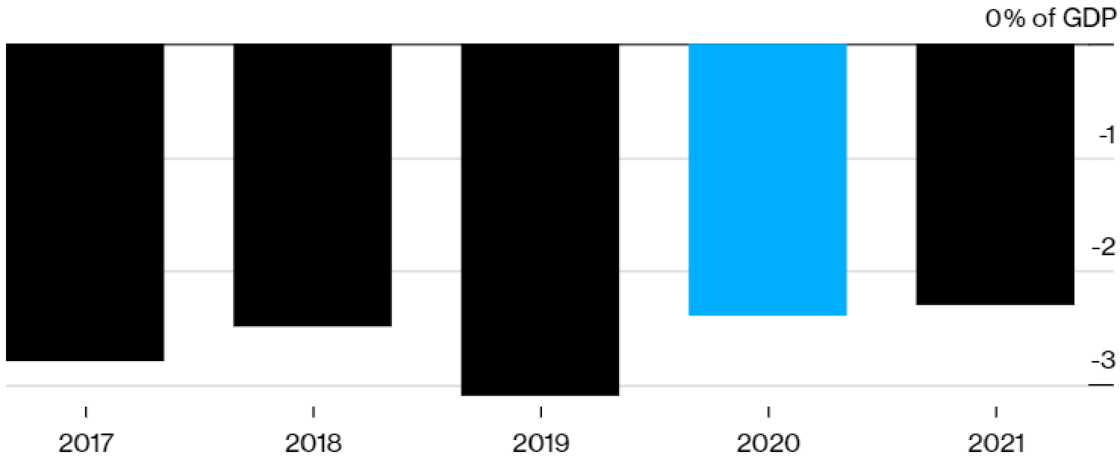

Figure 46: France Budget Balance (*Source: Bloomberg*)

As a result of the prolonged protests and the impacts from the COVID-19 pandemic, President Emmanuel Macron tacked away from consolidating finances at the end of 2018 by unleashing EUR 17 billion of tax cuts, which have contributed to keeping public debt near 100% of economic output. As shown in figure 46, the forecasted budget deficit is estimated to be at -2.4%. This means France is now left with little margin for further stimulus if necessary.

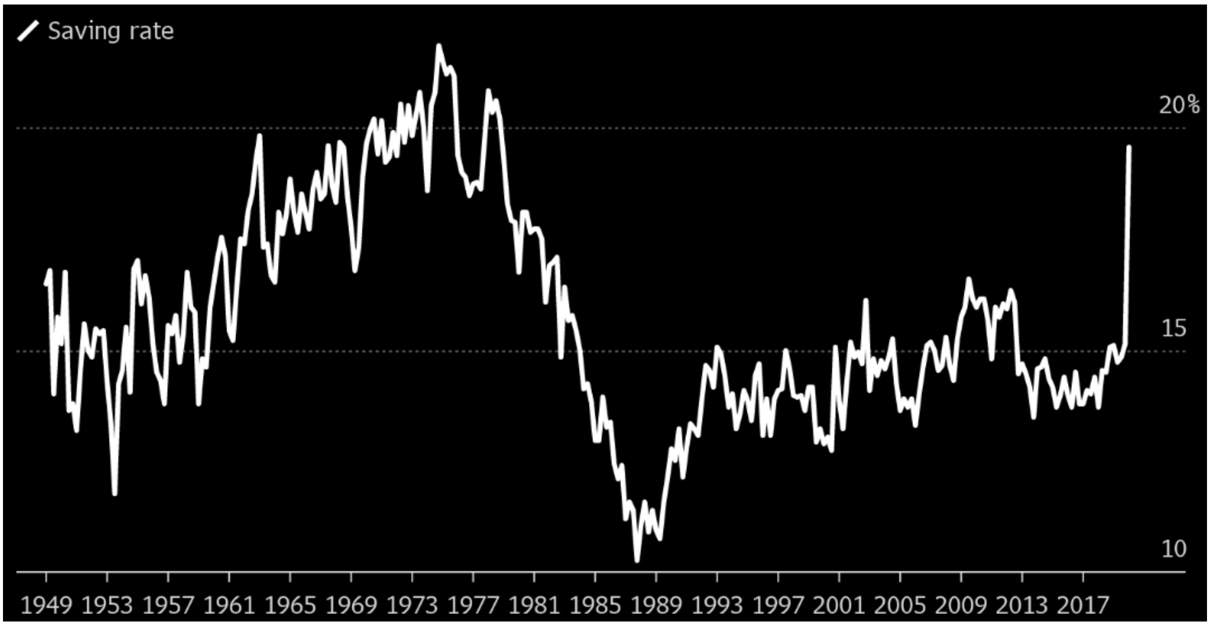

Figure 47: French Savings Rates Surge (*Source: Bloomberg*)

In line with the technical recession, the general demand in the French economy has further decreased as French savings rates surged (Figure 47), to 19.6% in the first quarter from 15.1% as consumers cut back spending in the lockdown and prepared for difficult times ahead.

FX TRADE IDEA: LONG EURUSD

Figure 48: EURUSD Weekly Chart (*Source: TradingView*)

Entry: 1.1025
Take profit: 1.1813
Stop loss: 1.0770
Risk to reward ratio: 3.09

Fundamentally, the long-term outlook for the EUR is propped up by a solid framework of monetary support by the ECB and the EU member nations' governments. The impacts of the forecasted PEPP expansion along with the Franco-German plan for a EUR 500 billion Recovery Fund are set to lay the groundwork for an eventual rebound of the economies, albeit gradual and muted. Although divisions between the economically conservative (i.e. Frugal Four) and the less frugal South (Italy and Spain) remain wide, current plans in motion by the ECB and France and Germany would help to dispel doubts for now.

On the premise of a broader global recovery, we may see a risk-on sentiment and the outflow of the dollar toward higher-yielding and perhaps faster-growing economies. In addition, with the flood of liquidity unleashed by the Fed, excess reserves parked at the Fed could see a reallocation into EM portfolios later in the year. It must be noted that these are under the assumption that the untimely renewed U.S.-China trade tensions do not completely derail the risk environment.

From a technical analysis point of view, the EURUSD has generally been ranging which could suggest that the pair has been ranging and can signal a potential breakout to either side, especially after volatile movements in the past few months triggering a high number in the Average True Range indicator. There have also been two bullish White Marubozu candles, and the second one has decisively broken above the long-term downtrend since 2018.

EURUSD may find buying pressure when it touches the previous downtrend trend line, which is going to be used as the entry level for this trade idea. The Stop Loss would be at the break of the support level at 1.0770. The Take Profit would be at the next strong resistance level which is in confluence with the 61.8% Fibonacci retracement level measured from the previous high and the previous low on the chart. The trade idea would have further confirmation if the price retraces to the previous downtrend trend line and the 20MA crosses above the 50MA.

SWITZERLAND (Overweight)

The Era of Low and Negative Interest Rates

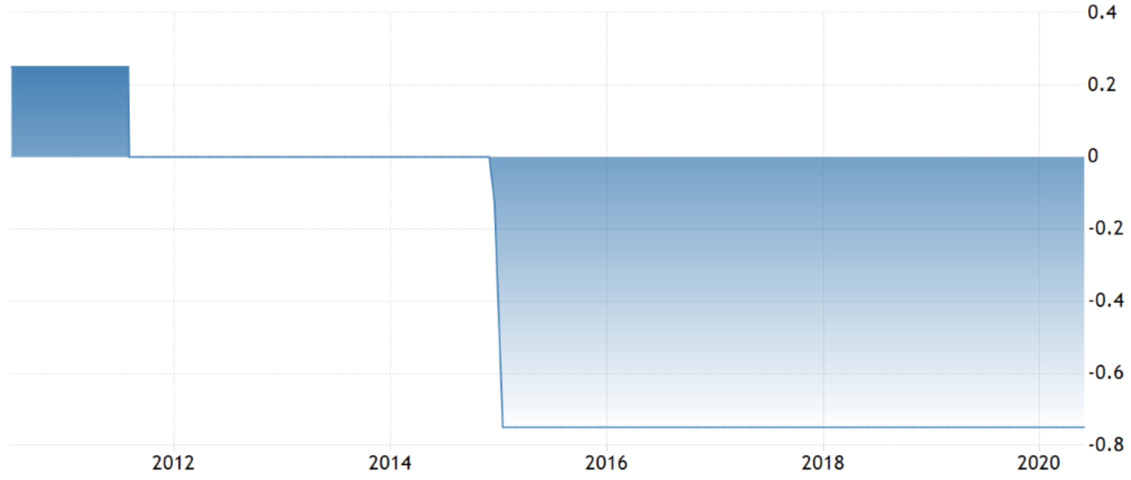

Figure 49: Switzerland's Interest Rate (*Source: Trading Economics*)

As discussed in the previous report, the interest rate of Switzerland has been at -0.75% since 2015, even with the outbreak of the COVID-19 global pandemic that has caused rapid rate cuts for countries around the world, including the U.S. and Australia, with rate cuts of 100bps and 25bps respectively. It seems like the Swiss National Bank (SNB) has found a sweet spot of -0.75%, or rather a level that the SNB realised would not be wise to go lower.

The SNB said it was going to step up its currency interventions to prevent the further rise of the CHF, as it has previously risen significantly as a result of the global trade war. Coming into 2020, the central bank has stated that the CHF has become "even more highly valued" due to the COVID-19 outbreak and the world's financial markets being under strong pressure. During the recent monetary policy assessment, the SNB has decided to maintain its expansionary monetary policy and kept both its policy rate and interest rate for overnight deposits at -0.75%, which are as forecasted by analysts.

Even with the rate cuts around the world, the Swiss Franc (CHF) has generally been trading at a range-bounded level. For instance, apart from the rapid movement of the United States Dollar (USD) during the initial financial markets crash around March 2020, the USDCHF has generally been trading at the levels between the range of 0.9600-0.9800.

The SNB has been confidently betting that no other country would challenge the SNB's low rate of -0.75%. What this means is that as long as other countries do not venture into the negative territories, the CHF would continue to remain relatively weak, which is beneficial for Switzerland's exports, since Switzerland has a positive trade balance of USD 12 billion in net exports.

We believe that at the status quo if the other major economies do not dip into negative interest rates territory, the SNB is likely to maintain its interest rate at -0.75%. The SNB is not likely to raise the interest rates anytime soon especially when the other countries' interest rates are at a record low. Moreover, the SNB is also not likely to lower the interest rates any further as even with the COVID-19 crisis, it has proven that there is great resistance in further lowering the country's interest rate deeper into negative territory, as this may cause greater damage to the economy in the long run as negative interest rates hurt the Swiss banks' profits and other forms of financial uncertainty as a result of challenging risk-based pricings.

Further Decline Expected in Switzerland's GDP

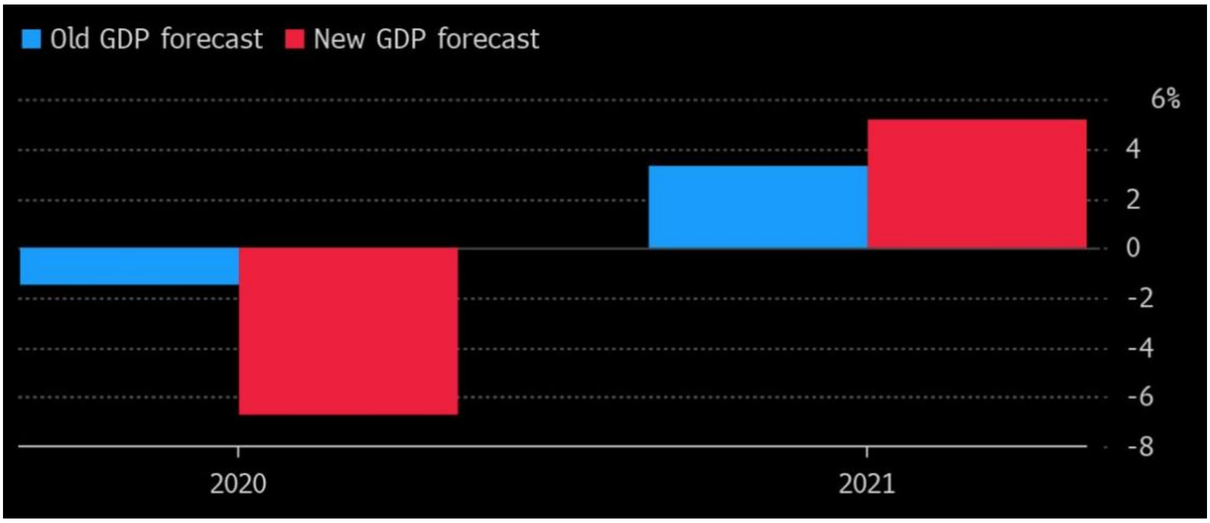

Figure 50: Swiss GDP Is Set for Its Sharpest Fall in Decades (*Source: Bloomberg*)

As seen in figure 50, Switzerland's State Secretariat for Economic Affairs has slashed its GDP forecast to shrink by 6.7% in 2020, faring worse than it did in the previous financial crisis of 2009. First and foremost, the global GDP is going to take a toll as a result of the COVID-19 crisis. Furthermore, in the forecast of the previous report, Switzerland was already expecting a fall in GDP. This is largely due to the slowdown in economic growth and forecast for 2020 has previously declined from 1.8% to 1.4%, according to Credit Suisse, prior to the economic destruction caused by the COVID-19 pandemic. reduced service exports due to a drop in demand for tourism and events.

With a low growth before the COVID-19 pandemic, Switzerland is headed towards a severe recession this year due to the economic fallout of COVID-19. Analysts from UBS bank have forecasted a GDP drop of 1.3% this year if the virus is generally contained in Switzerland as well as its trading partners. If the crisis continues in the second half of the year, GDP growth could fall by 3%. This could potentially cause a domino effect in other macroeconomic indicators such as the sustained rise in unemployment rates, which could further weigh on household spending. Furthermore, corporate bankruptcies could cause defaults on loans from banks, which could also reduce the volume of mortgages and hurt the construction sector. In this case, an economic rebound is not expected until 2022.

Nevertheless, if the pandemic is brought under control without a second wave of global infections, the Swiss economy is likely to rebound sharply in 2021. Overall, the Swiss economy, being a relatively mature one, is expected to have a greater decline in economic growth as compared to other emerging economies. Its relative economic growth compared to other developed economies would largely be dependent on the post-COVID-19 crisis management by the government in the form of economic policies and other aids such as increasing public spending and stimulating private consumption.

Relative Ease for Switzerland's Real Estate Market

One of the potential economic bubbles burst to look out for, as discussed in the previous report, is the rising real estate market bubbles. This is largely due to the increasing supply of housing as a result of low interest rates. Fortunately for the real estate market, the increase of housing supply has been slowed down as a result of the economic downturn as well as a slowdown in manufacturing due to various forms of social distancing measures.

According to analysts from Credit Suisse, the Swiss housing market is expected to remain stable overall. It is highly unlikely that there will be waves of selling in the owner-occupied real estate market because the low mortgage interest rate would mean that homeownership is still cheaper than renting. Furthermore, the emergency package by the Federal Council of Switzerland is likely to alleviate income shortfalls.

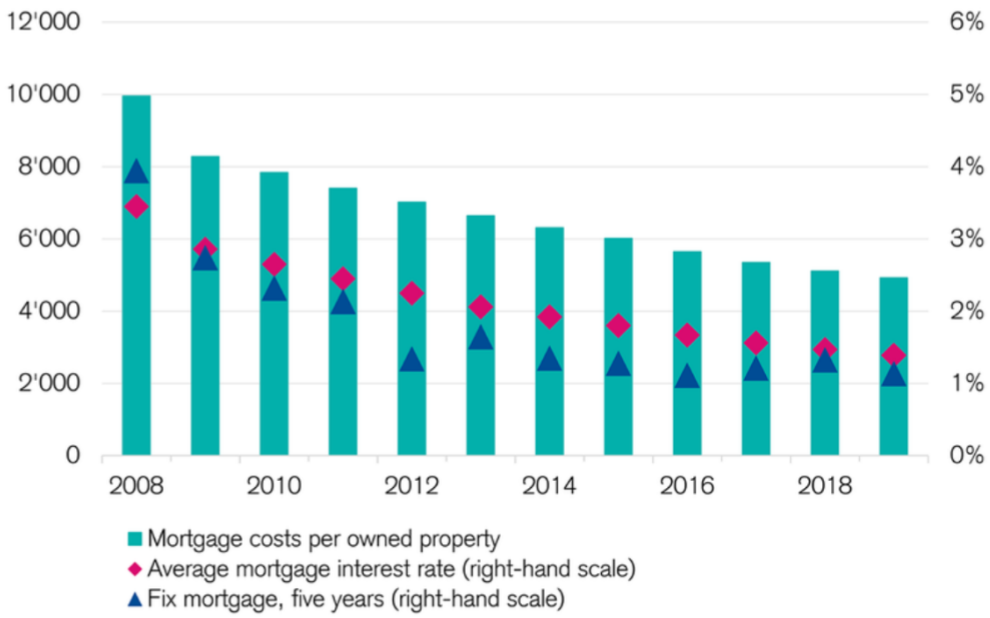

Figure 51: Mortgage Interest Burden Has Halved Since 2008 (*Source: Credit Suisse*)

As seen in figure 51, the mortgage interest cost per owner-occupied property has been halved since 2008. For individual homeowners, this means that most homeowners are less likely to have difficulties in servicing their mortgage debt as a result of a temporary loss in income. On the mortgage front, it is expected to be relatively stable too as the possibility of defaults is low due to the low mortgage interest burden in recent years and financing requirements have been tightened on several occasions.

Consequently, this ties back to our view that negative interest rates are likely to stay for long since this helps to keep the mortgage interest low as well. Once the pandemic subsides, the real estate market is expected to rebound quickly to its pre-crisis state, with the exception of luxury real estate which may feel the effects for a longer period due to lower demand for high ticket purchases.

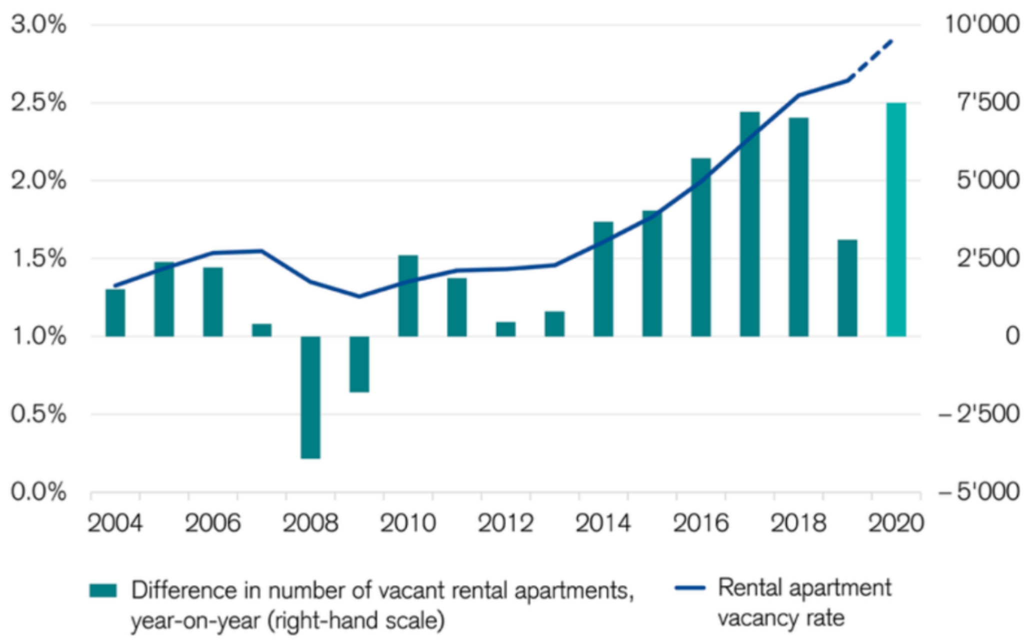

Figure 52: Number of Vacant Rental Apartments Expected to Increase Significantly (*Source: Credit Suisse*)

Unfortunately, the impacts of COVID-19 on the rental apartment market would be more significantly adverse than on the owner-occupied real estate market. The decline in demand has been due to border closures, rising unemployment, and widespread uncertainty. According to Credit Suisse, an additional 7,000 to 8,000 rental apartments are expected to be vacant this year. The vacancy rate is likely to rise to 2.9% (Figure 52).

Perhaps the segment that suffers the brunt of the blow is the commercial real estate market as the demand for additional office space has come to a standstill. The general fall in demand and economic activities would continue to hurt the commercial real estate market. Moreover, there have been increasing trends of companies allowing their employees to work remotely especially after the COVID-19 crisis, for example, with Twitter leading the way of allowing employees to work from home 'forever'.

Resilience Seen in Switzerland's Strong Labour Market

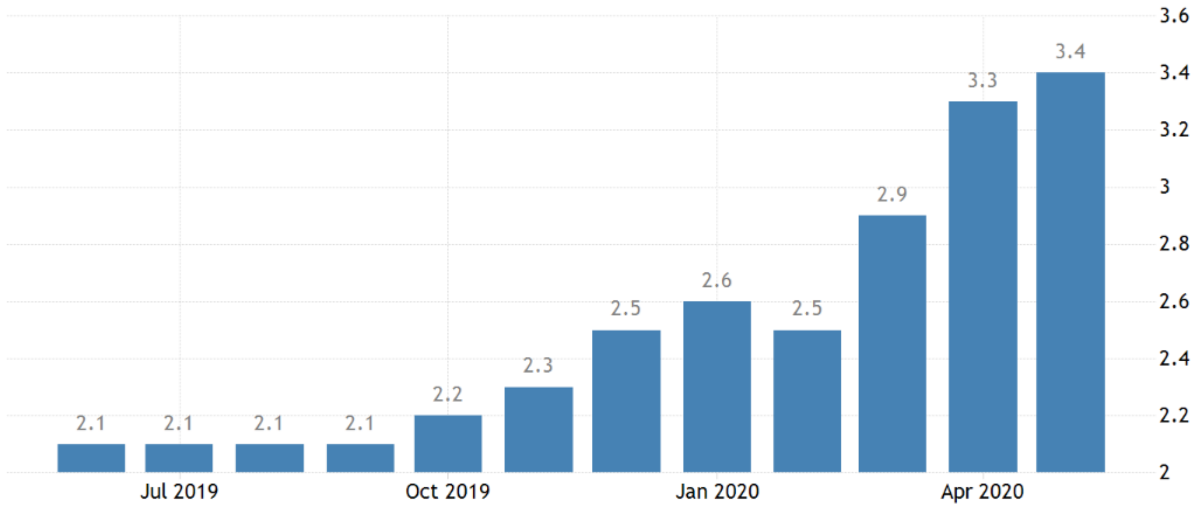

Figure 53: Switzerland Unemployment Rate (*Source: Trading Economics*)

As the global economy slows down and unemployment rates surge to record high in some countries, Switzerland's labour market has seen relative strength in terms of unemployment rates. Although there has been an increase in unemployment, as expected by the COVID-19 crisis, unemployment has only risen by 1.2% from the start of the year, as compared to other developed economies such as the U.S. which has seen an increase of 7.5% in the unemployment rate, from 3.6% to 11.1%. This is largely due to Switzerland's healthy and well-educated economy that focuses on high skilled industries such as financial services as well as Switzerland's efficient workforce.

As the COVID-19 situation improves, we would expect the unemployment rate to fall rather quickly and Switzerland is expected to return to its low unemployment rate of around 2% at the end of 2020 since the Swiss job economy has a strong foundation, which generally helps the economy to accelerate again.

The 21st Century Gold Rush and Lingering Uncertainty

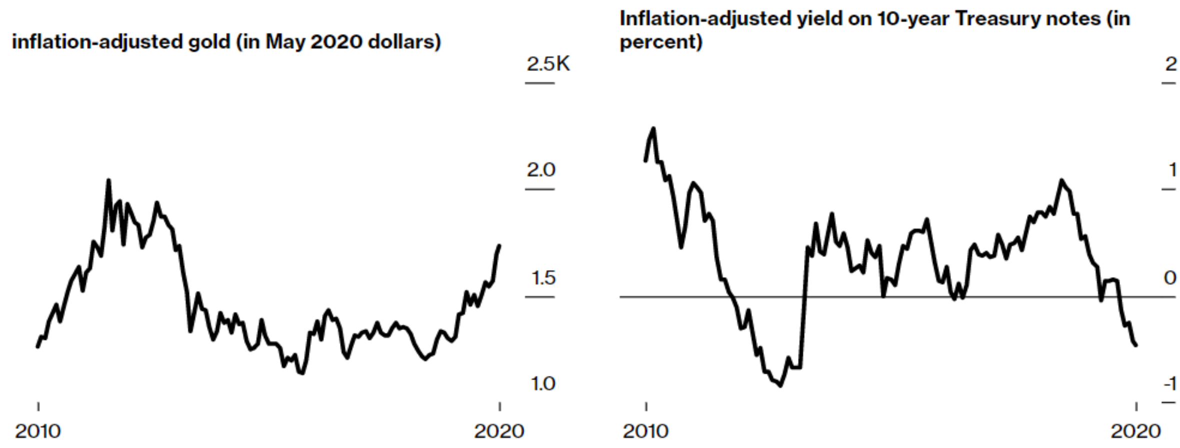

Figure 54: Gold Rises When Treasury Yields Fall (*Source: Bloomberg*)

As seen in figure 54, gold prices generally rise when interest rates and Treasury notes fall. Moreover, the rate of increase in gold supply has been decreasing and gold has limited supply as compared to fiat currency that can be printed endlessly, especially seen in the amounts of quantitative easing used around the world. Notably, the United States has projected to inject USD 3.5 trillion in government securities with these newly created dollars.

The past few months have been excellent for gold and XAUUSD has risen tremendously after hitting major support at the 1500 zone. Since the start of the year, gold has rallied from 1520 to closing as high as 1748 per ounce, which means a return on investment of 15% in less than half a year.

This means that USDCHF will be further pushed down, due to the correlation as gold is one of Switzerland's largest exports. Investors are gaining clarity that gold was relatively cheap and could be a worthwhile purchase as a safe haven asset.

Moreover, as we start to see the unwind of the USD treasury trade and the market absorb the impacts of the policy responses around the world, we will quickly see that the market will shift towards stores of valuable assets such as gold. Investors will move away from currencies that are only backed by the level of trust shown towards the government of the issuing nation. This level of trust is slowly falling due to the mismanagement of COVID-19, especially seen in the U.S. where Trump has clearly underestimated the impacts of the virus. More importantly, the more money printed, and the more stimulus has been injected, the greater the risk of inflation returning, causing a relative depreciation of currencies against gold as gold is considered an inflationary hedge, causing the gold price to increase relative to currencies.

From the supply side, the closure of gold refineries in Switzerland has resulted in a sense of shortage in physical gold, especially at a time that more investors want to buy the precious yellow metal. Moreover, the lockdown and flight cancellations are interrupting the physical availability of gold, further driving the price of the asset.

On the side of the USD, the dollar weakened after the U.S. Federal Reserve announced that it would purchase U.S. Treasuries and Mortgage-backed securities in unlimited amounts to stabilise the market, otherwise known as "unlimited quantitative easing". With the Fed ready to supply unlimited USD, the value of the USD will eventually be eroded against currencies with lesser supply.

Strength Expected for Swiss Franc Safe Haven

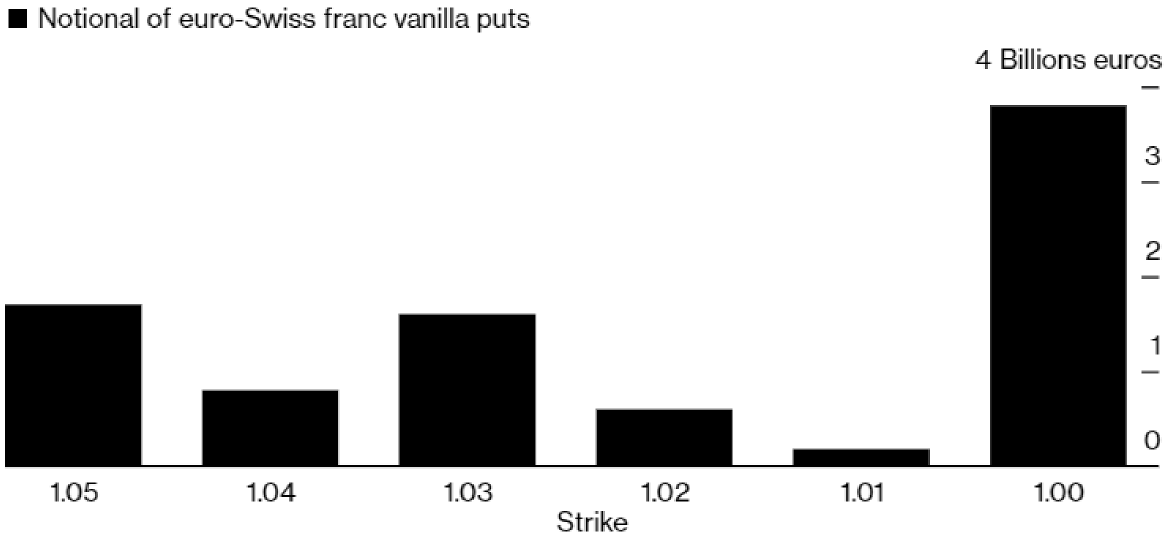

Figure 55: Investors Hedge Against a Big Surge in Swiss Franc (*Source: Bloomberg*)

According to figure 55, investors are also expecting CHF to appreciate against not only the USD, but the EUR as well, as investors have increased their Euro-Swiss France vanilla puts to a total of close to EUR 4 billion. Swiss Finance Minister Ueli Maurer announced that Switzerland is going to raise a CHF 20 billion (USD 21 billion) fund for state-backed emergency loans. Since last week, there have already been over 30,000 applications and the government has already guaranteed CHF 4 billion worth of lending in just two days. Maurer has indicated that the loan fund is likely going to increase as the government is prepared to spend "as much as necessary" in order to save jobs.

UBS has also calculated that the Swiss federal government could spend up to CHF 145 billion more without endangering its AAA credit rating. This is good news for Switzerland and hence the CHF as the government has been proactively aiding businesses and cushioning the economy from the impacts of COVID-19. Nevertheless, the situation is not sustainable in the long-term and the first indicator to look out for is the amount of money being pumped into the loan fund, should the amount exceed CHF 145 billion, or should the crediting rating be endangered, it may cause the CHF to depreciate. Further economic uncertainties are expected as countries such as the U.S. and Australia are pointing fingers at China for mishandling the COVID-19 pandemic.

FX TRADE IDEA: SHORT NZDCHF

Fundamentally, the CHF will trade at a premium largely due to the ongoing uncertainties surrounding the economic and political situations around the globe. In addition, there would also further drive the price of gold up and cause the CHF to appreciate as well because gold is one of the main exports of Switzerland.

In view of the potential second wave of COVID-19 infections around the world, this trade idea would be shorting the NZD, which can be considered a risk on commodities currency, against the CHF which is a safe haven currency that may further strengthen due to the correlated appreciation of gold. In addition, the Reserve Bank of New Zealand's (RBNZ) dovish policy stance remains a potential source of relative underperformance for the NZD and New Zealand's economy is likely to suffer a significant economic hit due to its harsher lockdown measures and a fall in demand of commodities exports.

Figure 56: NZDCHF Weekly Chart (*Source: TradingView*)

Entry: 0.6225
Take profit: 0.5816
Stop loss: 0.6350
Risk to reward ratio: 3.27

From a technical analysis point of view, the NZDCHF has been in a long-term downtrend since the start of 2019 and has generally traded within the downtrend price channel, with the exception of March 2019 as the financial markets experienced a crash. The NZDCHF is currently near a resistance zone and has recently reacted to it.

The price is currently near the upper limit of the Bollinger Bands, which could also suggest that the price is almost ready to snap back to the middle or lower limit of the Bollinger Bands. As for the Stochastic RSI indicator, it also suggests that the NZDCHF is currently overbought, which even has a stronger confirmation as seen by the divergence in the Stochastic indicator (lower high in the price, but higher high in the Stochastic RSI).

The Stop Loss has been set at the break of the resistance zone and downtrend channel as well. As for the take profit, it has been set at the next major support zone which is in confluence with the 50.0% retracement of the Fibonacci indicator.

UNITED KINGDOM (Underweight)

The United Kingdom (UK) is a region in Europe that consists of England, Wales, Scotland, and Northern Ireland. Its official currency is Pound Sterling (£), the world's oldest currency. It is the 80th biggest country but it has the 5th largest nominal GDP in the world (USD 2.83 trillion in 2018). The EU (taken as a bloc) is the UK's largest trading partner, which accounted for 45% of total exports and 54% of total imports in 2018.

The UK economy is mainly driven by the service sector which accounts for more than 75% of the total GDP. The financial service industry is the most crucial, with the UK's capital, London being the financial hub of the country. London is the world capital of foreign exchange, with an average daily turnover of USD 2.426 billion in 2016. Furthermore, manufacturing is the second-largest sector contributing about 25% of the total GDP. The UK aerospace industry is the third-largest national aerospace industry, which includes BAE Systems, a British defence and aerospace company which is also the largest defence contractor in Europe. Moreover, agriculture accounts for less than 1% of the total GDP.

Export accounts for 30% of the UK's total GDP and some of the main export items are cars, packaged medicines, and crude petroleum. Cars are the largest exports in 2019, where 81.5% of all vehicles made in Britain are exported. In 2019, the UK exported GBP 24.7 billion worth of pharmaceutical products and 20% of the world's best-selling prescription drugs were developed in the UK. Moreover, although the UK is not known as an oil country, crude petroleum was its 3rd biggest export in 2018.

UK Has Finally Gotten Its Freedom for Better (Or Worse)

The UK has officially (and finally) left the European Union on 31st January 2020, bringing an end to 47 years of UK membership of the EU. The UK will continue to follow all of the EU's rules and its trading relationship will remain the same during this transition period until the 31st December 2020. During this transition period, there are still some issues that need to be talked about. The key issue will be the free trade agreement which is crucial to the UK as EU is the UK's largest trading partner, accounting for 45% of UK exports in 2018.
The free trade agreement is highly crucial because once the UK leaves the single market and customs union at the end of the transition, all the trade barriers and tariffs imposed by the EU will take effect on the UK. At the same time, the UK will also impose its tariffs on EU products. Recently, the UK announced its post-Brexit trade plan which involved lower tariffs which hopefully will incentivise the EU to come into an agreement after assessing the impact of tariffs on their economy.

The UK has ruled out the option of extending the transition period although it seems that the conversation between EU and the UK have stalled badly, with both sides unwilling to budge on fundamental issues. The situation is further worsened by resources and focuses diverted to contain the spread of COVID-19. The UK mentioned that it will break off negotiations and told businesses to prepare for a no-deal split if sufficient progress in the talks isn't made by June.

At this rate, the most concerning problem is the impact on the businesses in the UK. Retail, agriculture, and manufacturing industries are the most vulnerable sectors if no-deal happens. Businesses in manufacturing industries will face higher tax, regulatory burden, and longer customs processes. Moreover, in the retail industries, the new non-tariff barriers which will apply regardless of the results of the UK-EU deal will cause higher prices of certain goods and thus, retailers might face slimmer margin and lower revenue overall. As the EU is the key destination for agricultural exports, exporters will likely face lower volume as they lose the competitive pricing.

Although trade talks between the two sides are still ongoing in the background, time is not on anyone's side. The UK and EU realistically have until October 2020 to agree on terms. However, with resources being diverted to deal with the COVID-19 emergency response, it is increasingly likely that extension will be needed. Moreover, businesses will not be ready for a change in trading conditions. With the impact of COVID-19 resulting in the fall in demand due to the lockdown imposed by the government, the main priority for businesses will be to survive and this leaves insufficient time for them to adapt. Even without the impact of COVID-19, new customs documentation will be required, and in the case of service-related businesses, access to the European market will become significantly more restrictive. Since the service sector makes up more than 75% of the UK's economy, it is even more likely that there will be an extension, especially in the current virus-impacted situation.

Nonetheless, the UK has started a post-Brexit free trade deal with the other countries such as the U.S. Forming a trade deal with the U.S. is seen to be the biggest prize from leaving the EU as it will also strengthen their political and economic ties. The trade deal will cover various aspects from goods to digital services. However, striking a free trade deal with the U.S. may only deliver 0.16% boost to the UK economy, and this will fail to make up the expected loss in trade from leaving the EU.

As a result, there are still a lot of uncertainties even after the UK has successfully exited the EU with the main problem being the free trade deal agreement post-Brexit. It is no wonder that business investment does not improve as investors' sentiment is still clouded by the uncertainty of the trade deal. Hence, the consequence of Brexit will affect the long-term economic growth of the UK while the short-term performance will be shaped by how the UK manages the spread of COVID-19. Nonetheless, the consequence of Brexit will mainly lie on the ability of the UK to form attractive free-trade deals with EU and other countries as it does not only affect trading activity but also how companies conduct businesses.

After Brexit, Comes COVID-19

The UK has imposed a lockdown on 23rd March 2020, which is very crucial to reduce the number of cases, given that the UK has 312,000 cases as of 30th June 2020. Thus, with such a lockdown and government's advisory to practice social distancing, the demand side will be the most affected as people adjust their behaviour to reduce the risk of exposure to the virus. UK's consumer confidence posted the biggest fall in more than 45 years from -9 in March 2020 to -34 in April 2020 and staying low at -34 and -30 in May and June 2020 respectively. Consumer spending is expected to fall by 2.5% in 2020. While the demand will recover, the recovery rate is poised to be slow as the government will gradually ease the measures due to fear of the 2nd wave of virus outbreak which will further limit the trajectory of the economic rebound.
Therefore, it is estimated that the UK's economy will slow sharply, causing the UK to enter a recession with the overall GDP expected to fall by 14% over 2020 overall, driven by a 25% decline in the 2Q2020. The recession will be driven by both consumption and investment which will fall sharply due to falling confidence, as well as the impact of public health measures put in place to contain the virus.

Luckily, some measures have been taken both by the Bank of England (BoE) and the government to support the economy. BoE has cut their interest rate to 0.1% on 19th March 2020, which is an all-time low to support businesses which require borrowing and launched a further GBP 200 billion bond-buying program to inject liquidity into the market on 7th May 2020, taking the QE to a total of GBP 645 billion. Such measures will support small businesses and the most affected industries such as the retail and tourism industry. During its latest meeting on 18th June 2020, BoE maintained its interest rate at 0.1% amidst the badly impacted economy as UK GDP contracted by around 20% in April 2020.

The government has also introduced various measures in response to the economic impact of COVID-19. For example, the Coronavirus Job Retention Scheme aims to minimize the impact on the unemployment rate by contributing over 80% of workers' salary. That means that workers can retain their jobs, even if their employer cannot afford to pay them. Moreover, the government has also set up a lending facility for both small and medium enterprises (SMEs) and big businesses to improve their liquidity as economic activity is greatly reduced.

Thus, we believe that the short-term outlook (next 6 months) for the UK will be dominated by the impact of COVID-19 pandemic whose adverse impact will gradually decrease until the end of 2020. Nonetheless, the situation is highly dependent on domestic and global COVID-19 containment measures, including the development of vaccines. It is therefore possible that the prolonged impact from COVID-19 will last into the first half of 2021. The UK is likely to suffer from a more severe downturn than seen in the 2008-09 recession if the impact of COVID-19 is prolonged. Thus, our current forecast is that the UK economy will enter a recession in 2020 and will recover by 1H2021 (Figure 57), assuming the global containment measures show success.

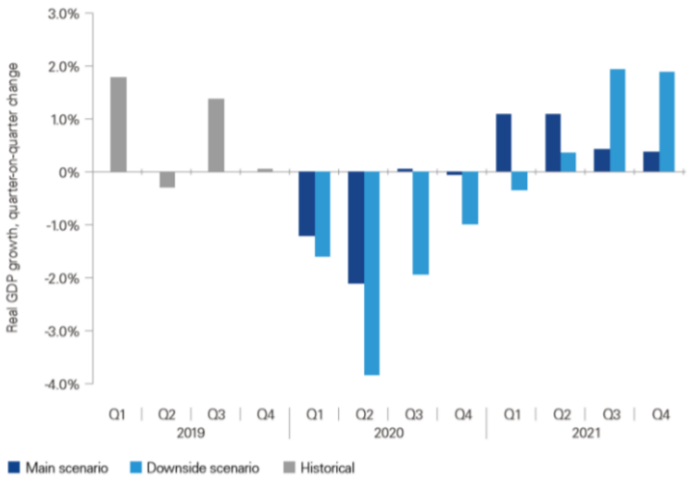

Figure 57: UK GDP Forecast 2019-2021 (*Source: ONS, KPMG*)

Interest Rate Staying Steadily Low

On 11th March 2020, BoE made an emergency interest rate cut from 0.75% to 0.25% to support the economy due to the adverse effect of COVID-19. However, this move is also supported by the weak economy, despite the successful orderly Brexit.

The GDP growth flatlined in January 2020 even before COVID-19 hit Europe which triggered the possibility of an even weaker economic growth. Growth stuttered during 4Q2019 although the decisive general election result in December boosted business optimism. However, it did not make up for the weakness of the previous two months partly because there are still a lot of uncertainties with regards to the next steps. Coming into 2020, improving business confidence in January did not translate into real economic growth. Then the COVID-19 outbreak began to take hold.

Even after the announcement of the orderly Brexit, consumer and business confidence was picking up quite slowly. The Office for National Statistics said a 1.2% drop in manufacturing output in the three months to January, pulled down the UK's growth rate to zero, dashing hopes that the economy would enjoy a bounce after December's general election.

On 19th March 2020, a special meeting was held, and a further 0.15% cut was announced to 0.1%, which was an all-time low for the UK in response to the dampened economic growth due to COVID-19. In the most recent meeting on 7th May, BoE maintained its interest rate at 0.1**%.** Apart from cutting interest rate to 0.1%, BoE has gone all-in by introducing a further GBP 200 billion money creation scheme via its quantitative easing programme, increasing the total bond purchase to GBP 645 billion. This is done by buying additional UK government and corporate bonds to hold down the cost of borrowing and pump cash into the economy. Such a measure is especially important to the economy affected by COVID-19. As consumers reduce their spending significantly due to the lockdown of the country, businesses will suffer from a liquidity crunch and will have a tough time paying off their bills. As such, with a lower cost of borrowing, this will help to increase the funding to businesses, especially the small and medium businesses (SMEs) which might not have enough cash reserves to survive through the economic downturns. BoE maintained the interest rate at 0.1% during the latest meeting on 18th June 2020.

Moreover, BoE also launched a new Term Funding scheme with additional incentives for Small and Medium-sized Enterprises (TFSME), financed by the issuance of central bank reserves. TFSME will help reinforce the transmission of the reduction in Bank Rate (interest rate) to the real economy to ensure that businesses and households benefit from the BoE's actions. Therefore, TFSME is a targeted approach to help the SMEs obtain additional borrowing to SMEs as they typically bear the brunt of credit supply contractions during the periods of heightened risk aversion and economic downturns.

Overall BoE's aim stays the same, which is to meet the 2% inflation target. However, inflation is set to stay low, averaging 1.4% in 2020, due to weakness in demand and falling global oil prices. However, we expect that the supply of goods will be disrupted due to the temporary closure of some workplaces and the disruption of supply chains. Thus, shortages of intermediate components might lead to supply bottleneck which may push up prices slightly in certain categories. Nonetheless, we do not expect the overall rate of consumer price inflation to rise. Rather, we expected inflation to continue its recent low trend because the overall impact on headline inflation will be moderated by the falling price of products and services affected by lower demand as a result of the outbreak. Moreover, the additional introduction of charging caps on water bills by the industry regulator Ofwat since April will bring overall inflation further down.

Hence, we believe that the interest rate will likely stay at 0.1% given the slow recovery of economic growth and the added uncertainty from the formation of the trade deal with the EU. BoE wants to keep a very accommodative stance to ease the end of the Brexit transition period. Moreover, global growth will be significantly slower as countries around the world see much lower economic activity with a slow recovery of demand as the spread of COVID-19 is hard to contain. As such, the UK's economy will not only get impacted internally both from structural and political problems, but also from weak global growth. However, it is less likely for BoE to cut the interest rate to the negative zones to protect the banking system.

<u>Battered Labour Market Despite Its Strong Performance</u>

In line with our analysis from our previous publication, the UK labour market is one aspect of the UK economy that remains resilient entering 1H2020. The number of jobs continued to rise during 4Q2019, despite the weaker economic growth with firms increasing the number of vacancies at the start of 2020.

This is driven by various factors, including the flexible labour market and pay which gives employers more room to adjust the contracts of the employees rather than firing them. Another factor is the UK's structural problem which is the falling productivity (Figure 58). With low productivity growth, firms need relatively more workers and hence, the increase in hiring.

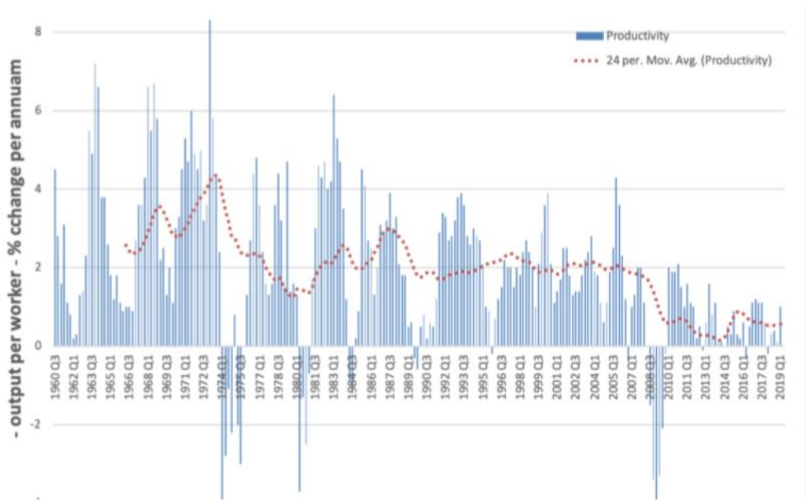

Figure 58: UK Labour Productivity (Annual %) Has Been Falling (*Source: ONS*)

UK employment rate hit new highs at the start of the year at 76.5% (Figure 59). However, such a strong performance does not last as the adverse impact of COVID-19 starts to take a toll on the UK's economy.

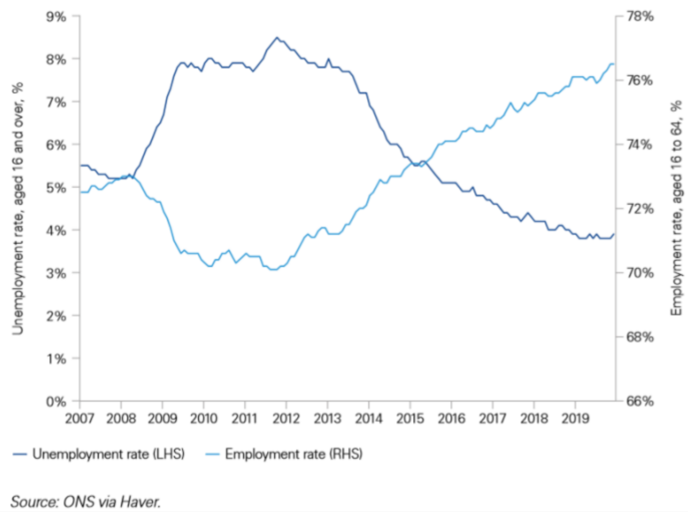

Figure 59: UK Employment Rate Hit New Highs at the Start of the Year (*Source: Ons*)

With the COVID-19 outbreak, we expect that the labour market will be impacted quite deeply despite its strong performance. It is estimated that about 7.6 million jobs or about 24% of the UK workforce are at risk because of COVID-19 related lockdowns. This number includes those who are faced with permanent layoffs and temporary furloughs. The impact across sectors is highly uneven with the accommodation & food services sector having the highest proportion of jobs at risk followed by the wholesale and retail sector as demand generally falls and people practising social distancing. However, the government has adopted measures such as the Coronavirus Job Retention Scheme intended to avoid mass layoffs. However, such a measure does not give the incentive to retain jobs and hence, reduces its effectiveness.

Hence, the UK labour market is expected to be impacted quite heavily, both from COVID-19 outbreak and uncertainty over the UK's future economic progress.

Post-Brexit Business Investment Is Not Rebounding, What's the Matter?

Even after the orderly Brexit is achieved, businesses remain reluctant to invest. Business confidence shot up after the December election, but weak demand has put pressure on business-to-business (B2B) sectors. For instance, logistics, financial services, and professional services all performed worse in 4Q2019 than in 3Q2019 (Figure 60). This trend of weak demand continues in three months to 2020, leading to fifth consecutive quarters of decline in profitability for business and professional service firms.

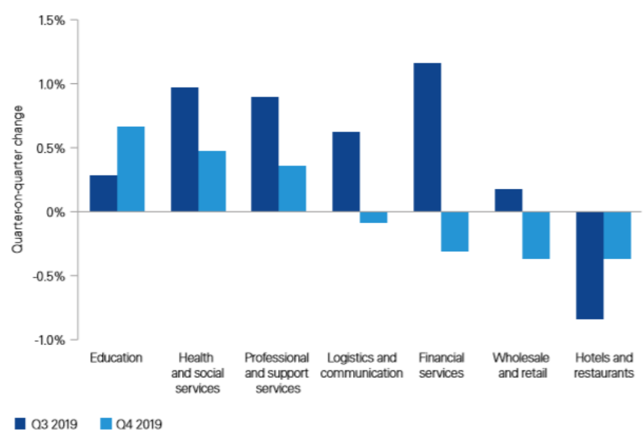

Figure 60: Major Service Sectors Show Broad-Based Weaknesses (*Source: ONS*)

It is no wonder that the weak performance drags on business investment, which further contracts due to COVID-19 pandemic. It is estimated that COVID-19 related disruptions and uncertainty result in investment contracting by 11.2% in 2020. Coupled with the uncertainty with regards to the UK's free trade deal agreement with the EU and some adaptation required following the exit of the UK from the EU, businesses will be even more reluctant to invest. However, a recovery from the pandemic should support a pick-up in investment with 5.2% growth in 2021.

The role of business investment is very crucial in solving the deep-seated productivity problem. The UK total investment rate, which includes investment by households, businesses and government stands at the 3rd lowest in the entire OECD, with total investment accounting for about 17% of GDP. With business investment having a larger impact on UK productivity, falling business investment practically creates a vicious cycle. The problem is aggravated firms as firms are not effective enough at adopting innovations and most firms undertake little or no R&D activity. Moreover, the problem is exacerbated by Brexit.

The UK's post-Brexit future is uncertain. But one thing is clear: boosting economic growth will depend heavily on addressing long-standing productivity challenges. Labour productivity in the UK has consistently lagged many other advanced economies including France, Germany, Sweden and the U.S. Productivity matters because it is the fundamental driver of national prosperity (productive capacity, technically speaking), and hence of personal incomes and tax revenues.

The consequences of Brexit (even with a trade deal) would have a knock-on effect on UK productivity. Reduced trade, foreign direct investment (FDI), and the movement of people between the UK and EU could lead to less innovation, investment, access to talent, and fewer economies of scale. As a result, this will disproportionately harm the productive, traded sectors of the economy such as pharmaceuticals, financial services, and technology which are ultimately Britain’s economic lifelines. Brexit thus exacerbates the United Kingdom’s productivity challenge and might affect businesses’ willingness to further invest.

Falling business investment and low productivity are likely to be self-reinforcing. Hence, the UK should solve its structural problem especially in the service sector as it accounts for about 80% of the UK’s GDP and form a good free trade agreement to win over the businesses and increase business investment.

FX TRADE IDEA: SHORT GBPNOK

Figure 61: GBPNOK Daily Chart (*Source: Investing.com*)

Entry: 12.3554
Take profit: 11.4066
Stop loss: 12.7794
Risk to reward ratio: 2.2

Our view is that we are bearish on GBPNOK. On the GBP side, our view towards GBP is bearish. This is mainly driven by 2 factors.

The first factor is the uncertainty due to Brexit. While the UK has officially exited the EU since 31st January 2020, the problem is the uncertainty regarding the post-Brexit free trade deal agreement with the EU. Both the UK and EU realistically only have until October 2020 to agree on terms. This UK-EU agreement is very crucial as it will affect the cost of running businesses. Recently, the UK government has announced its new tariff regime and showed a clear sign that there will be no extension to the transition period. However, with resources diverted to the containment of COVID-19 and the low readiness levels of businesses to adjust their operations to the new post-Brexit rules, the businesses will likely pressurize the government to extend its transition period. Therefore, with the uncertainty around the ability of the UK to reach a trade deal with the EU and the possibility of further extension, this will lower investor confidence in the UK, and thus, in line with our bearish view on GBP.

The second factor is the impact of COVID-19 on the UK's GDP. The service sector accounts for about 75% of UK's GDP and with lockdown and travel restrictions being imposed, UK services sector activity will likely fall substantially. Activity in the UK services sector slumped to an unprecedentedly low level in April, with the HIS Markit/CIPS UK Services PMI registered 13.4 in April 2020, down from 34.5 in March 2020, signalling a rapid decline in UK service sector output although it has picked up reaching 47 in June 2020. Nonetheless, the risk of a second wave of COVID-19 is real given how the daily new cases spiked in the U.S. and reopening of business will likely be gradual. Thus, investor sentiment would fall substantially combined with the UK-EU uncertainty and thus, we believe that GBP is going to weaken in the 3Q2020 and 4Q2020. Overall, the Pound increasingly resembles the more liquid emerging market currencies rather than a core G10 currency.

On the NOK side, we are bullish towards NOK as oil price is stabilising and likely to increase in 3Q2020 and 4Q2020 although in a slow pace as oil demand slowly recovers as governments start to re-open their economies and cuts to oil supply will help to prop up the oil price. In mid-May, demand in the oil markets continues to move upwards as people start to hit the roads, which accounts for about 50% of oil demand. Gasoline demand in the U.S. was up 46% since the low point on 3rd April. The rise in demand for oil has been seen in Europe, U.S., China. The rise in oil demand, although at a slower rate, will help to prop up oil prices.

On the supply side, major oil producers have decided to cut their oil output. OPEC+ agreed to cut their oil output by 9.7 million bpd and Saudi Arabia has also recently announced to cut another 1 million bpd starting from June. As a result, it is in our view that oil price will recover although at a slower pace and NOK will likely appreciate in 2H2020.

From technical analysis, we observe that GBPNOK is bearish. GBPNOK has been in the downward channel since late March. The RSI currently stands at 49.5482 which has been increasing, along with the MACD line rising above the signal line. We foresee that GBPNOK will rise to the 12.3554 which is at 50 Fibonacci level as investors might react positively with the possibility of QE expansion by the BoE and short-term weakening of oil due to the uncertainty with regards of the risk of 2nd wave of COVID-19. We will also enter at 12.3554 and take profit at 11.4066 which is at 23.6 Fibonacci level and near the resistance-turned-support level. We put our stop loss at 12.7794 at 61.8 Fibonacci level, bringing our risk-reward ratio to 2.2.

RUSSIA (Underweight)

Russia was previously known as the Soviet Union and has transformed from a centrally planned economy to a free-market economy. Nonetheless, the government still holds a role in various industries such as the energy and banking sector.

Russia is the 11th largest economy based on GDP adjusted by PPP in 2018 (USD 1.6576 trillion). It is mainly dependent on commodity exports especially energy products such as oil and natural gas. It is the world's third-largest oil producer behind the U.S. and Saudi Arabia and has the eighth largest oil reserves in the world. In 2018, oil export revenue contributed to 7% of its GDP and half of the federal revenues. As such, it is no wonder that there is a strong correlation between ruble and oil price.

Russia is also the world's largest diamond producer and believed to have the largest diamond reserves in the world. It is estimated that Russia contains over 30% of the world's natural resources

The Russian economy has grown significantly as its GDP per capita has approximately doubled since 1999. It is mainly driven by the service sector which accounts for more than 60% of the total GDP. Some important segments include wholesale and retail trade, public administration (health and education) and real estate. Moreover, the industrial sector accounts for more than 30% of the total GDP with mining, construction, and manufacturing being the most important industry. Russia has a large and sophisticated arms industry, which produces high-tech military equipment such as fighter jet, nuclear-powered submarines and ballistic missiles. Furthermore, agriculture accounts for less than 5% of the total GDP.

The "New Normal", but Abnormal Impact

COVID-19 has taken a toll on Russia's economy. Russia's GDP growth is expected to tumble by more than 5% in 2020. This is mainly driven by a fall in consumption as economic activity falls by a third due to lockdown and change in behaviour of the population due to fear of infection. Moreover, oil price has plunged more than 60% since the start of the year and is likely to stay low at least until the end of the year driven by weak demand recovery. Moreover, coupled with the OPEC+ agreement of cutting the oil production, this will put further pressure on the Federal's budget and export revenue.

In addition, unemployment in Russia may reach 7-8% or 10% in the worst-case scenario, an increase from the current rate of 4.5 %. Nonetheless, the government has also taken some steps to help the unemployed by raising the unemployment benefits to the minimum wage level. To counter the socio-economic effects of the COVID-19 pandemic and provide support to the economy, the Central Bank of Russian Federation (CBR) and government have announced a range of policy response measures.

The government has imposed a six-month deferral on social security payments and temporary deferral of rental payments on state or municipal property for small and medium enterprises (SMEs) as they face a significant fall in revenue. Moreover, to minimize the impact of COVID-19 on the labour market, the government introduced interest-free loans aimed at salary payments for SMEs and large companies. The government also deferred tax payments (except VAT) for vulnerable sectors which are most-affected by COVID-19, such as entertainment and leisure, tourism, and health and sports sectors.

Moreover, CBR will continuously provide FX liquidity by increasing the limit on its foreign exchange (FX) swap operations. It also expands subsidized lending and partial credit guarantee programmes to SMEs which are deeply affected by the reduced economic activity. CBR will also soften the requirements for lending to the most affected industries. Hence, CBR ultimately aims to improve liquidity in the market and extend funding to businesses impacted by COVID-19.

Nonetheless, the extent of the financial assistance provided by the government is considered insufficient which stands only at about 2% of GDP. The cautious economic policy response suggests that the policy is focused on stability and maintaining reserves (although it has about USD 570 billion in reserves, to be exact). Such a view is reasonable as the government might foresee that oil price will likely to stay low and coupled with weak demand both locally and globally, putting pressure on the Federal budget.

As a result, it is forecasted that a rebound in the Russian economy is likely to be limited in 2021 as there is insufficient policy support. However, there are signs that Putin will introduce a bigger stimulus to prop up the economy. Ultimately, the dynamics of economic recovery will largely depend on the domestic and global containment measures as well as the development of the vaccines. Meanwhile, the short-run impact can be minimized through the measures taken by the Government and CBR.

Clear Stance, but Might Not Be Enough

The CBR's monetary policy remained consistent with the inflation-targeting regime. Inflation has been on a downward trend since April 2019 (Figure 62) and continues to be below CBR's target of 4%. As a result, CBR has been loosening its monetary conditions.

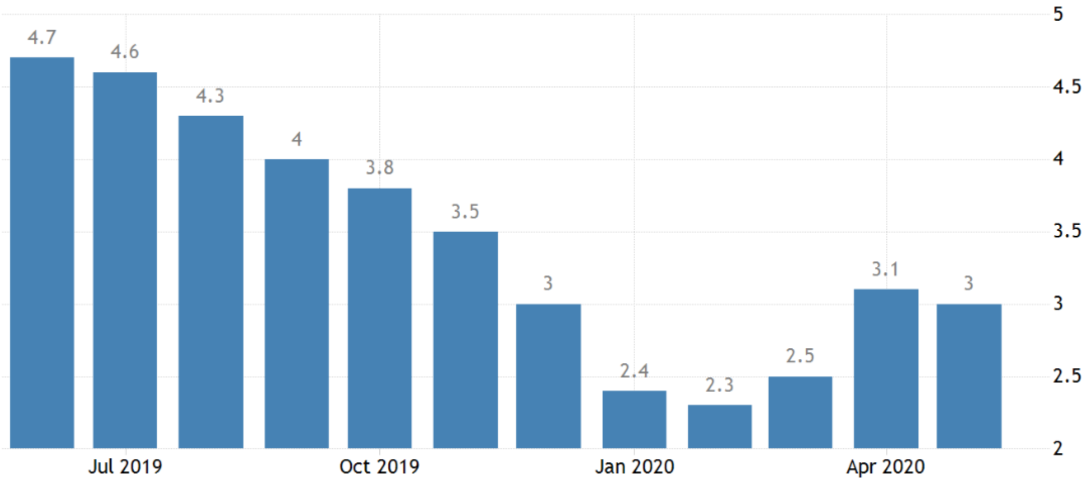

Figure 62: Russia's Declining Inflation Trend (*Source: Trading Economics*)

The declining inflation was driven by three main factors.

Firstly, the VAT rate hike's pass-through to consumer prices has mostly taken effect at the beginning of the year with a decreasing effect in the second half of the year. Secondly, the appreciation of Rouble in the first half of the year through the increase in the price of imports. Lastly, the sluggish domestic demand affected by a continued contraction of real disposable income, which was further aggravated by the VAT rate hike, as we have forecasted in our previous publication.

Since the outbreak of COVID-19 in early February, CBR has maintained its accommodative monetary policy to support the economy. The CBR cut its interest rate by 50 basis points to 5.5% on 24th April 2020 as the spread of the COVID-19 pandemic and a historic plunge in oil prices have taken a toll on its economy. A rise in inflation expectation is considered as temporary as we have seen that March 2020's inflation peaked up, mostly driven by the depreciation of ruble as investors adopted a risk-off stance against the emerging market (EM) currencies. On 19th June 2020, the CBR cut their rate further by 100 basis points to 4.5% as inflation risks remain low and the economy continues to contract.

Our view is that CBR will continue to adopt its accommodative policy and likely to cut its rate further even if it causes a further depreciation of ruble. This is because CBR will also adopt some measures to stabilize ruble through its FX sales approach and this will offset the impact from cutting the interest rate, although they have cut their daily intervention from USD 155 million/day to USD 150 million/day. Such a dovish approach is inevitable as Russia's economic forecast is deteriorating and the government is less inclined to boost its fiscal support, as the government is conservative to the use of its reserves. Therefore, it appears that the stringent fiscal approach may be pushing the CBR to support the economy from the monetary side. Nonetheless, supporting the economy only from the monetary side might not be sufficient given the weak consumption exacerbated by falling real disposable income and rising household debt and weak business investment demand.

Dying Russia’s Lifeline

Brent crude oil – the benchmark of Russian’s Ural oil – has taken a wild ride in 2020, hitting 18-years low price at USD 19 per barrel, falling by about 70% from the start of 2020 at USD 68 (Figure 63). The general downtrend since the start of the year was triggered by various factors.

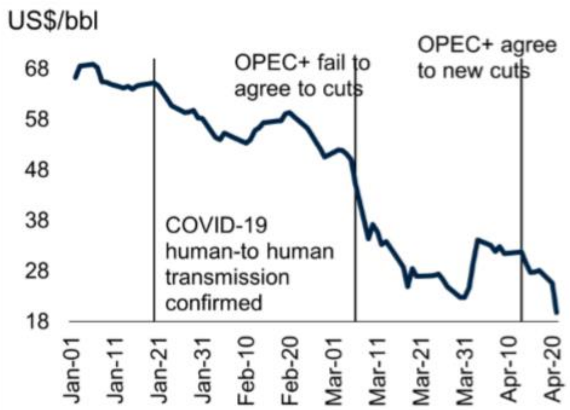

Figure 63: Falling Brent Crude Oil Price Reaching a Multi-Decade Low in April (*Source: Bloomberg*)

The first factor is the significantly reduced demand due to the plunge in economic activity caused by COVID-19. The global market faces the lowest demand in 25 years as governments across the world impose lockdown to contain the spread COVID-19. As lockdowns are imposed, the use of both road and air transportation have fallen drastically as governments impose work-from-home policy and travel restrictions started to take place. As transportation accounts for around half of global oil demand (Figure 64), it is no wonder that oil demand is expected to fall by 9.3 million barrels per day overall in 2020.

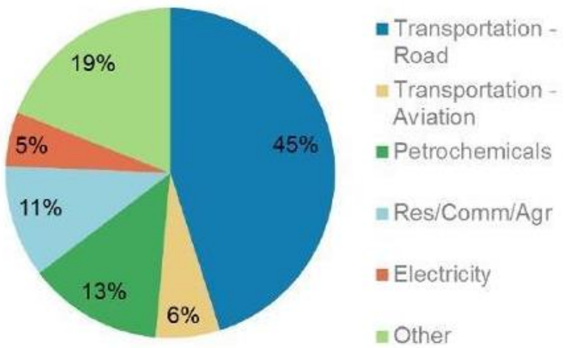

Figure 64: The Global Oil Demand by Sector in 2016 (*Source: OPEC World Oil Outlook 2040*)

This results in the oversupply of oil, especially when various oil rigs are starting to operate, such as those in Norway and Brazil. Moreover, before 2020, it was expected that the overall oil supply in 2020 will increase. The extent of the oversupply is so bad that U.S. oil price turned negative for the first time on record after oil producers ran out of space to store the oversupply of oil left by COVID-19. As oil storage is reaching its capacity, oil glut fuels demand for crude tankers as floating storage. As a result, the charter rate for very large crude carriers (VLCCs) spiked up to USD 180,000 per day.

The second factor is Russia-Saudi Arabia oil price war. This happened in March 2020, when Saudi Arabia initiated a price war in response to Russia’s refusal to reduce oil production to prop up oil prices. As a result, Brent crude oil plummeted.

Our medium-term forecast (6 months) is that oil price will stay on the low territory as it will take time for demand to return to its pre-COVID-19 level before oil price comes back to USD 60 territory.

On the supply side, OPEC, Russia and other allies (OPEC+) eventually agreed on 13th April 2020 to cut their oil output by 9.7 million bpd (about 10% of global supplies) in May and June 2020. Russia and Saudi agreed to make some of the biggest cuts (about 2.5 million bpd). However, the actual cuts will likely be somewhat smaller because both Russia and Saudi Arabia used a different starting point than other countries to measure their pledged reductions. Thus, the real cut of production off the market will be closer to 8.4 million barrels a day. Moreover, the limited storage capacity will force oil producers (the non-OPEC+) to cut their output, even without the agreement. Moreover, in May, Saudi Arabia announced that they will cut oil output by another 1 million barrels a day starting from June

On the demand side, although global demand for oil has fallen significantly, oil demand is expected to pick up in 2H2020, although at a very slow pace (Figure 65). As governments start to open up their economies at a gradual pace, the economic activity starts to increase and demand for oil starts to pick up. It is expected that global demand may take more than a year to reach the pre-pandemic level of roughly 100 million barrels a day.

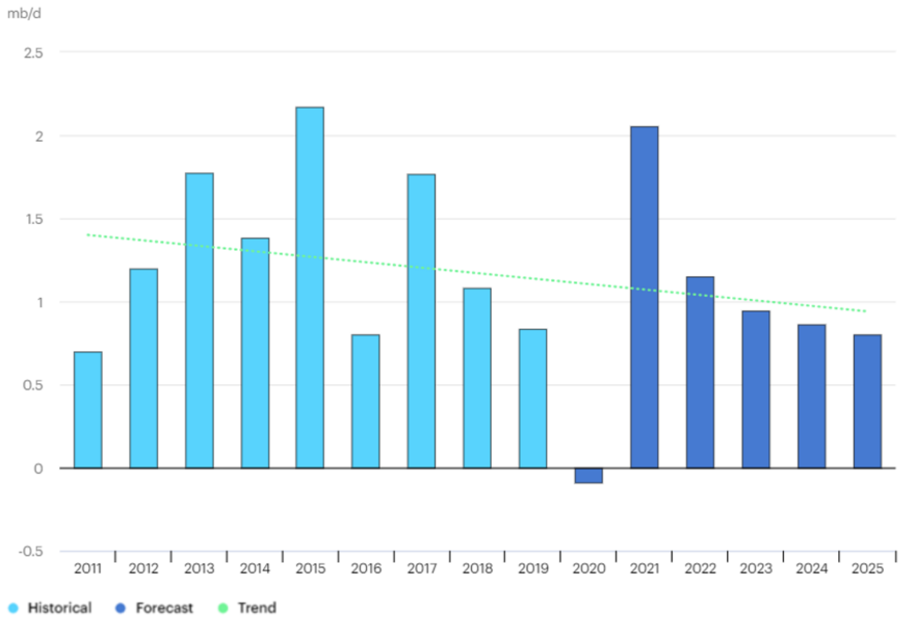

Figure 65: Global Oil Demand Growth Forecast 2011-2025 (*Source: IEA*)

In our view, despite cuts to oil production, the weak global demand still outweighs the lower supply, at least in 3Q2020. Such a divergence between demand and supply will put a downward pressure on the oil price. Thus, while it is expected for the oil price to increase, the rate of increase will be gradual. However, it is assumed that the second wave of COVID-19 spread does not happen and economic activity gradually increases.

Therefore, the energy export revenue in 2020 will definitely take a big hit to Russia and this will affect its GDP and Federal budget drastically. Nonetheless, it is in our view that oil price will increase gradually driven by the increase in demand as governments start to re-open their economies and cut oil supply as we move from 3Q2020 to 4Q2020.

Battered Ruble

The ruble has weakened on the back of lower oil prices and slowing activity due to lockdown measures amidst COVID-19, with the USDRUB reaching an estimated average of 73.7 in March compared to an average of 63.9 in February where COVID-19 just started to take a toll on the oil demand and hence, price of oil (Figure 66). USDRUB, however, has been steadily falling since March onwards as oil price stabilises and CBR intervenes to stabilize the currency.

Figure 66: Ruble Has Been Weakening Against USD on the Back of Lower Oil Prices (*Source: TradingView*)

For oil and gas exporters like Russia, the impact of the falling oil price is immediate. Even Gulf states with long-standing pegs to the dollar, such as Saudi Arabia, are coming under pressure. The plunging oil price has caused ruble to be one of the world's worst-performing currencies (Figure 67). Negative dynamics were also registered for other emerging market currencies, as the MSCI International Emerging Market Currency Index declined by 3.5% in March, after a 1.5% decline in the previous month.

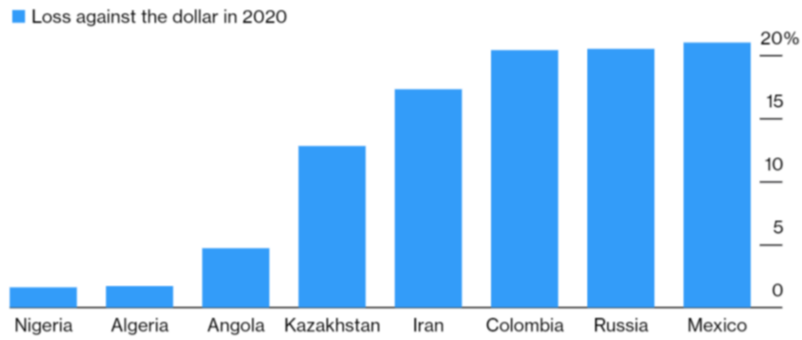

Figure 67: Performance of Major Oil Producers' Currencies Against USD (*Source: Bloomberg, bonbast.com*)

However, due to the very high dependency of Russia to the oil price, ruble has been hit very hard by the falling oil price. The market reacts substantially because oil has been the lifeline for Russia's GDP and Federal budget and with such a low price, Russia is likely to face a budget constraint to both support the economy from COVID-19 and to fund its National Projects. The problem with Russia is its high cost of production if oil stays at a low price.

Russia's dependency on imports (which grow in cost when the ruble depreciates) is much lower right now and this helps to minimize the inflationary pressure due to the depreciation of ruble linked to the crude oil price collapse. Social pay-outs and supply-side problems will add to inflationary pressures but contracting private consumption will curb annual inflation. Moreover, Russia's inflation levels are currently still way below the 4% target level, and hence, there is a buffer for the depreciation of ruble. Russia's inflation is projected to average just above the Russian central bank's 4% target in the next two years. On the other hand, the depreciation of ruble will also benefit the exporters as their goods are now more competitively priced.

The CBR has stepped in to introduce preventive measures to address exchange rate volatility. With the oil price going below the fiscal rule threshold, starting from 10th March 2020, the CBR has switched to foreign currency (FX) sales in the fiscal rule framework. In addition to that, on 19th March 2020, the CBR established a mechanism for additional FX sales on the domestic market. In case the price for Urals oil falls below USD 25/barrel, the CBR will conduct FX sales to compensate for oil, gas, and oil products exporters' revenue fallout.

As the oil price gradually increases, ruble will likely start to appreciate against the greenback. However, the extent will also depend on how the government deals with the economic downturn internally.

Ambitious Yet Futile

In 2019, Putin proposed a new broad-based stimulus package called National Projects. The program established very specific targets to hit by 2024 in various categories from social services, infrastructure to technology and ecology with a budget of USD 400 billion (RUB 25.6 trillion) over six years. This program aims to improve Russia's falling labour productivity, foreign investment inflows, and living standards.

However, things seem to be different in the execution process. In the first ten months of 2019, spending on National Projects was behind the schedule. In fact, only 52% of the planned annual amount was spent on the National Projects (24% in infrastructure projects and 12.3% in information and communications technology). We expected this problem last year as the execution itself lagged behind the original schedule. The problem is even worse now with the impact of COVID-19 on the Federal budget and hence, it is in our view that the National Projects and other fiscal measures will be delayed.

The main problem is that the government will need to draw money from its reserves to support other new measures introduced in response to the impact of COVID-19. Moreover, the main source of the Federal budget – oil revenue – has been battered so hard by the dramatic fall in price due to lower demand. In addition, tax revenue has also taken a hit as economic activity and consumption fall due to lockdowns. Tax revenues crashed by 31% in April as spending slumps and oil prices fell. It is expected that household consumption is expected to fall by about 2.6% in 2020. Furthermore, the fiscal stimulus introduced as a response to COVID-19 will result in a bigger budget deficit. Although the depreciation of ruble will help on the export side, the impact is likely to be minimal as global demand and sentiment have also weakened. Hence, it is highly likely that Russia will end up with a larger budget deficit and might affect its budget allocation to the projects.

Moreover, other problems that will aggravate Russia's Federal budget are the existing Western sanction – which is likely to become increasingly permanent – and the threat of new restrictions especially by the U.S., and retaliatory domestic regulatory restrictions. These restrictions will continue to damage the operational environment for doing business in Russia across multiple sectors into 2020–2021, with the financial and energy sectors most likely becoming the targets for potential new sanctions.

Thus, with the budget deficit expected to be seen this year due to COVID-19, a case for a further delay of this project is strengthened.

Nonetheless, our view is that this fiscal project would have very little impact on the economy in years to come and this will have an impact on Russia's GDP. This ambitious multi-billion-dollar nationwide project has been poised to fall well short of its goal of reviving the country's stagnating economy. The project is planned to be implemented over six years and expected to contribute only about 0.1% in 2020 (estimation prior to COVID-19 outbreak). As such, this economic project is likely to bring very minimal impact, and Russia's GDP is expected to grow below 2% between 2022-2024.

FX TRADE IDEA: SHORT USDRUB

Figure 68: USDRUB Daily Chart (*Source: Investing.com*)

Entry: 70.9 to 71.272
Take profit: 65.342
Stop loss: 73.719
Risk to reward ratio: 2.40

Our view is that we are bearish on USDRUB. On the RUB side, we believe that it will be bullish in 2H2020, driven by 2 main factors.

Firstly, the oil price is likely to rise, although in a slow pace as oil demand slowly recovers as governments start to re-open their economies and cuts to oil supply will help to prop up the oil price. In mid-May, demand in the oil markets continues to move upwards as people start to hit the roads, which accounts for about 50% of oil demand. Gasoline demand in the U.S. was up 46% since the low point on 3rd April 2020. The rise in demand for oil has been seen in Europe, U.S., China. The rise in oil demand, although at a slower rate, will help to prop up oil prices.

On the supply side, major oil producers have decided to cut their oil output. OPEC+ agreed to cut their oil output by 9.7 million bpd and Saudi Arabia has also recently announced to cut another 1 million bpd starting from June 2020. As a result, it is in our view that oil price will recover although at a slower pace and ruble will likely appreciate in 2H2020.

Secondly, CBR's intervention in the FX market will help to protect ruble from depreciating too much although oil prices remain low. CBR's stance has been that they are unwilling to use Russia's foreign exchange reserves which amount to USD 570 billion, as it regards them as a strategic asset against the possibility of further Western sanctions against Russia. Moreover, the money in the National Welfare Fund (NWF) also won't be used to defend the ruble, as that money is solely tasked with supporting the budget and covering the RUB 3-4 trillion federal budget deficit that is expected this year, driven by measures to contain the impact of COVID-19.

As such, CBR's decided to sell its 50% stake in the state-owned retail banking giant Sberbank to the Ministry of Finance for RUB 2.14 trillion (USD 29.1 billion) to raise money which will be used to support ruble. This USD 29bn is expected to be sufficient to defend ruble until September 2020, by which time the oil price is likely to stabilise and oil price will have recovered enough.

In case the oil price falls again, CBR will be gradually selling (its USD 29.1 billion) until the end of September as long as the price of Urals stays below USD 25/barrel. CBS has sold more than USD 2 billion in April 2020 as Urals price was below the USD 25/barrel threshold. Thus, the central bank is effectively compensating for the shortfall of export earnings, supplying the domestic market with that amount of currency as if the Urals price was USD 25/barrel.

Thus, since CBR's currency sales will automatically protect the ruble from depreciating too much, and the USD 29.1 raised will practically buy the government 5 months for the worst effects of the crisis to fade. Hence, it is our view that ruble will appreciate in 2H2020.

Now on the USD side, the near-term U.S. economic outlook darkens, with a slow recovery to follow. So far, the economic data in the U.S. suggests some improvement. The U.S. unemployment rate surged to 14.7% in April 2020 and fell to 13.3 % in May 2020. The 2Q2020 GDP is forecasted to shrink an unprecedented 35.0% after contracting 4.8% in 1Q2020. The crux of this problem is the spread of the virus.

The lockdowns to contain the spread of the virus has caused a significant slump in economic activity with the U.S. Manufacturing PMI reaching 36.1 in April and likely to rebound slightly higher to 38.1 in May. An increasing number of states are gradually relaxing lockdown restrictions although there have been concerns that it might be too early to restart activities although daily new cases figure has fallen moderately to about 15,000 new cases per day. In the early June as states across the U.S. start to reopen their businesses, seven states are reporting new highs for current COVID-19 hospitalization as of 25th June 2020.

As a result, state officials and companies have decided to delay reopening measures after the record high in new infections. More stringent rules have been imposed across states, such as Nevada and North Carolina which ordered residents to wear masks in public and Virginia moved to implement new workplace safety rules. The total confirmed COVID-19 cases in the U.S. has reached 2.84 million with 131,488 deaths as of 2nd July 2020, bringing the U.S. to the country with the highest number of COVID-19 cases.

It further proves that the risk of the second wave of COVID-19 is real and will dampen the rebound of the economy. In the U.S., the situation is even more complicated as there is a tension between the industrials who promote early reopening of the economy and the general public whose main concern is the spread of COVID-19. Moreover, the government's action towards the containment of COVID-19 is relatively lacking compared to other countries like Singapore or South Korea. Without a strict containment regulation, re-openings of the economy will be difficult and creates a vicious cycle

Nonetheless, while the removal of restrictions is important to re-start activity, any economic recovery also depends on how willing people are to participate in economic activity due to the fear of virus spread. Ultimately, the fate of the U.S. economy lies on its ability to fully contain the spread of the virus.

Furthermore, we are also seeing an outflow from USD into higher-yielding EM currencies due to the risk of recovery. The government also seems to be bearish towards the economy as Fed hinted for additional fiscal support, after USD 2.3 trillion monetary stimulus over the last few months. Ultimately, the fate of the U.S. economy lies on its ability to contain the spread of the virus. As of now, our view is that the U.S. still has a long way to go to contain the spread of the virus and thus, in line with our trade idea of shorting USDRUB.

From technical analysis, we observe that USDRUB has been in the downward trend channel since March 2020. Currently, the RSI is at 33.79, and will likely fall further to the oversold area and we will likely see a rebound at 61.8 Fibonacci level towards 70.9 to 71.272 at 50 Fibonacci level before hitting the upper bound of the downward channel. We will enter the position at the range of 70.5 to 71.272.

We believe that USDRUB will go further down to 65.342 at 78.6 Fibonacci level which is also a strong resistance-turns-into-support line (tested 7 times). This will be our target price (65.342). We will put our stop loss at 73.719 which is the 38.2 Fibonacci level, bringing our risk-reward ratio to approximately 2.4.

TURKEY (Underweight)

The world's economy has been hit hard by COVID-19 and Turkey's economy is not spared. Prior to the virus outbreak, we saw Turkey have a surge in their domestic consumption at levels that surpassed its Emerging Markets counterparts. The virus has also slowed a lot of the political disruptions as the government introduced multifarious measures to keep the virus contained within the country. Looking forward, we see Turkey once again struggle with their political sphere with their foreign counterparts as well as further challenges from the virus.

Turkey's exports are mainly machinery and transport equipment (31%), manufactured goods (25%) and iron and steel (6%). Note that their exports of mineral fuels including oil has risen drastically last year. Their main export destinations are Germany (9%), UK (6.3%), Italy (5.4%) and Iraq (5.2%)

Dealing with the Virus

The impact of the virus on Turkey is palpable, with some of the main sectors of the Turkish economy being heavily implicated due to the restriction of travel. We saw the tourism sector as well as the demand for Turkish exports being heavily affected. Prior to the virus, the demand for Turkish exports rose due to the weakening Lira. However, due to the restrictions imposed in Turkey to contain the virus, we saw the demand for exports fall as well. The effects of the virus caused a steep drop in the Turkish economy's confidence as shown in the graph below:

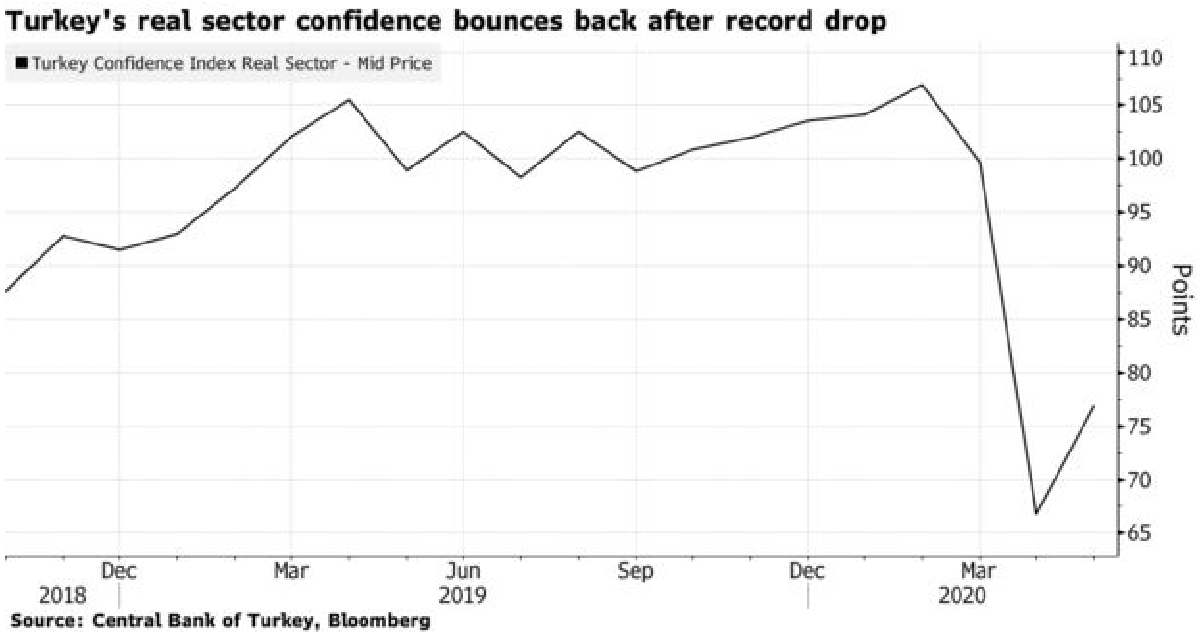

Figure 69: Chart of the Turkey Confidence Index Real Sector (*Source: Bloomberg*)

In April 2020, however, we saw a slight bounce in the confidence of the Turks as the economy found some stability amidst the COVID-19 turmoil. Taking a look at the COVID-19 situation in Turkey, we see that the build-up of cases has slowed, to the extent that the recovery rate has superseded the infection rate. The infection rate has also flattened, which is a good sign for the country – being able to contain the virus.

Looking forward, it is important that the Turkish government puts in more effort to contain the virus, to give foreigners the impression that their country is free from the pandemic to increase their severely damaged tourism industry.

The country's finances, however, does not look ready to battle the pandemic for sustained periods as seen from the mounting debt built up across the years. In April 2002, the country's debt stood at an all-time high of 1,575,600 million TRY.

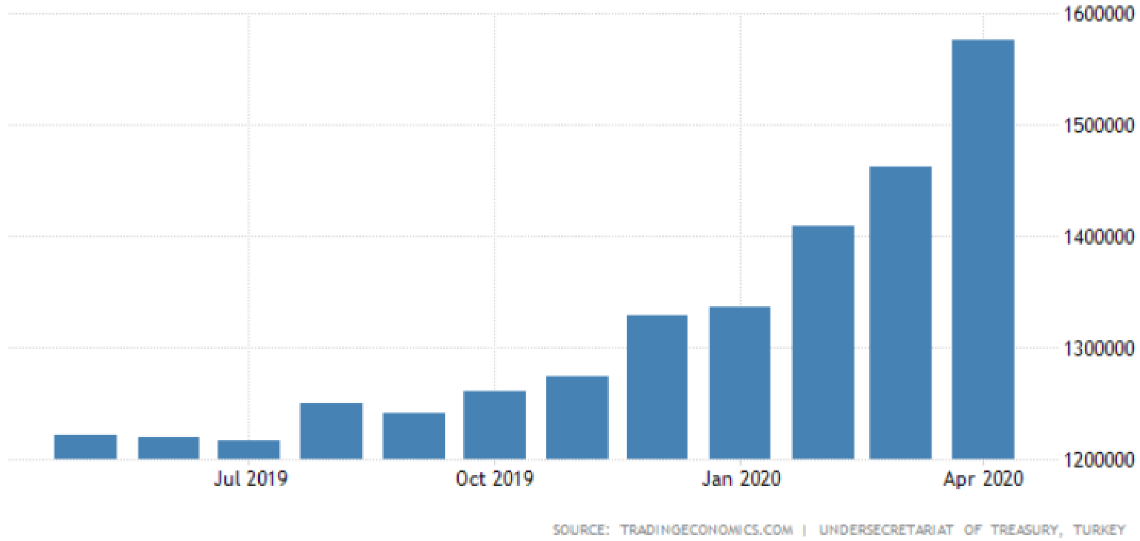

Figure 70: Government Debt in Turkey (*Source: Trading Economics*)

At the same time, the net foreign-currency reserves have taken a toll in 2020, and it is facing even more pressure from COVID-19. The Turkish government has also dismissed any possibility of seeking fiscal support from the International Monetary Fund, which will further implicate the country's ability to keep their economy afloat amidst the virus.

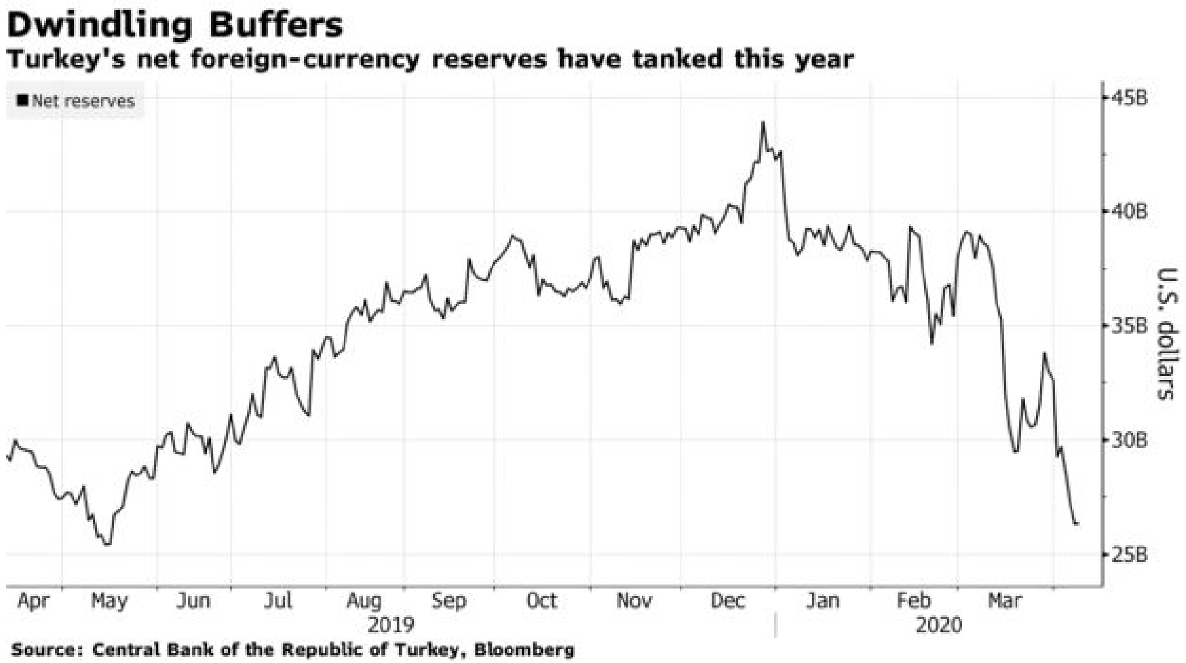

Figure 71: Turkey's Net Foreign-Currency Reserves (*Source: Bloomberg*)

The political decisions that are being made at the cost of Turkey's economy may take away Turkey's pre-virus impetus of a recovering economy and lead the country into a full-blown recession.

Another measure that the Turkish government has turned to is import compression as a form of limiting their amounts of imports by applying taxes to imports. At the same time, they have capital controls such as legislations as a hard stop to the volume of imports coming into the country. Reducing the country's reliance on their imports will increase the demand for domestic products. There temporary measures are in place to protect its own economy during the pandemic. While these short-term solutions will be able to prop the market up in this pandemic, the fundamental problems that the country is facing is inflation, as well as their political instability which will deter investors from investing in Turkey.

Looking forward, a large part of Turkey's future will be pivotal on their COVID-19 situation. As of 29th May 2020, the government has laxed many measures in place to contain the virus by removing curfews and reducing restrictions on travel between the cities. This newfound mobility for the population of 83 million strong will undoubtedly stimulate much of the domestic economy – one that had bolstered the falling economy before the virus – and will allow the economy to be saved from recession in the short term.

If successful, we will see an increase in employment as well as a growth in the country's GDP. The Turkish government will also remove its tax deferment that was in place to aid the fight against COVID-19, allowing the government to increase their own reserves from the brink.

However, we remain cautious about this move by the Turkish Government as these restrictions are the foundation that allowed the country to contain the virus in the first place.

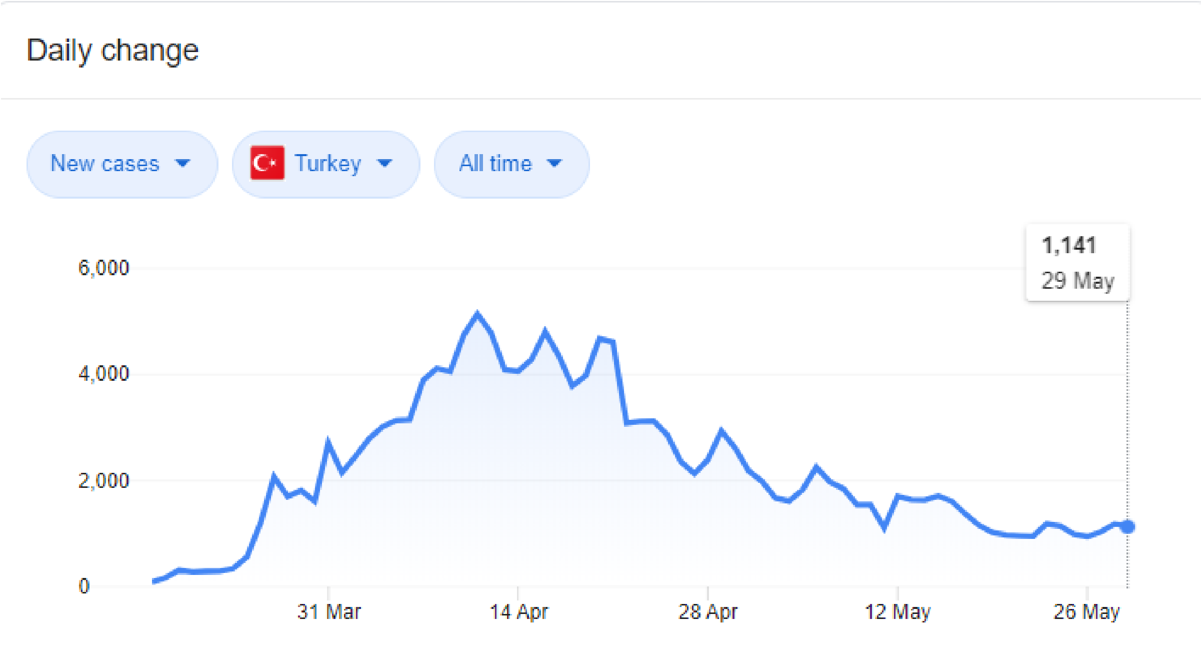

Figure 72: Turkey's COVID-19 Cases (*Source: Wikipedia*)

The chart above shows that although the COVID-19 cases in Turkey has been controlled, but it is too soon to say that it has been properly contained. Allowing inter-city travel may be counterproductive for the containment of the virus, despite its short-term economic benefits. There is also a slight possibility that the country is understating its numbers to save its suffering tourism economy and to boost the confidence of their citizens.

Turkey's local economy is also relying on cheap credit to keep their domestic businesses afloat amidst the pandemic. This move has caused lending to surge by 60% as companies have taken advantage of these lower borrowing costs to refinance their debt. Banks have extended their loans so that businesses are able to meet their asset ratio - an important move to allow cheaper lending. However, should this move backfire and Turkey relapses to another phase of uncontrolled pandemic, we will see the government's budget taking a huge toll as businesses default on their debts and the government resort to other methods to refinance these debts or to keep their local economy afloat.

Ideally, the country can still afford to keep measures tightened for a prolonged period. Their first priority should be to further control the COVID-19 spread to salvage their tourism sector and boost investors' confidence that the country is able to control the outbreak before increasing domestic demand through loosened measures.

Lira's Laments

The government has many regulations in place to restrict the trading of the Lira, to protect their currency. There have been many new currency interventions, such as the USD 15 billion currency swap deal with Qatar has allowed the Lira to strengthen in light of potential financial stability. Foreign investors who were previously unimpressed with the weakening lira has shown some respite as the Lira strengthened against the dollar, now trading at 6.8218 as compared to the 7.1968 in early May.

Figure 73: Central Bank of Turkey Interest Rates (*Source: Trading Economics*)

The strengthening of the currency sheds the potential light at the end of the tunnel for Turkey. Part of the reason for this newfound strength was due to the cut in interest rates by the Central Bank of Turkey. The cut is the right step towards market stimulation as well as a healthy level of inflation - one that is correlated to the growing economy, rather than stagflation. We would expect further cuts, allowing for more borrowing of the Lira. This increment in the foreign reserves will aid with the government's budget spending to fight the aforementioned COVID-19.

Interest rate cuts will cause a healthy level of inflation but at the same time increase foreign investments as foreign investors' shorter-term goal is to see the country stay afloat amidst COVID-19. On the other hand, modest interest rates will be a better stimulus than more drastic cuts (despite interest rate levels standing at 8.25%, which signifies more room for further cuts) as uncontrolled inflation will once again deter foreign investors from investing in Lira-denominated assets.

The Central Bank of Turkey has also implemented other fiscal policies as well as easing to support the economy. In light of the virus, these methods are a short-term solution to the devastated economy and are justified despite the noticeable side effects of inflation as well as a diminishing currency reserve. These measures provided liquidity to lenders as well as a lifeline to households devastated by the virus.

In the longer term, drastic cuts in interest rates will also erode Turkey's competitive advantage amongst the other emerging markets' assets in terms of their carry trade. This will potentially weaken the currency even more.

Exports Contraction

The top few Turkish exports are closely related to the manufacturing industry, with vehicles (15.3% of total exports) being at the top.

Turkey's exports have remarkably made new highs in January and February, despite the start of the outbreak. The 4.9% surge in the first quarter came from the shifting of orders by importers of different countries. Countries like Israel (one of Turkey's main importers) have shifted a large portion of their imports including steel, iron and vehicles from the Chinese to the Turks. This shift in supplier is because of Turkey's reasonable prices (stemming from their weak currency) and their proximity.

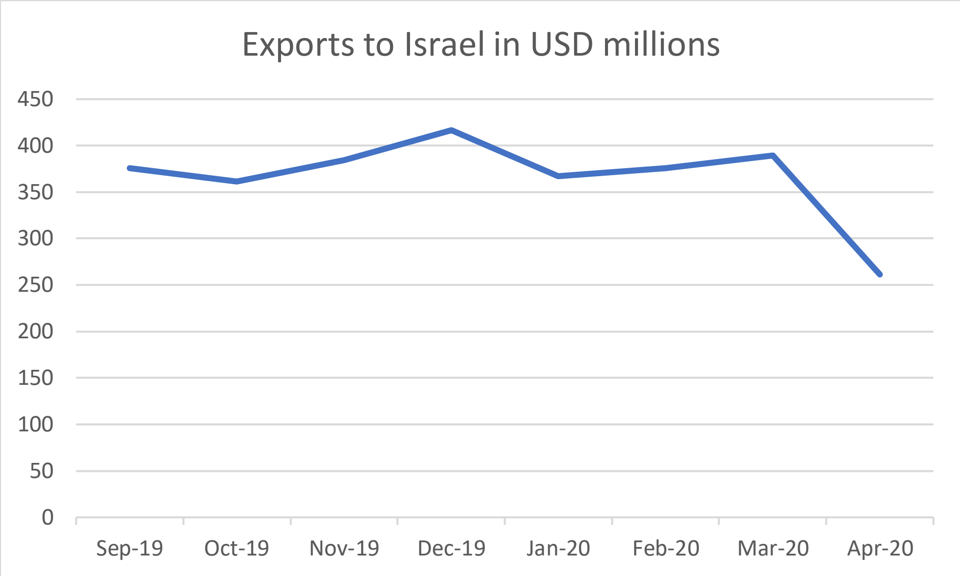

Figure 74: Exports to Israel (*Source: Trading Economics*)

However, this surge was short-lived as most of the imports were simply front-loading of goods in preparation of the virus. We saw a 32.9% decline in exports to Israel in April, hinting at Israel's economy suffering, such that the previously purchased inventory has not been fully cleared.

Looking forward, Turkey will remain as a key exporter for many countries as long as their products remain competitive and their currency weak. This pandemic has given them customers that will stick around for a long period after the pandemic subsides.

With global auto sales expected to fall by a whopping 22% due to the pandemic, we expect Turkey's export for vehicles, mineral fuels as well as metals (all linked to automobiles and transport) to fall drastically throughout the year as well. This will be coupled with layoffs within their largest export sector and will in turn snowball to weakened domestic demands.

In 2019, a notable change in the Turkish exports are their processed petroleum oils, which increased by 62.6% from 2018. This drastic change placed it comfortably as the 7th largest Turkish export. At the same time, Turkey is looking to explore for oil wells in Libya. The eastern Mediterranean is an area that are filled with oil sources and Turkey is looking to expand its share in the oil industry by tapping onto these sources.

Zooming in to Turkey's largest importers, Germany and Italy's imports have been severely affected by COVID-19, with Germany facing their first recession since the World War. Italy's forecasted imports in 2020 is expected to fall by 14.9% due to the stagnation of their economy. Overall, the protectionism caused by COVID-19 has reduced overall exports and imports, leaving countries to rely on their domestic demand to keep their economy afloat.

Although the outlook in the shorter term is pessimistic due to the demand shock from Turkish exports, we expect to see a sharp bounce as soon as the COVID-19 situation is controlled within their importers. A recovery in the automotive and manufacturing industry will also benefit Turkey's exports after the COVID-19 situation tides over.

FX TRADE IDEA: LONG USDTRY

Figure 75: USDTRY Daily Chart (*Source: TradingView*)

Entry: 6.8295
Take profit 1: 7.2021
Take profit 2: 7.3394
Stop loss: 6.3394
Risk to reward ratio (for take profit 1): 1.59

The trade idea presented is to long the USDTRY trading pair. While Turkey looks promising in the further future when COVID-19 is in control globally, the short-term outlook is still at an underweight due to its heavy reliance on their tourism sector as well as their exports.

The frontloading of exports is partially responsible for the fall in the USDTRY trading pair, causing it to break the strong upward channel that it has been following since March. The positive news on their balance of trade is also responsible. Looking forward, the numbers will not look as good as countries reduce their demands for Turkey's main exports which are heavily reliant on the global manufacturing industry.

This trading pair is also largely dependent on the U.S. markets. As we speak, the U.S. has also been starting to shift their focus on reopening their retail markets – and this will strengthen the previously weakened domestic market within the U.S. We will see the strengthening of the U.S. market to be stronger than Lira's rally, causing the trading pair to be more bullish. Whilst the U.S. has resorted to easing to stimulate the market, Turkey also has a lot of room for interest rate cuts. Their interest rates currently stand at 8.25%, and analysts have predicted another 100bps cut by the end of 2020.

The technical analysis of the chart shows that the trading pair is underbought, having tested the 35% underbought level before hitting key support from the previous structure. However, we think that the currency pair will resume its upward momentum as Turkey tries to stimulate its economy again through easing or interest rate cuts. Our stop loss is represented by the 0.618 Fibonacci retracement level whilst our first, more conservative take profit level stands at 7.2021, which was the previous high that was tested.

SOUTH AFRICA (Underweight)

South Africa has had a history of piling debt and a lot of the country's healthcare and other infrastructure are not as developed as their emerging markets counterparts. A large part of their population still remains detached from technology and the country needs major restructuring to keep up with the rest of the world.

Needless to say, COVID-19 has negatively impacted the country's economy severely – reducing demand for their exports and tightening the government budget as much of it is spent on controlling the pandemic.

The export breakdown of South Africa stands at gold (16%), diamonds (9%), platinum (8.3%) and coal (5.8%). A large driver of the economy is their finance department at 20%, while government spending and trade comes in after at 18% and 15% respectively.

The African Debt Bomb

Well before the onslaught of COVID-19, Africa had been heavily in debt. The government needed a lot of additional funds to restructure their companies, especially the electricity companies that were powering the mining industry. These mining companies were facing dangerous blackouts due to the inability of the country's infrastructure to handle their operations. In addition to restructuring, the government has also taken up more debt to fund the retraining programmes for existing employees to upgrade the people of Africa. South Africa has also increased the amounts of government bonds to be sold weekly at auctions in an attempt to aid with their budget deficit.

To add insult to injury, Moody's downgraded Africa's credit rating – a move that started the exodus of capital outflows from the country. This credit downgrade was late as compared to Moody's credit rating counterparts, who had downgraded their ratings to junk territory in 2017 in light of the increasing debt.

The credit downgrade did not come as a surprise even before the pandemic. Africa's mounting debt-to-GDP ratio has been increasing at a worrying rate as shown below:

Figure 76: Africa's Debt to GDP Ratio (*Source: Statista*)

In addition, the debt service costs made up 13% of the total government expenditure and 16.4% of revenue in Africa's 2020/21 budget. This is a drastic increase from the mere 8% in 2009/10.

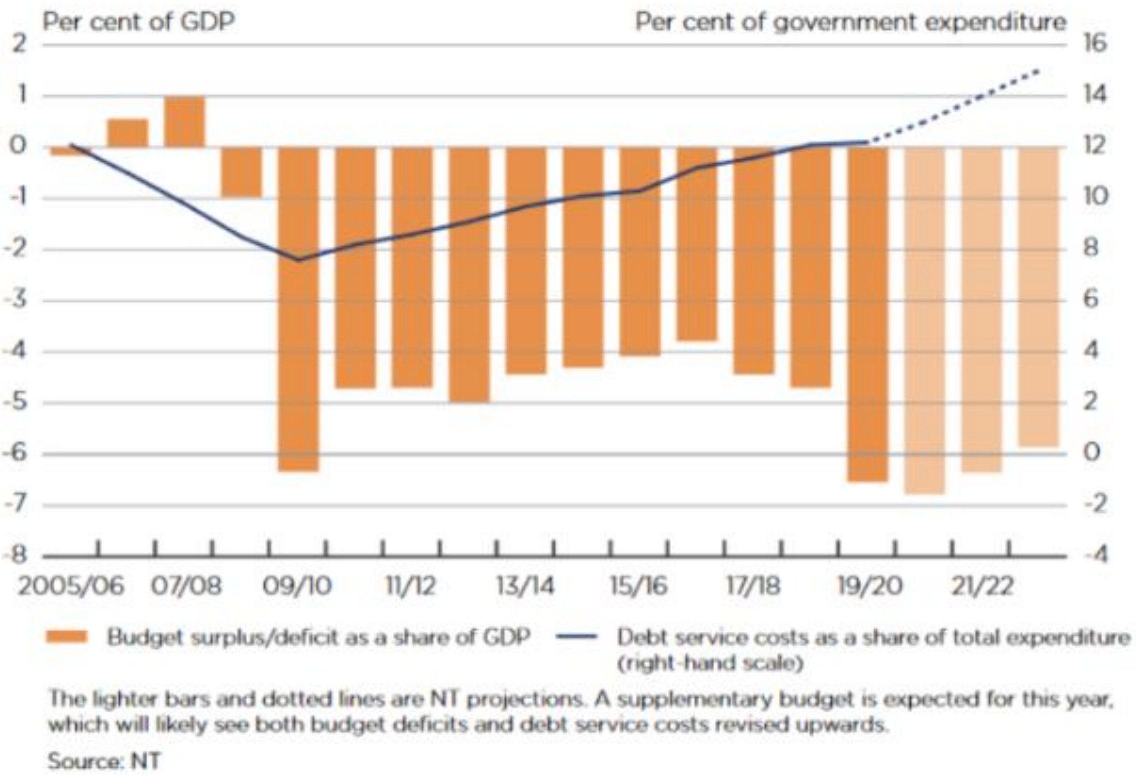

Figure 77: Government Budget Balance and Debt Service Costs (*Source: New York Times*)

Touching on COVID-19, the poor healthcare infrastructure coupled with loose implementations on restrictions has caused investors to be worried about the country's actual count of their infected citizens. The government has also dedicated much of its already limited budget on fighting the virus, further incurring even more debt for the country.

Africa has also been hit especially hard along with other countries that are dependent on minerals and commodities as their main export. The plummeting oil and commodity prices along with the ever-weakening African Rand has increased external debt servicing costs and severely impacted the country's balance of trade.

Looking forward, there is a silver lining that in this turmoil for the country is that most of the government's debt (90%) is denominated in their local rand. While debts that are denominated in foreign currencies have increased exposure to exchange rate risks, a large part of the country's debt is safe from the potential currency depreciation that might follow should capital outflows cause the rand to nosedive.

In order to fund the government's latest ZAR 500 billion stimulus package, President Cyril Ramaphosa has asked for foreign aid to freeze the debts that they owe for two years while the country tries to tide over the pandemic. While foreign investors may be reluctant to have their payments delayed, many agree that this is the only way to prevent the country from falling further into a recession and possibly defaulting on their existing debts. South Africa's Term-to-maturity of foreign debt stands at 10.0, and it is expected to grow as South Africa issues out even more bonds to plug their fiscal deficit. This bleak outlook for the country may negatively affect its credit ratings even more - causing them to lose access to reasonable rates for borrowing.

African finance ministers have also requested for some debts owed by Africa's poorer nations to be completely cancelled while other nations' debts refinanced into longer term and lower interest rates loans.

The SARB has announced that they would expect a GDP contraction of 7% and unemployment is expected to rise by 20 million in 2020.

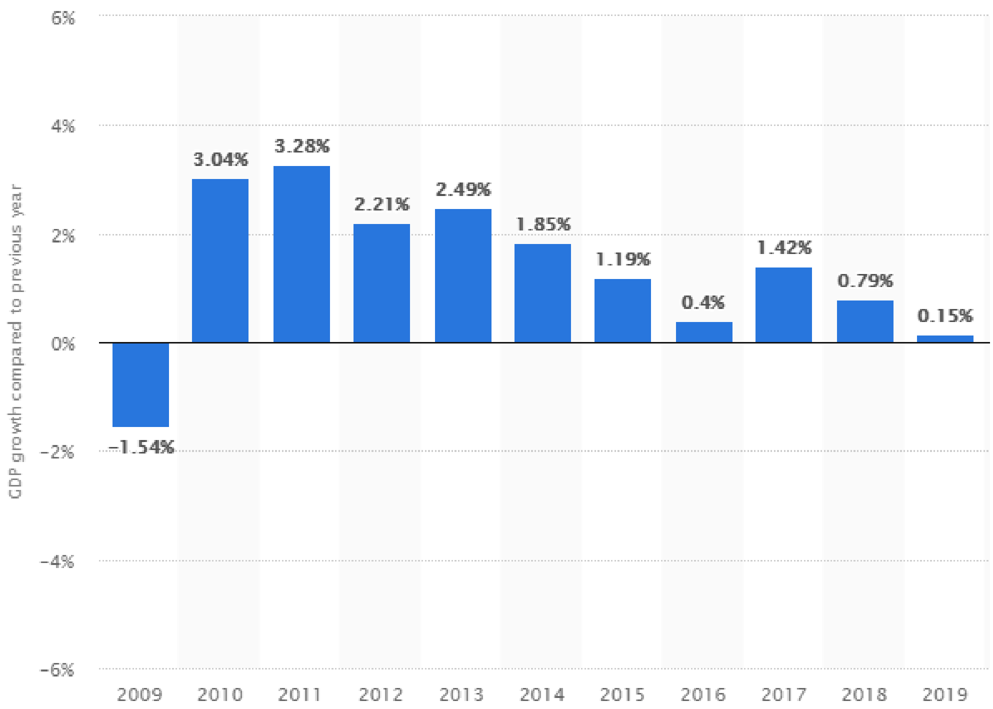

Figure 78: South Africa Real GDP Growth Rate (*Source: Statista*)

While the country has been facing almost stagnant real GDP growth rate in the past 2 years, this 7% contraction will be putting the country back by years in terms of their economic output. The worst that Africa has faced before this was a mere -2.1% in 1992 post World War II.

However, the bank has also announced that the growth forecast for the following years of 2021 and 2022 are 3.8% and 2.9% respectively. This is under the bold assumption that the country has kept the virus in control by then (in addition to staying afloat amidst this trying period), and the aforementioned restructuring programmes would go according to plan.

China will be at the forefront of Africa's debt relief, as they are the biggest creditors of Africa. While they are likely to endorse a temporary debt payment freeze as requested by African countries and agreed upon by the G20 major economies, it is unlikely that China will provide further debt relief in the near future. This is because of China's efforts to help its own economy recover and to prepare for a possible wave two of COVID-19. The U.S. is also unlikely to step up with further debt relief for Africa given Africa's heavy borrowing from China.

<u>Locust Invasion</u>

A large part of Africa has been hit severely with waves of locusts. These locusts threaten not only the country's economy, but it threatens the food security of locals who have already been hit by COVID-19. Agricultural products make up 5.8% of the country's exports, but most of the food that is consumed by locals are being grown locally as well. The damage caused by these locusts are drastic – with some swarms capable of wiping out 200 tonnes of vegetation in a day.

The World Bank has pledged USD 500 million to fight the locust swarms in Africa and the Middle East. The projected economic damage of the locusts without intervention could result in a USD 8.5 billion loss for the countries. A large portion of this money will go towards the short-term compensation for farmers in terms of seed and animal fodder to keep their livelihood afloat while the remaining money will go towards training and air control – the more permanent solution to the problem.

Looking forward, despite the intervention by the World Bank, countries affected by the swarms of locusts are expected to face economic losses of USD 2.5 billion in 2020. The death toll and unemployment which could follow would also severely weaken the countries' domestic demand and put even more pressure on the government's budget to deal with the problem.

Juggling both COVID-19 as well as the locusts will be an uphill battle for Africa, and it is in dire need of external, cheap financing to keep their economy afloat.

Commodities and Other Exports

As the virus is being controlled within the country, Africa has taken measures to stimulate the economy in hopes of recovery. South Africa diesel shortage will be eased as 30% of previously sedentary refineries will be active. This has also extended a planned shutdown of the Glencore Plc-owned Astron Energy Cape Town refinery. Despite the plummet in oil prices, we expect to see a healthy rebound when the global manufacturing industry picks up.

The global manufacturing industry has taken a hit in light of the pandemic, and we remain neutral on the price of oil due to the risk of a second wave of outbreak. Should there be no second wave, we expect a healthy rebound for the price of oil, which will benefit Africa's GDP growth as they rekindle their previously idle oil rigs. Many of Africa's top exports are metals that are heavily involved in manufacturing processes. As companies have frontloaded a large portion of their orders in light of the pandemic, we expect to see a fall in the number of exports for these metals throughout the year.

South Africa also relies a lot of the global demand for gold and precious metals. This could be good news as the price of gold is testing new highs in light of the pandemic. As interest rates remain low (and expected to remain low as the higher debt in U.S. does not push bond yields higher), we expect the price of gold to increase as well. Higher inflation stemming from easing by the different countries (most notably the U.S.) as well as a rebound in the aforementioned oil prices will lead to demand pull inflation as when the COVID-19 situation has stabilised. These factors will lead to a bullish price for gold and benefit Africa.

FX TRADE IDEA: LONG USDZAR

Figure 79: USDZAR Daily Chart (*Source: TradingView*)

Entry level: 17.548
Take profit: 19.148
Stop loss: 17.180
Risk to reward ratio: 3.15

Despite the USDZAR hitting record highs earlier in the year, we are looking to long the currency pair. This stems from South Africa's weak economy – one that is bogged down with heavy debt and poor infrastructure. The mounting debt coupled with the increasing costs of debt has put enormous pressure on the South African economy. The chicken and egg situation of having too tight of a government budget to fund restructuring and education has led to increased borrowing, but at the same time even more debt for the country to handle.

Looking forward, we see a possible second wave of COVID-19, which will take an enormous toll on the South African economy as their healthcare infrastructure and technology may not be able to keep up with a second wave. A second wave of virus can also hurt foreign economies, particularly those that have been providing South Africa their much-needed debt relief. This will affect the manufacturing industry reliant country and their ability to repay their debts if they are not given debt relief.

Juxtaposing South Africa's economy to the denominator, the U.S. seems to be in a better position than South Africa. The U.S. has been preparing to reopen their retail stores which will boost their domestic economy, strengthening their currency against the South African Rand, pushing the currency pair up. At the same time, parts of Africa have been bogged by swarms of locusts, which will affect both the morale and livelihood of locals, who depend directly on their vegetation for food. Unemployment is also expected to rise further in South Africa despite the reopening of oil rigs. Government spending drives a large part of the economy and a tighter budget will delay the country's much needed restructuring efforts.

Looking forward, South Africa will likely carry out both easing and interest rate cuts as there is still room for both. A large portion of South Africa's currency is denominated in its own rand and therefore, cheaper borrowing and injection of money will greatly aid the economy, but at the same time give upward pressure towards the currency pair.

The currency pair has recently broken its upward channel since March. The currency pair has also found support in previous structure. The RSI has been tested at the 33% level earlier in May and we expect to see the currency pair resume its upward momentum in a few months. There was a strong bearish divergence noted in the RSI and a safer bet would be to wait for a slight correction around the 61% Fibonacci retracement level before carrying out the trade. The strengthening of the currency stems from optimism over South Africa's COVID-19 situation as well as promises of debt relief to the country. However, given the mounting debt and high unemployment of the country, we expect their GDP production to still remain low given the slowdown in the global manufacturing industry.

We will be looking at a take profit level of 19.1458, which is represented by the precious high before a double top was formed. We will also be taking our stop loss at 17.1758, which is a support combination by previous structure and the Fibonacci 0.618 level.

CHINA (Overweight)

China's economy was reeling from the headwinds caused by the U.S.-China trade war in 2019 causing the economy to grow at its weakest pace in the last 3 decades. The end of the trade war was a false dawn to a strong Chinese recovery as COVID-19 swept across the world. China is no longer on track to achieving its goal in doubling the size of its economy by 2020 from 2010 and has abandoned their 2020 economic growth target as of 22nd May (which will be elaborated on below). We feel that the strong response to COVID-19 coupled by its resilient economy would provide China a strong base to recover and get its growth story back on track in 2021. However, there are some potholes on the road to recovery and China must ensure that it is able to maintain her relationship with the U.S. and ensure that there is continued investments into their capital markets.

COVID-19: A steady Recovery for China

Total Coronavirus Cases in China

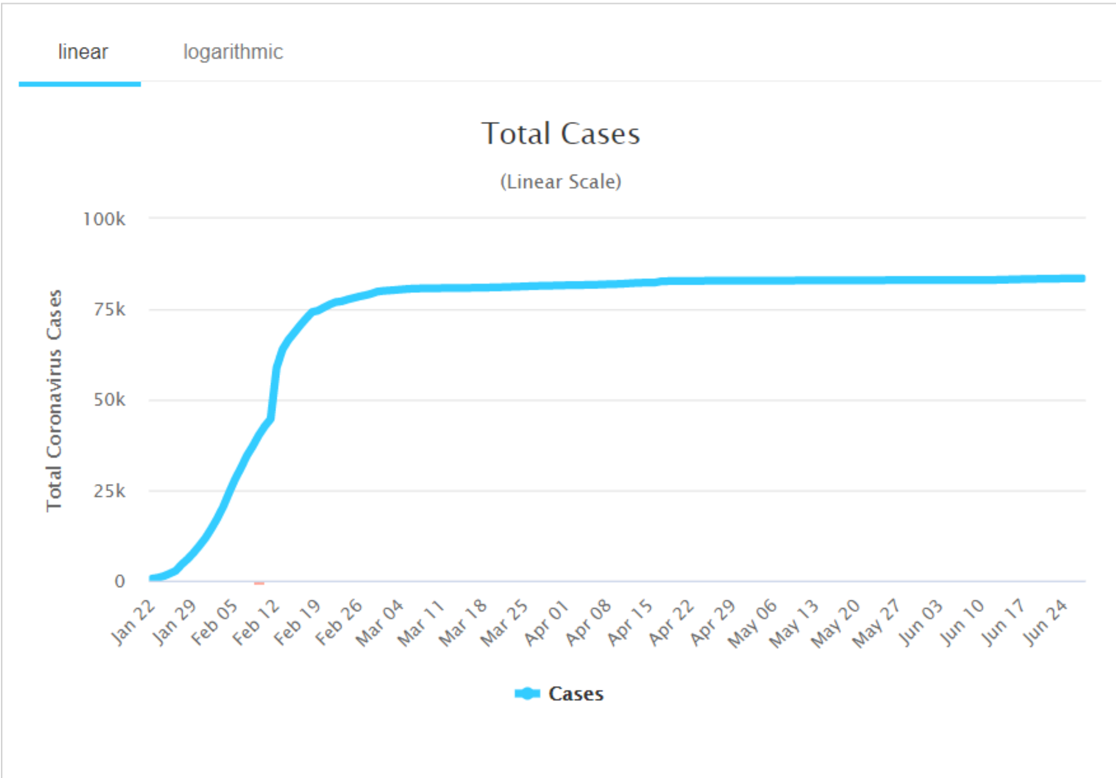

Figure 80: Confirmed COVID-19 Cases in China till 28th June (*Source: Worldometer*)

COVID-19 was first identified in Wuhan China in December 2019. In 5 months, the virus has swept across the world infecting more than 5 million individuals and killing more than 300,000 people (as of 31st May) with no end in sight. China responded quickly, shutting down Wuhan, the centre of the pandemic by Chinese New Year. This led to China being one of the fastest countries to recover with imported cases exceeding community spread by late March. As you can see from the figure above, the number of confirmed cases slowed down significantly.

China has continued to remain vigilant for a "second wave" which was evidently shown when a new cluster of cases emerged in its Rust belt Region consisting of Jilin, Liaoning and Heilongjiang in the Northeast. Bloomberg reported that the government sprang into action halting public transport services for more than 100 million people and sealing off residential compounds in some cities. According to Xinhua news, Wuhan has retested its whole population in a span of 10 days to combat asymptomatic cases. Another instance of a second wave emerged in Beijing with nearly 270 new locally transmitted cases being reported since June

11. China put up a similar response in Beijing and the outbreak has been reported to be contained by NBC with health officials reporting a daily case increase in the single digits. This aggressive testing will ensure that new cases are quickly identified and separated from the rest of the population to prevent another outbreak of the disease.

China has also announced new social distancing and hygiene measures to prevent the spread of the virus. The World Economic Forum reported that there are strict enforcements for people to wear masks in public and fines for those who cough and sneeze without covering their mouth or nose in public. Various infrastructure like plastic shields have been installed in schools and restaurants to help provide ample division between people. We feel that China's strict measures will help reduce the community spread of the virus.

According to Bloomberg, China is also the frontrunner in developing vaccines for the virus. By mid-May, there were 5 drugs undergoing human trials with over 2,000 individuals enrolled for phase 2 trials. We expect China to continue to speed up development of the vaccine but only expect it to be available in 2021. The WHO has come out to say that the best ways for countries to combat COVID-19 are through aggressive testing and enforcement of social distancing measures until a safe vaccine is created. We think that China's public health plans against the COVID-19 virus are aligned to WHO's recommendation. Due to the political system in China, there is less bureaucracy present and Beijing can push policies down to swiftly contain the virus. We have continuously seen a swift and decisive response from the Chinese government containing second waves in the rust belt and in Beijing. This is advantageous for China's economy as it will help limit the impact and spread of the virus. Therefore, we feel that China has a strong handle on the COVID-19 situation. They will continue to remain vigilant to prevent a second wave and reopen the economy in fast and safe manner. A faster reopening of the economy would help China return to "business as usual" as fast as possible. We think that China will have a relatively faster reopening compared to other countries who have been affected by COVID-19 as their public health response is not as robust as the Chinese.

U.S.-China Relations: Tethering in the Balance

Our team covered on the breakthrough in U.S.-China relations with the signing of the phase 1 deal on 13th December in our last report but shared our reservations that the phase 1 deal was merely a new baseline and that there could be other matters that could sour the relationship between these 2 countries.

The relationship between both countries have since taken a turn for the worse ever since the COVID-19 pandemic erupted at the start of the year. On 29th May, Trump came out to bear no responsibility for the 100,000 American deaths during the pandemic and has shifted the blame to China. Both countries have exchanged words blaming each other on the handling of the virus which ultimately led to Trump announcing that the U.S. would leave WHO. Both countries have also exchanged words in regard to the phase 1 deal, Hong Kong and the securities market. We will slowly elaborate through this report on the various sticking points of their relationship.

2020 : U.S. trade in goods with China

NOTE: All figures are in millions of U.S. dollars on a nominal basis, not seasonally adjusted unless otherwise specified. Details may not equal totals due to rounding. Table reflects only those months for which there was trade.

Month	Exports	Imports	Balance
January 2020	7,215.3	33,280.6	-26,065.3
February 2020	6,815.0	22,813.1	-15,998.1
March 2020	7,971.9	19,805.4	-11,833.5
TOTAL 2020	**22,002.2**	**75,899.1**	**-53,896.9**

Figure 81: U.S. Trade with China (*Source: U.S. Census Bureau*)

On the trade front, we cannot discount the fact that the U.S.-China trade deficit has been on a steady decline as we can see from the table. This has been Trump's goal since the start of the trade dispute. Arguably, while the COVID-19 situation may have led to a distortion in the trade numbers and may not be an accurate representation of their trade relationship, we are of the view that the drop in exports to China in February 2020 was due to the strict lockdown posed. We see that U.S. export numbers recovered in March 2020 to higher levels than January 2020 (which was pre COVID-19) and we expect it to continue to increase overtime. The data shows that the trade balance between the U.S. and China was improving after the phase 1 deal was signed.

In Early May, Steven Mnuchin and Vice Premier Liu He discussed about the phase one deal and pledged to press ahead despite the virus causing a disruption to some of the milestones that China had to achieve. Mnuchin came out on 22nd June to backtrack on comments made by Trump on the decoupling of U.S. and China saying that he does not think this is a reasonable policy option at this point. We believe that this statement made by Mnuchin has reassured that the U.S. will continue working towards a trade deal with China with markets also rebounding after the announcement of the news.

According to CNBC, China has made some purchases of U.S. agricultural goods but remain far off from the promised USD 77 billion increase as the Chinese economy is still getting back up to speed. On 1st June, Bloomberg reported that the Chinese government told state-owned traders Cofco and Sinograin to suspend American farm good purchases. This include products like soybean and pork. In our opinion the statement made was revealing an inevitable outcome as the Chinese would not have been able to meet the demand either way.

We also see a new sticking point for U.S.-China relations in the form of Hong Kong where Trump brought forth criticism on Beijing's new security legislations for the country. U.S. is still seen as a balancing power within East Asia with military presence in Japan and Korea. The U.S.' political stance has always been to be the "big brother" and be the aid to weaker nations. Trump has stated that he would begin the process to remove Hong Kong's privileged trade status which would remove some of the privileges China would have enjoyed when Hong Kong returns to them.

With the ongoing war of words between China and the U.S., Larry Kudlow has gone on CNBC on 28th May to suggest that the trade deal will continue. We think that even after China's escalation (reducing agricultural imports), the phase 1 deal would continue as China was already going to miss those targets and the escalation is merely an empty threat which create no additional losses for the U.S. We feel that the U.S. will not escalate the situation and continue to only make verbal threats which we believe is a stance that Trump is trying to angle for his upcoming re-election. We do not expect him to act upon his words as it is merely a means to drum up protectionist American support. We also expect China to get their way in their treatment of Hong Kong as it is inevitable that the country would fully re-integrate with Beijing.
The relationship between the 2 superpowers have strained especially during Trump's presidency. We continue to believe that the phase 1 deal remains as the baseline for their current trade war and that verbal exchanges without serious actions would continue between both nations.

China's Growth: A U-Shaped Recovery

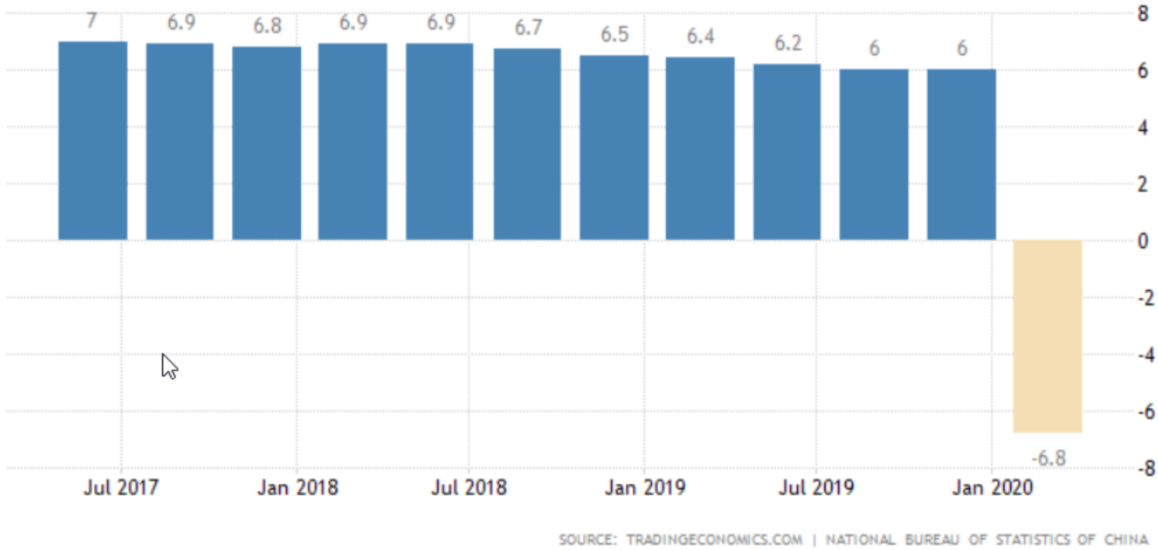

Figure 82: China's Quarterly GDP growth (*Source: Trading Economics*)

According to the latest IMF projections, China is set to grow at just 1% in 2020. However, this is at a faster pace as compared to the rest of the world whose collective GDP is estimated to decline by 4.9%. This number is also in contrast to its most recent quarterly growth rate which was at -6.8%. In a statement on 22nd May at the National People's Congress, the Premier of the State Council of the People's Republic of China Li Keqiang announced that Beijing will abandon its 2020 economic growth target. He cited that the difficulty to predict certain factors and the uncertainty caused by the pandemic contributed to the decision. The Caixin manufacturing PMI rose to 50.7 in May from a historical low of 40.3 in February. Manufacturing is the most important sectors contributing to about 39% of China's GDP in 2019 according to Statista. Demand conditions remain weak due to a notable fall in export orders. Firms continue to cut their workers with backlogs shrinking for the first time since February 2016. A CNBC report dated on 25th May shared that China is likely to be the first economy out of the lockdown, but other countries might not be ready to start importing from them soon. We expect business sentiment in China to continue to recover as the rest of the world recovers from the virus but at a slow rate. Big importers of Chinese goods like the U.S. and EU are still emerging from their lockdowns, hence we expect manufacturing to pick up slowly.

The Caixin China General Services PMI rose to 55.0 in April up from the low of 26.5 in February. This was the third straight month of contraction for services which have been the worst hit from the pandemic. Services make up 53.9% of China's GDP in 2019 according to Statista. We feel that measures for crowd control and social distancing will become a new normal across the country. Travel restrictions have also not eased as the rest of the world is still grappling with the virus. Hence, we expect to see services continue to show weakness. We only expect to see things return to normal levels once a vaccine has been released. China's consumer spending in April shrank by 7.5% as compared to a year earlier and was attributed to the widespread loss in jobs. To counter the drop in consumer spending, China has set a job creation target of 9 million new urban jobs compared to 11 million last year with urban unemployment rates rising to 6% from 5.5% last year. We feel that this job creation will help spur the Chinese economy put spending power in the hands of the burgeoning Chinese middleclass but is not enough to return all the jobs lost during the COVID-19 crisis.

We expect a U-shaped recovery as China is unable to quickly return to the levels before COVID-19 struck. GDP targets have been abandoned which shows that the country is not looking to return to its 6.1% annual GDP growth in 2019. Firstly, Factories are still restricted on the demand side as the rest of the world emerges from their respective lockdown. Secondly, services will also not resume normal operations due to social distancing and safety measures. Lastly, jobs will not return to pre-crisis levels. We do not see the 3 points happening in the span of the next few months and hence rule out a V-shaped recovery and postulate a U-shaped recovery.

PBOC: Shoring Up the Chinese Economy

The PBOC previously responded to the trade war by cutting their top tier value-added tax to 13% (from 16%) in April 2019 as well as raised the personal income tax threshold to USD 705 in January 2019. This was done to spur domestic consumption which has been a focus to move China's economy away from being trade dependant. The total tax cuts for 2019 amounted to USD 324 billion for that year. We feel that these policies helped to provide a counterbalance to the tariffs that were implemented by the U.S.

This year, the PBOC set a local special bond quota of USD 527 billion which was USD 225 billion more than the previous year. This was used to shore up the central bank and allow them to offer a USD 350 billion package which allowed them to temporarily exempt value-added tax from public transport, the hospitality and tourism industry, the food and entertainment industry, culture and sports, aviation as well as ports. Corporate income tax as well as taxes from self-employed individuals will also be postponed to next year. Low income earners will be allowed to postpone the payment of their social insurance premiums and all employment related government charges have been cancelled. There was also a 5% reduction in electricity prices paid by companies while internet and broadband fees were cut by 15% on average. Rent payment for tenants on state-owned property was lowered with some even being exempt.

The special bonds issued by the PBOC is not included in their budget and does not contribute to the government budget. However due to this stimulus, the deficit ratio is targeted at 3.6% which is a record high as compared to 2.8% last year. We feel that this increase in deficit is not worrying with S&P and moody maintaining their credit rating at A+ and A1 respectively (it has maintained its rating since 2017). Due to the extraordinary times, China had to come up with extraordinary policies in order to shore up her economy.

Figure 83: China's Loan Prime Rate (*Source: Trading Economics*)

China was early in the global rate cutting cycle cutting Laon Prime Rates by 10bps in February 2020 and by 20bps in April 2020. These early cuts were expected as China was the first nation to face the brunt of the virus. However, with rates being held steady in the May meeting and with China on the cusp of recovery, we feel that the PBOC will continue to keep rates at this level.

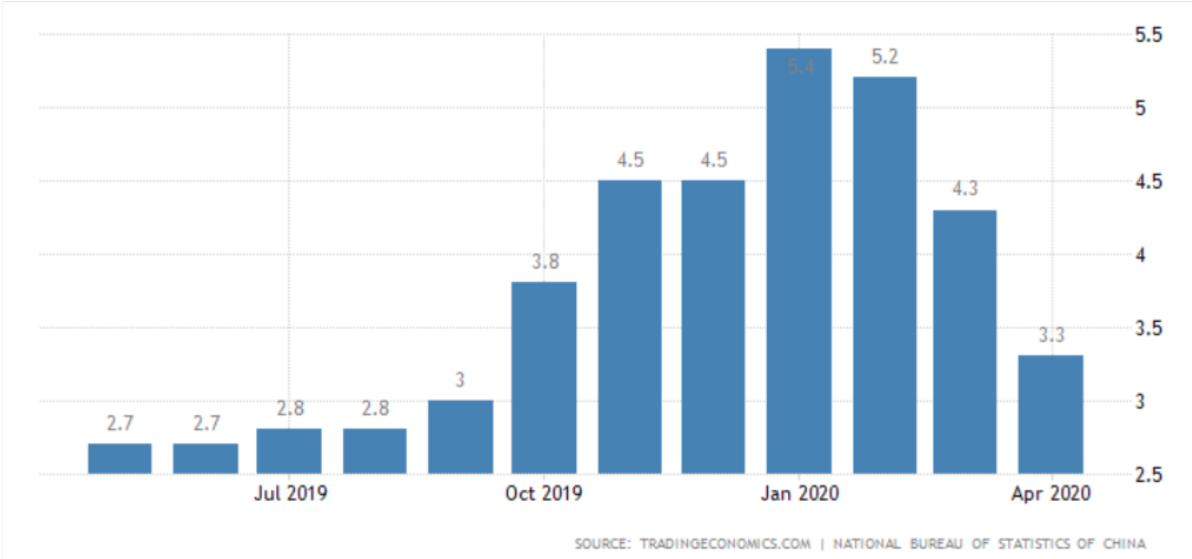

Figure 84: China's CPI (*Source: Trading Economics*)

We previously reported that the CPI was above the PBOC's target in November and December. However, we do not view it as a sign of an overheated economy as it was driven by the increase in pork prices due to the African Swine Flu outbreak. After the COVID-19 outbreak, we saw a weakening in price pressures and CPI fell to 3.3% in April after peaking at 5.2% in February. We expect to see CPI stabilize as the factors for the cost push inflation with South China Morning Post reporting that pork prices have fallen from their historic high of CNY 41 per kg to CNY 28 per kg in May. We also expect the weakened economy to cause more weakening price pressures with low growth expected for 2020.

We feel that the PBOC has good control of the monetary situation in China. Targeted fiscal policies to protect jobs and business coupled with disciplined monetary policy to keep a check on inflation will provide a springboard for a strong economic recover.

Capital Markets: Internationalisation Stunted

China's financial industry is estimated to be the size of USD 45 trillion. In our previous report, we discussed about how China was pushing to internationalize its financial markets allowing global firms to set up majority owned securities entities in China by raising the cap on foreign ownership of securities operations to 51%. This was finally passed on 1st April which has caused a flurry of activity in the securities industry with banks like J.P. Morgan increasing their China hiring as reported by Finews Asia.

Figure 85: Shanghai Composite Index (*Source: Market Watch*)

Our previous report also predicted a strong 2020 for Chinese equities. Markets peaked in December due to the closing of the phase 1 deal which is in line with our prediction. However, the COVID-19 crisis brought about a strong bearish sentiment to the market and we saw a market sell off in the Shanghai Composite. The market met a second bottom as the virus spread aggressively around the world affecting investor's sentiment expectations of global demand. We have since seen the index recover and expect it to trade above its 200 moving average as the country begins to reopen and demand for Chinese goods returns to the world. This was in line with EPFR's report that more than 800 funds invested USD 500 billion in Chinese stocks in April which is up by about 20% a year ago. COVID-19 has caused a dent in the Chinese equities narrative but we feel that China's economy is still positioned to perform relatively better than its peers which would give it greater allocations from fund.

However, China faces a new threat which could cause a halt in their internationalization in the capital markets. Luckin Coffee disclosed on 2nd April that they uncovered a massive cooking of the books to a tune of more than USD 300 million in fake revenue for its final 3 quarters in 2019. This scandal has damaged investors' confidence in listed Chinese companies with discussions of a potential delisting of Lukin's shares. This is not the first time Chinese companies have committed fraud in American financial markets with hundreds of Chinese companies taking advantage of reverse merger loopholes to avoid regulatory scrutiny. According to the SEC Chairman Jay Clayton, one of the biggest problems that regulators face with China firms is that they are prevented from inspecting the auditing done by Chinese audit firms. There are corporate agreements with 23 other foreign regulators, but China is not one of them. This means that Chinese companies in fact are not put on the same corporate governance playing field as other listed companies.

This has led to a push from the U.S. congress with a bill by Sen Marco Rubio introducing a bill to delist firms that are not compliant with U.S. regulations for a period of 3 years. The bill also made mention and emphasis on China. Donald Trump has also made verbal threats to forcibly delist Chinese companies which as of February 2019 encompasses 156 companies worth a total of USD 1.2 trillion. This could cause a ripple effect and cause a flight of capital. However, Chinese IPOs have not been completely frozen out of with Kingsoft Cloud being the first Chinese IPO to go public after the Luckin Coffee scandal on 8th May. The shares are now trading around 18% higher than its midpoint targeted range.

In our previous report, we were very positive on the effects that the internationalization of Chinese assets would allow China to gain a greater importance in the financial world. We feel that Luckin Coffee brought about a reminder on the rampant securities fraud that happened with Chinese companies after the great financial crisis. Even though there are potential accounting irregularity risk, Justin Leverenz from Invesco has rightly pointed out that the Chinese stock market represents the next new opportunity. We feel that investors should continue to increase their weightage on Chinese equities but need to ensure a high level of due diligence is done.

FX TRADE IDEA: SHORT USDCNH

After the DXY peaked in mid-March due to tight USD funding around the world, we saw Dollar strength ease off as the Fed introduce swap lines to ease dollar funding. Investors began to buy USD as a safe haven in a risk off move and USDCNH has been on a general uptrend since. The pair has hit a high of 7.17 around the end of May 2020. However, we believe that this trend would reverse. We expect to see the world move into a general risk on sentiment as lockdowns begin to ease. This would cause the USD to weaken and emerging market currencies like the CNH to strengthen. We expect to see a u-shaped recovery in China commencing as it has effectively dealt with the second wave of COVID-19 decisively. We are confident that the worst is over for China and we will continue to see a return of manufacturing and exports. We do not expect to continue to see the Yuan at record weak levels with the PBOC setting the daily reference rate at 7.1277 on 28th May which was far off from where the currency was trading at. As mentioned in our previous report, we understand that China is making a second push for Yuan internationalization and will not benefit from such a weak Yuan.

The U.S. has continued to struggle to cope with a second wave of COVID-19 due to the country being governed using a federal system. This has led to some states reopening while others remain in lockdown. As of 26th June, Florida saw an increase of cases from 56,000 to over 114,000 and has set daily records on 7 of the last 13 days as reported in the guardian. We think that a return to lockdown conditions across the U.S. would cause a spike in jobless number and would put further stress on small businesses. We have seen the challenges that the U.S. government has faced in order to get handouts to its citizens and small business and we expect a further strain on the financial system which would cause it to collapse. This will cause a negative sentiment towards the USD.

Figure 86: USDCNH Hourly Chart (*Source: Saxotrader*)

Entry: 7.0880
Take profit: 6.9246
Stop loss: 7.1277
Risk to reward ratio: 4.12

Using the 1-hour chart for the pair, we are looking to enter a short position for the pair at 7.0880 support level which has held firm as it was tested on multiple occasions over the last few weeks. We look to set a stop loss at the 7.13 level which is slightly above where the PBOC set their daily reference rate on 28th May. We expect the it to be the highest level in which the PBOC would allow the CNY to appreciate which would impact where the CNH would trade as well.

Figure 87: USDCNH Daily Chart (*Source: Saxotrader*)

On the daily chart, we have seen the pair return towards the 50 level after being in the oversold position and expect CNH to continue to strengthen in the upcoming months due to the economic conditions which we have discussed above. We look to set our take profit level at 6.9246 which was the previous support level for the pair as it contained the virus during the early phase of the COVID-19 outbreak. This gives us a risk-reward ratio of 4.12.

Our main area of comparison for both economies is in terms of their response to COVID-19. We believe that a strong government with the ability to deal with the virus would provide right foundation for economic recovery after these trying times. As covered in this report, China has effectively controlled the spread of COVID-19 and has effectively dealt with second waves that have affected the country. On the other hand the U.S. is unable to come up with an effective solution to rid the virus from their shores. Additionally, they have continued to struggle to get cash in the hands of individuals and businesses. China has created a stronger base for economic recovery which is why we have proposed an investment thesis of shorting the USDCNH.

HONG KONG (Underweight)

The past year has been a rough year for Hong Kong, resulting in an economic recession. The recession deepened in Hong Kong in the first quarter of 2020, with real GDP contracting sharply by 8.9% from a year earlier, the steepest for a single quarter on record. Considering the sharp economic contraction in the first quarter, the high uncertainties surrounding the pandemic and the uncertainty of Hong Kong's future, the real GDP growth forecast for 2020 as a whole has been revised downwards to -4% to -7% as announced by the Financial Secretary on 29th April.

The Double Whammy of COVID-19 and Protests

The Great Lockdown Recession, as termed by the IMF, tips a global recession of -4.9% for 2020, which was revised from its initial prediction of -3% earlier in the year. It has been a rather eventful period for the last few months with the emergence of COVID-19 that had caused major damage to the global economy. Hong Kong, being one of the most interconnected economies in the world, was greatly affected by this global phenomenon.

Just as other economies around the world look to recover as their virus restrictions ease, Hong Kong's reprieve appears fleeting: Clashes between the police and protesters are resuming and worries about another virus wave remain. In last semester's report, we predicted that the negative outlook of the Hong Kong economy will continue into the start of the 2020 year due to the ongoing protests which were likely to escalate into the new year. However, being dealt with the double whammy of Hong Kong protests and the COVID-19 virus, we can expect the economy's negative outlook to worsen to an even more severe degree.

Despite having numerous transport links with Mainland China, where the virus originated from, Hong Kong dealt with the virus quickly and efficiently, garnering many praises from the world. To date, Hong Kong has around a thousand cases and 4 deaths, which in current times is an excellent result as compared to the rest of the world. As a result, the Hong Kong workforce can return to work much earlier as compared to countries such as Singapore. However, the decrease in retail sales was imminent and being an international hub, Hong Kong was adversely affected by the continual decline of the global economy.

The biggest strain has been on retailers, hotels, bars, and restaurants. The drying up of the tourism industry due to the months of protests as well as the restrictions caused by the virus has resulted in retail sales slumping by more than 40% for an unprecedented second straight month in March as inbound visitors sank by 99%. In Hong Kong, tourism is one of the 4 main pillars as identified by the Hong Kong government, comprising 4.5% of the GDP of Hong Kong back in 2018 when Hong Kong was experiencing its peak in tourism revenue. We see that these circumstances for the tourism and the retailers in Hong Kong to persist into the year, which will further dampen the outlook of the economy. Besides, with China looking to clamp down Hong Kong, we can expect the protests to continue after the virus cools down, prompting a longer recovery time for the economy. Thus, due to the double whammy of both the protests and COVID-19 and the way things are looking to play out in the remaining year, we see the Hong Kong economy to continue doing badly for the next half year.

With the political tensions between China and Hong Kong heating up which we will be covering in-depth in the remaining portion of the report, Hong Kong can expect the number of tourists from Mainland China to continue declining as well as the continuation or perhaps even escalations of the protest against the rule of China. Given the circumstances, it would seem a near-impossible task for the Hong Kong economy to attain the level of prosperity that is seen before the protests and the virus.

Is Hong Kong Doing Enough for Its Economy?

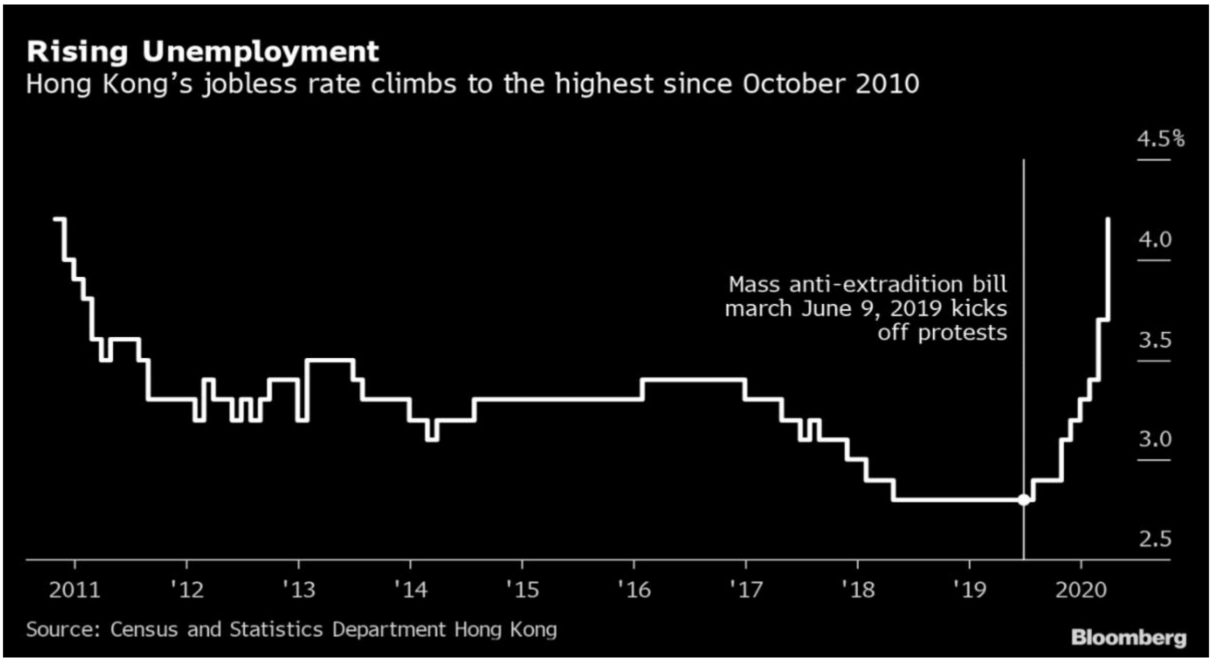

Figure 88: Unemployment in Hong Kong (*Source: Bloomberg*)

Notably, the Hong Kong government has announced an HKD 137.5 billion (USD 18 billion) financial relief package to help those ailing businesses as well as their workers. However, these measures are full of flaws and have aroused concerns from the public. Firstly, the money would only be distributed to recipients who have a Mandatory Provident Fund (MPF) pension scheme account. In Hong Kong, the residents who are employed have to contribute 5% of their monthly salaries to the fund. However, for many Hongkongers who engage in freelance activities, a large portion of them did not sign up for the MPF as they are already struggling to make ends meet and could not afford to contribute to this fund monthly. As a result, they would have missed out on the handout provided by the government. Secondly, the government has provided very little support to unemployed people in Hong Kong. As seen from the chart above, the unemployment rate in Hong Kong has been rising.

The measures to support this group of people have been insignificant. To qualify for the social security support scheme that supports the unemployed, the unemployed workers must be 'poor'. The asset cap for a one-person household is capped at HKD 66,000, after an improvised change to the initial cap of HKD 33,000. This means that as long as you have assets worth more than the amount stated, you would not receive a dollar from the scheme even if you are unemployed. A large proportion of Hongkongers have an asset size of HKD 66,000 in savings, however, it is not a big amount and would barely be sufficient to meet the average cost of living of HKD 82,380 per year. As such, this policy does not grant the majority of the households the rebates they require. Many middle-class Hongkongers have been affected by job loss but do not qualify for this support scheme. This will cause a strain towards the spending power of Hongkongers and negatively affect consumer spending.

In our previous report, we mentioned that Hong Kong's USD 2.5 billion package to combat the effects of the Hong Kong protests was an example of ineffective policy targeting as it only addresses the short-term impacts of the protests, while in the long run, the economy will continue to suffer from the effects of the protests. It turned out to be true as the economy contracted by 8.9% from a year ago, the worst reading in four decades of data. The contraction had largely been affected by the COVID-19 situation, however, we believe that the stance whereby the Hong Kong Government is adopting is not aggressive enough to generate sustainable effects for the economy. We believe that the policies are not negative but rather, their policies have only targeted a specific group of people which would result in an insignificant impact of these policies. In the face of political unrest and COVID-19 affecting a large proportion of citizens, the expansionary policies from Hong Kong are not far-reaching enough to positively affect a large proportion of their citizens.

Although the Hong Kong economy has seen to be resilient in the past few decades, for the horizon of the next 6 months, our stance remains similar to the previous report, we predict that the economy will continue being in a slump with little to no improvement.

<u>China's Clampdown on Hong Kong</u>

Ten days after China lifted the lockdown of Wuhan, it turned its attention towards Hong Kong and ramped up pressure on it. On the 17th of April, the liaison office of China in Hong Kong effectively announced that it has the full authority to interfere in Hong Kong's internal affairs. After which the following day, 15 veteran leaders of the city's democracy movement were arrested. Chairman Xi has appointed a new China liaison head in Hong Kong, Luo Huining, a Communist Party stalwart with a reputation as an enforcer. Luo has previously called the pro-democracy movement a threat to national security. Chairman Xi also appointed Xia Baolong, who oversaw a crackdown on churches when he was the Communist Party chief of China's Zhejiang province, as director of the Hong Kong & Macau Affairs Office. These drastic actions within a week have clearly shown that China is done playing along with the antics of the protestors. The stance maintained by China has always been similar throughout this ordeal, which is to rather lose Hong Kong as a financial gateway than to ever cede political control. We think that these actions will continue to negatively affect the Hong Kong economy as citizens fight a futile battle against the China juggernaut.

Figure 89: Secretary of State of U.S.'s Tweet (*Source: Twitter*)

As once famously remarked by Eurasian writer Han Suyin and also mentioned in our previous report, Hong Kong is existing on "borrowed time in a borrowed place", it is inevitable that one day China will "reclaim" back the city of Hong Kong. Hong Kong is also caught in yet another battle between two of the world's superpowers, the U.S. and China. As seen in the image above, U.S. Secretary of State Mike Pompeo said on Sunday he believed China had threatened to interfere with the work of U.S. journalists in Hong Kong and warned Beijing that any decision impinging on Hong Kong's autonomy could affect the U.S. assessment of Hong Kong's status. As a result, as of 28th May 2020, U.S. secretary of state Mike Pompeo has said Hong Kong is no longer autonomous from China. This meant that the 'special treatment' that the U.S. has granted Hong Kong since 1997 would very possibly cease to exist, allowing Hong Kong to be subjected to the policies the U.S. imposed on China. This would threaten Hong Kong's status as a financial hub and in the long run, resulting in a loss of investor confidence as well as a further blow to the already weakening Hong Kong economy. We also expect to see an inflow of capital into other southeast Asian counterparts such as Singapore, a long-standing rival of Hong Kong. We expect the U.S. stance towards Hong Kong to move to a similar tone it has with China as they will begin to view them as "one and the same". This would erase Hong Kong's status as an open economy for trade and finance and reduce the inflow of goods and capital into the city. We expect this to negatively affect their economy especially their financial sector.

With China's offensive stance going into the year with its dealing with Hong Kong, coupled with the rising tensions between China and the U.S. due to the disputes over COVID-19, U.S. has already declared that they do not view Hong Kong anymore as an autonomous country, thereby linking Hong Kong together with China. This does not matter whether Trump or Biden gets elected in the coming elections as the U.S.' stance regarding this issue is pretty clear-cut as of now. As a result, we can foresee Hong Kong losing their special privileges granted to them by the U.S. and they may face a similar treatment as China. Even if Hong Kong still manages to keep its relationship with the U.S. guaranteeing its special treatment, in the long run, investors would still lose confidence in the country due to the uncertainty surrounding its future. In terms of the long-term outlook, from the way it is looking thus far, we feel that Hong Kong would eventually be suppressed under the reign of China which may eliminate Hong Kong's status as a financial hub in the region. With the free trade and low tax rates being one of the main selling points for Hong Kong, such privileges could be compromised China looks to eventually reclaiming back Hong Kong, and this has been quite evident as of late. In terms of the 6-months outlook, the outlook looks bad with China not looking to soften their stance which may eventually result in the loss of the U.S.' trust. Given the bad shape of the current Hong Kong economy, this may yet be another blow to the economy.

<u>Hong Kong's Status as an International Retail Hub in Jeopardy</u>

Dubbed as a "paradise" for shopaholics, Hong Kong is known to offer an abundance of goods from high-end fashion brands to busy local markets. However, with the recent political tension and COVID-19 situation surrounding Hong Kong, we could see Hong Kong losing its status as an international retail hub, starting from the luxury retail sector.

As estimated by Morgan Stanley, Mainland customers account for roughly half of all luxury retail shopping in Hong Kong. Hong Kong's exposure to mainland tourists was its biggest selling point for luxury brands. To capture the huge market of mainland tourists with rising spending power, brands expanded store networks aggressively, outfitting prime spaces with whopping rents. Another reason why Hong Kong developed into an international luxury hub was its tax-free policy which proves to be a competitive advantage as compared to China's heavily taxed imported goods.

However, in recent years, China has desperately been trying to revive its local luxury market in an attempt to boost declining consumer spending in the country. According to Bloomberg, the gap between prices of upscale goods onshore and overseas shrank to 15% last year from about 30% three years ago after a series of cuts to China's luxury sales taxes. This shows that China has been actively pushing for the migration of mainland luxury goods shoppers from Hong Kong to China. We expect their efforts to continue in the same direction as the country continues to look for means to boost their consumer spending. With initiatives such as Singles' Day, Chinese corporations have been actively looking for avenues to direct consumer spending towards themselves. As mentioned in the previous report, China is looking to develop its two cities, Shanghai and Shenzhen into the regions' 'future cities'. These attempts are showing signs that Hong Kong is gradually losing its value to China.

According to Morgan Stanley, Chinese shoppers are key for luxury brands as they accounted for 35% of global luxury spending in 2019 and the number would only look to increase to a size of 50%. As such, it is of utmost importance that these brands hold on to that part of the market. As a result, due to the decline of mainland tourists to Hong Kong and the fact that the decline would only continue in the future, many big luxury brands have been pulling out of the Hong Kong retail scenes. Luxury brands such as Chanel and LV have opted out to shut down their retail stores in the city of Hong Kong. There has also been a trend whereby brands moved directly into the local scene of China to engage the locals directly. Chow Tai Fook Jewellery Group, Hong Kong's largest jeweller will close up to 15 city outlets next year according to Kent Wong the managing director of the group. This was due to sales in Hong Kong and Macao slumping by 48% between October to mid-November compared to the previous year. The company has instead opened more than 300 stores on the mainland in the six months during that period in order to bring their goods and services directly to the Chinese consumer. We expect to continue to see a trend of exits from the Hong Kong market to engage directly with the Chinese consumer. This will cause a reduction in stores which would affect employment and tax revenue for Hong Kong.

The tourism sector contributed 4.5% to Hong Kong GDP back in 2018 and is a key component of the revenue generated by the Hong Kong economy. It would be declining in the future as there would be fewer tourists contributing to the economy. This would not only affect the luxury market but all other related sectors like the Food and Beverages industry. Tourism has also been harshly affected by the protest and outbreak of COVID. The Hong Kong economy is highly dependent on this sector and we expect to see it being the worst hit over the next 6 months. This would cause a higher number of jobless people in Hong Kong. This would also cause a snowball effect which would cause Hong Kong to be a less desirable tourist location. With the looming COVID-19 virus threat and the political tensions between China and Hong Kong, it would certainly be a long while before Hong Kong can attain back to its former glory of having 65 million visitors in a year back in 2018. We expect to see tourism numbers to continue to fall and that the numbers will not sustainably return to pre-COVID levels.

Is Hong Kong's Resilient Property Market a Double-Edged Sword?

Hong Kong has one of the strongest property markets in the world and has long landed homeowners a tidy profit. According to Ricacorp, apartment prices in the city have been on an almost exclusively upward trajectory for the past 17 years. Even as the COVID-19 virus spread, 97.5% of sales in the first quarter resulted in a profit as seen from the chart above.

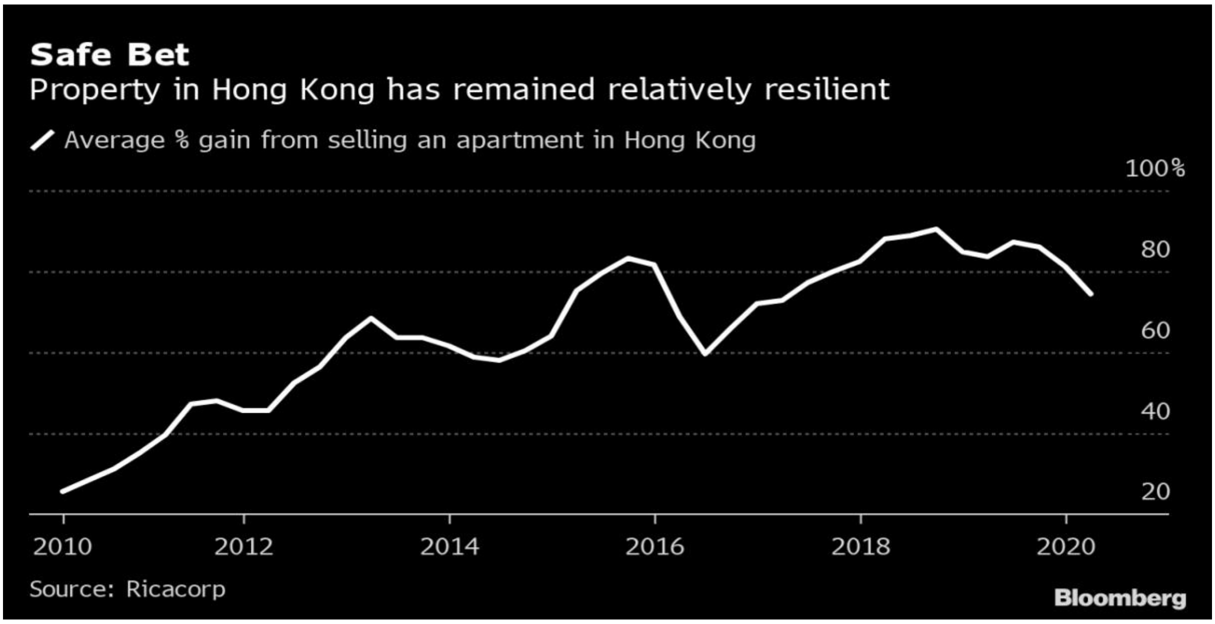

Figure 90: Profit from Selling Property in Hong Kong (*Source: Bloomberg*)

However, since the start of the year, for grade A properties in Hong Kong there has been a 9.3% drop in sales volume from the peak in September 2018 when mainland banks and insurers still saw Hong Kong as the primary launchpad to expand globally. Capital controls on Chinese firms like HNA Group Co that binged on debt to acquire assets globally. The U.S.-China trade war and last year's protests put an end to much of that ultimately resulting in the fall of the capital values of Hong Kong offices. This trend would look to continue in the near future. Capital values for retail have been hit even harder than the offices which have been down 14% to HKD 33,964 per square foot from HKD 39,478 at the end of last year. They are 27% under highs of HKD 46,344 per square foot in March 2014, when the city was in the midst of a tourist boom.

Figure 91: Price of Hong Kong Offices (*Source: Bloomberg*)

Despite the fall in the capital values for retail shops and offices, Hong Kong housing, on the other hand, has remained resilient. Home prices have fallen just 7.7% since last June's peak, just as the protests in Hong Kong were gaining momentum.

Although there was a slight fall in the prices since the start of the year, we predict that the prices should pick up in the near future again due to the nature of the Hong Kong property market. As seen from the graph, in the Global Financial Crisis back in 2008, there was a sharp rebound after the crisis deflated the property prices, showing the resilience of the property market in the face of crisis. Similarly, in this case, we predict the property prices to remain resilient during the crisis.

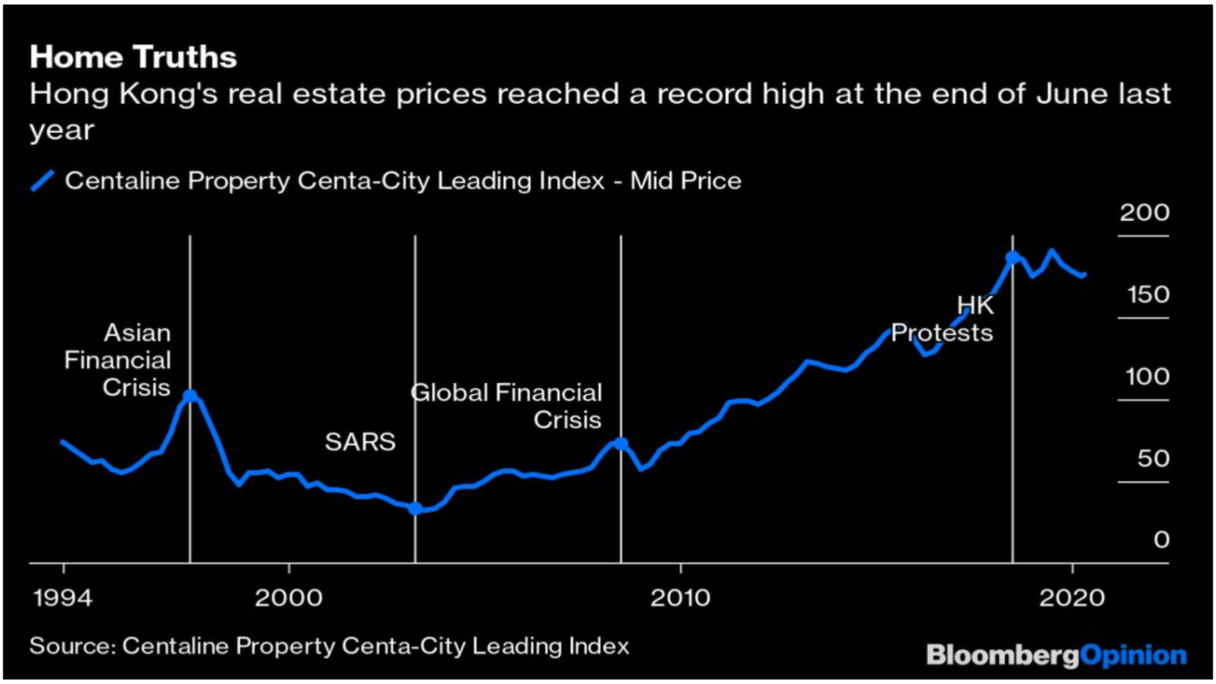

Figure 92: Real Estate Prices in Hong Kong (*Source: Bloomberg*)

In Hong Kong, according to Bloomberg, due to the supply shortage resulting from the limited amount of properties to be shared among the residents, the number of transaction volumes would be rising despite the hiccups resulting from the COVID-19 virus. As seen in the graph below, the number of transactions has been rising again in April.

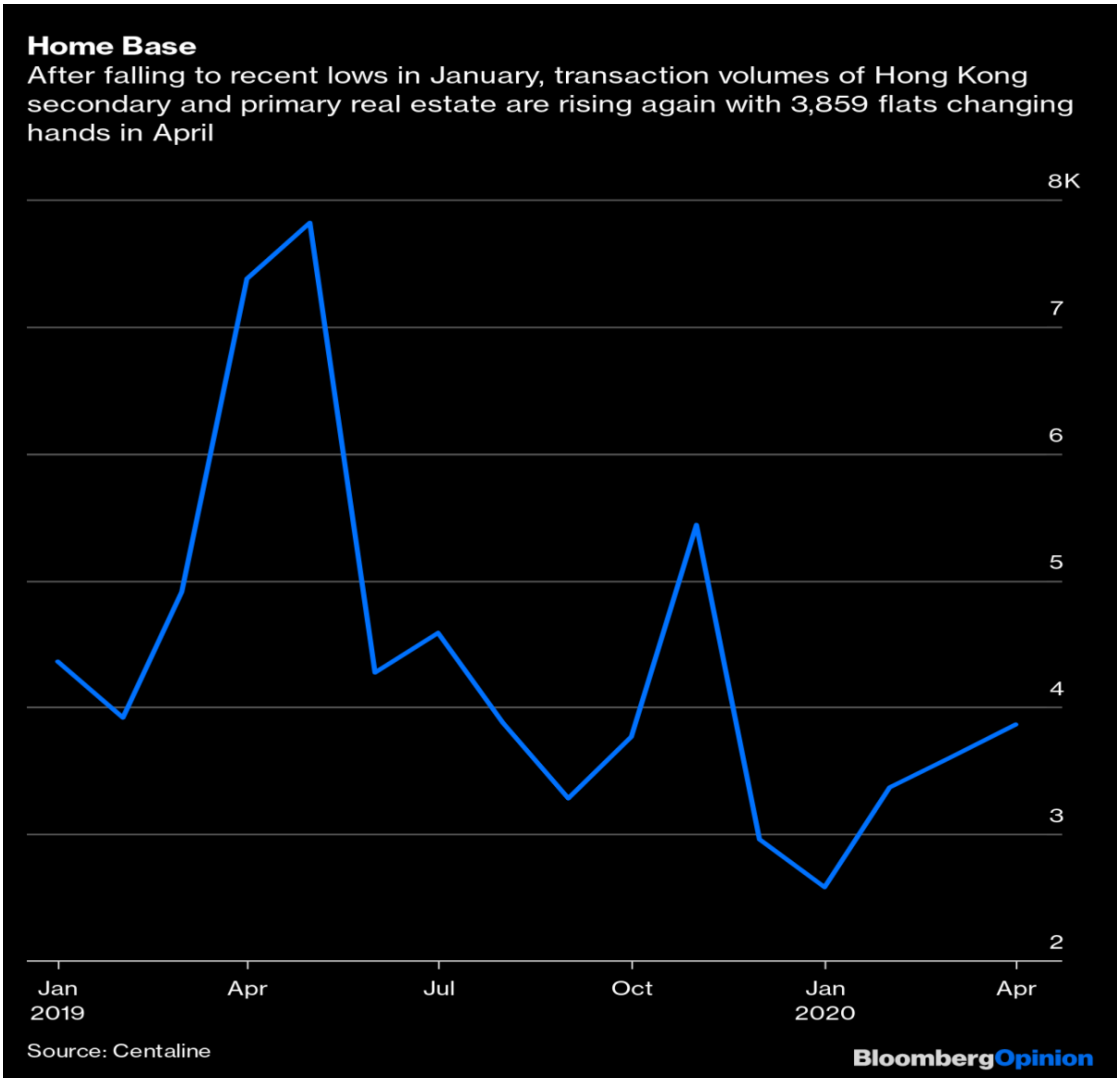

Figure 93: Number of Transactions of Flats in Hong Kong (*Source: Bloomberg*)

For the past 37 years, the city has run a managed peg between HKD 7.75-7.85, tying the Hong Kong currency to the USD. As a result, the HKMA has to mirror the Fed's moves in order to maintain the peg. With the Fed rates close to zero and the one-month interbank rate, against which most mortgages are priced, is at its lowest since April 2018, and well under the 5% of 2007, this would mean that homeowners would not have to worry too much. In fact, this would even encourage investors purchasing more homes due to the cheap rate of lending. With the Feds not looking to change their stance anytime soon for the outlook of the next 6-months, we predict that the prices of property houses will continue rising to provide a slight hint of optimism for the Hong Kong economy.

However, with the rise in property prices, it would also mean higher rent for the locals in Hong Kong. In a country like Hong Kong where the majority of the residents live on rented properties instead of owning their own houses, the rental fee is an important part of their spending. While it may be true that rising property prices spur consumption in the local economy as the homeowners are getting richer, the rise in rental costs which is often similar in terms of trending with the prices of properties would result in regular households having to fork out a larger percentage of their pay to pay for their rent. This would thus result in a loss of purchasing power, which may ultimately negate the positive effects arising from the rising property prices. With unemployment set to increase in the near future, the rise in property prices may hence be a double-edged sword as non-home owners may struggle further in terms of their financial means to cope with the rising rent prices.

FX TRADE IDEA: LONG USDHKD

As the financial hub connecting the West to the East, Hong Kong promised investors with its free-flowing capital policies, with a promise of financial stability and consistency. In 1983, the currency was pegged to the USD. This was due to concerns regarding the future of Hong Kong after 1997 when the handover of control from the British to China was set to take place. The rate at which the Hong Kong dollar was pegged to the USD has changed over time, however, for the past 37 years, it has remained pegged to the U.S. currency. For the past 12 years since the Great recession, Hong Kong has flourished being the brokers between the East and the West. The pegged currency has given the country stability when it came to trade and investors.

Mentioned in our previous report, we had acknowledged that the HKD has no immediate danger of falling out of the range that has been allowed to trade with regards to its peg with the Dollar due to its strong currency reserves. As seen from the chart, Hong Kong has always maintained more than twice the required amount of foreign reserves needed to cover the monetary base (MB). As such, in the case of emergencies, Hong Kong can keep the USDHKD currency pair within the peg.

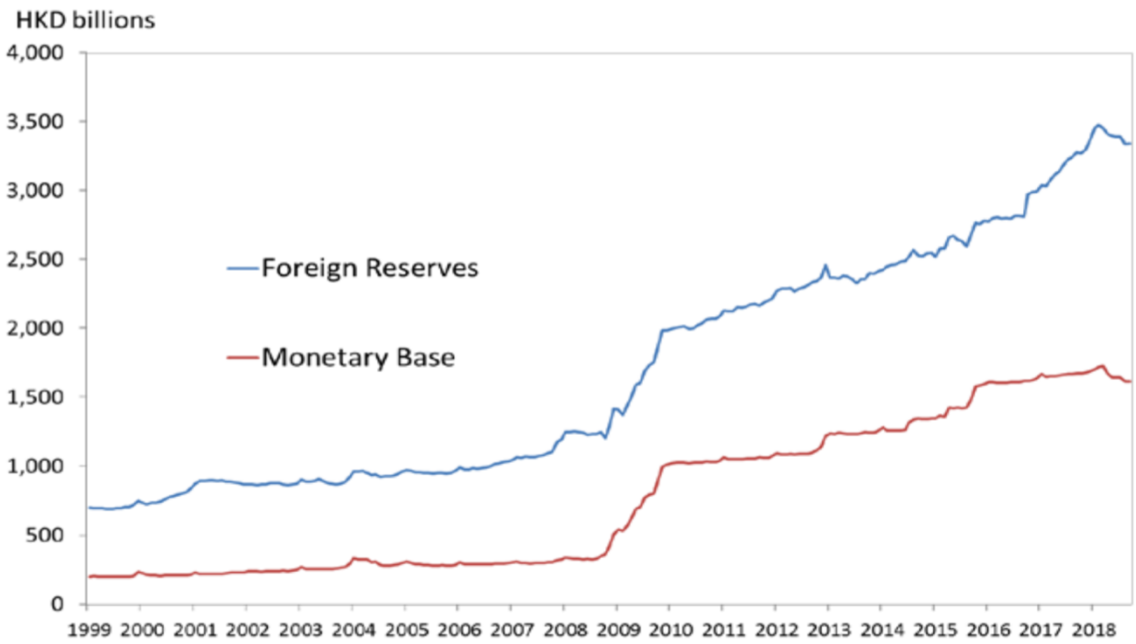

Figure 94: Foreign Reserves Against the Monetary Base for HK (*Source: HKMA*)

Despite the HKMA's ability to prop up the HKD if there was to be a case whereby the peg would be broken, there is still a lot of uncertainty revolving around this situation. All eyes are on the U.S stance on determining the fate of Hong Kong. Massive capital outflow out of Hong Kong would be expected if the measures pertaining to Hong Kong's status as a free economy were to be compromised.

In April, according to Bloomberg, The Hong Kong Monetary Authority (HKMA) sold HKD 2.79 billion (USD 360 million) of the city's currency in the early hours of Wednesday's local time in an attempt to devalue the very resilient Hong Kong Dollar. The Hong Kong dollar has been trading sideways for the past 2 months between the 7.757 and 7.75 range and this will look to continue for the next few months.

As we can see from the current range whereby this currency pair is currently trading at, the pair is dangerously close to breaking at peg. However, as mentioned above, in our opinion, the peg would not break as Hong Kong has enough reserves to prevent this from happening. Thus, we predict that this currency pair should be in a long position given the bad outlook of the Hong Kong economy which may cause outflows of capital from the country, ultimately devaluing the HKD currency.

Figure 95: USDHKD Hourly Chart (*Source: TradingView*)

Entry: 7.75026
Take profit: 7.75081
Stop loss: 7.74997
Risk to reward ratio: 1.9

As we can see from the RSI indicator, the trend is generally heading towards the oversold region and the MACD indicator indicates that there would be a bearish trend incoming. As such, we believe that given that there would not be a break in peg, the price whereby this currency pair trades at would only go up from here. We would take profit at the 7.7508 region whereby this currency pair would test the resistance line and our stop loss is at 7.749 region whereby the currency pair breaks the peg.

TAIWAN (Overweight)

Taiwan's economy was not adversely affected by the U.S.-China trade war as they had benefited the return of overseas-based Taiwanese companies that were seeking to avoid the effects of the trade war. This resulted in them relocating back to Taiwan. This put their economy in a much better position to combat the drawbacks from the COVID-19 virus as their supply chain was not as dependent on overseas countries. Coupled with its smooth handling of the virus, Taiwan's GDP growth for 1Q20 was at a respectable 1.54%. Although it was a slowdown from the 3.31% growth that we saw in 4Q19, amidst the COVID-19 virus saga, Taiwan has done an exceptionally good job with it. Hence, we think that the Taiwan economy is well equipped to weather the storm brought about by the COVID crisis.

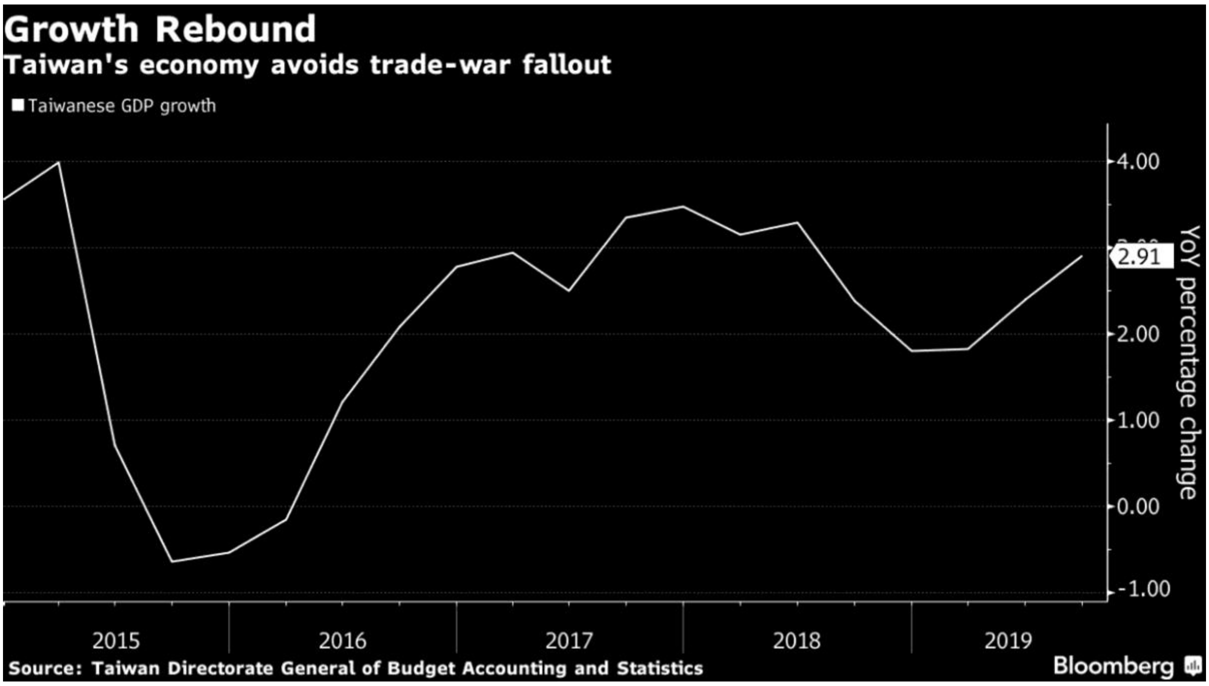

Figure 96: Chart Showing the Relationship between Taiwan's Growth and the Trade War (*Source: Bloomberg*)

Taiwan's Handling of the COVID-19 Pandemic

Despite the decline in retail sales that was expected due to the COVID-19 virus, the country's total exports in Q1 increased by 3.7% from last year, mainly due to the 20 % surge in electronic component exports alone. As a result, the blow of the decline in retail sales was cushioned by the surge in exports revenue, providing the push behind Taiwan's positive growth this quarter.

Our opinion was that Taiwan's growth numbers were better because it imposed COVID-19 preventive measures quite early and thus avoided a total lockdown. Peoples' lives and work were not affected as much as they were in other countries. Taiwan's government introduced a travel ban on visitors from China, Hong Kong and Macau soon after the number of COVID-19 cases began to rise in mainland China. Thus, they were able to control the virus and ensure that their way of life was not affected as drastically as other countries around the world. Moving forward, with strict border controls still enforced within Taiwan and its low community spread, we expect the economy to remain open.

Before the COVID-19 pandemic, Taiwan's tourism was resilient despite the boycotting from China, reaching an all-time high of 1.143 million visitors in December 2019. Tourism is one of the main pillars of the Taiwan economy, as such, the impact from COVID has taken a toll on the economy. however, the negative effects from the decline in tourism revenue was offset by the positive gains from other sectors that would be covered below. Given the circumstances of the world right now, tourism has been on a decline throughout the entire globe. In June 2020, Taiwan launched a 3-part plan in order to attract international tourists. Phase one is currently underway which includes the drawing up of a pandemic prevention tourism plan, comprising various tourism-related guidelines including quick action plans in the event of a fresh outbreak. Travel and tourism players have also undergone training courses equipping them with the skills on how to bolster confidence among tourists. As such, after the worst is over, we can expect Taiwan's tourism to be back at its peak as the world slowly opens up again in the future.

Also, as seen in the graph below, due to the early measures taken by Taiwan, there was no full lockdown and closure of the economy that happened. As a result, the manufacturing sector did not face any steep contractions as compared to other countries. We expect a drop in global demand to negatively affect this export dependent economy but do not see manufacturing dropping to the lows experience by other countries who experienced a full economic lockdown. Hence, we do not expect to see a recession, rather we expect slower growth to hit the Taiwanese economy.

Figure 97: Purchasing Managers' Index, Manufacturing Composite, March 2020 (*Source: Financial Times*)

<u>Taiwan's Economic Growth</u>

As mentioned in our previous report, Taiwan has a strong kit of policy tools to weather an economic downturn should one come. As a result of their disciplined government spending with deficits running less than 5% of GDP for the last 10 years as well as decreasing government debt dropping from a high of 34% to 30.9%, Taiwan has more room for fiscal spending. Thus, to weather the effects of the COVID-19 virus, in April, Taiwan's Executive Council increased the fiscal stimulus package to TWD 1.05 trillion (equivalent to USD 34.64 billion), of which TWD 81.6 billion are subsidies for employers to prevent a spike in unemployment. It also cut interest rates for the first time in more than four years to a new low of 1.125% and said it would provide banks with the financing of TWD 200 billion to support companies battling the virus fallout. As compared to its other neighbours in North Asia like Japan, Korea and Hong Kong, Taiwan does not face the threat of a liquidity trap and have been able to use monetary policy to help boost economic spending. This would prevent the economy from collapsing under the economic stress brought about by the pandemic. With the support provided for by the government, small local business can look to tide through this period as world's economy gradually normalizes again.

Despite these measures, we expect the retail sales to continue declining for at least the next 6 months as the people would be looking to save up instead of spending more, causing a reverse multiplier effect. Particularly for a country such as Taiwan with an average household savings rate of 32.6% as compared to the 7.6% rate of U.S. households. During this period of uncertainty, we can expect the savings rate to go up which would cause stimulus into the economy to have a reduced impact.

Taiwan relies heavily on the exports and manufacturing sectors particularly electronic manufacturing. The challenge is their famed semiconductor sector is facing is that they are currently stuck between Trump and Huawei. As part of his campaign to stop Chinese telecom giant Huawei Technologies' fifth-generation, or 5G, technology gaining ground around the world, U.S. President Donald Trump wants to block Taiwan's semiconductor companies from selling microchips to it. As such, he has threatened to prevent American suppliers from getting their goods from Taiwan. It would be interesting to see how this plays out as the semiconductor industry in Taiwan decide between a corporate backlash from the U.S., or losing one of their main clients, Huawei. We think this ultimately will not affect the semiconductor industry to a large extent as Huawei still has a strong presence within their domestic market and South East Asia. The U.S. does not have very strong bargaining power with Taiwan and we do not expect to see Taiwan cede to these threats.

Despite the rise in exports for the first quarter of 2020, we predict the exports revenue to decline for the rest of the year as these goods and services are not considered as necessities, and with the global economic outlook looking bad, the demand for them would likely decrease as well. The Taiwan Institute of Economic Research (TIER) has lowered its forecast of GDP growth to 1.09% for the year 2020. Due to the decrease in global demand for the goods that Taiwan are known for exporting, coupled with the continual decline of the retail sector that we predicted, we can see that the Taiwan economy's outlook into the next 6 months to slow down. Although the country is will not likely go into recession, the growth is still expected to contract as compared with the outstanding growth that it has managed to achieve for the past year. This still puts Taiwan in a strong spot as compared to its peers.

Taiwan’s Political Scene

As Taiwanese President Tsai Ing-wen begins her second term of presidency, we can expect another 4 years of resistance from Taiwan as opposed to the 'One China' rule. President Tsai has recently issued a call for an equal dialogue with Beijing after being sworn in a pared-down inauguration ceremony, which the Chinese government rejected unless she accepts the notion of Taiwan belonging to China's 'One China' Policy.

In the report from the previous semester, we discussed the loss of allies for Taiwan. Many nations had abandoned Taiwan to form alliances with China. The moves by China aimed to limit Taiwan's international space and weaken the administration of President Tsai Ing-wen, and with her re-election, we can look to China maintaining its stance of snatching allies away from Taiwan. The risk that we mentioned previously was that in the near future, should Taiwan cease having any official allies on the world stage, the ability to join trade agreements and have an influence on the world stage will diminish significantly and have an effect on their economy.

However, during this period of crisis, Taiwan has managed to garner support from both the U.S. and Europe. Taiwan has shown its capability to excel as an individual country in its efforts to deal with the virus, garnering global praises. Not only that, but Taiwan has also sent millions of masks to the U.S. and Europe, in an attempt to strengthen the ties in between them, and to ensure that it does have powerful nations behind its back. Taiwan's success against COVID-19 has shown that democracies could fight the virus without resorting to authoritarian measures, serving as a key rebuttal against Chinese propaganda showcasing the strength of its system against the West. Taipei's openness also contrasted sharply with the lack of transparency about the initial outbreak and subsequent diplomatic pressure from Beijing, providing the foundation for Taiwan's independence in the long run.

In last semester's report, we mentioned the trend of Taiwan companies relocating back to their homeland from China. The COVID-19 pandemic is only expected to accelerate this shift back to Taiwan. As quoted by the Taiwan Institute of Economic Research: "Distrust in China is rising in the U.S. and Europe, which will push more companies to re-evaluate China-dependent supply chains,". Major companies such as Innolux, a display panel maker owned by Apple supplier Hon Hai Precision Industry, or Foxconn, is investing an additional TWD 70.1 billion in Taiwan. It now manufactures core parts in Taiwan to be assembled in China but plans to start producing some products entirely in Taiwan. It is building a new factory in the city of Tainan that will be almost entirely automated. Another example of another major company making moves for their relocation back to Taiwan printed circuit board supplier Unimicron Technology, which will spend TWD 26.5 billion to expand a Taiwan plant. Although the company has production facilities both on the island and on mainland China, it has allocated 80% of its capital spending for this year to Taiwan. These show that generally, with the lack of investor confidence in China's economy as well as the new measures that the Taiwan government has introduced to draw these companies back to their homeland, we can expect more capital inflow into the Taiwan economy.

Despite that and Taiwan's efforts to reduce its reliance on China for the past few years, China is still Taiwan's largest trading partner. Judging by China's stance against Hong Kong, we believe that China will not go soft on Taiwan as well with them having recently sent 8 military planes into Taiwanese airspace. Fortunately, there have been no escalations (as compared to the border clash in China and India), however this show of force has been seen by analyst as a reminder of the threat of China-Taiwanese conflicts that could potentially happen in the future. With the rise in troubles in Hong Kong, we expect to see a move of China's political attention towards the island state to quell the riots. Taiwan and China's relationship may not be at its strongest point, but we do not see any further escalation in the immediate future and expect their open economic relationship to continue.

Taiwan's Insurance Lifers

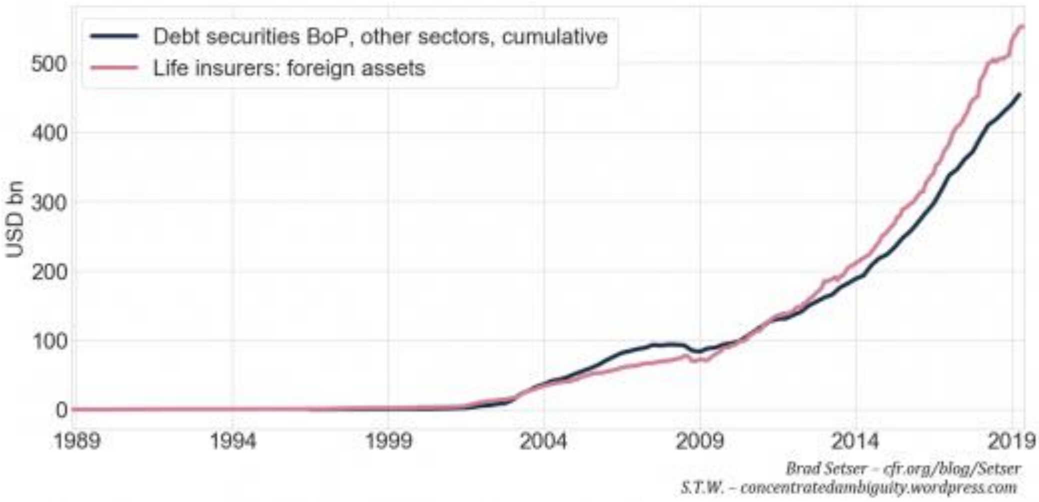

Figure 98: Taiwan's BoP Debt Purchases and Foreign Assets of Lifers (*Source: CFR*)

According to CEIC, Taiwan has a gross savings rate of 35.0% as of March 2020. Low-interest rates with 10Y yields at 0.400% as of 26th June coupled with a limited social safety net has given rise to a large volume of foreign asset purchases by Taiwan. As you can see from the figure above, Taiwanese lifers (life insurance companies) are the main buyers of foreign assets in the country. Due to this dynamic, it is important to understand the buying flows and patterns of Taiwanese insurers as they affect the FX hedging and open FX positions for the TWD. According to the council for foreign relations, there is USD 250 Billion of hedging for the Taiwanese life insurance industry. This shows the possibility of large movements in the USDTWD pair when these entities move to invest.

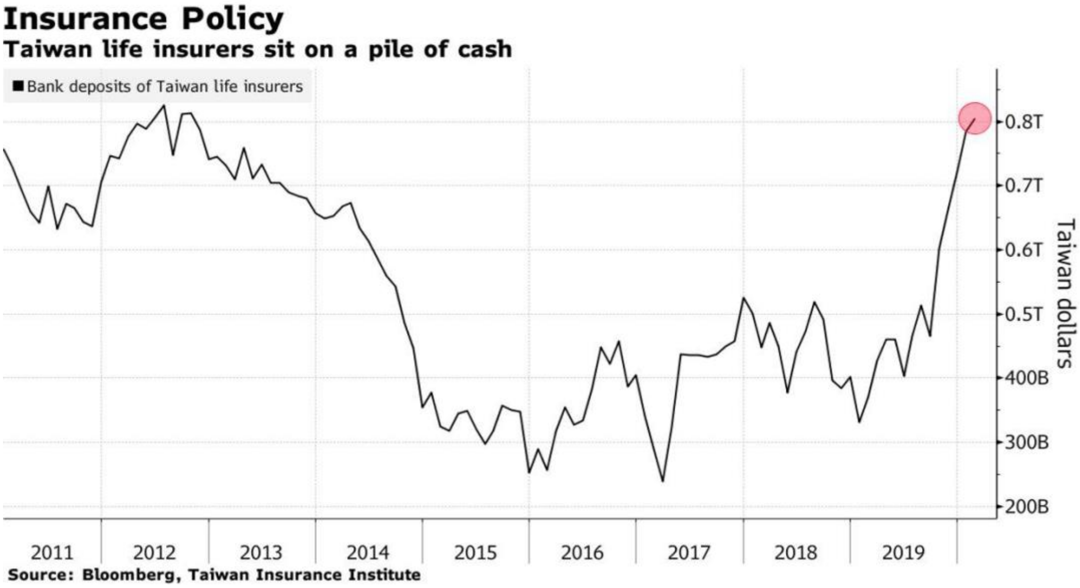

Figure 99: Taiwan Cash Balance, End of January 2020 (*Source: Bloomberg*)

As seen in the graph above, Taiwan life insurers were taking on a de-risking stance by piling up on their cash reserves during this time of uncertainties. Their cash at the end January was at record levels and we expected it to continue to remain high during the early parts of the virus. Based on an USDTWD exchange rate of 30, cash deposits are around USD 26 billion for the lifers. We expect to see this high cash rate to slowly deplete as the economy begins to recover and the lifers begin to invest.

Due to the nature of their investment timeframe of life insurance companies where their investments returns are targeted over a long period of time, a popular investment choice are long term U.S. corporate bonds. According to the business times, the slump in the U.S. corporate bond market in Taiwan created an opportunity for these lifers to buy U.S. IG at a discount in April. Abel Lin the managing senior executive VP from Cathay Life added that they would continue to add to their holdings.

As we see the economy recover, we would start seeing large buying of USD from lifers in order to continue to load up on foreign assets due to their relatively higher returns (especially for longer tenure products). This will cause an increase in supply of TWD in the market which would cause the TWD to depreciate.

FX TRADE IDEA: LONG USDTWD

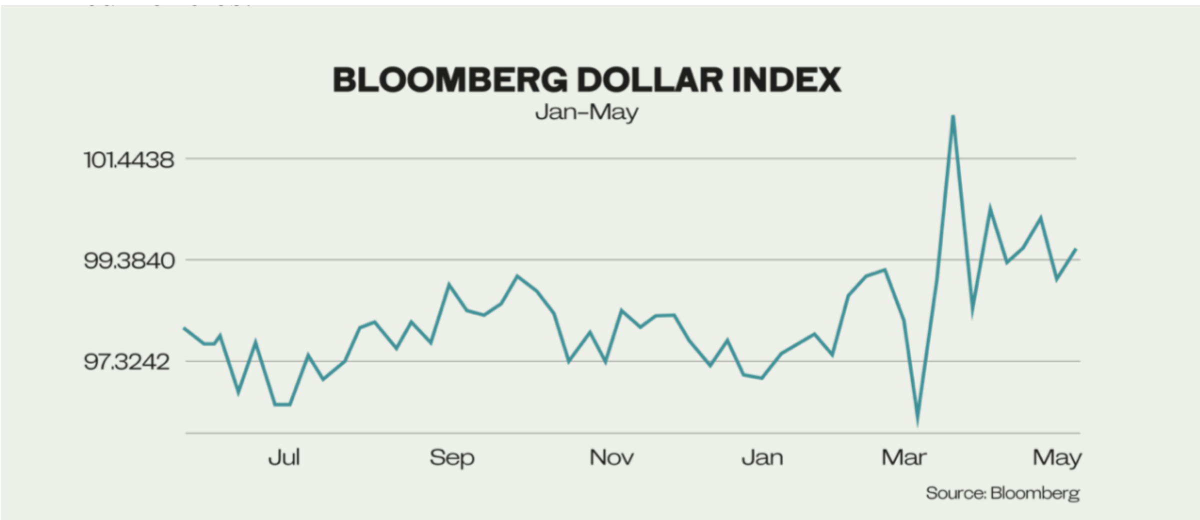

Figure 100: Dollar Index (*Source: Bloomberg*)

Our trade idea from 1H2020's report was a short on USDTWD, with an entry at 30.425, take profit at 30.328 and a stop loss at 30.515. The trade was fulfilled due to the resilience and performing Taiwan economy. This time round, we will propose a long of this currency pair. Although the Taiwan economy is still doing relatively well as compared to other economies, we predict that for the next 6 months, due to the general risk off sentiment within the world, we expect flows to move out of EM currencies like TWD towards safer currencies like the USD.

As a safe haven currency, the Dollar would be expected to stay resilient throughout this entire ordeal. As seen from the figure below, during the peak period of March, the dollar shot up as investors rushed in to get hold of the dollar as a safe haven asset. We feel that the possibility of a second wave in the western world will drive the dollar upwards. As such, in comparison, we believe that the dollar will outperform the Taiwan currency.

Figure 101: USDTWD Hourly Chart (*Source: TradingView*)

Entry: 29.529
Take profit: 29.695
Stop loss: 29.456
Risk to reward ratio: 2.27

As we can see in the chart above, we can see that there has been a bearish trend for the past month, as identified by the support and resistance line. However, recently, we can see that there is a trend reversal as this currency pair is on a bullish trend now as seen from the second pair of trend lines. Currently, the RSI has been hovering around the mid-range level, indicating neither overselling or overbuying of the currency while the MACD indicator indicates that a bullish trend would be following. As such, we will choose to enter the trade now at 29.529, taking profit at 29.695. Our stop loss will be at 29.456, whereby the currency pair's bullish trend comes to an end, resulting in them testing the support line at that level.

JAPAN (Underweight)

The year 2020 is forecasted to be the deepest recession of the post-war era for Japan. Economic activity has plummeted in the first half of 2020, reflecting the impact of the pandemic and significantly lower external demand from other countries. Consumer spending has also been largely affected with the onset of COVID-19 and the introduction of a tax hike.

The 2020 Tokyo Olympics was initially expected to add 1.2% to overall GDP 2020. As mentioned in our 2019 report, Shinzo Abe intended for the event to be the fourth arrow aimed at revitalizing Japan's economy. Unfortunately, due to the spread of COVID-19, the 2020 Tokyo Olympics was cancelled. They held off imposing a lockdown and only declared a very delayed state of emergency on 7th April which caused a sharp rise of COVID cases to 3,600.

A sufficiently large-scale fiscal support and the gradual lifting of the confinement measures recently may help to mitigate the economic hemorrhage partially, but a second outbreak with the recent re-opening will impart another economic blow. GDP is expected to fall by 6% in 2020 in the event of a single-hit (one wave of reinfection) scenario and by 7.25% in the event of a double-hit scenario (two waves of reinfection), according to OECD estimates.

A vaccine is likely to only be available late 2021, 12 to 18 months away. Japan, like the rest of the world, will continue to suffer the impacts of the virus until then. It would take at least 2-3 years at the very least before the pandemic dust settles for Japan. Therefore, our Research team is not confident of Japan's economic performance to be overweight Japan at least for the foreseeable 12 months ahead.

GDP Growth – Slowing the Hemorrhage and Hunkering Down

In the 2019 report, we believed that the 2020 Tokyo Olympics and the stimulus package rolled out in December 2019 would be insufficient to negate the negative effects of the October 2019 consumption tax hike.

The Japanese economy had already been slowing down since 2018 due to the trade war between the U.S. and China, which negatively impacted global trades for many economies big and small. In addition, Japan was also embroiled in its own trade dispute with South Korea, although the negative impact is estimated to be much smaller than the impact on Korea's economy. This fragile state was further exacerbated by the implementation of the consumption tax in October 2019. As a result, it reduced spending by consumers and Japan's GDP shrank by an annualized rate of 7.1% during the last quarter of 2019.

The onset of COVID-19 was the last blow on Japan's economy and seen to lead it towards a steep recession. The steep drop in oil prices also caused markets to crumble and the yen to gain, impacting Japanese exports negatively.

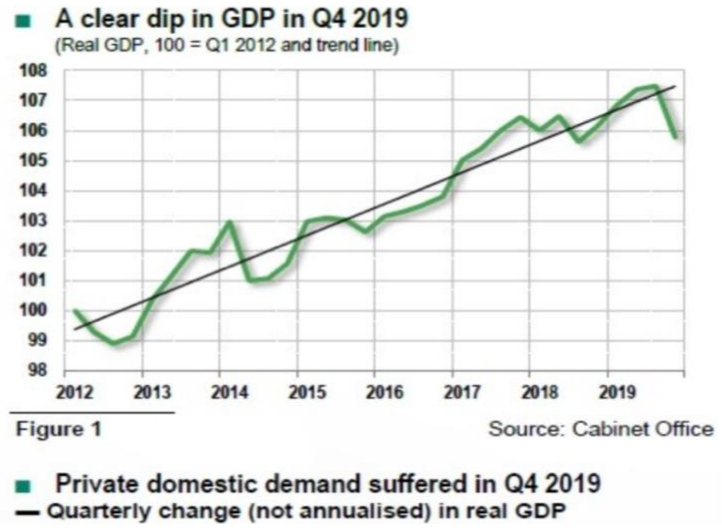

Figure 102: Japan’s GDP (*Source: FXSTREET*)

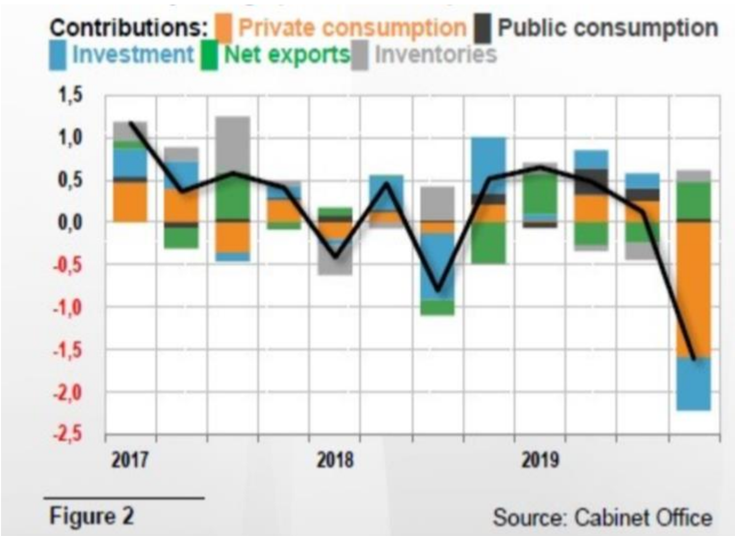

Figure 103: Factors Contributing to the Change in Japan’s GDP (*Source: FXSTREET*)

In the 2019 report, we correctly forecasted that the consumer tax hike would result in slower growth numbers. Prior to the consumer tax hike in October 2019, consumer spending had already shown signs of weakness. The spread of global pandemic has further impacted consumer confidence and caused a double-whammy as Japan struggled to cope with both the contractionary impacts of COVID-19 and the consumer tax hike. As a result, the already thrifty economy of Japan is even less willing to spend. Private consumption which accounts for roughly 60% of the country's GDP has already declined by 2.8% largely due to the tax hike and a major typhoon last year. The onset of the COVID-19 dealt further blow to private consumption, where total credit card spending already fell about 15% in the first half of March 2020, compared to the pre-COVID-19 levels in the second half of January 2020. Japan's economy is expected to contract by 4.1% in 1Q2020 and another 11.0% in 2Q2020 from the previous quarter, the largest drop in 11 years.

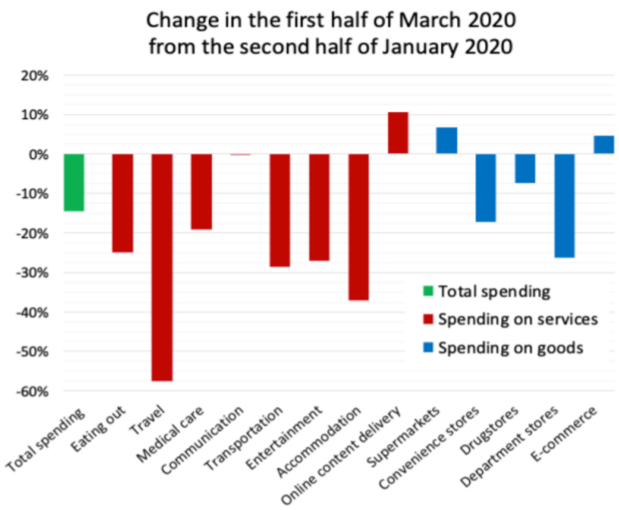

Figure 104: Credit Card Spending (*Source: VOX*)

After the outbreak, Prime Minister Shinzo Abe called for a state emergency and announced two stimulus packages to cushion the economic impacts of the pandemic and help recovery at a later stage. In early April, the government also launched a wide range of measures to support households and protect businesses and employment.

The supplementary budgets not only provided a range of subsidies to accelerate growth in the recovery stage but also set aside a contingency fund of 2.1% of GDP for potential reinfection at a later stage.

Before the pandemic, Japan had initially hoped that the 2020 Tokyo Olympics would help to shore up their weakened economy. Due to the global pandemic, the event has been postponed. However, we believe that the direct impacts of this are rather limited compared to other economic challenges that Japan faces. As mentioned in our 2019 report, the Olympics has arguably already boosted the economy by increased construction in the years leading up to the event which has already been factored into the GDP of previous years. Amidst the backdrop of the COVID-19, tourism and consumption spending also declined drastically. Japan did enjoy positive effect from all the infrastructure built up and the pre-Olympic tourist arrivals in the months before the scheduled event. However, due to the pandemic, Japan could not continue to reap the benefits of all pre-Olympic built up and with domestic spending already weakened.

Trade, tourism and manufacturing have been severely hit as Japan's 2nd largest trading partner, China, was the epicentre of the pandemic. China ranks number 2 in terms of the USD value of imports from Japan, totalling USD 134.70 billion, which is 19.10% of Japan's total exports.

Japan has tightened rules on foreign investments in industries core to its national security, to protect them from foreign state interference. These apply to more than half the listed companies in Japan and mainly arise from concern over Chinese investment in the country. Foreign investors are now required to report in advance when they wish to obtain more than 1% stake in a firm, compared to the previous threshold of 10%. As a result of the new rules, many institutional investors may be required to seek approval before investing and board nominations in sensitive industries may be subjected to more stringent government review.

This is seen as an act of protectionism which would lower investor activism and deter global investors, thereby reducing foreign direct investments in Japan in the near term and long run. Japan can expect its foreign direct investment to fall noticeably due to the new rules. While it is crucial for national security, it is less beneficial for Japan's reputation as a destination for Foreign Direct Investment and capital inflow in the long run.

While Japan faces a flattening of the COVID-19 curve, hoping for a "V"-shaped recovery is too optimistic. With a vaccine expected to be available only in mid to late 2021, economies around the world are unlikely to recover to normalcy any time soon. Most countries are now rushing to reduce restrictions and re-open their economies in the face of reinfection risks. It is a risk every country is taking as prolonged lockdowns have had and will continue to have hemorrhaging effects on their economy. Every economy is expected to go through cycles of lockdown-reopen-lockdown as reinfections are expected to come in 1 – 2 waves within 2020 after reopening, according to OECD's estimates. Therefore, the reopening has got to be accompanied by careful measures in place. This needs to continue until the availability of a safe and effective vaccine.

Japan's Trade Balance – Impact from COVID-19

In the 2019 report, we expected a trade deficit for Japan due to the headwinds from the U.S.-China Trade War and their own dispute with South Korea. This was reflected accurately in January 2020's trade deficit.

However, February 2020 saw Japan recording a higher-than-expected trade surplus of JPY 1108.77 billion, the largest since 200. This was due to Japan's imports plunging 14%, the 10th straight month of decline since May 2019 and its exports contracting only 1.0% YoY. China, Japan's largest trading partner was the first country to be hit with COVID-19. China went into a lockdown and factories were shuttered. This reduced a great part of Japan's imports from China. At the same time, most other countries only had low rates of infections at that time, compared to China and Japan's exports to them were not affected yet. Thus, despite Japanese export contracting for the 15th consecutive month, it was a less severe 1.0% YoY, compared to the contraction in Japanese exports of 14.0%, leading to a large surplus in February.

In March 2020, with COVID-19 spreading fast and furious globally, many of Japan's trading partners were affected. This caused Japanese exports to fall by 11.07% YoY. The trade surplus thus plunged by 99% to JPY 5.408 billion in March 2020 compared to JPY 517.29 billion in the same month a year earlier, well below market expectations of a JPY 420 billion surplus.

Exports for May fell at the fastest pace in over a decade. Yen-denominated merchandise exports dropped 28.3% year-on-year in May after falling 21.9% in April, largely due to lower machinery and transport equipment shipments as foreign demand fell drastically. The reading marked the sharpest decline since September 2009. In the meantime, imports fell 26.2% in May after dropping 7.2% in April.

The merchandise trade balance was negative JPY 0.8 trillion in May, which was narrower than the JPY 1.0 trillion shortfall in the same month a year earlier. The 12-month trailing trade deficit narrowed to JPY 2.2 trillion in May from JPY 2.3 trillion in April.

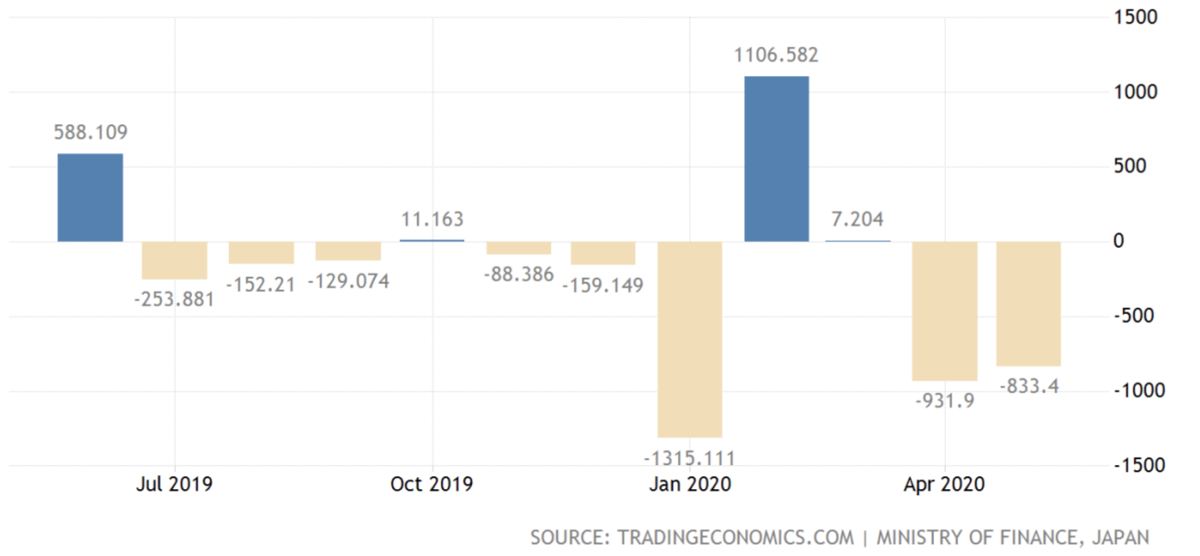

Figure 105: Japan's Trade Balance in 2020 (*Source: Trading Economics*)

Analysts believe that both the U.S. and China, Japan's 2 largest trading partners, will fall short of even a U-shape recovery. Data has shown that Japan's shipment to the U.S. tumbled 16.5%, exports to the European Union fell 11.1% while goods headed to China plunged by 8.7%.

The crisis also renewed talks by Japanese firms on reducing their reliance on China. Japan has earmarked USD 2.2 billion of its economic stimulus package to help its manufacturers shift their production out of China as COVID-19 disrupted supply chain between major trading partners. This move coincides with what should have been the celebration of warmer ties between the 2 nations, with Prime Minister Abe expecting a meeting with President Xi pre-pandemic, and subsequently, Japan sending masks to China when they were short in supply. We believe that this is not a political standoff between Japan and China. This is more about diversification of supply chains that already started in 2018 due to the U.S.-China trade war.

While Phase 1 of the U.S.-China Trade Deal was signed in January 2020, little progress has been made so far. Bloomberg analysis points to China only fulfilling 22% of its USD 36.5 billion target and she only has 3 months to 30th September 2020 to reach that target. Thus, Trump is urgently bringing the trade war into focus and it will hurt the global trade flows again, adding more woes to the already pandemic-scarred economy of Japan and elsewhere.

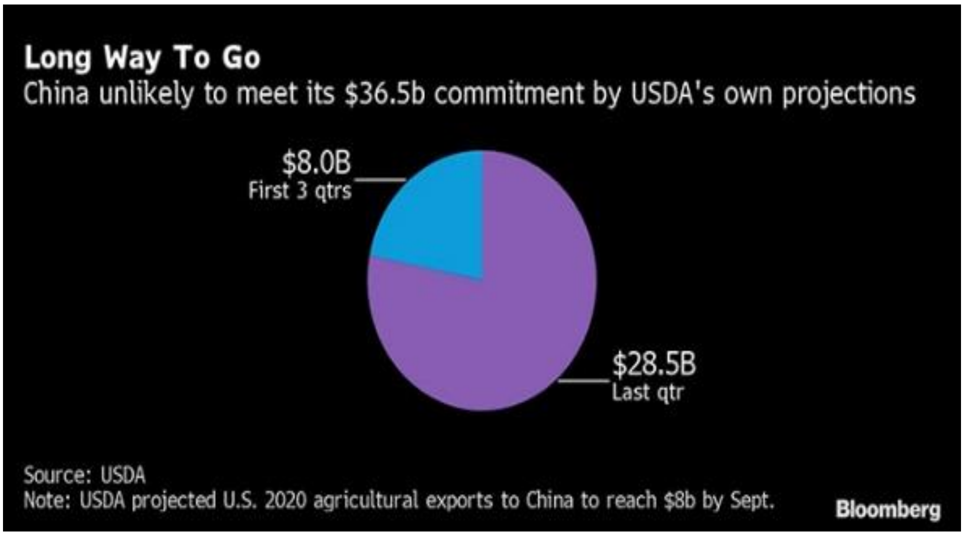

Figure 106: China’s Commitment to the Phase 1 Trade Deal (*Source: Bloomberg*)

In addition, relations between South Korea and Japan have been worsening with no resolution in sight. They were embroiled in a trade dispute since mid-2019, where they imposed trade restrictions on each other. Their previous meetings in December 2019 and April 2020 produced no major break-through as the COVID-19 issue has resulted in more trust issues between the two. Due to the impacts of both COVID-19 and export curbs, Korean imports of consumer goods from Japan plunged 37% in April 2020, compared to a year earlier.

In the 2019 report, we expected South Korea to take steps to restructure their supply chains and replace Japanese chemical supplies with Korean sources. South Korea has been inviting more overseas companies to set up shop in Korea to produce for Korean companies. The process was accelerated by the onset of COVID-19 due to its impact on the supply chain.

Despite Japan easing some of the curbs, many South Korean companies have already started to switch to domestic sources for a more stable stream of supplies, although local sources are less economical and of lower quality. Stella Chemifa, a Japanese manufacturer of inorganic fluorine compounds is a case in point. It suffered an 18% drop in net profit for the year that ended in March 2020. Another example, Rival Morita Chemical Industries, also suffered a 30% drop in its exports to South Korea in January 2020. A senior official at the Korea Semiconductor Industry Association also predicted the trend will be permanent and irreversible. We tend to agree with the direction of this trend and believe that Japan’s exports to Korea would continue to fall over time.

The trade war between U.S. and China that started around the middle of 2018 has created a chain of disruptions to the supply chains in Asia, with Japan starting to consider reducing their exposure to and adjust their supply chains out of China. The trade tension between Korea and Japan has also added to the disruptions. These changes will permanently change the trade flow pattern for Japan.

In the months ahead, we do expect Japan to continue to experience trade deficits as her trading partners focus their resources towards battling the pandemic's impact on their domestic economies, as they try to reopen their countries progressively amidst very high risks of a second wave of reinfections.

The availability of an effective vaccine is the only way to put a stop to the haemorrhage. The reignition of tension between the U.S. and China, as well as the trade dispute with South Korea, will only mean a very bumpy road ahead for Japan.

Japan's Interest Rates – "Low and Steady"

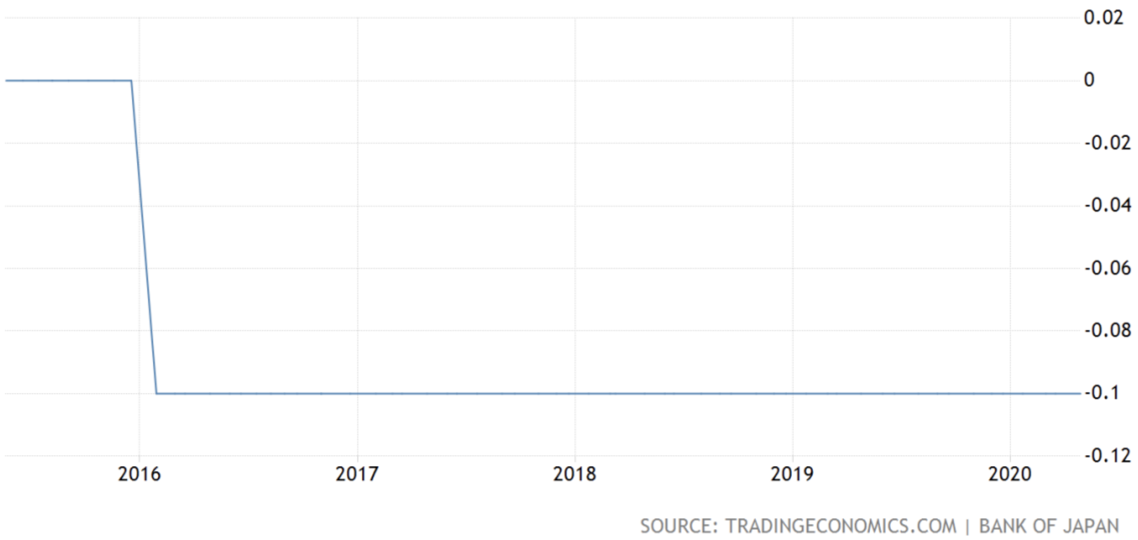

Figure 107: Japan's Interest Rates (*Source: Trading Economics*)

IMF had warned Japan in 2019 against too many rate cuts to spur the economy and they further reiterated their stance to Japan and other economies with low existing interests. Decreasing interest rates further would have limited effect when consumer sentiment is low, and consumers are unwilling to spend. On the other hand, they could weaken profitability in parts of the financial sector and encourage short term investment activities that are not economically productive.

In June 2020, the BoJ revised upwards the amount of business loans it could back under a pre-existing scheme designed to support the economy. The BoJ also left the short-term policy rate on the current account balances of banks that it holds unchanged at minus 0.10%.

The loan support program helps banks lend to businesses at low-interest rates. The Bank of Japan has revised the total potential value of the program to JPY 110 trillion, up from JPY 75 trillion. They have also reiterated that they would continue to purchase Japanese government bonds (JGB) with no cap on the upper limit to keep the 10-year JGB yield at around 0.00%.

The Financial Services Agency has also made provision for banks affected by the pandemic to draw on their regulatory capital and liquidity buffers. It is expected that this accommodative stance will continue to be in place way into 2021 until the economy shows signs of improvement.

The BoJ April 2020 meeting minutes revealed that the intent of "inflation targeting" seems to have been put on hold, in view of the more severe economic problems from the pandemic. This implies that even if core CPI inflation were to turn negative, the BoJ will not rush to implement fresh easing measures. In short, BoJ will continue to direct efforts towards injecting more liquidity into the market, keep money supply flowing, encouraging banks to lend and keeping interest rates low. This will likely stabilize the financial markets and are intended to buffer the businesses during the crisis and prompt spending on capital investments.

Saving the SMEs, the "Backbone" of Japan

According to the trade ministry, 99.7% of all businesses in Japan are small or medium-sized. They are known as the "backbone" of Japan's economic progress. Employing roughly 70% of the working population, these stores that span across a wide array of sectors account for a large portion of economic output. Currently, many are facing financial difficulties and having trouble keeping afloat, which is to be expected. The global lockdown measures that result in the sharp drop in tourism impact many travel and tourists related businesses such as small hotels, travel agencies and cruise line operators. Small manufacturers have also cited the disruption of supply chains and export markets have come to a standstill.

Kuroda, the current Governor of the Bank of Japan, highlighted that the small to medium businesses are facing more "more serious challenges than during the Lehman crisis," and further easing of interest rates would have minimal impact in supporting these businesses.

In response, Japan released its version of the "Main Street" scheme. The Bank of Japan would pump in USD 280 billion to support government-launched funding-aid programs in commercial banks which lend to smaller firms. The scheme aims to support small businesses impacted by the pandemic and to prevent the economy from sliding into a recession. This helps to allay increasing fears of a spike in bankruptcies and job losses in Tokyo, due to the pandemic. The central bank would also pay 0.1% to banks that boost such lending. Government guarantees are also in place to cover any losses that may emerge. Overall, the effectiveness of the program will still depend on Bank's faith in the SME's and their willingness to lend to them amidst deteriorating financial standing of the SME's due to bad economic conditions. This will, in turn, impact the dispersion of funds across this sector to be able to make an impact and help shore up this very important sector from going belly up.

BOJ's policy adjustment is very necessary and part of a global campaign by central banks to help small businesses and low-income households that are most hard hit by the pandemic. These are the "Backbone of Japan" and also for many other economies.

Japan's Deflationary Problem – Where Are We Heading?

Japan suffered nearly two decades of deflation until 2013 when Prime Minister Shinzo Abe's "Abenomics" stimulus policies helped revive parts of the economy out of the doldrums. Many analysts believe Japan was on the brink of heading towards recession before the onset of the pandemic. The onset of the COVID-19 pandemic has dealt a heavy blow to its fragile economy and stoked fears of a return to deflation.

Figure 108: Japan's Core Inflation Rate (*Source: Trading Economics*)

The core consumer price index, which excludes the price of fresh food, was unchanged in May in month-on-month and seasonally- adjusted terms, after falling 0.5% in April due to weak oil prices and lockdown measures that increase deflation risks. This latest decline was largely due to lower prices for transportation and energy. The core consumer price index decreased by 0.2% in May compared to the same month last year, as it did in April. The change was also substantially below the Bank of Japan's target of a 2.0% increase. Overall inflation was unchanged at 0.1% in May. Focus Economics Consensus Forecast panelists expect overall consumer prices to drop 0.1% in 2020, which is unchanged from last month's estimate. In 2021, the panel sees prices rising by 0.2%.

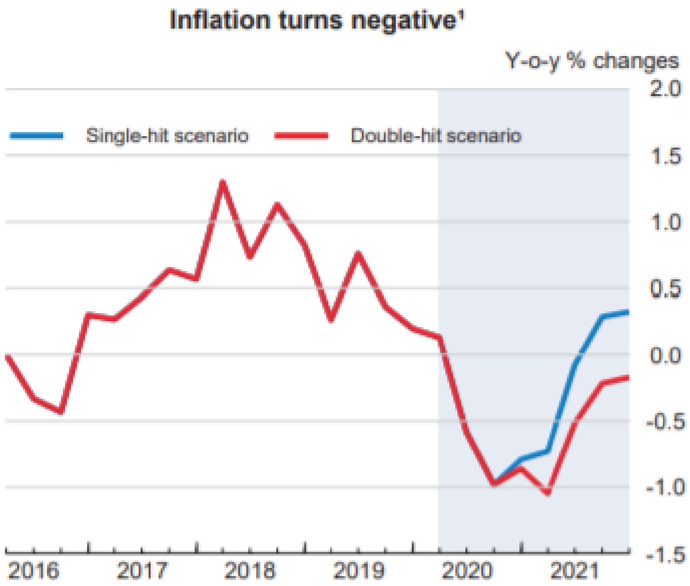

Figure 109: Japan's Inflation Rates (*Source: OECD*)

A return to deflation, however, will be a blow to Prime Minister Shinzo Abe who touted the end of stagnation as a key success for Abenomics stimulus policies. However, Japan and the rest of the world are going through unusual times due to the pandemic and from BoJ's recent statements, we believe that inflation targeting policy will be put on the backburner for the time being.

The Ministry of Finance has cut the number of inflation-linked bonds from the original JPY400 billion in December 2020 to JPY 200 billion, the lowest in 7 years. This is a sign that the BoJ does not expect a rise in price levels anytime soon. The Bank of Japan has slashed price forecasts and lowered its assessment of inflation expectations. These reflect weak signs in the economy and indicate a slower rise in prices in the future.

What is important for Japan now, is to mitigate the depth and severity of the economic decline on all fronts. In addition, they have also put in place sufficient measures alongside the reopening of prefectures and cities and to avoid the onset of a second wave as much as possible. We believe that Japan has a high chance of re-entering a deflationary period given current weak economic conditions.

FX TRADE IDEA: LONG USDJPY

Figure 110: USDJPY 4-Hourly Chart (*Source: TradingView*)

Entry: 106.80
Take profit: 107.80
Stop loss: 106.30
Risk to reward ratio: 2

When COVID-19 started it's spread out of China in February 2020, the USDJPY saw a high of around 111.50 on 23rd February 2020 with the trading market buying USD due to the shock and uncertainty of the virus. It subsequently plunged to a low of about 103.50 on 8th March 2020 as Japan looked relatively 'safe' compared to China and Korea. It was all very volatile and driven by unruly sentiment. In the recent 3 – 4 weeks, the USDJPY has also started to track the Dow Jones Industrial Index. The positive correlation only started around 18 May 2020. This implies a 'risk-on' mode correlating with a buy USD sell JPY direction.

Japan is likely to continue to struggle in coping with the negative impacts of the Virus, with the potential of a second wave of infections likely to occur due to the opening of most of its prefectures and cities. However, the first 'wave' of infection is viewed to have 'settled' with testing, containment and re-opening in place. Thus, we expect the USDJPY to trade in a range of 105 to 110.

We can see that the RSI hovers around 50 handle. The MACD line has also crossed over the signal line on 23rd June 2020 and has remained above since, signalling an uptrend. This is further supported by the graph crossing above the SMA line recently. These indicate a buy signal and hence we would suggest to long USDJPY at 106.80, with a take profit level of 107.80 and a stop loss of 106.30. This would give us a risk-reward ratio of 2:1. The U.S. interest rate is currently at 0.25%, higher than that of Japan which is at -0.1%. This gives a positive rate differential which would add to the expected profits.

SOUTH KOREA (Underweight)

January 2020 saw the signing of phase 1 of the U.S.-China trade deal and Japan taking a conciliatory tone towards South Korea. Amidst what was thought to be the easing of tensions, the South had expected their economy to pick up in 2020. However, this did not pan out in the way they had expected.

With the onset of the COVID-19 pandemic, all of South Korea's trading partners were hit – starting with China, Asia, Europe and then the U.S. Being an exported oriented economy, South Korea was especially vulnerable. The world economy would be hit harder than during the Great Depression with the IMF revising global growth from a previous forecast of +3.5% to -4.9% for 2020. Similarly, they expect South Korea's economy to contract by 1.2%.

The cutting of interest rates and large fiscal stimulus may help to cushion the impact of COVID-19 on South Korea's economy. However, with the recent spike in the second wave of infections and a vaccine only likely to be available 12 to 18 months later, South Korea will continue to suffer from the impacts of the virus till then. As such, we are not confident of South Korea's performance for the near future.

<u>"G-D-P: Going-Down-Progressively"?</u>

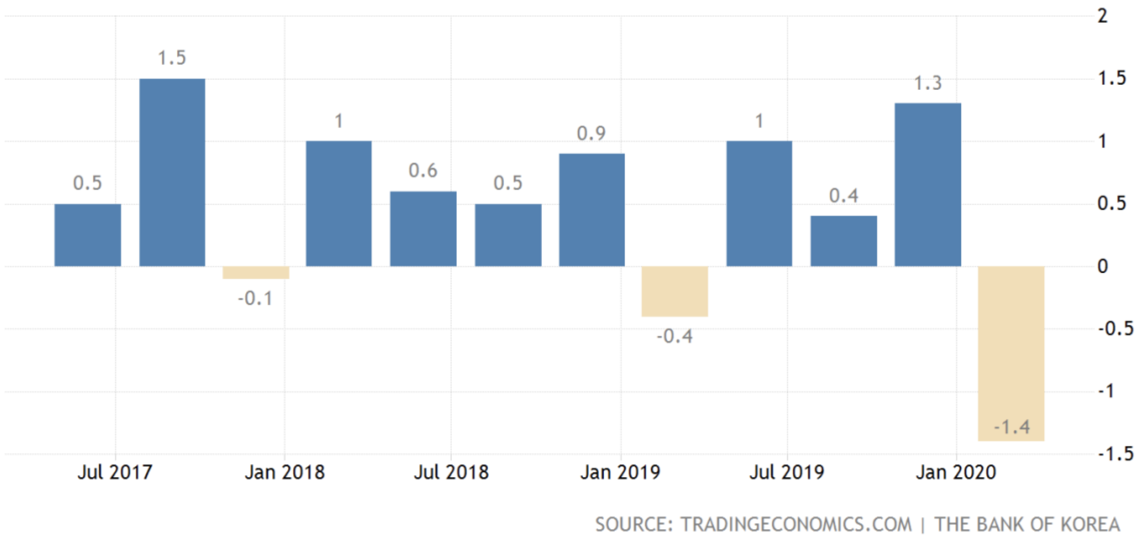

Figure 111: South Korea's GDP Growth Rate (*Source: Trading Economics*)

In the 2019 report, we expected South Korea's economy to contract in 2020. We believed that they would continue to suffer dire impacts from being sandwiched in the U.S.-China Trade War as well as from their dispute with Japan, both of which weighs on export numbers. South Korea's GDP did contract by 1.4% in 1Q2020. This was a steep decline from the growth rate of 1.3% in 4Q2019. While this was slightly better than the expected contraction of 1.5%, it was nonetheless the sharpest drop since 2008. While South Korea's exports were weakened by the U.S.-China Trade War, they were less impacted by their dispute with Japan than we had anticipated. The unexpected outbreak of the pandemic also played a role in causing the GDP to contract. The falling domestic demand also hurt their economy as the number of daily infections in South Korea continued to climb sharply during the early months. Within the short period from February 2020 to April 2020, the number of infections multiplied from a single digit to a five-digit figure.

The International Monetary Fund (IMF) expects the global economy to experience the worst recession since the Great Depression, surpassing that of the Global Financial Crisis which occurred a decade ago. They also expect South Korea's economy to shrink by 1.2% in 2020, slashed from a 2.0% growth estimated in October 2019. This would be South Korea's first contraction since 1998. However, at the current progress of the situation, we believe that South Korea's economy would contract more than 1.2% for 2020.

In late February to early March. Services declined by 2.0%, Manufacturing by 1.8% and Construction by 0.3%. However, we believe that the worst is not over yet for South Korea. In the first 20 days of April 2020, overseas exports data indicated a sharp drop of 26.9% as compared to a year earlier while the Manufacturing PMI fell to 41.6 from 44.2 in March 2020, the lowest in a decade. South Korea's heavy dependence on exports also means that containing the virus domestically is not enough to see significant signs of recovery. South Korea needs its trading partners and the World to start to recover from the Virus. However, recovery is dependent on a vaccine being available. U.S., UK, Europe, China and many pharmaceutical companies are racing against time to develop a viable vaccine and it is not expected to be ready until at least 1Q2021 or 2Q2021. We believe that sectors dependent on human behaviour such as services and tourism would be the worst hit by the pandemic in the long run. As lockdown measures ease, most sectors would find the momentum to bounce back. However, as people would still refrain from unnecessary travel and gathering to avoid risks, these sectors would continue to suffer the impacts of COVID-19 and will take a while before they return to pre-COVID levels.

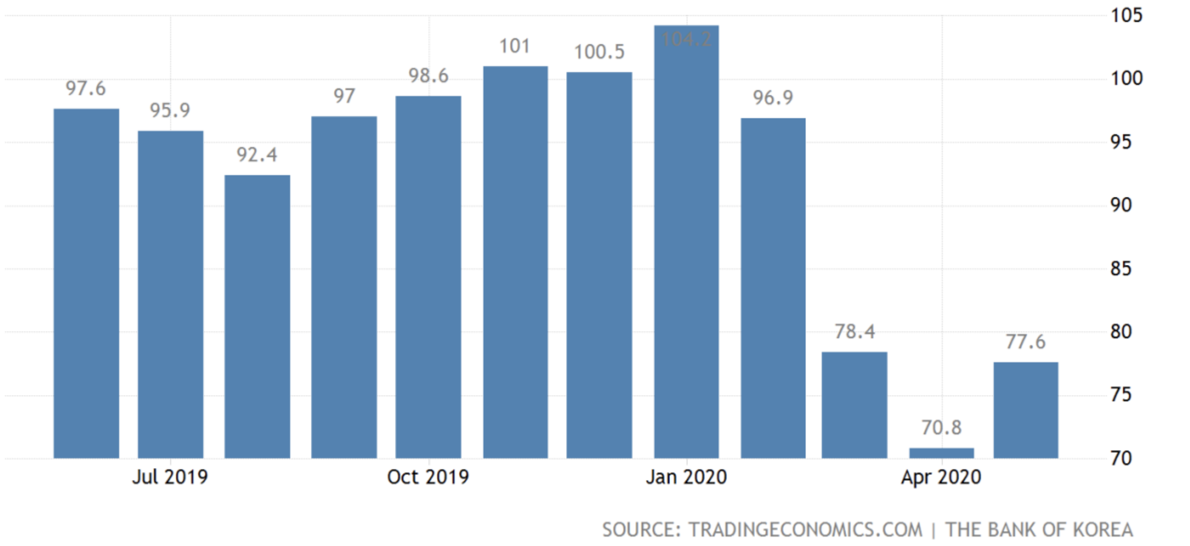

Figure 112: Consumer Confidence in South Korea (*Source: Trading Economics*)

South Korea witnessed a rapid surge in COVID-19 cases since 19th February 2020. By the end of February 2020, the country had the greatest number of COVID-19 patients outside of China. Learning from their experience of SARS and MERS, the government acted quickly. Using a combination of early mass testing, surveillance and contact tracing as well as self-isolation, South Korea managed to effectively contain the outbreak and flatten the curve within a month. However, the recent easing of lockdown measures has seen a second wave of infection with cases increasing at a daily rise of around 50 since, signalling that the war against the virus is far from over. Despite this, President Moon remains hesitant on re-imposing stronger social distancing guidelines. Consumer confidence fell to a decade low of 70.8 in April 2020 compared to 101.7 a year earlier. While the reopening witnessed consumer confidence rising to 77.6, we expect that domestic demand is unlikely to recover to pre-COVID levels by the end of 2020. As a result of the second wave of COVID-19 leading to a spike in infections, their citizens will continue to practice social distancing, restricting their movement and affecting consumer spending. We expect to see a slow recovery in consumer spending in South Korea as the country is still grappling to contain the virus effectively and return to normalcy.

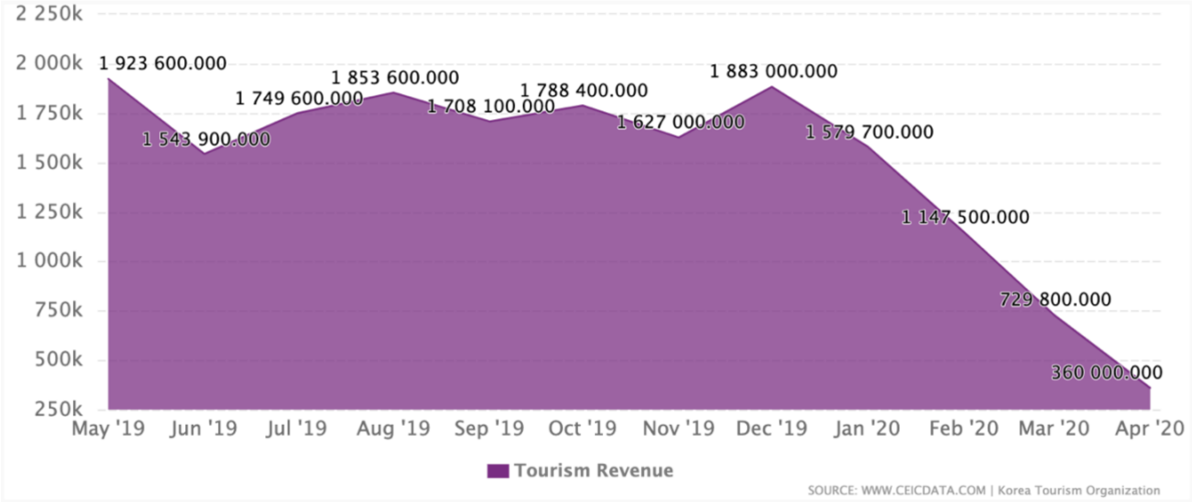

Figure 113: South Korea Tourist Revenue (*Source: CEIC Data*)

Tourism revenue fell sharply due to global border control. The Korea Tourism Organization confirmed that 9 planned events have been cancelled while 4 have been postponed. Tour cancellation and suspension of flights have also hurt South Korea’s economy. While Tourism only contributes to 2.7% of South Korea's GDP, it is one of the fastest-growing sectors with a rise of 14% in 2019. Furthermore, the fall in demand due to lower tourist numbers have also resulted in knock-on impacts on other sectors like retail and food and beverages. This has affected unemployment rates in Tourism related labour markets and contributing to a lower GDP. We believe that Tourist volume will not pick up this year. It will be very hard for any country right now in their economic state to handle a further onslaught of cases from international visitors. The world will need a vaccine to be available to be confident in scaling back some border control to allow tourist visits. With fears of contracting the virus, foreign visitors will choose to cut down on unnecessary travel plans which in most cases are holidays and tourism visits. Thus, we expect tourist numbers to remain low for at least the next year. The whole world needs to have the infection rates and spread of virus under control before South Korea can expect a portion of its tourist volume back. South Korea, like many of its peers, cannot afford another big hit of the virus.

We believe that it is overly optimistic to expect a V-shaped recovery for South Korea in 2020. We expect export numbers to remain low with major export partners like the U.S. and EU still grappling with reopening. With trade in South Korea reported at 83% of its GDP, their heavy reliance on trade makes it challenging to recover when their trading partners face slow economic recovery. To add on, consumers and businesses will also continue to exercise caution until the availability of a vaccine. As such, we expect export numbers to remain low in 2Q2020 with domestic spending also unlikely to return to pre-COVID-19 levels.

Trade Balance and Supply Chain

Prior to COVID-19, South Korea's chip exports showed early signs of improvement after a year-long slump. Semiconductor shipments, South Korea's largest source of income rose 12% in the first 10 days of January 2020. Exports were also seen to rise by 5.3% in the first 10 days of January 2020. Despite this, an economist at KTB Investment and Securities commented then that the growth is not enough to lead South Korea's economic recovery due to a prolonged period of poor performance in 2019, caused by the U.S. China Trade War.

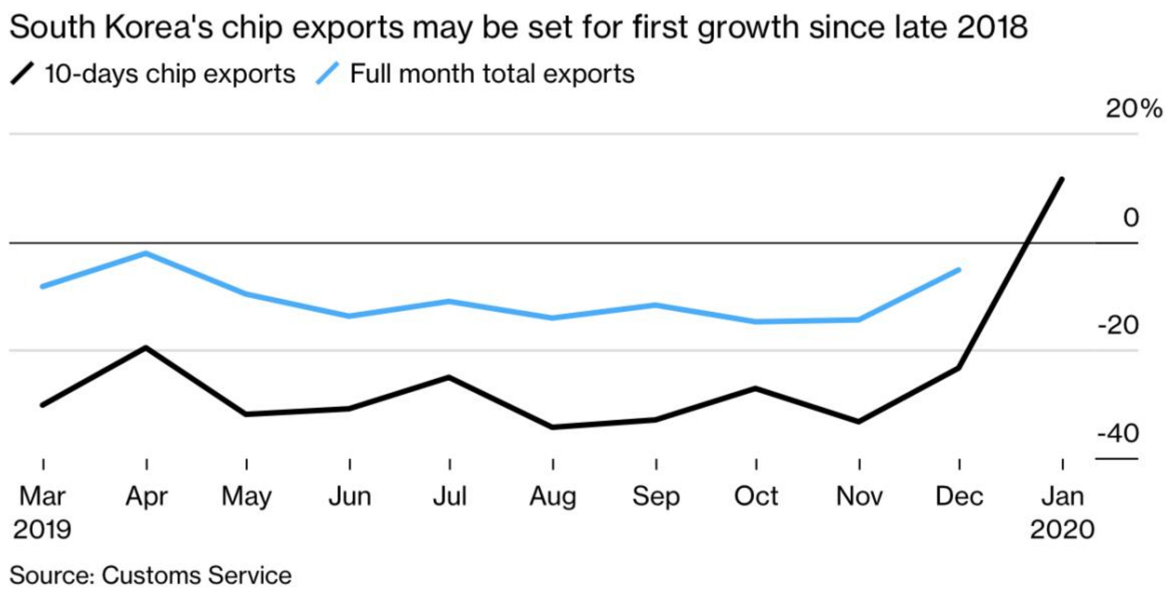

Figure 114: Growth in South Korea Semiconductor Shipments (*Source: Bloomberg*)

South Korea's relations with Japan have also been worsening with no resolution in sight. The 2019 trade dispute between the 2 nations led to the imposition of multiple trade restrictions on each other. The outbreak of COVID-19 also resulted in more trust issues with little concrete cooperation between only Japan and South Korea. In our 2019 report, we had expected South Korea's semiconductor industry to suffer as restructuring their supply chain to replace Japanese chemical supplies would take a considerable amount of time. However, they acted quicker than we had anticipated in the previous report. In a move to reduce reliance on Japan for crucial resources, South Korea has managed to secure Du Pont to invest USD 28 million in South Korea to produce advanced photoresists and other materials by 2021. Many South Korean companies have also switched to more stable domestic and alternative sources despite the higher prices, stating that minor differences in chemical quality will have a negligible impact on the overall product quality.

We are not optimistic about further improvement in the relationship between the two countries for the foreseeable future. While restructuring their supply chain takes time, South Korea has already made significant progress and will continue to reduce their reliance on Japan for many of their raw material sources for their electronic industries. Having a domestic industry would provide more secure sources and South Korea will benefit from this independence in the long run. Furthermore, South Korea stands to gain from being self-sufficient during such turbulent times. With a domestic industry, South Korea can reduce reliance on other nations, such as Japan, for key economic resources and reduce business uncertainty.

Recessions in the West, along with the challenges faced in restarting China’s economy will continue to weigh on Korea’s exports in 2H2020. As Sung Yun-Mo, Korea’s trade, Industry and Energy Minister had underscored the financial crisis in 2008 mainly affected developed economies. COVID-19 is an unprecedented global pandemic that has brought on demand shock throughout the whole world and is more severe as it impacts the entire global trade and supply chain. We see the recover in the chemical industry as a small with for the South Korean economy but is unable to create a large enough impact to lift the country out of its economic slump.

Figure 115: South Korea's Trade Balance over the years (*Source: Bloomberg*)

The pandemic shut down factories around the world, disrupting manufacturing and supply chain. South Korea's trade volume plunged in the first 10 days of May. Exports contracted 46.3% YoY in the period to USD 6.9 billion. On the other hand, imports fell by 37.2% to a value of USD 9.6 billion, remaining ahead of the exports. Shipments to both The United States and Europe halved compared to the same period a year earlier, declining by 54.8% and 50.6% respectively. Similarly, shipments to China, South Korea's largest trading partner, contracted by 29.4%. Local South Korean automakers have also suspended various operations to cope with the falling demand across the globe. Only North-Asian facilities will continue operations albeit at a lower rate. European and American operations have been suspended. The pandemic has forced the closure of international borders and factory shutdowns and it has brought back thoughts of 'reshoring' – a line of thought that was highlighted when Donald Trump became the President and triggered the U.S.-China trade war. In February 2020, the government rolled out a package of incentives which includes exemption from corporate tax and subsidising costs for building smart factories. This was to reduce Korea's reliance on Chinese supplies which was at 30.5%. However, due to South Korea's tighter restrictions and higher costs, many firms remain hesitant to move.

Both the Korean exports and imports will continue to decline for the foreseeable future. Korean exports will be impacted negatively as worldwide demand for Korean products continues to drop. This will also lead to less demand and imports of raw materials for the exported goods. On top of that, local demand for foreign goods will also decline due to the impact on the local economy from the pandemic. We expect South Korean exports to be hit harder. While South Korea still struggles to contain the rise in the second wave of infections, they are recovering faster than their foreign counterparts. As such, we expect their domestic economy to perform better than other countries but for Korean exports to decline more than their imports which would cause their economy to continue to struggle.

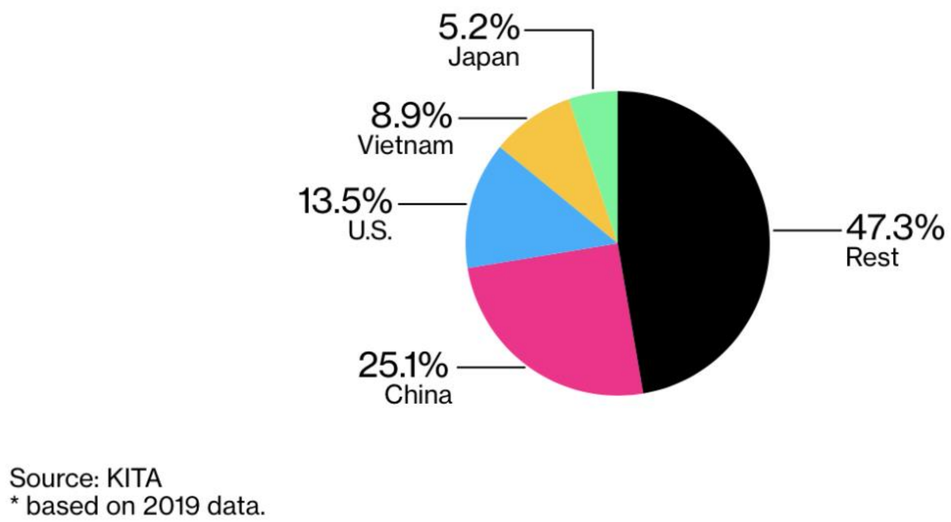

Figure 116: South Korea's Trading Partners (*Source: Bloomberg*)

With economies around the world currently facing the dire impacts of the pandemic, we expect that they require time to restart their economies. As such, South Korea is likely to face a fall in trade volume and export demands from across the globe and from their major trading partners. While this may paint a gloomy picture for 2H2020, it would benefit the South in the longer run as their efforts in re-shoring and restructuring their supply chains will reduce over-reliance on any one nation and find more secure sourcing within their country.

<u>Interest Rate - On Hold for Now</u>

Due to the slump in global trade and South Korea's self-isolation measures that hit domestic consumption, the Bank of Korea slashed interest rates by 25 basis points to a new low of 0.50% in May 2020.

Figure 117: South Korea's Interest Rate (*Source: Trading Economics*)

Jeffrey Halley, a senior market analyst, has noted that cutting rates would be an ineffective response to the global slowdown. COVID-19 impacts both the supply chain and consumer consumption. Prior to COVID-19, South Korea's years of loose monetary policy had limited impacts on improving the country's slowing growth. The added uncertainty in the duration and intensity of the pandemic would further reduce the effectiveness of economic stimulation through monetary policies. The spread of virus fears resulted in consumers being the most pessimistic in more than a decade, reducing their willingness to spend. As such, attempts to boost domestic demand have limited success, especially since social distancing measures restrict gathering and discourages citizens from loitering outside their homes.

While the economic outlook remains bearish, interest rates in South Korea are unlikely to be slashed further due to the possibility of hot money and liquidity trap. Cutting rates further will likely result in large-scale capital flight and businesses that have already been hit by the impacts of the pandemic may find it even harder to fund their operations. The COVID-19 pandemic is also expected to run into 2021, cutting rates in the near future will also leave them with little ammunition to deal with poor economic growth in future months. As South Korea entered a technical recession in 2Q2020, this decreased consumer confidence, spending and investments. As a result, the poor outlook will significantly limit the economic benefits from a lowering of the interest rates. We expect interest rates to be on hold. South Korea has run out of ammunition on terms of monetary policy to support the economy which has put it in a dire situation to spur an economic recovery in this climate.

Insufficiency of Fiscal Stimulus

Prior to the COVID-19 pandemic and ahead of April 2020's elections, President Moon announced a fiscal stimulus of USD 51 billion devoted mainly towards building infrastructure. In the wake of the downturn in the global memory chip market, U.S.-China Trade War tensions and China's economic slowdown, he had hoped this would boost the economy. This signalled a change in his policies as he had previously ruled out the use of the property market to revitalise the economy. While he underlined his promise to contain the property market, such a move is likely to contribute towards Seoul's property bubble and widen inequality in the nation which could potentially result in social unrest further out.

To curb property prices, South Korea has tightened mortgage rules, lending rules and increased capital gains tax as well as taxes on property ownership to rein in speculative investments, especially by corporations. Despite this, the median Seoul apartment price was KRW 920 million in May 2020, having increased every month through the COVID-19 outbreak.

The Seoul housing problem arose from record-low interest rates and looser mortgage rules. With interest rates likely to remain low due to COVID-19, savings are unattractive and property will remain hot, regardless of the new rules. This, coupled with the government's policy to prop the economy will continue to drive property prices up. Furthermore, President Moon's move to tighten the rules mainly impact low to middle-income buyers who have to borrow to purchase while those with sufficient cash will not face much problem, contributing to the widening of the inequality gap in South Korea.

Currently, South Korea faces its worst growth since the 1998 Asian Financial Crisis. To deal with the impacts of the pandemic, South Korea implemented its third supplementary budget in June 2020 which sharply increased its total fiscal stimulus to KRW 270 trillion, the largest in a decade. This would see South Korea’s debt-to-GDP ratio increasing steeply to unhealthy levels, from 2019’s amount at 36.7% to a projected 43.5%. Such measures highlight the long-term economic challenges of the nation in the face of a global slump. It is expected that the fiscal stimulus may not save the South Korean economy from a potential "massive recession." However, part of the fiscal stimulus is dedicated to what is called the "Korean-style New Deal" in which they planned to promote AI and fifth-generation technology in hopes that this would support the economy and create sustainable jobs for future generations in the post-virus era. The Bank of Korea has also rolled-out an unlimited asset purchasing program as part of its quantitative easing measures. This increases money supply and encourages lending and investment which will promote a healthy rise in domestic demand when the pandemic subsides.

However, we believe that fiscal stimulus can at most, cushion the impact of the virus on the economy. The supplementary budget will protect jobs and prevent most small-medium enterprises from going belly up. Despite this, bankruptcies will still be inevitable. There will still be firms that slip through the safety net and this will take time to recover from.

According to CNA Insider, every 12 minutes, a South Korean is declared bankrupt. The massive lending by the government to overcome the financial difficulties caused by the pandemic will cause the high household debt in South Korea to rise further, contributing to more household debt defaults.

Furthermore, it has limited effectiveness in boosting the economy. Public fears of routine activities will remain and with the negative outlook, they will be less likely to spend. Traditional stimulus is also unable to provide support to international supply chains and manufacturers will continue to grapple with the impacts of the virus. The economic recession is due to the virus and not a result of financial problems such as the one in the 2008 Financial Crisis. The fiscal stimulus will mitigate the impacts of the virus but it will not target the root cause directly. Only the availability of a vaccine could effectively target the fundamental reason for the economic downturn and allow normal economic activities to resume.

FX TRADE IDEA: LONG USDKRW

While South Korea managed to quickly restructure supply chains to reduce reliance on Japan and control the first wave of infections efficiently, the outlook over their economy remains pessimistic. As a bellwether for world trade, South Korea's economic performance depends on their trading partners. With many economies suffering from the impacts of the pandemic, trade volume is expected to fall and impact their economy. The monetary and fiscal policies launched by the government are also expected to have limited effectiveness and would at most help to cushion the economic impacts of the pandemic but would not move the dial for the medium to long term.

Statistically, the United States has done quite badly in the pandemic crisis, contributing to nearly 25% of total global infections of around 9.94 million and about 25% of 497,000 deaths. Fed has also cut interest rates to 0.25% and has rolled out several programs and stimulus packages to cushion the economy. Yet, the USD has consistently been a haven during the COVID-19 outbreak. The Dow Jones Industrial Average has also recovered about 60% of its approximately 11,500 points drop after the outbreak. With the South Korean economy continuing in its current fragile state and that the world will likely see the return of COVID-19 in a second and third wave, the U.S. will be in a better position compared to South Korea.

Thus, being long USD and short KRW is a better way to express the outlook.

Figure 118: USDKRW Daily Chart (*Source: TradingView*)

Entry: 1200.00
Take profit: 1230.00
Stop loss: 1185.00
Risk to reward ratio: 2

We can see that the 50SMA has crossed over the 100SMA and 200SMA in end-February 2020 and early-March 2020 respectively and has remained above since, suggesting that the market is currently in an uptrend. This is supported by the graph which appears to be crossing over the 20SMA (light yellow). As SMAs are less prone to temporary price swings, they provide a good estimation for longer-term investments. This is further confirmed with the use of MACD. The MACD line has crossed over the signal line in mid-June 2020, with the MACD histogram now lying above the baseline. These indicators point towards a buy signal. As the currency pair is on an uptrend, the RSI refrains from dipping into the conventional oversold level of 30. Instead, they hover between a more bullish range of 40 to 70. Thus, any dips into the newfound level of 40 can be bought into. We suggest entering a trade for USDKRW at a comfortable level of 1200, a stop loss at 1185 and a take profit at 1230. This gives us a risk to reward ratio of 2.

INDIA (Underweight)

In our initial review of India in December 2019, we expected the RBI to pursue another repo rate cut due as a dovish monetary policy was necessary for a country plagued with high unemployment, low output of capital goods and a fragile banking sector. Since our coverage in December, India's repo rate– the interest rate that the RBI charges for funds given to banks – has been lowered from 5.15% to 4% in an attempt to make funds cheaper for banks thus aiding them to bring down lending rates. While we initially expected a sluggish growth for India to be supported by the rate cuts in late 2019, they have been unable to deal with the damage of the pandemic. The collapse in manufacturing and services PMIs and weakness in goods export data have been more significant in India when compared to other Asian countries.

The plague of COVID-19 has affected both developed and emerging economies, India is no exception. The UN slashed India's projected growth rate to 1.2 % in 2020 and forecasted that the global economy will contract sharply by 3.2% as the COVID-19 pandemic paralyses the world, sharply restricting economic activities, increasing uncertainties and unleashing a recession unseen since the Great Depression of the 1930s. Hence, we are downgrading India's growth forecasts on a looming global recession and domestic economic activity being much weaker than expected due to the nation-wide lockdown imposed until 31st May.

Since the lockdown in March, the country's PMI has taken a major decline. The services purchasing managers index (PMI) plunged by 43.9 points to 5.4 in April from 49.3 in March, the lowest in the world, hitting single digits for the first time and staying below 50 (Figure 119). The services sector makes up more than half of India's gross domestic product and will be devastating for an economy that is unlikely to benefit from the lacklustre global economy in 2H2020. Given the likelihood that disruptions could last longer, we assume the economic weaknesses in the short term could intensify and the significant secondary impacts (job losses, reduced income levels, corporate defaults, rising NPLs, rating downgrade, etc.) could delay a potential recovery. We postulate a risk that India's real GDP could contract by a much larger magnitude of 4-6% on a YoY basis in FY21 (versus +4.2% YoY growth registered in FY20).

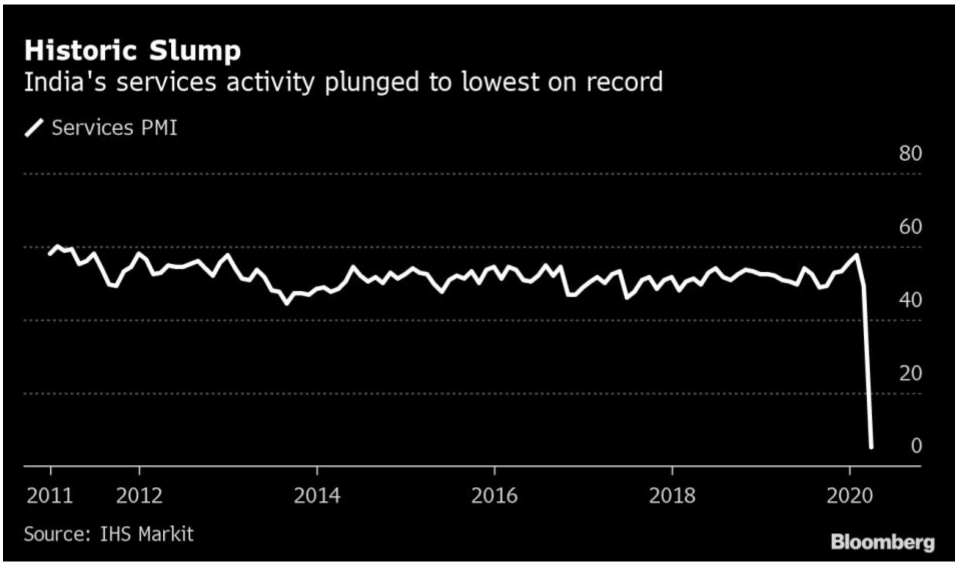

Figure 119: India's PMI (*Source: Bloomberg*)

Fiscal Support, More Harm Than Good?

Prime Minister Narendra Modi announced an INR 20 trillion (USD 266 billion) fiscal package in May, to defend against the impact of COVID-19. This scale seemed impressive and above market expectations, with an emphasis on making the economy more self-reliant via local manufacturing and improved supply chains, enabled by five pillars – economy, infrastructure, technology, demography and demand. The lockdown might also be extended further, even as restrictions are being eased gradually.

However, on the fiscal front, the revenue shortfall was already translating into an increase in the deficit from budgeted -3.5% of GDP to at least -5.5%. Considering a modest policy response so far, it seems the fiscal stimulus this year could correspond to about 2.0-2.5% of GDP. However, the fiscal deficit will be much higher, at about 5% of GDP, if we consider the substantial revenue shortfall from slowing growth. We estimate the central government's deficit to widen from the budgeted 3.5% of GDP to 8% of GDP in FY21E. This incorporates some oil buffers available to the government, due to higher taxes on petroleum products, in the wake of the sharp fall in global oil prices.

Figure 120: India's Debt to GDP Ratio (*Source: Trading Economics*)

Even though the government has made efforts to reduce India's fiscal deficit since the one-off easing after the global financial crisis (GFC), they have consistently missed the targets set by FRBM (Fiscal Responsibility and Budget Management) Act. India's public debt to GDP declined from 72.24% of GDP in FY08 to 66.58% in FY14 as nominal GDP grew faster than the rise in public debt. Since then, public debt to GDP levels have gone up and stood at around 70% in FY19. Modi's administration has already announced their desire to abandon the budget deficit aim this year and we might expect a downgrade in the country's sovereign ratings. We think that the current data reinforces the likelihood of a continued deficit in FY20 and FY21 and expect potential growth to be limited unless the administration actively pursues structural reforms.

Dangerous Wave of Disinflation

While India was struggling with rising vegetable prices in 2019, 2020 points to a disinflationary future. With the economy opens up gradually, we expect supply chain distortions to linger, when the weak demand impulse will become more dominant by depressing core and non-food demand. Normal monsoon and lower oil prices will likely moderate CPI inflation pressures. This together with base effects should take the headline CPI to sub-4% by 4Q2020 and average 3.9% in FY21. The Wholesale Price Index fell 3.21% in May on an annual basis (Figure 121), the most since November 2015, after an increase of 0.42% in March, according to a media statement released by the Ministry of Commerce and Industry. While economists had initially forecasted a fall of 1.2%, suggesting that the disinflation might be more severe than expected.

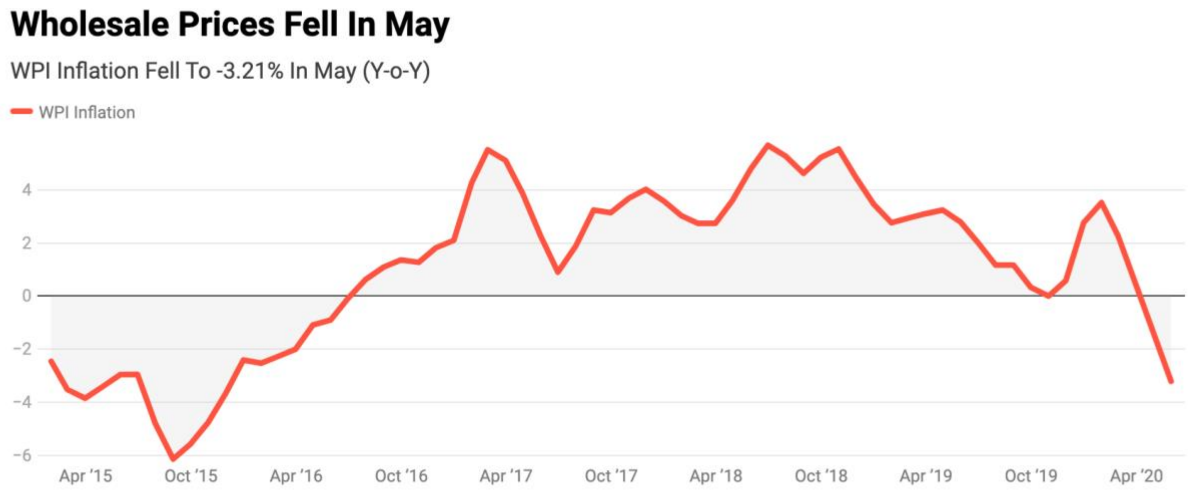

Figure 121: India's WPI (*Source: Ministry of Commerce, Bloomberg*)

This also ties in with an ebbing concern that the sizeable liquidity surplus in the banking system spurring inflationary pressures. However, further fiscal support, higher bond issuances and purchases by the central bank, the larger surplus of cash is unlikely to provide inflationary pressures given weak demand. Even as COVID-19 ceases, the scars from the shutdown - elevated unemployment, shattered consumer and company confidence, and staggered returns to work - may keep price pressures in check, prompting RBI to hold interest rates at record low levels for a protracted period. India's unemployment rate is now at a record high of 27.1%, according to the Centre for Monitoring the Indian Economy and with no clear indication when India will emerge out of the lockdown.

It is a worrying sign for India because it could lengthen what may be the deepest recession the country has ever seen. Ebbing pricing power would make it more difficult for companies that piled on debt in the good times to meet their obligations. This could prompt them to make additional cuts in payrolls and investment or even default on their debts and go bankrupt, ultimately leading to an increase in unemployment and NPL.

Monetary Space for Further Action

On 22nd May, in an unscheduled meeting, India reduced the benchmark repo rate by 40 basis points to 4%, the lowest since the measure was introduced in 2000. Additionally, India also announced the 40 basis points cut in reverse repo rate — the interest rate that the RBI offers to banks for funds parked with the central bank — which will prompt banks to make available funds for the productive sectors of the economy. With daily new cases of COVID-19 still rising, high-frequency indicators showing very slow activity resumption and only a modest fiscal stimulus (1.2% of GDP) being announced, we think further policy support is needed. We expect the RBI to lower the repo rate by another 35 basis points in 2H2020. There is a need to boost confidence in the financial and consumer sector so that resources are available to fund growth.

Discretionary consumption has outpaced staple consumption over the past two years. However, given the lockdown enforced by the government nationally because of the COVID-19 threat, we expect this trend to reverse unless further monetary support is given.

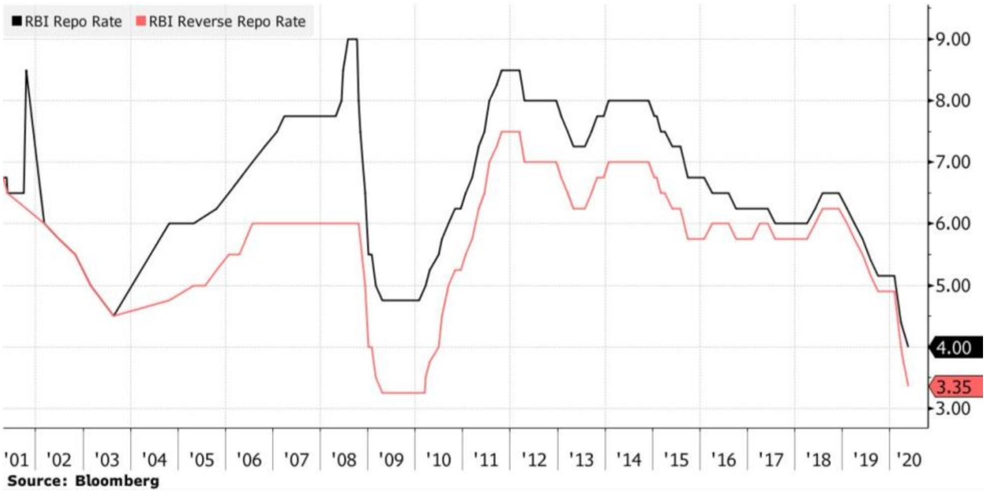

Figure 122: RBI's Repo Rate (*Source: Bloomberg*)

Bleak Consumer Outlook

Over the past few years, households' disposable income growth has been impacted amid weaker job creation trends and the automation overhang. The household balance sheet was also constrained as households were funding consumption by taking higher leverage and lowering savings amid mild income growth. Against this backdrop, the potential job losses and reduced income levels in the wake of the COVID-19 shock will likely further constrain households' purchasing power. Nearly two-thirds of India's labour force are either self-employed or work as casual labourers, and these have been significantly affected due to the ongoing mobility restrictions. Notably, households' private consumption expenditure on services has been rising over the years and accounted for 30% of GDP as of FY19. However, with the pandemic looming over the population, private consumption growth decelerated sharply to 2.7% YoY (vs. 6.6% YoY in the December 2019 quarter). With the current pandemic continuing to overshadow the country and causing mobility restrictions among homeowners, we expect a significant delay in recovery and causing a further strain on India's growth targets.

As India emerges from the lockdown, 2Q2020 should mark the trough in the current cycle. Consumer discretionary sectors, products and services, would require a longer time for recovery. Drivers of agricultural output are expected to provide a counterbalancing effect, as Kharif season begins.

The Need for Support in the Financial Sector

At the heart of the economy's problems is a lingering credit slowdown, made worse by a crisis in the shadow banking industry nearly two years ago following the default by one of the nation's biggest infrastructure lenders. Shadow banks had been responsible for millions of small loans on everything from cars to gold jewellery to luxury apartments over the years.

India's financial sector is fragile. The resultant income losses spurred by the COVID-19 shock could result in increased delinquencies in both corporate and retail loans with a risk of Non-Performing Loans (NPL) ratios rising. This is already prompting many banks and NBFCs to become more risk-averse - lending standards have been tightened and risk premia have risen. There is a need to instil confidence in the financial sector so that credit flow momentum could be improved, and resources are available to fund growth. However, given the operational, regulatory, and administrative hazards to get this framework in place, we are doubtful that immediate relief to the banking sector will be possible by 2H2020 and expect further capital infusions.

Financial institutions will be faced with higher stress on their books as the underlying business viability and credit quality of borrowers has been damaged by the lockdown. As of September 2019, non-performing loans (NPL) ratio for commercial banks stood at 9.3%. What is urgently required is additional regulatory capital for banks to weather the NPL shock. With financial markets in a whirlwind, the responsibility to fund new capital needs to be borne by the government or the RBI. Otherwise, India's financial sector will never fully recover from NPL-induced stress.

FX TRADE IDEA: LONG USDINR

Figure 123: USDINR Daily Chart (*Source: TradingView*)

Entry: 75.027
Take profit 1: 76.010
Take profit 2: 76.306
Stop loss 1: 74.839
Stop loss 2: 74.500
Risk to reward ratio: 6.80

The pair broke resistance in late February and began to trade above 72.000. As of May, the pair has lingered between 74.000 and 76.000 which it has not touched since late April. Due to the interest rate cut from the Reserve Bank of India and the worries about unknown complications which could still confront India's economy due to the COVID-19, the short term appears to have more risk of weakness for the Rupee. Given fragile fundamentals, the currency may remain weaker for longer. Our medium-term outlook is bullish (next 3 months) and we expect the USDINR to go beyond the 76.000 marks. We are starting to suspect that downsides are going to be more benign going forward as price action has started to diverge from the lower Bollinger, alongside easing downside momentum with the bottoming MACD line. Thus, we recommend entry at 75.027 and take profit at 76.306 which is the major resistance line. Over the longer-term (6 months), the recovery of India's economy and a return of risk-taking could boost the INR, and shift investments out of the USD. Should that scenario play out, we expect USDINR to touch the base at 74.500. We recommend a stop loss at 74.839, with a risk to reward ratio of 6.80.

In alignment with our analysis in December 2019, the Indian rupee has weakened year-to-date against a backdrop of broad USD strength. India's economic growth has also been dealt a strong blow by the nation-wide lockdown, which began on 24th March, and has recently been further extended to 3rd May. However, we think that the INR remains exposed to further downward pressure in the short term. Moody's downgrading India's sovereign rating from Baa2 to Baa3, and negative outlook for India should increase doubt around India's future IG status amid widening fiscal imbalances.

With the COVID-19 crisis, alongside the rising Sino-U.S. tensions, as well as increasing labour cost in China, will likely push more China-based MNCs to diversify supply chains. The existing trend of production relocation in the low value-added sector from China to other emerging markets will likely be reinforced. We expect more MNCs to maintain China as a primary production base while increasingly looking for alternative suppliers (such as India). In the long term, India might be one of the key beneficiaries of this desire for diversification. Additionally, the inclusion of Indian government bonds in global indices could result in potential inflows that are supportive of the INR. However, geopolitical tensions between China and India could weigh on the INR in the short to medium term.

On the other hand, the adverse economic impact of the containment measures to slow the spread of COVID-19 is hitting the U.S. economy as hard as other economies, bringing U.S. growth superiority to an end. Higher interest rates in the U.S. drove the demand for the USD before the COVID-19 pandemic; when the crisis hit markets, increased demand for safe-haven assets and USD funding stress underpinned the greenback. However, looking ahead, near-zero U.S. interest rates should make the USD less sought-after, and the Federal Reserve's measures to ease USD funding stress should also weigh on the currency. The USD is fundamentally overvalued, but the structurally better return of U.S. assets compensates for this. The cyclical recovery in the next 12 months will reduce the appeal of the USD, and hence justify a short-term bullish view and discretionary measures in the longer term.

SINGAPORE (Underweight)

In our initial coverage of Singapore in December 2019, we expected a potential rebound of its tepid economic growth. However, that has been overshadowed by the pandemic and hence, we now expect the economy to sink into a deep and protracted recession of -7%. This is our renewed base case given that the circuit breaker measures successfully contain the outbreak. The latest measures by the government to contain the spread of the virus has taken a heavier toll on businesses already struggling with the existing challenges of poor earnings and weak cash flows.

A Year for the Bear

Based on advance estimates, the Singapore economy contracted by 2.2% on a YoY basis in the first quarter of 2020, reversing the 1.0% growth in the preceding quarter. On a quarter-on-quarter seasonally adjusted annualised basis, the economy shrank by 10.6%, a sharp pullback from the 0.6% growth in the previous quarter.

Singapore's economy is highly driven by exports. Singapore holds status as the premier port in Southeast Asia, making trade a key part of the economy with manufacturing and service industry being the key drivers. Yet, global demand has been worsened by the increasing rate of unemployment in key markets in Europe and the UK. While China may be recovering, there is still a long way ahead until a vaccine is found and aviation, trade, etc. can return to normal. Total trade decreased by 10.2% in April 2020, after the 0.6% growth in March 2020 while total exports contracted by 10.7% in April 2020, after the 3.1% increase in March 2020. Meanwhile, total imports decreased by 9.7% in April 2020, following the 1.9% decline in the previous month. (Figure 124). The silver lining lies upon Singapore's non-electronic non-oil domestic exports. On a YoY basis, non-electronic NODX grew by 12.8% in April 2020, easing from the 20.5% expansion in the previous month. Pharmaceuticals (+174.3%), food preparations (+66.3%) and non-monetary gold (+25.0%) contributed the most to the growth in non-electronic NODX (Figure 125). However, global demand will remain weak amid the pandemic overcast and we are unlikely to see a recovery in trade-in 2H2020.

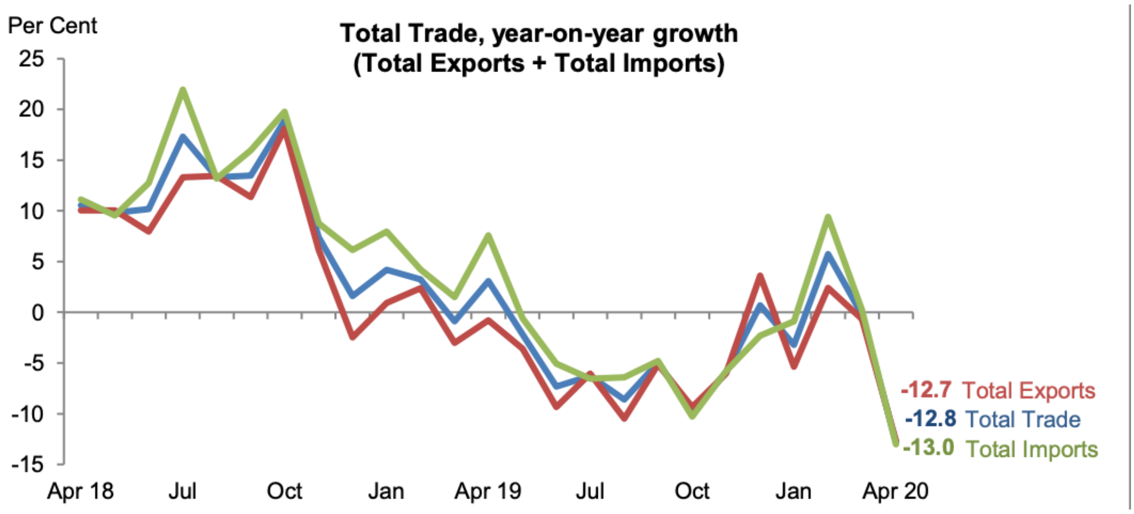

Figure 124: Total Trade YoY growth (*Source: Enterprise Singapore*)

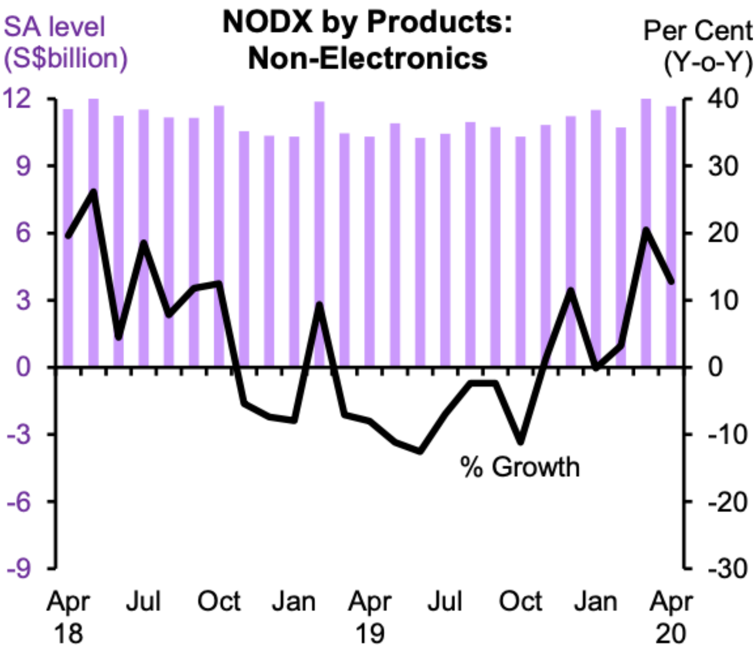

Figure 125: Non-Electronic NODX (Non-Oil Domestic Exports) (*Source: Enterprise Singapore*)

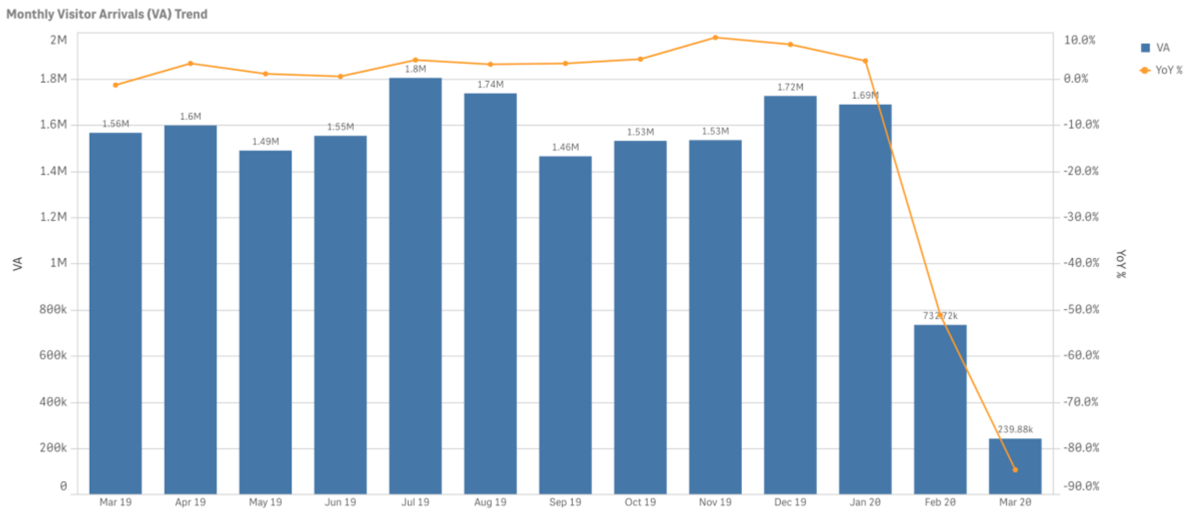

Figure 126: Monthly Visitor Arrivals (*Source: Singapore Tourism Board*)

There is also downside risk to the overall GDP figure due to deeper contraction in the tourism sector. Specifically, total tourist arrivals reported a sharp plunge of 51% YoY in February, led by steep declines in tourist arrivals from China (-98%), South Korea (-74%) and Indonesia (-46%). These three key markets are among the top tourism markets for Singapore and account for a combined share of 38.6% of the total tourist arrivals. Similarly, the aviation and hospitality sector has been adversely impacted. We expect further damage in these sectors beyond 2H2020, given the widespread fear of travel and mobility restrictions imposed by governments.

Retail Sector in Slumps

The retail sector is likely to see more downside. Overall retail sales index fell by about 13.3% YoY in March, and consumer spending will very likely fall even lower. F&B and discretionary item segments have all reported more than 23.7% drop in sales, and only supermarkets sales were up. Risk is that the numbers could fall even deeper into the red in the coming months amid the effects of the circuit breaker measures and a limited phase 1 reopening. Business owners anticipate that demand is unlikely to see a V-shaped recovery post circuit breaker period as the re-opening of the economy is implemented in phases. Given the weakness in retail sales, retail and F&B operators with stronger balance sheets are more likely to tide through the headwinds. The only bright spot within the industry comes from the supermarket sector, which has seen a 35.9% YoY growth in March retail sales given the stockpiling and a change in dining habits amid the pandemic. The relief measures in the Solidarity Package will help, but some businesses with weaker financial standings may not survive this crisis. This implies more company cessations, bankruptcy and job losses ahead.

The economic slowdown shows visible effects on Singapore's April inflation figures. Singapore's CPI contracted to -0.7% YoY in April, driven by sharper declines in the cost of private transport. Core inflation also saw a contraction to -0.3% YoY from -0.2% the previous month. Private road transport costs contributed the most to the decline, recording -5.5% YoY in April. This is due to steep drop in car and petrol prices as well as the suspension of Electronic Road Pricing (ERP) charges. The lack of consumer activity has translated into declining figures. Services inflation suffered a decline to -1.1% YoY; while the cost of retail and other goods contracted deeper to -1.6% YoY on the back of sharper drops in telecommunication equipment prices and prices of personal effects. We expect cost pressures to remain low given that individuals are likely to defer purchasing goods and services outdoors until phase 2 comes into play. Furthermore, the prices of travel-related items will be low due to the sharp reduction in aviation and tourism activities.

In light of the downside risks, we expect the growth forecast to be more pessimistic than the forecasted figure of -7% previously. Compared to the MTI's forecast, the tranche of Singapore's economy seems to be deeper, and the duration of the contraction is also expected to be more protracted. Headline YoY GDP growth could fall below -7% in the 2Q2020 and will likely remain in negative territory till 2Q2021, assuming recent strength in industrial production and exports due to pharmaceutical backfires. This will be the worst Singapore has seen since independence.

Red Packets Might Not Be Sufficient

Finance Minister Heng Swee Kiat presented on 26th May an SGD 33 billion fourth Budget for 2020. The fiscal deficit widens to SGD 74 billion (15.4% of GDP) funded in large part by an SGD 52 billion drawdown of reserves (SGD 31 billion of which relate to this latest package). This 'Fortitude' Budget follows 'Unity', 'Resilience' and 'Solidarity' Budgets. The total official COVID-19 stimulus effort now stands at SGD 93 billion or 19% of GDP.

While such measures have dampened the damage of the pandemic, they may not be sufficient to ensure that businesses stay afloat. The employment contractions were observed across Manufacturing, Construction and Services. The overall unemployment rate increased from 2.3% to 2.4%. Furthermore, it is highly likely that Singapore's unemployment rate may rise to 3.6% in 2020 from 2.3% in 2019, according to estimates. Amongst residents, the unemployment rate could likewise expand to 4.2% by year-end, from 3.2% in the previous year. We expect to see the pandemic continue its havoc streak for the Singapore economy and growth prospects to be highly improbable.

We expect the Singapore economy to sink into a deep and protracted recession. Many companies may crumble, and more jobs could be lost. Even if Singapore succeeds in bringing down the number of local cases, it will still be a long way before economic activities resume to normalcy. Singapore's cautious 3-phased lockdown exit strategy, where many aspects of on-the-ground execution are not yet clear, may deepen the lack of earnings visibility. How regional economies will emerge from lockdown is also unclear. The potential for a second or third wave of new infections cannot be discounted, which is a real risk as borders begin to open. The recovery of the little red dot will definitely be a slow and arduous one.

Fiscal Policy to Do the Heavy Lifting

The Monetary Authority of Singapore (MAS) affirms that it will adopt a 0% per annum rate of appreciation of the policy band starting at the prevailing level of the SGDNEER. There will be no change to the width of the policy band. This policy decision hence affirms the present level of the SGDNEER, as well as the width and zero percent appreciation slope of the policy band going forward, thus providing stability to the trade-weighted exchange rate. As the MAS does not set rates but instead manages the currency against major trading partners as a policy tool, Singapore's interest rates tend to track U.S. benchmarks.

The MAS has stated that the next policy meeting would be as scheduled in October. We expect no further adjustment in FX policy this year and see that it would change due to economic forces rather than merely based upon GDP growth or inflation projections for MAS for a shift in strategy. Our takeaway from the MAS's 'April' policy statement was the focus on stability and liquidity provision while fiscal policy provides a cushion for Singapore's economy. Expectations of a stable currency should depress interest rate risk premia – helping to keep SGD interest rates low.

FX TRADE IDEA: SHORT USDSGD

Figure 127: USDSGD Daily Chart (*Source: TradingView*)

Entry: 1.41255
Take profit 1: 1.42002
Take profit 2: 1.43014
Stop loss 1: 1.40078
Stop loss 2: 1.39026
Risk to reward ratio: 2.9

In response to the virus outbreak, the MAS has eased its FX policy but made it clear that fiscal policy will take the lead in supporting the economy, as it puts SGD stability in focus. However, rising U.S.-China tensions are a risk and could weigh on the SGD. Strong fundamentals support the longer-term outlook of the SGD. It is expected that Singapore's current account surplus will decrease to 12.9% of gross domestic product (GDP) in 2020, down from 17.3% of GDP in 2019. Despite the substantial decrease, Singapore still has one of the largest current-account surpluses in the region, which backs the SGD.

On the other hand, we see USD as vulnerable over the coming months for three main reasons. Firstly, safe-haven flows into the U.S. currency are receding. Market confidence has been increasing over recent weeks that the worst for the economy is passing. The DXY dollar index reached a peak of around 103 on 23rd March, at the same time as broad risk aversion reached its height and global stocks reached their low. Since then the dollar index has fallen. Secondly, the Federal Reserve has been the most aggressive of the major central banks in monetary easing. The interest rate premium of the U.S. over other major G10 countries has been eroded during the pandemic. Meanwhile, the Fed's balance sheet has grown by USD 3 trillion over the course of the pandemic, at least twice as much as the growth in the European Central Bank's balance sheet. Lasting political tensions have been rising in the U.S., pointing to a decoupling with China. Additionally, recent polls are suggesting a win for Democratic presidential candidate Joe Biden in November. The resulting political uncertainty, specifically in relation to regulations and taxes, is also likely to weigh on the USD.

However, in the longer term, we expect the USDSGD to take the cue from broader USD weakness, with a gradual downtrend towards a break of the support level at 1.40078 and a further decline in USDSGD. In the longer term, we expect it to move towards the next support at 1.39026 and reach 1.38 by 1H2021. Given the presence of lower Bollinger at 1.411, we cannot rule out that USDSGD may head higher in the short term albeit limited gains as seen in the convergence in the MACD. We recommend an entry at 1.41255 and a take profit at 1.40078. Should the bearish trend continue, we recommend a second take profit at 1.39026. We will set a stop loss at the first resistance level of 1.42002 with a risk to reward ratio of 2.98.

THAILAND (Underweight)

Thailand's economy has suffered heavily as a result of the COVID-19 pandemic, causing a major impediment to its economic growth, both internally and externally. The Bank of Thailand (BOT) has slashed interest rates while the government has been actively providing stimulus aid to combat the economic fallout. Locally, the situation of COVID-19 has largely stabilised for Thailand. However, its neighbouring partner, which is a significant contributor to its tourism industry, China, has seen a second wave of the COVID-19 pandemic.

Previously, consensus on the BoT's policy rates was to remain neutral and they had adopted a neutral stance on their policy rates in December 2019 despite falling exports with concerns regarding the rise of the nation's household debt. However, the BoT's stance changed when COVID-19 hit as Thailand's economy was adversely affected by the COVID-19 pandemic, as they struggled to revive its economy. The 2019 trade war concerns also led to a weakening outlook for Thailand, as mentioned in the previous report, and are now further exacerbated by COVID-19. Although fears of a trade war are still around the corner, a large part of Thailand's economic slump is currently due to COVID-19 instead of a potential trade war breaking out between the U.S. and China. Inevitably, the development of the Eastern Economic Corridor (EEC) together with the Thailand 4.0 initiative is likely to be delayed as well following the setback from external headwinds, which will be detrimental for Thailand’s economy.

<u>Lowest Record Interest Rate to Date</u>

The COVID-19 pandemic has proved itself to be a sturdy external headwind that has plummeted economic growth in many countries. Following the outbreak of the epidemic, central banks around the world began easing interest rates aggressively to spur the economy in a period of dry spending and investment. Thailand started to cut its policy rate on 5th February 2020 by 25 basis points and held a dovish stance on easing their interest rates to combat a declined growth of its GDP. The BoT’s last interest rate cut was on 20th May 2020, which brought the nominal rate down to a record low of 0.50%. The latest meeting on 24th June 2020 saw it keep the rate unchanged.

The interest rate cuts, however, have not been very effective in achieving its aim of reviving the economy. For one, COVID-19 has fundamentally damaged the aviation and tourism industry as people from all walks of life ceased to travel during times of the infectious outbreak. Thailand’s tourism sector has been hit the hardest as they saw a massive decline in tourism activities. For now, Thailand is not taking any chances and the country's borders are firmly shut to prevent further spreading and containment of the virus. Figure 128 shows a steep decline in tourist arrivals, following the outbreak in 2020, where it reached an unprecedented record low of 0 in April 2020 and even remained at 0 in May 2020.

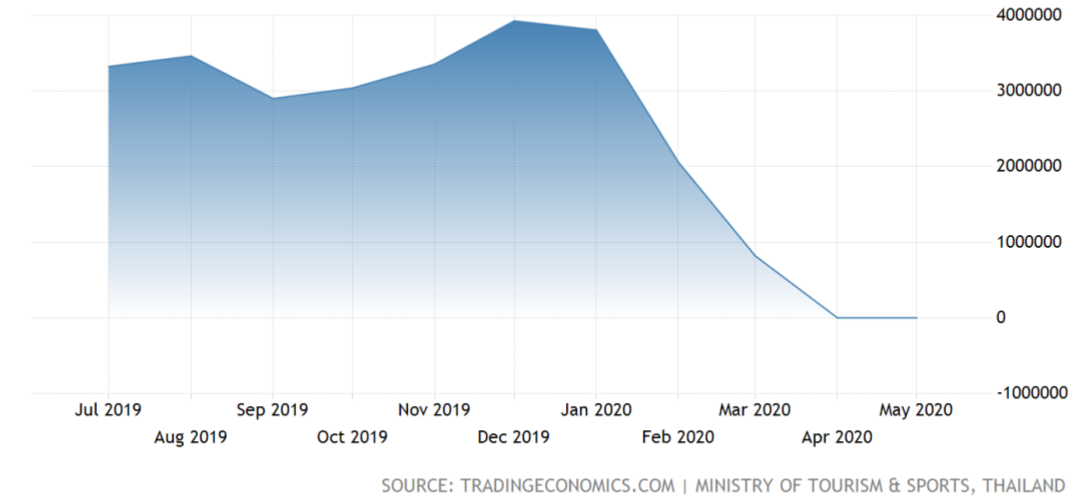

Figure 128: Thailand’s Tourists Arrivals (*Source: Trading Economics*)

Yuthasak Supasorn, governor of the Tourism Authority of Thailand (TAT), has indicated that the earliest they expect international tourism to return is 4Q2020. Clearly, the central damage done to Thailand's GDP is the abolishment of demand from tourism as a result of the pandemic and easing the interest rates has done little to revive the loss to lessen the impact of the outbreak. With the current record low rates, there is a more critical caveat for Thailand's low policy rate, with concerns regarding their ballooning household debt as a percentage of its GDP. Thailand's household debt to GDP ratio as of 2019 is at an alarming 79% or the equivalent of THB 13 trillion (USD 404 billion).

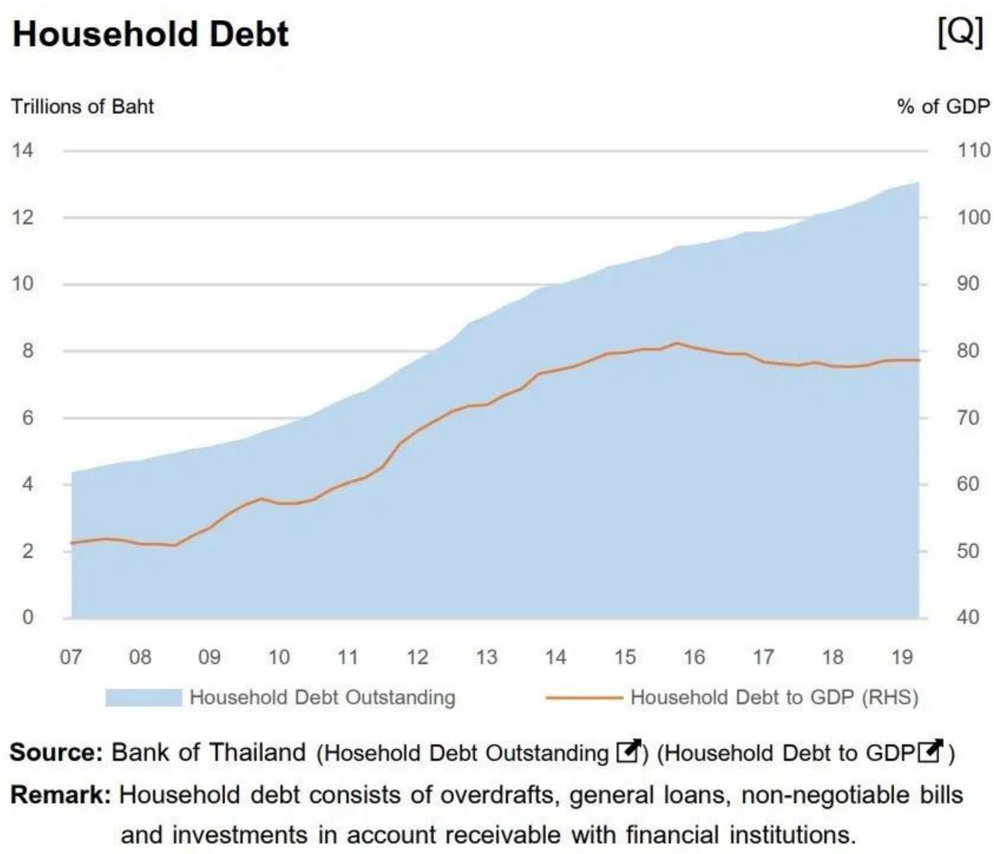

Figure 129: Thailand's Household Debt to GDP (*Source: Thailand Business News*)

With lower interest rates, this household debt will likely worsen if consumers take up new mortgages to take advantage of the record low rates. If current household debt breaches the record high back in 2015, it is likely to create unrest fears for consumers and investors alike. Although the COVID-19 pandemic is currently evaporating consumer sentiments, consumers might, in fact, not be encouraged to take up new loans and especially so at a time of increasing uncertainty. Now, interest rate cuts are not functioning as a conventional way of stimulating the economy, but instead, are dealt as a way to improve consumer's confidence in the economy. One of the main factors when looking for recovery of Thailand's economy is consumer's confidence in returning to Thailand. With the COVID-19 pandemic still ongoing, they can only rely on internal sources for economic growth in the current time frame. Moving forward, Thailand may likely continue to ease their rates even further as needed because the epidemic has affected the tourism sector of the country, leading to a considerable dent in their economic growth. Many countries may well do the same and follow suit, keeping interest rates low to spur on consumer confidence and the economy in times like such.

The BoT needs to adjust interest rates with great precaution moving forward, because of their current record low policy rates. On the one hand, it wants to spur consumer's confidence using interest rates and help businesses tide through this period of crisis, which will ensure that economic activity in the country remains firm. On the other hand, once the economy starts propping up with the recovery of consumer sentiments, new mortgage loans would pick up reasonably quickly as consumers take advantage of the record low rates to lock in the mortgage interest. This will translate to the household debt picking up swiftly as well. Should the massive household debt begin to spiral out of control, it would be disastrous for the

Thailand government to regain the trust of consumers and investors, undercutting confidence in the Thailand economy again and leading the problem back to square one.
Thailand also wants to avoid being caught in a deflationary trap because the current inflation rate has been one of the lowest among Southeast Asian countries (Thailand experienced deflation back in 2015). Current annual average inflation sits at 0.1% in May, while core inflation is a mere 0.4%. Given the economic damage that the pandemic has caused, a deflationary trap is looking like a possibility as consumers start saving and spend less during times of financial hardship.

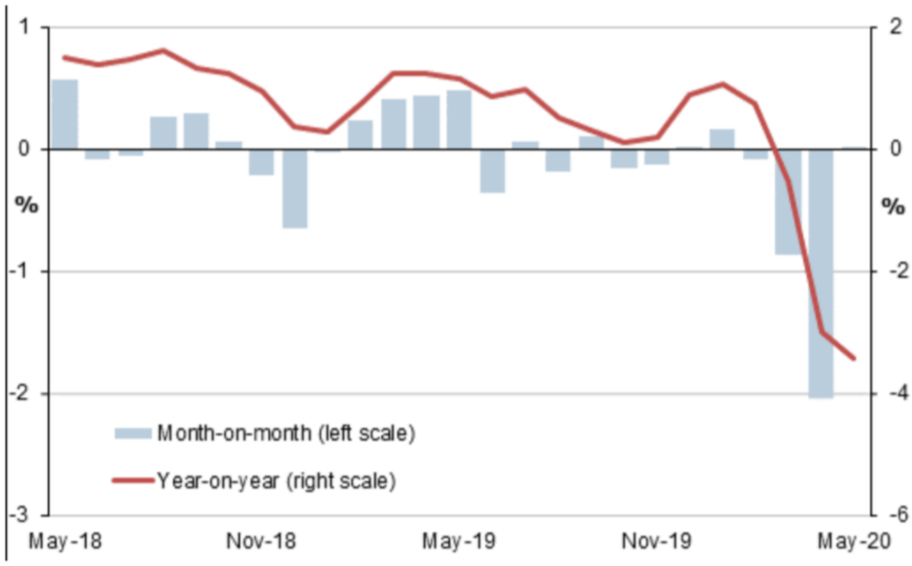

Figure 130: Thailand’s Inflation Change (*Source: Focus Economics*)

As seen from figure 130, YoY inflation in Thailand posted the greatest drop in over a decade. If the current nominal policy rates fall below Thailand’s inflation, it would mean that the real interest rates which consumers borrow at now are higher than the nominal rate. This leads to an environment whereby the real interest rates would, in fact, be increasing, which will translate to a further dampening of consumer and investment spending. As GDP output contracts, the deflation gets worse (more negative), which leads to rising real interest rates, resulting in costlier borrowing costs and further cuts in spending by both consumers and businesses.

Thailand's Economy Took a Dive

Thailand's economic growth has already been sluggish in 2019 due in part to the trade war causing a global economic slowdown and the reduced export competitiveness of Thailand's exports.

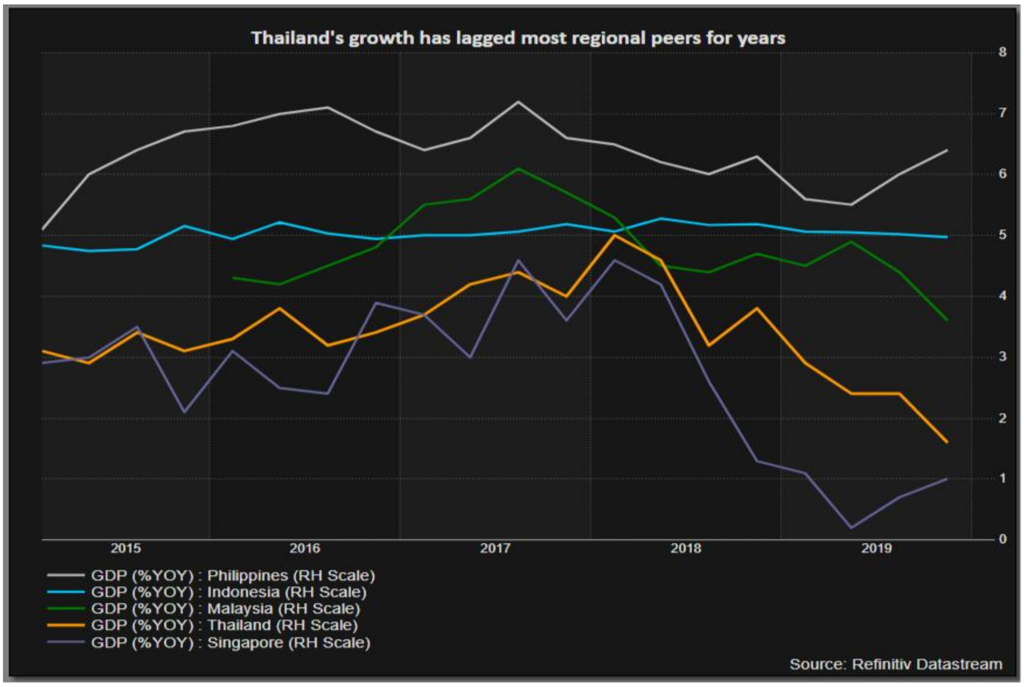

Figure 131: Thailand's GDP Growth Comparison (*Source: Reuters*)

Thailand is hit with another wave of economic turmoil in the COVID-19 pandemic, which has damaged Thailand fundamentally in terms of their exports. Thailand is known for its tourism industry, which accounts for 20% of its GDP. With drastic declines in tourism numbers to be expected with little to no demand in aviation and travelling currently, this source of GDP for tourism has essentially vanished for Thailand. For now, Thailand is focusing on reviving domestic tourism as they begin to ease lockdown measures for facilitating the reopening of certain tourist attractions. From January to March, foreign tourist numbers in Thailand slumped 38%, with the number of Chinese visitors plunging 60%, which are Thailand's biggest source of tourists. The current account surplus that Thailand has been enjoying throughout the years will no doubt be getting smaller and the loss of confidence in the Thai Baht will follow. The historic strength of the Baht relies on the strong foundations of the Thai economy, with its current account surplus being key to the reason why it appreciated almost 8% against the greenback in 2019. In 2020 alone, the appreciation of the Baht was completely wiped out. With such a strong reliance on tourism, it is unfathomable to picture how the Thai economy would perform in the headwinds of COVID-19.

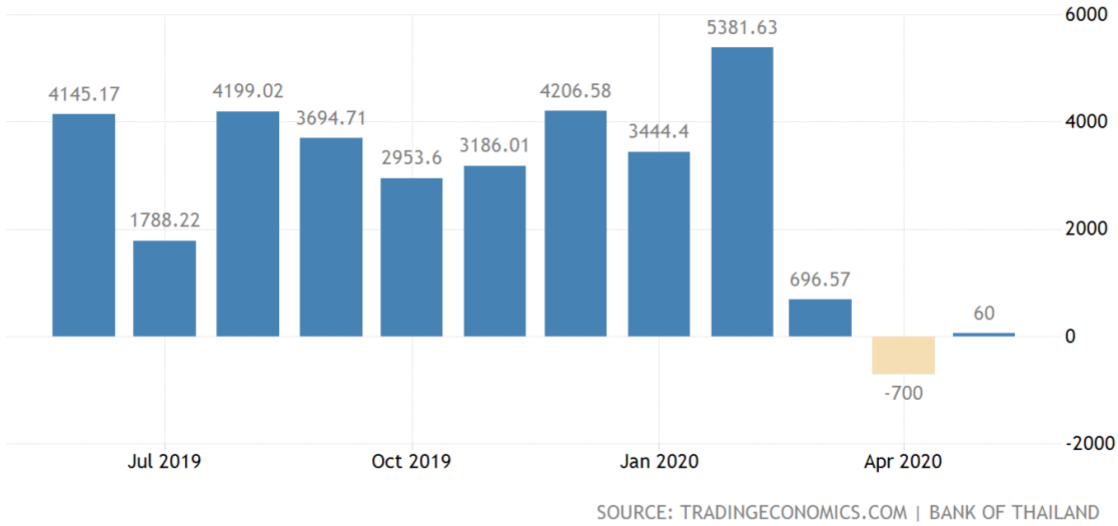

Figure 132: Thailand's Current Account (*Source: Trading Economics*)

The current account surplus is thus set to deteriorate at unprecedented amounts, and this would create further downward pressure on the baht, resulting in a net outflow and depreciation of the baht. As illustrated from figure 132, Thailand, a country that is heavily reliant on tourism and exports, even had a deficit in the month of April. Undeniably, the depreciation of the Baht would prove useful for Thailand's export competitiveness, but this might also mean a loss of confidence for Thailand's economy. The problem here also stems from a worldwide COVID-19 induced recession. In a global economic slowdown, a depreciation of the Baht would not be very effective when the income of its major trading partners has been adversely affected. In other words, exports in Thailand are not as robust as before and this increase in exports is not considered an authentic growth of their exports as they may only be artificially and temporarily inflated by a depreciation of the baht currency.

Not only has the COVID-19 done severe damage to the tourism sector and current account surplus in Thailand, the pandemic has also plunged consumer confidence to a low of 47.2 in May, the weakest ever since the Asian Financial Crisis in 1998.

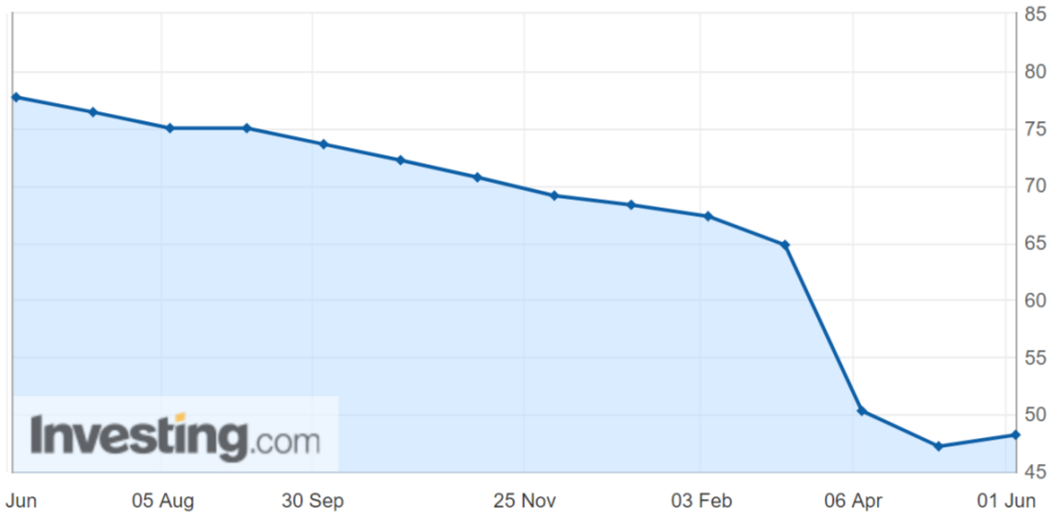

Figure 133: Thailand's Consumer Confidence (*Source: Investing.com*)

The knock-on effect includes persistent low inflation numbers (core inflation at 0.4% in May) as a result of decreased consumption and investment expenditure which have repercussions of a deflationary spiral as mentioned previously. On the production side, output contracted mostly for agriculture (-5.7%), manufacturing (-2.7%), construction (-9.9%), transportation and storage (-6%), accommodation and food service activities (-24.1%), administrative and support services activities (-6.7%) YoY. Through a multiplier of contractions, national income for Thailand will be reduced and the government will have fewer tax monies to spend on the economy. In addition to the lower government budget, massive layoffs have also skyrocketed unemployment numbers considering the fact that most employees in the tourism-related industry have been furloughed as a result of the closure of these industries. Estimates for the number of job losses would come at a whopping 10 million should the pandemic persist for 3 - 6 more months.

China, one of Thailand's biggest trade partners, holds the highest percentage of tourists that visit Thailand. As the COVID-19 pandemic has resurfaced in China recently, it is very likely that Chinese tourists would not be visiting Thailand anytime soon as the impacts of the outbreak still remain vivid in the minds of tourists. Moreover, cases of COVID-19 in Thailand have not yet been successfully eliminated, meaning people would likely be precautious about getting outside their house and also minimising travelling as far as possible to limit the spread of COVID-19. If tourism in Thailand does not pick up soon which is likely to be the case for the year 2020 for the reasons above, Thailand can only rely on domestic stimulation and resort to more fiscal stimulus in order to revive its faltering economy. However, with fewer tax monies as a result of the current situation, it would be a great challenge for the government, given that they would have a smaller and limited budget to spur economic growth in Thailand.

In 2H2020, Thailand would have to pay close attention and monitor the number of COVID-19 cases. Given that their economic growth hinges on the very sole factor of the eradication of COVID-19, Thailand has to rely on the efforts of the global economy to contain the virus to see a true revival of its tourism sector and its economy. If the outlook begins to worsen, the Thailand government has to step up its effort to boost GDP through other forms of methods such as focusing more on its domestic tourism instead. Thailand would then have to eliminate the pandemic in the country in order to see possible economic growth in the country.

Waves of Fiscal Stimulus Sparks Concern

The Thai cabinet approved its third wave of fiscal stimulus amounting to USD 58 billion (THB 1.9 trillion) on 7th April, its largest package to date to revive its economy. Out of the package, THB 600 billion includes providing financial aid to workers and employees whose business has been affected by Covid-19, THB 400 billion for investment projects to create jobs, THB 500 billion in loans to SMEs (where SMEs account for approximately 44% of GDP) to provide liquidity for their businesses to tide through its operating working capital and THB 400 billion for its Corporate Bond Liquidity Stabilisation Fund, aimed to help firms refinance their debt obligations in 2020 or 2021. Previously, the first and second wave of fiscal stimulus valued at THB 100 billion and THB 117 billion respectively were also announced with similar aims of combating COVID-19, including cash handouts for workers and tax reliefs for businesses.

Of the THB 1.9 trillion for its record stimulus package, THB 1 trillion would be financed from the Ministry of Finance through bond issuance. With larger sizes of fiscal packages that are increasing as they are being dished out, there has been growing concerns about the sustainability and affordability for the stimulus for Thailand's economy. With the current debt level of 43% of GDP, Thailand's GDP to debt ratio is projected to grow to 57% in 2021 according to a study done by Bloomberg. It is imperative to consider Thailand's Fiscal Responsibility Act established in 2018, as it puts the limit of government debt to GDP at 60%. The stimulus has driven this gap increasingly narrow because of the damage COVID-19 has done to the Thailand economy.

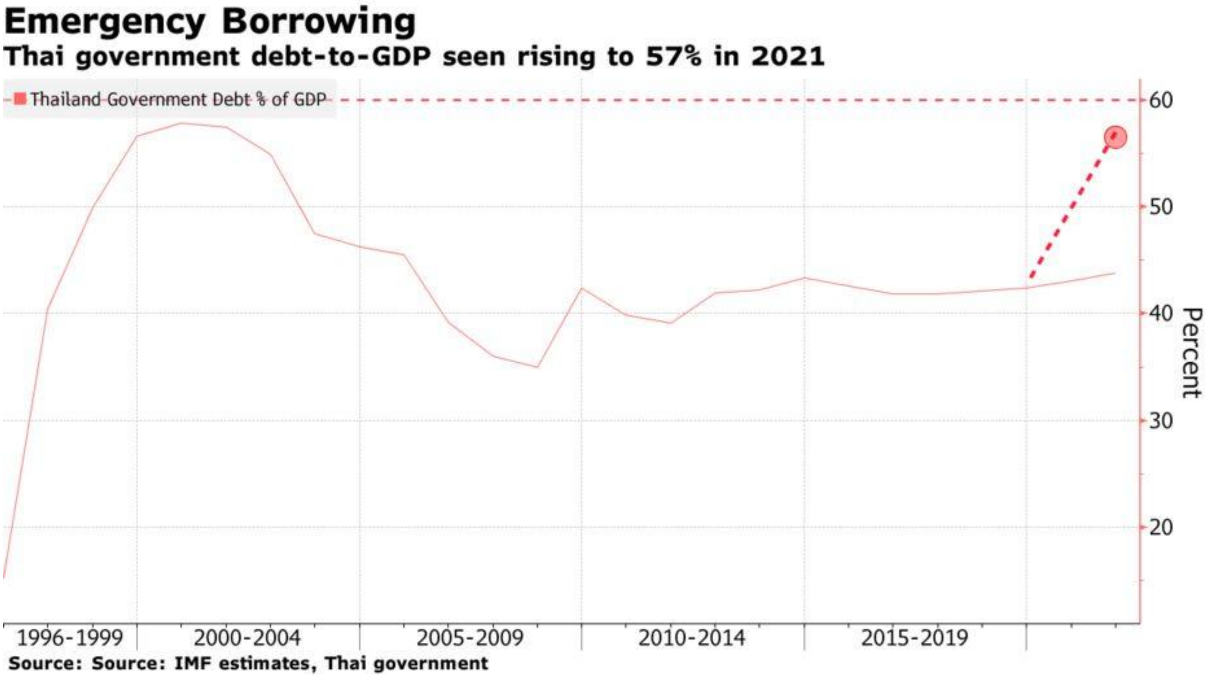

Figure 134: Thailand's National Debt to GDP (*Source: Bloomberg*)

For the bulk of Thailand's businesses that are impacted by the decline in tourism, the fiscal stimulus has been effective in keeping businesses afloat to tide through their working capital requirement and keep their workers, allowing unemployment to stay buoyed. However, it may not be well effective for recovering the economy because the majority of these tourism-related businesses suffered as a result of decreased demand due to COVID-19. Given that demand for tourism remains dry, this means that these businesses would be unable to maintain their profit margins back to the pre-COVID era and despite keeping the SMEs afloat, there is no stimulation in demand for economic activity. In addition, it is important to note that any fiscal stimulus that the Thai government is dishing out currently merely serves as a temporary measure to bolster economic growth in Thailand. What remains the crux of Thailand's economic growth has to be supported by its tourism industry which is being majorly impacted now by COVID-19. Thailand's measure to combat COVID-19 currently involves the closure of businesses that would expose people to risks of the outbreak, including shopping malls, bars and restaurants. Thai governors have also decided to start closing major hotel attractions in many provinces, including Chon Buri - one of Thailand's key strategic hubs near Thailand's ports. Finally, the Thailand government announced the closure of its borders and enforced restrictions on all international arrivals until the end of May in a bid to curb down on COVID-19 cases. It later imposed a nationwide curfew effective from 3rd April. These had inevitably contributed to lower economic activity in the country as consumers are tied to restrictions on what they can spend on. A decline of international tourism would also mean less tourist spending on the Thailand economy, resulting in lower stimulation for the economy as Thailand sacrifices its short-term growth for long-term recovery.

Moving forward, future fiscal stimulus may well be limited to spur on the economy if COVID-19 persists. They are also not a direct measure to counter against COVID-19. Although they help bolster the economic stifle, Thailand might have to turn towards a temporary focus on reviving its domestic tourism since it is likely that it cannot rely on foreign tourists for its economic growth in 2020.

FX TRADE IDEA: LONG CHFTHB

Figure 135: CHFTHB Daily Chart (*Source: Investing.com*)

Entry: 32.753
Take profit: 33.843
Stop loss: 32.503
Risk to reward ratio: 4.36

We observe money inflow to CHFTHB from the price chart above, from the low of 30.176 to the closing high of 34.295. This is unsurprising, given how the COVID-19 pandemic has negatively impacted the tourism sector in Thailand. As mentioned above, tourism plays a big part in Thailand's economy. For one, demand for the Baht is currently low, given the sudden decline of foreign tourists in Thailand. This blowout in tourism will also mean a fall in the current account surplus for Thailand, which is an essential aspect of baht's currency strength. This fall in surplus would weaken this property of the baht and likely cause investors to park their money elsewhere as they lose confidence in the deteriorating economy. The current COVID-19 sentiment has led to investors looking to park their exotic EM currencies to safe havens such as the CHF. As long as there are still fears and uncertainty regarding a potential second wave of COVID-19, it is highly unlikely that we will be looking at a recovery of the Baht as people remain cautious about travelling to Thailand, lowering the demand for baht.

On the CHF side, the Swiss Finance Minister, Ueli Maurer, has indicated to raise loans to provide aid for businesses to maintain their financial stability and that they are prepared to spend as necessary. Strong internal resilience can also be seen in the labour market as unemployment rates in Switzerland is at a tepid 3.2% as of June 2020, which is relatively low despite the impact of COVID-19. Historically, there has been a strong correlation between the prices of gold and CHF as gold is one of Switzerland's most significant exports. This makes CHF the safe haven of choice in the current environment in addition to the rampant fears of inflation as a result of the U.S. Fed's aggressive stance on QE. As the Fed continues to engage in QE and prints more money, this will devalue fiat currency like the USD, which will, in turn, increase the demand for gold as investors seek to hedge against potential inflation, which is good for the Franc.

We observe that the current price action of the CHFTHB is trading between the middle and lower band of the Keltner Channels (KCs). As CHFTHB failed to make a lower low, the current down trend could be in jeopardy, and we recommend waiting for CHFTHB to cross above the middle band of 32.753 for a price reversal, which it has done so for a few times in the past trading sessions. This could suggest that the recent retracement of the CHFTHB in price is a temporary one as fundamentals are clearly supporting downside for the Baht. Looking at the Accumulation/Distribution Line, we can see that it is trending up, showing strong buying interest despite the recent fall in prices. This is a bullish divergence and a good sign that a reversal is even more plausible at this point. Moreover, the RSI of 42.3 indicates that CHFTHB is neither considered overbought or oversold. Thus, we recommend waiting for confirmation of a crossover in the middle band of the KC before entering this trade, at the entry price of 32.753. The stop loss can be placed at the previous low of 32.503 while the take profit is set at 33.843, a price region around the previous high of the upper band KC.

VIETNAM (Overweight)

Vietnam is one of the leading Southeast Asia countries in terms of economic growth in 2019 attributed to high domestic demand, strong manufacturing and a high inflow of Foreign Direct Investments (FDIs). In 2020, Vietnam's GDP is still expected to grow, though at a slower rate of 3-4% as compared to pre-crisis projections of 6.5% according to the World Bank. The macro-economic and fiscal framework remains resilient with a reported GDP growth rate of 3.8% in 1Q2020. The country has mostly been successful in dealing with cases of COVID-19 and is slowly easing measures to set up the reopening of its economy.

The previous consensus on strong Vietnam economic growth was mainly attributed to healthy FDIs inflow and relocation of firms to Vietnam as a result of the U.S.-China trade war tensions. The effects of the COVID-19 however, have drastically reduced GDP growth though it has accelerated the shift of firms and supply chains to Vietnam, which is likely to cause steady FDIs inflow for the coming years ahead. Exports in Vietnam continue to dwindle in the face of strong external headwinds, mainly due to COVID-19 weighing down heavily on trade. As mentioned in the previous report, a current account surplus is still likely to continue for Vietnam at a decreasing pace due to trade war concerns, and the pandemic outbreak has accelerated this trend of dwindling surplus for Vietnam. We also forecasted a lack of supply in tourism workers due to the flourishing of Vietnam's tourism sector. However, the COVID-19 pandemic has caused an upheaval of tourism around the globe, leading to a reverse scenario of high supply and low demand environment for tourism.

COVID-19: "Friend" or Foe?

Vietnam's first case of COVID-19 was reported on 23rd January 2020 and to date, it has a little over 350 total cases with at least 320 of them recovered. This is a stark contrast to the rest of the world that is fighting with the pandemic. Vietnam has thus been hailed as a champ in tackling COVID-19, alongside nations like Taiwan and South Korea. The success was also compared to the SARS outbreak in 2003, with Vietnam being the first country to eliminate SARS. Efforts to contain the pandemic were lauded to effective quarantine and vigorous contact tracing, which has helped the country crackdown on cases of Covid-19. The Vietnam government was also quick to shut down and restrict travel as early as 1st February to prevent further clusters from spreading.

With over 261,000 tests being conducted, Vietnam has one of the highest ratios of tests to infections in the world though it is partly due to the low number of confirmed cases in Vietnam. In fact, the numbers tested might be considered low relative to the total population of 95 million.

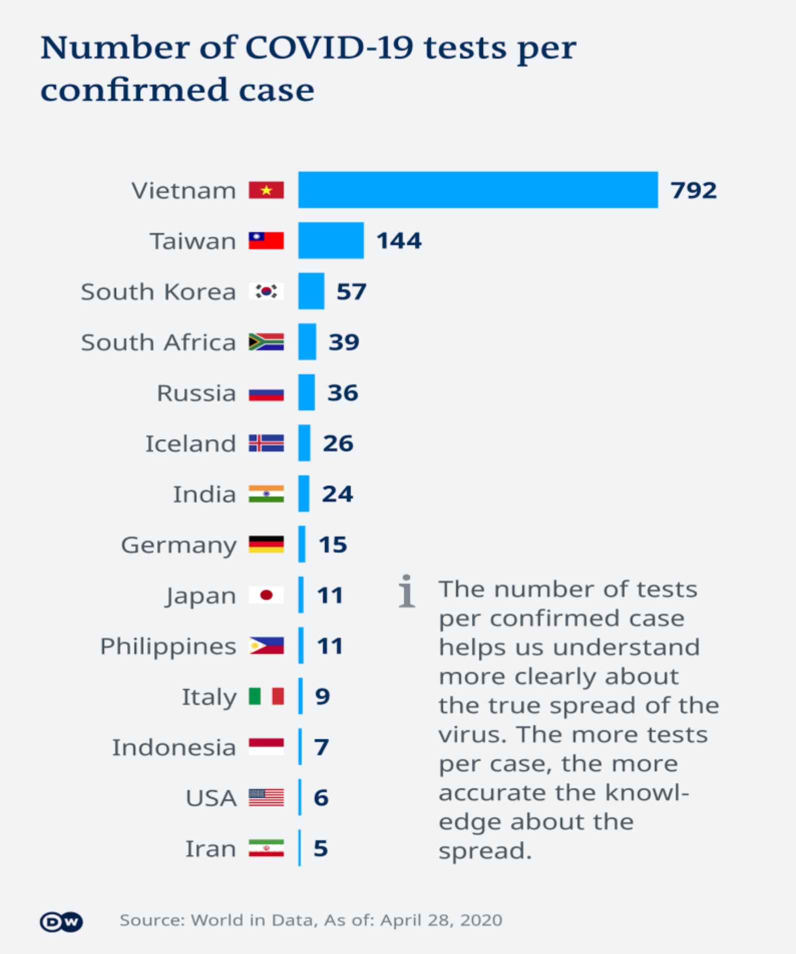

Figure 136: Vietnam's Tests Per Confirmed Case (*Source: Vietnam Insider*)

As it appears that COVID-19 remains well-contained in Vietnam, the government has allowed the reopening of its economy, which makes them one of the first few countries to ease lockdowns in major cities as well as social distancing measures on 23rd April. This includes the reopening of its schools and other businesses. However, this does not mean that Vietnam is sailing past the headwinds of COVID-19 well. Firstly, Vietnam is largely an open economy heavily dependent on trade. Hence, COVID-19 poses a serious risk for its economy when trading partners are being affected by the pandemic. Secondly, manufacturers with supply chains that are dependent on China suffered majorly from disruptions in early 2020. Vietnam, with over 40% of intermediate goods sourced from China that is being used as inputs, found their supply chain being cut off by COVID-19, forcing productions to cease immediately. Inevitably, this has caused a demand-supply imbalance in the market, leading to price distortions causing farm produce prices to slump in Vietnam. The disruption in China's supply chains has caused a domino effect of a cut in supply of raw materials for Vietnamese factories, which led to a fall in supply to the U.S. and European markets. The agriculture sector has also been adversely affected since China is Vietnam's largest export for its agriculture, forestry and seafood. Though some border crossings between China and Vietnam have been reopened to ease trade restrictions, certain borders are still closed and many non-essential services, such as bars and karaoke parlours, remain closed. Despite the external risks present to Vietnam, it has begun to restore the manufacturing, services and retail sectors. The internal resilience is currently immense, and this has helped to ease the unemployment numbers as well. Moreover, the Communist Party's congress is set to take place next year and authorities are likely to keep the economy spurring where they can likely claim credit for navigating the economy through this crisis well.

This event has potentially highlighted Vietnam's overdependence on a single market, China. One of the emerging trends from the pandemic includes the trend to move production away from China to be less dependent on China in the wake of the outbreak. The U.S. especially, are turbo-charging their initiatives in looking for ways to push companies to move manufacturing out of China. Dubbed as the "Economic

Prosperity Network", the U.S. government is working with several countries - one of which includes Vietnam, with the aim of restructuring supply chains to prevent similar occurrences from happening in the future.

Vietnam has already been one of the main benefactors from the U.S.-China trade war tensions, with many firms looking to relocate to Vietnam due to their lower cost of production. Now, this trend of shifting companies could well be accelerated by COVID-19 due to supply chain disruptions that have affected many firms around the world. Global giants such as Samsung Electronics Co., LG Electronics Inc. and Intel Corp. have already set up large operations in Vietnam. Alphabet and Microsoft are in the process of moving some production, including the flagship Pixel smartphone out of China and into Vietnam and Thailand because of the COVID-19 outbreak. In addition, the country's geographical proximity to China also makes it a viable alternative to relocate supply chains there. Alongside lower production costs, Vietnam is already part of several value chains and also has an integrated mode of transport, which includes large roads, broad rails and extensive port networks. Vietnam's participation in several free trade agreements (the latest one with the EU) and the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) is supporting factors for this accelerated shift in relocation. Strong investment promotion and the existence of special economic zones (SEZ) would make Vietnam attractive for companies looking to start new production sites or to expand existing ones and this should lead to robust investments and exports in the coming years that will allow them to stay ahead of its neighbouring competitors in 2H2020.

Figure 137: Vietnam's Projected GDP Growth in 2020 (*Source: Vietnam Briefing*)

<u>Vietnam's Fight to Combat a Trade Decline</u>

As discussed previously, Vietnam has been hit hard with low exports. This is because China, one of Vietnam's largest trading partners, is at the epicentre of the COVID-19 outbreak. Previous year estimates were already deteriorating attributed to stricter quality control and the U.S. Agricultural Bill placed on Vietnam. Now, it seems likely that the country would be unable to rely on its external sector for economic growth and depend on the fiscal stimulus that the government has provided for the country to boost domestic demand.

To combat the crisis, the government launched a USD 10.8 billion credit support package in early March, which includes policies to restructure loan terms, reduce interest rates and fees. In addition, the government has also offered two budget support packages of USD 1.3 billion, which include a reduction in taxes and fees for affected companies and an extension of tax payment schedules. The Central State Bank of Vietnam (SBV) has also lowered the key interest rate by 150 basis points this year to the current 4.5% in a bid to aid businesses tide over this difficult period by lowering their borrowing costs. Additionally, a loan support package worth USD 172 million was provided for businesses impacted by the COVID-19 outbreak.

Figure 138: SBV's Refinancing Rate (*Source: Trading Economics*)

Though these measures to help businesses cope with working capital would prove to be beneficial for companies and help to offset laying off workers to some extent given the relatively stable state of the pandemic levels in Vietnam, the exporting sectors and tourism industry would hardly benefit from the packages. Of the different sectors, processing and manufacturing industries were most heavily impacted with 1.2 million jobs affected according to the General Statistics Office of Vietnam (GSO). The root cause of unemployment in Vietnam can be clearly seen to stem from firms laying off workers as a result of the battered demand due to COVID-19. Instead of dishing out more stimulus packages for businesses, Vietnam has to rely on neighbouring partners to eliminate the pandemic in their community before we can see any meaningful trade to materialise. Moving forward, the government is likely to lower interest rates and give out stimulus packages as needed if COVID-19 worsens.

The Vietnamese government has also issued decree 41 on 8th April extending the deadlines for Value-Added Tax (VAT), Corporate Income Tax (CIT) and land rental fees to aid its people as well as promoting economic activity. Other measures to boost the economy include Directive 11, which postpones the collection of social security premiums, supporting labour training and reducing the charges and fees of businesses. A USD 2.6 billion relief package for locals was also announced which includes cash transfers to affected households, tax cuts or exemptions, together with the deferred social security contributions. The government can only hope this continues to fuel domestic demand with high consumer confidence in Vietnam that has managed to stay buoyed during this period of crisis. Consumer confidence in 1Q2020 measured 126 points, an increase from 125 in 4Q2019. Together with the rapid economic reopening, Vietnam might find success in the domestic economy. However, being one of the most open economies in the region with a relatively large dependence on foreign trade, investment and tourism, Vietnam would undeniably be unable to reach high levels of rapid growth matching those of 2018 and 2019. Only with the recovery of COVID-19 from neighbouring countries would Vietnam be able to function back to full normalcy with trade.

An Upheaval to the Tourism Industry

The tourism industry in Vietnam has been booming lately as Vietnam welcomed 18 million international arrivals last year in 2019, topping 2018's record, while domestic tourism also grew substantially on the back of sustained high economic growth. Being a labour-intensive sector, tourism generates many jobs and income opportunities for locals while also providing export diversification away from manufactured products. The majority of international visitors are from China, which makes up 32% of the visits in 2019. Vietnam's boom in the tourism industry during recent times is likely due to China's growing middle class, as they have contributed majorly to the flourishing of Vietnam's tourism sector.

When the COVID-19 outbreak happened, Vietnam's largest source of foreign tourists was suddenly cut off. Vietnam had banned all travels to China as early as 1st February and ended travel to and from China, which resulted in a sudden decline in demand for tourism workers and caused unemployment in the tourism sector to surge. This caused a large decline for the drop in GDP growth as the effects of the pandemic could be felt by the fall in tourism numbers in Vietnam. Over a recent four-day national holiday weekend (the Reunification day and Labour day holiday), the popular coastal city of Da Nang saw a whopping 98.5% fewer visitors YoY during the same holiday, while Hanoi saw visitor numbers drop by over 80%. As a direct impact of the COVID-19 pandemic, tourism revenues dropped 45% from January to April by USD 337 million (VND 7.9 trillion). Currently, some domestic tourism activities have been allowed to resume in Ha Long Bay and Bai Tu Long Bay from 1st May as the country saw cases of COVID-19 declining locally. As the current outlook on international tourism remains bleak, Vietnam is now pushing for the promotion of its domestic tourism, which will somewhat ease the drop-in tourism numbers, albeit not very significantly. With news of the emergence of the second wave of COVID-19 cases in China, Vietnam's tourism industry remains in poor shape in staging a recovery. This is going to have adverse impacts on Vietnam's GDP in the long run and if the situation continues, unemployment in Vietnam is likely to inevitably rise as the government's fiscal stimulus can only do so much to keep tourism businesses afloat.

In light of the growing tourism sector in 2019, it was estimated that Vietnam would have had to face a severe shortage of tourism workers. Ironically, the pandemic has allowed this supply shortage and demand imbalance to come into equilibrium. Currently, the demographics in Vietnam are rapidly developing in terms of educational standards in recent years. Due to the prior attractiveness of working in the tourism industry, many students in 2019 are pursuing tourism as part of their major. Furthermore, the government has provided an increasing number of training institutes and enterprises to be developed for these students. If everything else goes smoothly for Vietnam in 2021, the tourism industry in Vietnam would be set for a good reopening. However, current sentiments of the COVID-19 pandemic may well divert the prospects of working in tourism-related jobs for students, which can be a cause for concern if, in the future, demand for tourism picks up. This will cause a huge supply imbalance that Vietnam will face in the long run as training will take time.

ETF TRADE IDEA: LONG VanEck Vectors Vietnam ETF

To capitalise on the low number of COVID-19 cases in Vietnam and their impressive comeback, we look at the VanEck Vectors Vietnam Exchange-Traded Fund (VNM ETF), the only way to gain exposure to Vietnam's economy. The top 3 sectors that the VNM ETF holds include real estate (27.0%), consumer staples (13.9%) and information technology (13.3%).

Figure 139: VNM Weekly Chart (*Source: thinkorswim*)

Listed on: NYSEARCA
Ticker: VNM
Entry: 13.49
Take profit: 15.49
Stop loss: 12.87
Risk to reward ratio: 3.23

Looking at the VNM price chart above, it is likely that markets are pricing in a V-shaped recovery with reasons attributed to the government's swiftness in tackling COVID-19. Vietnam also emerged as one of the countries that managed positive GDP numbers for its quarters despite some of its neighbouring countries falling behind with expectations of plunging into a technical recession. This has potentially helped to buoy consumer confidence in Vietnam, which would be vital in bolstering further growth in the economy as the government injects more fiscal stimulus into the economy. In addition, COVID-19 has caused sentiments of overdependence on China and to rely less on them moving forward. In light of this, Vietnam stands in a favourable position in terms of more supply chains shifting there due to its low cost of production. If Vietnam is able to capitalise on this opportunity, its economy will well be invigorated with a newfound source of FDIs, which can further set the country up to be one of the fastest-growing economies in South Asia.

From a technical standpoint, the price can be seen rebounding from the low of 9.3 on 16th March and has rebounded over 45% in a period of fewer than three months. This shows that markets are primarily unfazed about the effects of COVID-19 on Vietnam's economy and investors have confidence in the recovery of the economy. Plotting the RSI shows that it has been on an uptrend and on a steady recovery since the low on 9.3 and is also nowhere near overbought signals. The MACD crossover of the signal line also signifies strong momentum held by the VNM ETF, supporting further evidence for the long trade. Using the 20-SMA (pink) and 200-SMA (teal) provides a dynamic support and resistance level for the VNM ETF respectively, which can also be set as our stop loss at 12.87 and take profit level at 15.49. To take advantage of the tailwinds of increased FDI and a resilient local economy, the current price of 13.49 is a reasonable entry for this trade for a risk-reward ratio of 3.23.

INDONESIA (Underweight)

The outbreak of COVID-19 in 2020 has definitely caught many by surprise and it is unfortunate occurrence right after the trade war in 2019 has resulted in major economic disturbances around the globe. With quarantines and lockdowns coming to full force, quite a number of economies have tilted into technical recessions including Indonesia. While a V-shaped recovery was initially hoped for, it has become clear that the uncontrolled nature of the outbreak and uneven recoveries around the globe will most definitely result in U-shaped recovery which will remain to be our base case for both countries.

Macroeconomic Trend Dominated by Pandemic

Coming into 2020, we initially expected a very definite macroeconomic trend to play out. Firstly, continued strong private consumption was expected, given improving consumer confidence and moderate inflation. At the same time, consumption contributed by political parties will go back to normalized level post-election. With the recovering economy, we also expected resurgence in investments especially infrastructure which will drive GDP growth in 2020. As trade resumes in 2020, a pick-up in commodity prices and demand can be expected which would drive exports recovery. This will be counter-weighted against the similar increase in import as capital investments too resume. All in all, net exports were expected to go back to the negative region in 2020.

With the outbreak coming to play, the most obvious revision we see is net exports. While initially a recovery in both exports and imports were to be expected, with an end result of negative net exports, it has become clear that the effect of COVID-19 is arguably similar to the 2019 trade war. Firstly, the outbreak has disrupted trade flows worldwide and with quarantine orders issued, many factories have halted operation. It is not a surprise that this results in slumping commodity prices and demand. Primarily, our attention is on the falling demand for energy-related commodities, which suffered the biggest fall in demand from the manufacturing sector. With crude oil prices depressed, other oil related commodities such as palm oil (which has lost more than 17% since 2020) and energy-related commodities such as coal (5% price fall YTD) - which are two of Indonesia's largest commodity exports, have come under pressure too. In April alone, exports value decreased by 7%, projection of 2.7%. Similarly, weakness in import growth is to be expected again. With many losing their jobs and an overall uncertain economic period, many are cutting spending, resulting in slumping imports.

More importantly, with the economic disturbances, businesses are again withholding key investment decisions and thus pressuring capital investments imports. In April, imports value decreased by 18.6%, higher than the initial projected 12.7%. A similar development can be seen in the household consumption which has slowed considerably and is expected to be less than half of the initial projection at 2.1% for the year. This is the lowest growth for household consumption in 21 years. As millions lose their jobs, the fear is that the worst is not over yet. While the Ramadhan season may help ramp up consumptions for the time being, spending may be significantly less than previous years, given the existing travel restriction. With the expected U-shaped recovery, we expect that the slowing consumption trend will persist through 2H 2020 and we remain cautious on the development of COVID-19 in Indonesia. We certainly do not exclude the possibility of a worsening unemployment situation which may result in real contraction of household consumption. Due to slowing imports and exports, we expect that net exports may again contribute positively to GDP for the second year, along with current account deficit improvement in the short term.

Weakness in Rupiah amidst Sell-Off

While in the previous report we highlighted the increasing foreign investors' appetite for Indonesia, the recent development in 2020 highlights an important point again regarding the sensitivity during the risk-off period. While indeed FDI coming into Indonesia was recovering, the outbreak has again triggered a sell-off similar to 2018 as investors fled risky emerging markets assets. FDI in Q1 2020 has fallen YoY by 9%. Similar development can also be seen in the forex market. In the beginning of 2020 - USDIDR managed to stabilize at 13,600, a level only seen before the 2018 sell-off. Once it became clear that the outbreak would have a long-lasting impact, the sell-off was merciless as IDR was one of the biggest losers with a fall in value of 20% against USD at its peak despite Bank of Indonesia's (BI) continuous market intervention. Going forward in 2H 2020, while we see that the worst may not be over for Indonesia yet and the economy is quite clearly still struggling, we also observe at this period a decoupling of the financial market with the real market. We expect USDIDR to continue to stabilize at 14,600 through the crisis thanks to BI market intervention. We could see gradual improvement towards the 14,000 level perhaps in 2021, provided the crisis will be over by then.

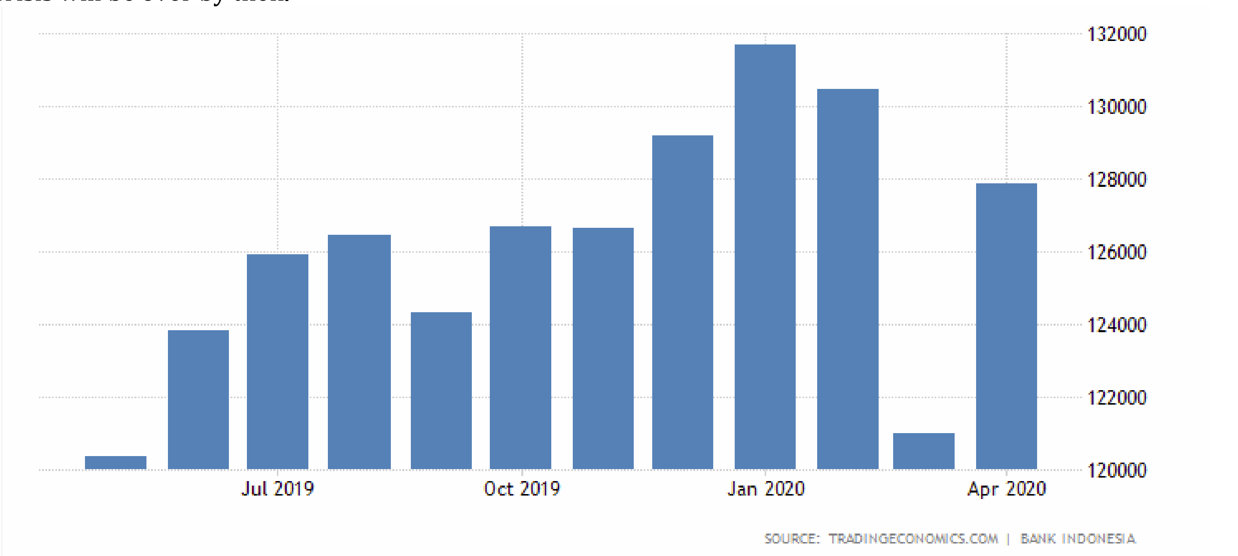

Figure 140: Foreign Reserve Level (*Source: Trading Economics*)

While it is unlikely that IDR will depreciate further in 2H 2020 owing to recovery in sentiment compared to the peak of sell-off in March, we could at best expect a slow recovery in IDR to the 14,000 level as foreign investors regain confidence in the region. Given BI's commitment to stabilize IDR at current levels through its triple intervention in the spot, bond (Indonesia SBNs) and DNDF market. BI also continues to improve its DNDF by expanding the types of underlying transactions available to be used for DNDF transactions. This should minimize volatility in the spot market as investors hedge IDR holdings. It is noted that BI aggressive market intervention has resulted in dwindling forex reserves for the country (down by USD 9 billion). However, the foreign reserve level was at record high levels prior to the crisis and the reserves have since jumped back in April thanks to 50-year tenure dollar-denominated issuances. While this poses a further long-term risk for the country, we do not see a further deterioration in IDR for the short to medium term.

Government Policies Amidst the Pandemic

Indonesia government was initially under fire when it stubbornly insisted on reporting 0 cases when the outbreak was rampant worldwide. Since the outbreak, the government has introduced a number of key policies both to support the financial market and social restrictions to control the disease. We shall discuss the financial policies first.

Figure 141: BI Key Policy Rate (*Source: Trading Economics*)

Just like many other countries, Indonesia's central bank has opted for a series of easing macroeconomic policies mainly focused to provide liquidity in the market. Among the key policies are slashing the primary benchmark rate by 50bps YTD, lowering USD reserve ratio by 4% and lowering IDR reserve ratio by 50bps for banks dealing with export-import clients. While the policies remain necessary to provide accessible financing to businesses especially in the hard-hit trading sectors, we note that macroeconomic policy remains to have limited effectiveness in Indonesia to bolster growth amidst the crisis. Firstly, the policy's main impact remains to benefit middle to large companies who need financing to service their debts and undertake restructurings during the period. MSMEs that still comprise the majority of Indonesia's economy will not stand to benefit from this thus limiting the policy ability to ease the real sectors. Secondly, we note that Indonesia's macroeconomic policy is relatively limited compared to other neighboring countries. In this regard, it is clear that Indonesia has a limited option with regards to further accommodative macroeconomic stance due to IDR's weak position.

With limited options regarding its macroeconomic policy, Indonesia has to rely more on fiscal policies to bolster the economy. In total, the government has announced USD 26 billion worth of fiscal stimulus (2.5% of GDP) to mainly help with health care costs and financial aid to the vulnerable households and businesses. While the policy is much welcomed to minimize the economic shock to consumers hit by the crisis, we also note that the policy comes at a significant cost. With the fiscal stimulus, the government had to pass a bill to increase the legal limit of the budget deficit to beyond the usual 3%. It is expected that the budget deficit could reach 5% - 6% in 2020 and slowly recover back to 3% in the coming years.

In terms of social measures, it is very unfortunate to see the slow action taken by the government. Even when it has become clear that the outbreak has reached Indonesia and the severity of the transmission demonstrated around the world, the government was slow to impose the lockdown measure (PSBB). This is exacerbated by poor awareness among the low-income groups especially who ignore the travel restriction. Since its first recorded case in March, COVID-19 cases in Indonesia have yet to peak and fears are the actual number could actually be higher given the limited resource with regards to rapid-testing in Indonesia.

All in all, we observe that the crisis has exposed Indonesia's key risks and weakness. On one hand, we still see potential in Indonesia as a fast-growing region. As the crisis subsides, we could expect a very strong recovery in 2021 as consumption picks up and investment activities resume. We still believe Indonesia to remain attractive for foreign investors, especially given the government's commitment to stay investor friendly with a number of business-friendly policies introduced in the beginning of the year such as the gradual reduction in corporate taxes and eased restriction on minimum wages. Regardless, we also see a very definite risk given Indonesia's current position. For one, Indonesia is in no position to adopt a more aggressive monetary or fiscal policy mainly due to IDR weakness. Aggressive fiscal policy has elevated the debt burden (of which 40% is denominated in foreign currency) which is worsened by IDR weakness. Further fiscal policy may reduce the government ability to service the debts. Monetary policy is also limited as the government has to make sure that further sell-off does not occur. While a sharp recovery in 2021 could help the government's revenue base to service its debt, elevated risk remains if the outbreak is not contained soon which could mean further slowdown into 2021. Judging from the government's competency, we have opinionated that Indonesia has a negative outlook (mainly due to the risk) for the next 1 – 2 years.

FX TRADE IDEA: SHORT USDIDR

Figure 142: USDIDR Daily Chart (*Source: TradingView*)

Entry: 14533
Take profit: 13999
Stop loss: 14765
Risk to reward ratio: 2.33

Fundamentally, we have reasons to believe that USDIDR above 15,000 is a level that the pair cannot sustain for long. As COVID-19 sentiment cools off and yield chasing resumes again, an influx of investors to Indonesia is more likely to bring the pair to pre COVID-19 levels of under 14,000. As of now, we set our entry point at 14,533 which is the resistance level of the previous band, supported with the 150-day MA line. While a death cross is observed, this does not signify anything given that COVID-19 fueled price action in the past few months. A death cross here means the normalizing of price levels back to pre-COVID-19 level. We set a stop loss at the support level of the previous band, which is also supported by the latest price action. This trade will give us a risk-reward ratio of 2.33. The time horizon of this trade is relatively short, and we expect the position to be closed within 2 months or less.

PHILIPPINES (Overweight)

The impact of the COVID-19 outbreak in the Philippines mirrors those of neighboring regions with falling household consumption, withheld investments and slumping imports and exports. While the unfortunate combination of volcano eruptions and the outbreak has resulted in a standstill in economic growth (and likely to persist through H2 2020), Philippines is likely to be able to rebound in 2021, owing to strong macroeconomic policy and fiscal policy.

Economic Recovery Delayed but Certainly Not Cancelled

The Philippines was expected to power through 2020 with strong performance, initially projected at 6.0% to 6.4%. With trade war uncertainty no longer in the way and inflation controlled, we initially expected continued strong private consumption (main driver of economy) as well as a pick-up in capital investments by government projects. We also expected a rebound in both exports and imports as businesses resume their capital purchases. While PHP had a strong run in 2019 as portfolio inflow came to the region, we expected slight deterioration against the greenback in 2020 as imports were expected to significantly pick up.

With the COVID-19 outbreak and strict lockdown policy enforced, the Philippines economy has been hit far worse than initially expected. Currently, projection is standing at around 0% GDP growth for the year, a far cry from the expected 10-year average of 6%. Firstly, merely two weeks into 2020, the Philippines was hit by the Taal volcano eruption, which displaced thousands of people and disturbed the agricultural activities around the area. More importantly, it disrupted tourism activity during its peak season in January. Tourism in the Philippines contributes to around 10% of GDP and it's easy to see why H12020 has been worse than expected for the Philippines. Moreover, the Philippines was hit by COVID-19 cases early during the pandemic, with the first case reported as early as 31st January. With this, capital spending and investments which supposedly was to drive growth in 2020 did not have any chance to recover. In 1Q2020 alone, investments are seen to be down by 18.3%. In the trade sector, focusing on the semiconductor sector with China, exports too were hit early as China battled with COVID-19. In March alone, both exports and imports were down by 24.9% and 26.2% respectively. With lockdown introduced early in March and running until now, we are also not surprised that private consumption took the biggest hit as businesses shut down and people limit spending with 1Q2020 number standing at a mere 0.2% YoY.

While the situation in the Philippines initially seemed positive with the daily cases contained, the number has spiked up uncontrollably last week. It is difficult to predict how the situation will evolve going forward. Given the government's active and tough measures against the outbreak, we are inclined to believe that this pandemic will be well controlled in the Philippines. With this, we can expect a gradual easing of the lockdown which will boost consumption as the fiscal stimulus takes into effect. Coming into 2H2020, we expect private consumption to pick up, albeit slowly. Moreover, with China recovering from the outbreak and lockdowns eased, we could see improvement in the export sector as early as 4Q2020.

The Philippines Has the Right Card to Handle the Crisis

Coming into 2020, we initially did not expect further rate cuts by Bangko Sentral ng Pilipinas (BSP). This is because inflation is likely to pick up from its moderate level in 2019 as private consumption improves and oil prices pick up in 2020, giving less room for further cuts. This is further supported with the expectation of a slight depreciation in PHP coming into 2020 as imported capital spending resumes. The outbreak of COVID-19 has pressured oil prices to record low for almost the whole of 1H2020 due to manufacturing activities coming to a standstill and oil producing countries not reaching a deal quick enough. This has helped to ease Philippines inflation, currently standing at 2.0% to 2.5%, well within the lower band range of the government's target of 2% to 4%. Moreover, the favorable oil price has also resulted in resilient PHP despite the sell-off happening in most emerging markets. Strong remittances have also helped with the stabilizing of PHP value. As a result, PHP remains to be the strongest performing currency in the Southeast Asia region, stabilizing at the 50.4 to 50.8 range despite a brief climb to 52.0 during the March sell-off. With these favorable conditions, BSP is in a prime position to adopt a strong accommodative stance. BSP has eased its key policy rates by 125 basis points YTD. This is expected to minimize disruptions to businesses going concern and banking activities making way for a strong recovery once the crisis is over. Going forward, we see the possibility of another 25 to 50 basis points cut by June if the COVID-19 condition continues to worsen.

Figure 143: Moderating Inflation Figure (*Source: Trading Economics*)

The Philippines also adopted fiscal stimulus worth 5.0% to 6.0% of GDP or about USD 23 billion. The majority of the fund will be used to benefit the vulnerable, low income groups to minimize the economic shock coming out from the pandemic. While such a fiscal policy is always welcome to bolster the economy, our interest is more towards the impact of the government's debt position. In this regard, we can observe the Philippines' strength in its ability to rely on fiscal policies to bolster the economy. Thanks to prudent fiscal policy in the past, the debt to GDP ratio stands at 41.5%. According to the Philippines' secretary of finance, the government is ready to pump in fiscal stimulus as it sees fit up to debt to GDP ratio of 50.0%. While there are concerns about the servicing of the debt in the future, we expect the Philippines to have no problem in this department for two reasons.

Firstly, the Philippines have shown strong economic fundamentals in recent years with improving unemployment numbers and strong GDP growth averaging at around 6%. We see that the key for the Philippines to recover from the crisis is swift recovery. With the government's strong commitment to adopt fiscal stimulus and the continued spending on infrastructure going forward, we do not expect much deterioration in the government's revenue base. Secondly, PHP's stable outlook and resilience also minimizes risk from a ballooning foreign debt. This is also due to investors' continued confidence in the fast-growing country. Philippines' credit rating continues to be rated BBB+ by Fitch, ensuring that affordable financing continues to be available to the government. All in all, with PHP strength and the government's strong fiscal position, the Philippines is in prime position to deploy necessary measures to guide the country through the economic turmoil.

Investors' Confidence to Empower Peso

While it is expected that the COVID-19 outbreak would put a hold to foreign investments in the region, we note that the Philippines continues to have investors' confidence as an investment destination thanks to its strong growth prospects. We note that in January 2020 alone, FDI is up by 12.1% YoY, reaching USD 657 million. While the number is expected to dwindle for the rest of 2Q2020, this continues to show the strong support for the economy. Compared to other emerging market currencies, PHP has less downside risk owing to the government's strong foreign reserves. The latest number stands at USD 89 billion, an all-time high. While the government stated that it adopts a floating approach for its currency management, it did quote a target of around 51. This limits downside risk for foreign investors in the region, limiting the sell-off impact.

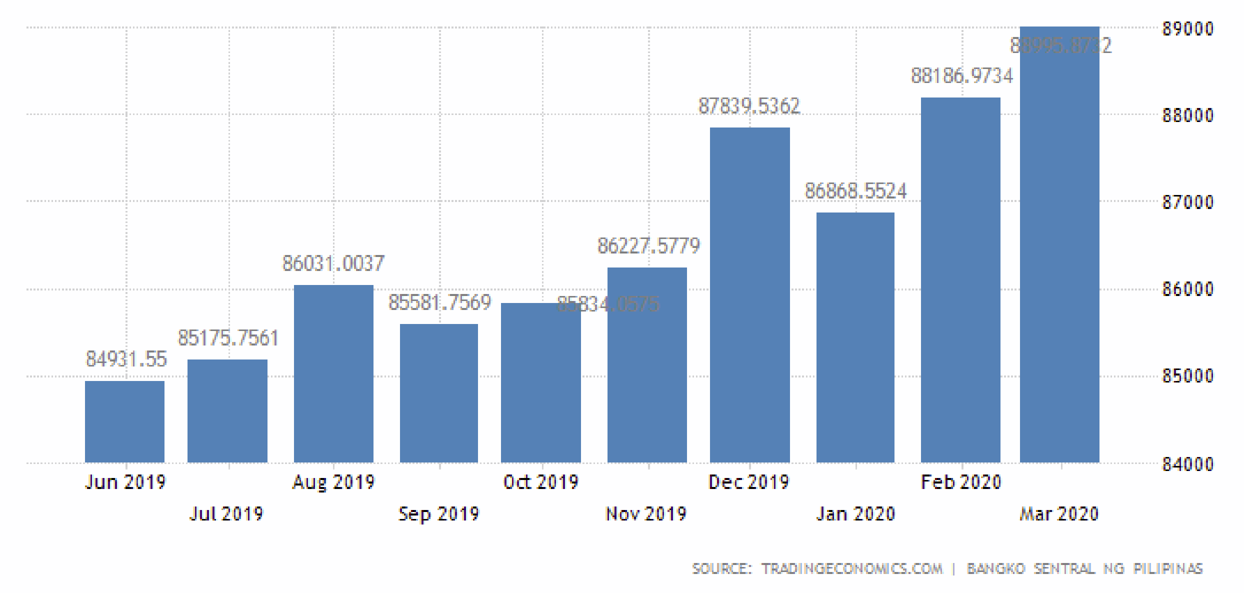

Figure 144: Strong Foreign Reserve (*Source: Trading Economics*)

While the currency is currently trading at a band of around 50.4 to 50.8 against the greenback, we expect that this will most likely fall to 51.0 to 51.5 going forward. Firstly, recovery in the economy in 2021 would also mean a resumption in import activities, especially for capital spending. More importantly, a very strong Peso will not be favorable for the Philippines, particularly for its tourism and exports. Given this, we opinionated that as the economy recovers, we expect a gradual depreciation to 51.0 to 51.5 level.

All in all, the Philippines seems to be one of the strongest performing countries in the region amidst the crisis. Much of its strength is due to the government's favorable financial position. This too is reflected by the generally positive sentiment from foreign investors. While recovery is not to be expected to be very rapid in 2H2020 (the risk of a worsening COVID-19 situation is still present), we expect strong recovery in 2021 with macroeconomic trends similar to what we initially expected for 2020.

FX TRADE IDEA: LONG USDPHP

Figure 145: USDPHP 4-Hourly Chart (*Source: TradingView*)

Entry: 49.80
Take profit: 50.40
Stop loss: 49.40
Risk to reward ratio: 1.56

Following the fundamentals analysis on PHP, we expect the depreciation (more like normalization) of PHP back to the ~51.0 band to be almost inevitable as the country recovers in 2H2020 and 2021. For the past 6 months or so, the pair has been trading in a pretty much restricted band of 50.40 to 51.0. Despite the COVID-19 sell-off, 50.40 seems to be a strong and tested support line for the pair and the level is only broken during the 1st June sell-off of the greenback. Currently, the pair is trading at a band of 49.80 and 50.40. The support level of 49.80 of the band is actually the lowest low level of the pair before the 2018 sell-off and therefore it signifies psychological support as PHP valuation is not likely to be higher than it was pre-2018 sell-off level. Therefore, 49.80 will be set as our point of entry with profit taking point at the band high of 50.40, which is also the support turned resistance line of the previous band. More interestingly, we can see that the pair roughly goes through one cycle every 1 month and setting stochastic at 28-day average we can see that the pair do respect the level relative to its 28-day average. Currently at 49.80, the pair is oversold, and reversal is likely to be seen. This gives support for entry at 49.80.

Our stop loss is set at 49.40. This is a relatively conservative level and a rather safe one given that 49.40 is the pair 3-years low. We do not expect that the pair will be touching such levels at all, given the fundamentals discussed above too.

This trade idea has a rather short horizon of around 1-2 months. For a longer-term trade, one may consider setting profit take level at 51.0. This is the level of the band that we expect USDPHP will trade at as the economy recovers in the next 6 to 12 months.

AUSTRALIA (Underweight)

2020 has not been a financially good year for most economies in the world and given its export-reliant nature, Australia was certainly not spared from it. Last year, against the backdrop of U.S.-China trade war uncertainty, the Australian economy was already tepid due to soured consumers' confidence and weak wages growth which dampened consumer spending. Now with the onset of two major crises this year - Australian bushfires and Coronavirus Disease 2019 (COVID-19) pandemic - it can be said that the health of the Australian economy is expected to deteriorate significantly. These major events have greatly shaped the outlook for the Australian economy in the years to come and recovery from these crises is not to be seen in the near future. The International Monetary Fund (IMF) has warned that Australia's economy would likely be one of the worst-hit economies in the Asia region and is expected to shrink dramatically this year as the global economy suffers its worst recession since the Great Depression.

In our previous December 2019 outlook, we mentioned that Governor Philip Lowe remains upbeat on the effects of its rate cuts to 0.75%, with quarterly growth outcomes expected to gradually strengthen. He had also hosed down prospects of future interest rate cuts but mentioned that the possibility of future monetary easing is not ruled out. However, the global economy took an unprecedented turn which dashed Australia's hopes of its economy reaching a 'turning point', ultimately resulting in the Reserve Bank of Australia (RBA) having to trim its official cash rate twice in March to a historic low of 0.25%. This reaffirmed our sentiment of a dovish outlook on Australia. The combined effects of the two major crises on the Australian economy and its outlook will be further discussed.

Australia's 'Black Summer'

The 2019-20 deadly Australian bushfire season, also known as the 'Black Summer', saw the warmest year on record across the Australian continent and a prolonged period of complex, devastating fires across multiple states. Extremely hot and dry conditions underpinned by years of reduced rainfall and severe drought has set the scene for this unprecedented fire - both in terms of scale and harm. The bushfire season was the worst on record for New South Wales (NSW), with three 7-day State of Emergency declarations being made for NSW in November, December and January due to dangerous bushfires conditions. Alongside with that, there were 25 deaths and 5.4 million hectares were burnt (6.8% of the state) in NSW. Nationally, the death toll stood at 33, with nearly 80% of Australians were affected either directly or indirectly by the bushfires and about 1 billion animals killed by the bushfires. Prime Minister Scott Morrison had been criticized for his mishandling of the bushfire situation as he was on vacation when it happened and even downplayed climate change as the cause of the deadly fires.

The fires in NSW were finally declared 'contained' on 13th February. This relief came after torrential rains marked the wettest week in the region in three decades. By 2nd March, for the first time in 240 days, not a single bushfire burned in the state of NSW. The fires have disrupted tourism and agriculture, which account for an important share of economic activity and employment in many of the affected regions. In particular, bushfire conditions intensified during the summer holiday period, which is an important time of year for regions that rely on tourism. Morrison had announced that the federal government would allocate at least AUD 2 billion for the bushfire recovery, with around AUD 76 million channeled to the tourism industry. He had described the funding - drawn from the Government's national bushfire recovery fund - as an "urgent injection" of funds for businesses impacted by the bushfire crisis.

COVID-19 Pandemic

Australia, which has a population of around 25 million people, had identified its first confirmed case of COVID-19 on 25th January 2020, in Victoria. The number of infections had peaked in March, attributed by Australia's major blunder of allowing 2,700 passengers to disembark from the Ruby Princess cruise ship in Sydney - even though many were showing COVID-19 like symptoms. More than 600 cases and 15 deaths have now been linked back to the ship. However, Australia had since then managed to bring down the number of COVID-19 cases under a responsive government led by Morrison, who swiftly bounced back from his mishandling of the bushfires.

As of 26th June, it has recorded a total of 7,595 confirmed COVID-19 cases, 104 deaths and 6,958 cases recovered. Since mid-April, there has been a sustained and relatively low number of new cases reported daily, with the daily rate of infections well below 1% in May, a fraction of what has been seen in many other countries. Having avoided the scale of sickness and death that has ravaged countries like the United Kingdom, United States (U.S.) and Italy, Australia is now in an enviable position as it has been able to flatten the curve of new COVID-19 cases, bringing nationwide daily infections down to low double digits compared to triple figures just two months ago (Figure 146). It is now said to be one of the world's most successful countries in the global fight against COVID-19, alongside with New Zealand, South Korea and Taiwan.

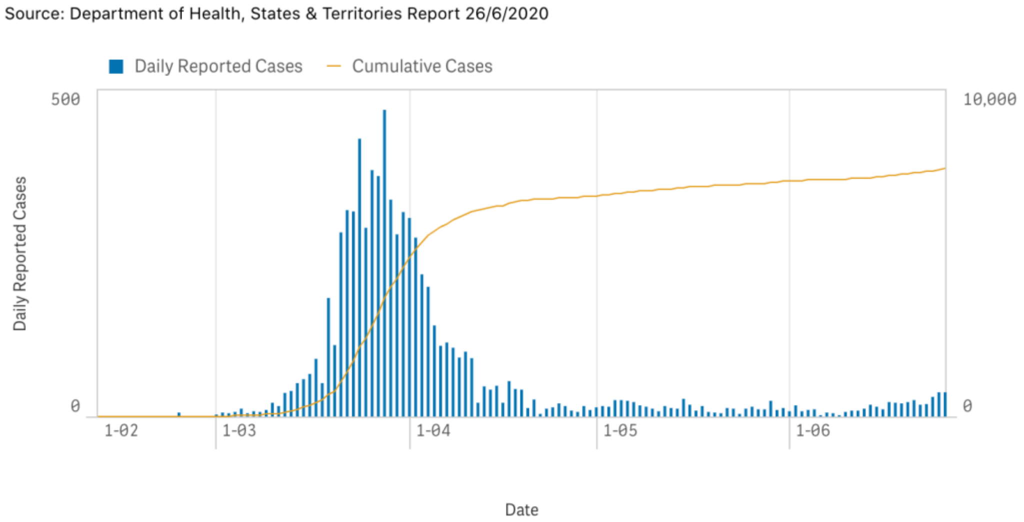

Figure 146: Daily Number of Reported COVID-19 Cases in Australia (*Source: Department of Health*)

However, while Australia has managed to effectively contain its virus spread for the past few months, it is starting to see a rise in cases recently which led many to question whether it will evolve to become a widespread second wave of the pandemic. Victoria state recorded 33 cases overnight, bringing the virus' reproduction number in the past week to an "unacceptably high" rate of 2.5 according to state's Health Minister Jenny Mikakos. That said, it is worth noting that community transmission is low, and 1,000 Australian Defence Force personnel have been deployed to provide extensive planning, logistical and medical support to ramp up testing. Hence, it is likely for infections to be quickly contained and infection rates to be reduced to the healthy level seen in May. Whether it poses a real threat to the Australian economy is to be observed in the following few weeks.

Restrictive Measures and Ever-Expanding Testing

Australia acted swiftly when the outbreak surfaced in the country, with its response to the pandemic being largely centred on shutting its borders, limiting public gatherings and conducting large-scale testing and contact tracing. On 1st February, Australia joined the U.S. in closing its borders to all foreign visitors who had recently been in China. Subsequently, on 19th March, Morrison declared a national emergency and travel advice has been upgraded to an unprecedented 'Level 4: Do not travel' to any country in the world. These restrictions led to travelling overseas being banned, foreigners are not allowed to enter the country, and Australians who return from other countries are kept in mandatory quarantine at specially designated hotels for two weeks. Besides that, social gatherings of more than two people are also forbidden and leaving the house is permitted only for essential reasons like buying food, exercising and medical reasons. All bars, clubs, cinemas, gyms and places of worship would be closed indefinitely, while restaurants and cafes would be restricted to take-away only. Draconian measures such as the introduction of fines and penalties in enforcing social distancing rules in some states have also been implemented. To further curb the spread of COVID-19, Morrison has announced on 16th April that the existing restrictions will remain in place for an additional four weeks before easing measures could be considered.

While closures of businesses, schools, travel restrictions and social distancing rules are common measures adopted by many governments around the world, Australia also paired these restrictions with widespread testing. Previously, only people who recently returned from overseas or who had come into contact with a confirmed COVID-19 case could be tested. However, Australia has ramped up its testing and expanded its testing criteria to include all health care works, aged care workers, prisoners and people in other identified hotspots who have a fever or acute respiratory symptoms. In addition to that, Chief Medical Officer Dr Brendan Murphy said Australia will start testing asymptomatic cases for the first time "to be absolutely sure that we are capturing every case that we can and that we are not missing cases." According to the Department of Health, 2,281,839 tests have been conducted across Australia to date and it conducts 2,099 tests per confirmed COVID-19 case, well exceeding those of Italy and the U.S. (Figure 147). This goes to show the effectiveness of testing and contact tracing in flattening the curve in Australia.

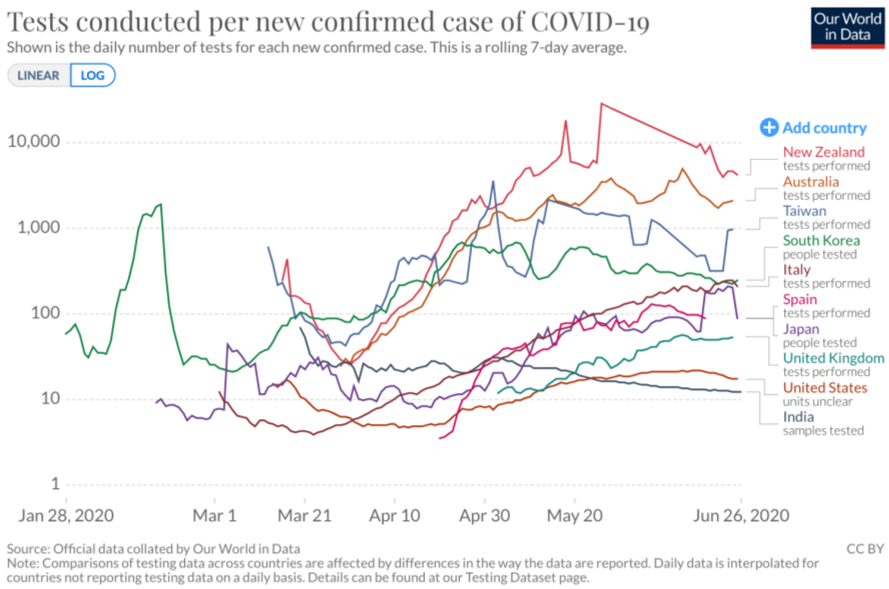

Figure 147: Number of COVID-19 Tests Conducted Per Confirmed Case (*Source: Our World in Data*)

Comprehensive Package Addressing the Impacts of COVID-19

To address and soften the impacts of COVID-19, the RBA and the Australian government has unleashed a comprehensive package of temporary measures targeted at supporting the economy and promoting the functioning of key financial markets. It is said that Australia's fiscal-monetary rescue package is one of the biggest and most aggressive amongst that of other nations, equivalent to 16.4% of gross domestic product (GDP).

On the monetary front, firstly, the RBA responded to the COVID-19 shock by cutting the official cash rate to 0.25% during an emergency meeting held on 18th March, bringing it to a cumulative 50 basis point cut in the month of March. The Board has also announced that it will not increase the cash rate target until progress is being made towards full employment, hence rates continued to remain at 0.25% on 3rd June's meeting. With regards to negative interest rates, Lowe has ruled out its possibility, saying that it will bring more costs than benefits to the Australian economy. Secondly, RBA launches its first-ever unlimited Quantitative Easing program which targets for the three-year Australian Government bond yield has been set to be around 0.25%. The RBA aims to achieve that by conducting purchases of Australian Government Securities (AGS) and semi-government securities (semis) across the yield curve in the secondary market. Thirdly, a 3-year AUD 90 billion Term Funding Facility for the banking system, with particular support for credit to small- and medium-sized businesses has been set up. Lastly, the remuneration of exchange settlement balances at the Reserve Bank at 10 basis points, rather than zero. Early evidence has shown that these measures are working as expected: Banks have reduced their lending rates to record lows, with interest rates for small businesses declining the most. The yield on 3-year bonds has settled at the target and the government bond markets in Australia are working well again. To date, the RBA has bought around AUD 50 billion of government bonds but has scaled back purchases recently as conditions have continued to improve. Nevertheless, RBA remained prepared to scale up these purchases again if necessary, to achieve the yield curve target and to assist smooth market functioning.

While being able to prop up the economy, there are limits to what can be achieved with monetary policy. Fiscal support is another essential tool needed to shore up consumers' sentiments and domestic spending - a main driver of the Australian economy. On the fiscal front, the Australian Government has announced three economic stimulus packages focused on providing support to households and business (Figure 148). The cost of these packages was estimated to be AUD 66 billion in 2019/20 (3.3% of annual GDP) and AUD 126 billion in 2020/21 (6.3% of annual GDP). The states and territories have also announced a number of spending packages, costing to be at least AUD 19 billion, just under 1% of annual GDP. These state measures have been predominantly targeted at small- and medium-sized businesses in the form of waivers on payroll tax and government fees and charges. Many states have also included measures to support households and specific industries. However, Morrison has warned that Australian should "get off the medication" of fiscal welfare and not get too accustomed to it.

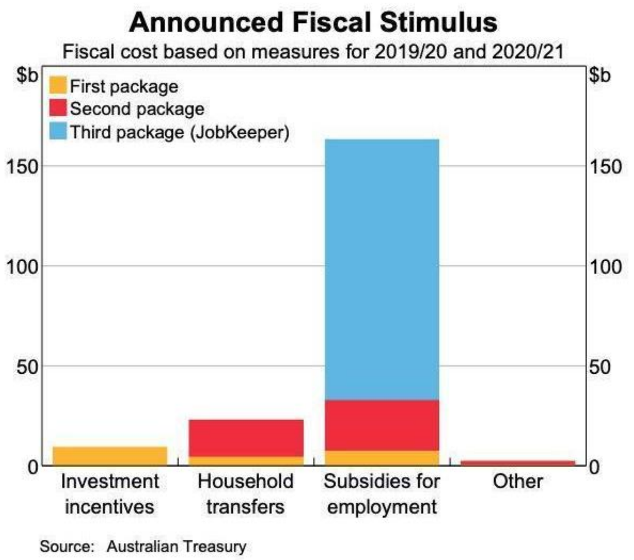

Figure 148: Fiscal Stimulus Packages (*Source: Australian Treasury*)

Although these will weigh heavily on public finances in the immediate future, they will not structurally weaken Australia's fiscal position. This is because Australia entered the crisis in better shape than most developed nations, with total gross government debt to GDP ratio at 42% at the end of 2019, compared to 103% in other advanced economies. Moreover, Australia has sold AUD 55.6 billion of bonds this quarter, with the latest record-breaking AUD 19 billion bonds sales in May, underscoring appetite for debt in one of the highest-yielding markets among Group-of-10 nations (Figure 149). Many offshores investors are rushing to Australian government bonds due to its high creditworthiness of triple-A credit rating and its attractive yield in this current low interest rate environment Global money managers, sovereign wealth funds and central banks snapped up 46.2% of the entire issue, compared to about 35% for previous government bond offerings. This strong demand indicates that Australia is well-positioned to fund its large economic stimulus measures. According to estimates from Australia and New Zealand Banking Group Ltd, this nation could sell up to AUD 250 billion of bonds in the coming months as governments around the world compete for funding to combat a COVID-19-driven economic downturn.

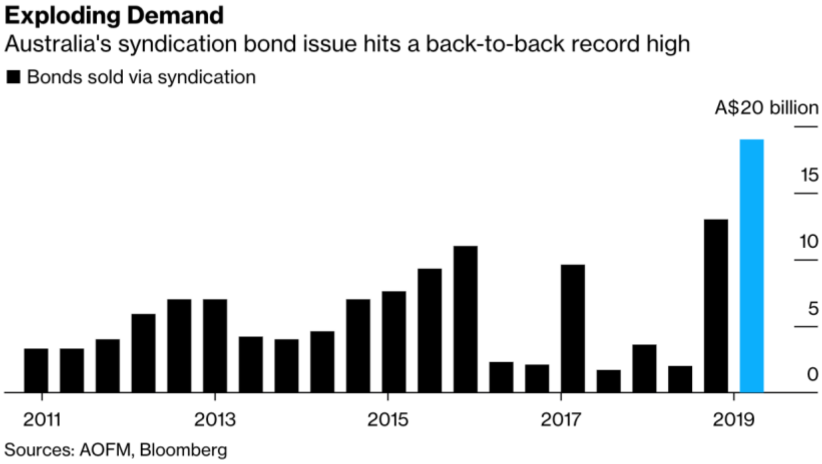

Figure 149: Bonds Syndicated in Australia (*Source: Bloomberg*)

According to Philip Lowe, the measures that the central bank has introduced to support firms and households are 'working as expected', and while it may not be able to stop a recession from happening, it will help limit collateral damage and boost recovery. We feel that it is best for the Australian economy if the RBA and Lowe keep their promise of staying away from negative interest rate policy, but with speculation around the U.S. Fed possibility pushing its federal fund rate into negative territory in future, the future remains unclear. We continue to hold the stance that quantitative easing, coupled with strong fiscal stimulus, remains as the appropriate method for Australia's recovery.

<u>The 'Lucky Country' Has Run Out of Luck for Economic Growth</u>

Australia - dubbed the 'lucky country' - has produced a record of uninterrupted economic growth that is unprecedented among developed nations. Its three-decade run without recession has largely depended on four pillars of support: population growth underpinned by immigration, its trading relationship with China, the housing boom and good economic policy. However, with the first three pillars not to be seen in 2020, many economists forecast that the pandemic will do what no crisis has done in three decades: plunge Australia's economy into a recession. Coupled to those factors are the growing uncertainty, as well as rising rates of unemployment, which are likely to further weigh on consumers' purchasing powers.

According to RBA's May economic outlook, the Australian economy is expected to record a contraction in GDP of around 10% over the first half of 2020, wiping AUD 50 billion from the economy - "the biggest contraction in national output since the 1930s" according to Philip Lowe. Although May saw the tentative easing of restrictions, it was only enough to see a slight softening of the pace of contraction as demand continued to fall sharply. The manufacturing sector in Australia fell deep into contraction in May, with the Commonwealth Bank Flash Manufacturing PMI showing 42.8 vs 44.1 (Figure 150) in April, signalling that output fell the greatest extent since 2009 and at a faster rate of contraction. Services PMI was at 25.5 vs 19.5 in April, while composite PMI was at 26.4 vs 21.7 in April. Manufacturers cited a range of COVID-19 issues, with the most prevalent including no new sales due to shut down, major customers cancelling orders, supply chain problems with inter-state freight movements, and delays, and increased prices for raw materials.

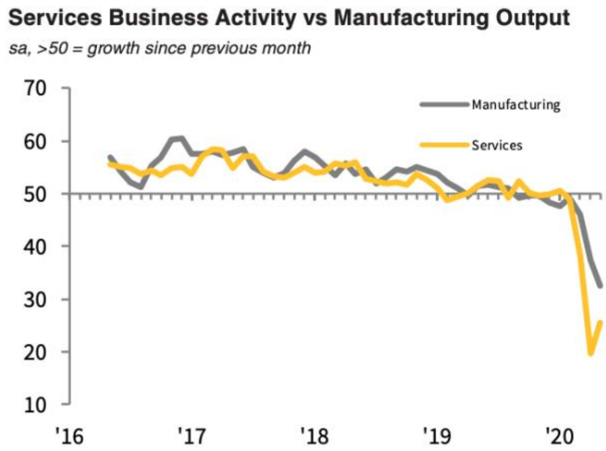

Figure 150: Manufacturing PMI (*Source: Commonwealth Bank of Australia*)

Australia's central bank has also mentioned that household consumption, which makes up around 55% of the economy, is likely to slump about 15% in response to the lockdown to stem the spread of COVID-19 and the outlook beyond the first half of this year. While on one hand it has been boosted by people stocking up on essentials during the lockdown, on the other hand, it was hammered as people could not eat out or go to the movies. With restrictions easing, retail spending has rebounded strongly, with preliminary retail figures showing turnover rose 16.3% from April (Figure 151). But according to James McIntyre, this only signals a shift rather than a recovery in household spending. The elevated retail spending reflects a diversion from non-retail activities than remain shut down and the retention of spending inside Australia that Australians would ordinarily make during offshore travels.

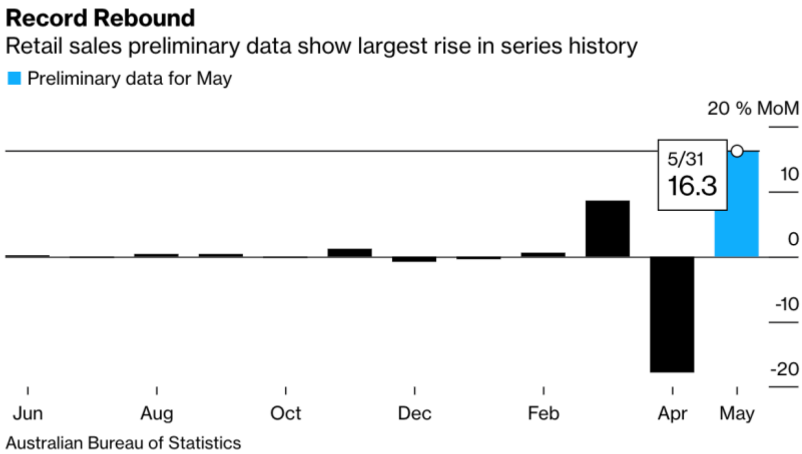

Figure 151: Preliminary Retail Sales for May (*Source: ABS*)

We feel that for overall consumption to drive further rebound, households must put aside concerns over job security and debt to drive spending. Though consumer confidence is now back around pre-COVID levels, with the Westpac-Melbourne Institute Index of Consumer Sentiment having rebounded 16.4% to 88.1 in May from the extremely weak 75.6 read in April (Figure 152), it still remains in the negative territory overall and down 7% from a year ago. Evidently, the general picture now is of continued intense pressure on family finances and concern about the near-term outlook for the economy, and whether or not consumer confidence is able to continue and sustain its recent upwards momentum.

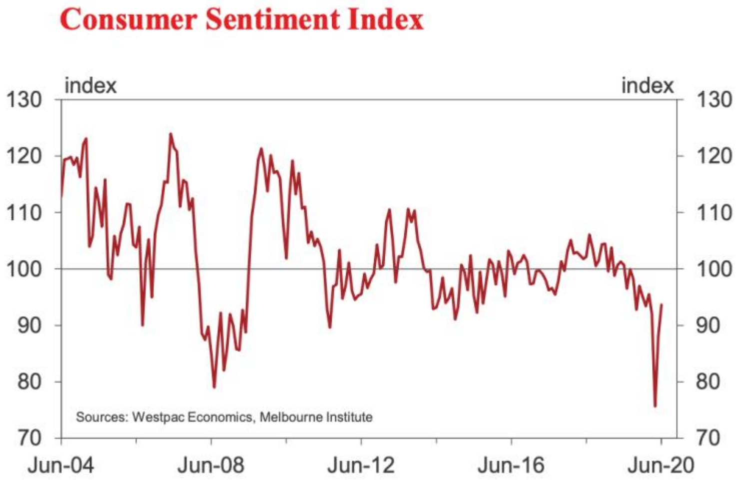

Figure 152: Consumer Confidence Index (*Source: Westpac-Melbourne Institute*)

Besides that, the economy has previously benefited from at least 1.5% annual economic growth attributed by its swelling population, yet this was not made possible in 2020 due to travel restrictions reducing travel and education exports, which was already evident by February (Figure 153). Net migration is set to fall 30% in the year ending 30th June, and a further 85% in the ensuing 12 months as part of the virus fallout. Consequently, there will be a large decline in education exports over the first half of the year. A significant share of Chinese students who had intended to study in Australia remained outside the country, and some students from other countries have withdrawn from their studies voluntarily or had their exchange programs suspended or cancelled. Domestic containment measures are also expected to decrease spending by international students remaining in Australia. Additionally, Morrison has signaled that Australian borders may be closed until mid-2021.

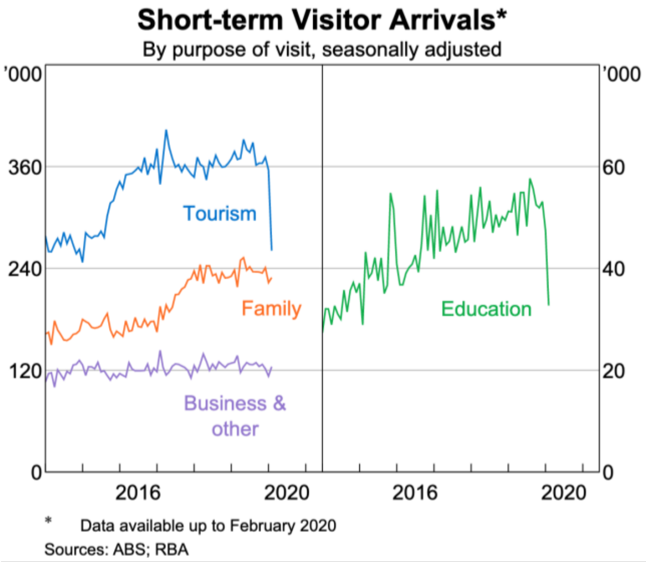

Figure 153: Short-term Visitor Arrivals in Australia (*Source: ABS*)

Moreover, GDP has always been reliant on Australian housing, which has mostly been a one-way bet on rising prices for the past two decades. However, with the onset of COVID-19, the housing boom has been affected as there is a lesser underlying demand for housing, and the indebtedness of existing households are expected to constrain the market in the period ahead. Rising unemployment, tighter bank lending and a sudden drying up of immigration will all impact home prices. To make matters worse, Australia has one of the world's highest levels of household debts (more than 200%), making it particularly vulnerable to a housing slump. Commonwealth Bank of Australia estimates that under a short, sharp economic downturn this year followed by a quick recovery next year, house prices will fall 11% by March 2023.

Nevertheless, Philip Lowe expressed confidence that the economy will "bounce back and recover". If restrictions are eased by mid-year, and most are lifted by year's end except for the ban on international travel, GDP could grow by 6-7% in 2021. Brendan Murphy also said that Australia's choice of a 'suppression' strategy, as opposed to a full shutdown of public life as adopted by neighbour New Zealand, could free the country of the virus without hefty economic penalties. We remain cautiously optimistic on Australia's recovery but note that consumption may take a while to recover, as higher unemployment, still-low consumer confidence and high household debts will weigh on consumption. The forecasts highlight the strong likelihood that monetary policy setting will remain very accommodative for a number of years, hence we believe it will help to spur consumption in future. We are hopeful for a U-shape recovery, given that there is no medical breakthrough yet, although the economy is gradually reopening. In addition, the onus is on substantial amounts of fiscal support to broaden the recovery, as well as the right timing of the withdrawal of fiscal support, for a U-shape recovery to be seen.

Australia's Unemployment Surge

The lockdown has taken a heavy economic toll as Australia's central bank predicts unemployment is poised to double by July to about 10% (~1.4 million people), as the economy contracts by 10% from peak-to-trough during the lockdown. Containment measures introduced from mid-March led to an immediate and large rise in job losses, as well as a significant reduction in the hours worked by many who retained their jobs. Workers in hospitality, recreation and other household services were most adversely affected. The jobless rate in Australia has hit the highest level since September 2015 with seasonally adjusted employment falling by 594,300 in April, which translates to the unemployment rate jumping a full percentage point in a month from 5.2% to 6.2% (Figure 154). This figure continued to surge to 7.1% in May as the economy posted its biggest back-to-back monthly job losses on record. According to Australian Treasurer Josh Frydenberg, he said the jobless rate is likely to climb to about 8% in the third quarter. It is, however, worthy to keep in mind the figure may grossly undermine the true unemployment rate, as people on the JobKeeper payment are classified as employed, even if they are effectively stood down by their employers. Alongside with that are other metrics such as underemployment rate which decreased 0.7 points to 13.1% and participation rate which decreased 0.7 points to 62.9%.

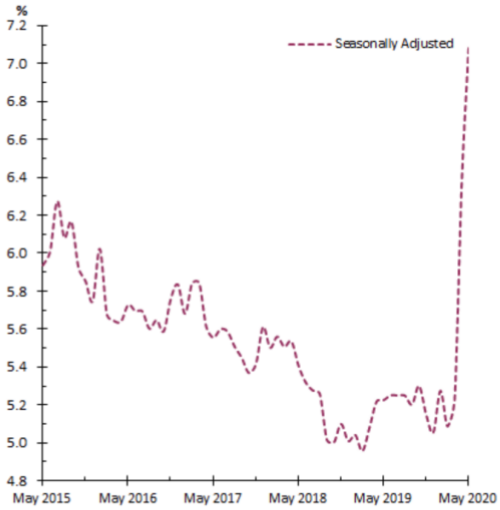

Figure 154: Australia Unemployment Rate (*Source: ABS*)

With restrictions on movement and business operations, alongside slumping sales, firms sought to reduce staff numbers. Australia business conditions deteriorated significantly in April, weakening across the trading, profitability and employment segments as large tracts of the economy were shuttered to contain the virus. While the conditions index - which measures hiring, sales and profits - bounced back from -34 in April to -24 in May, it still remained in the negative territory according to National Australia Bank (Figure 155). Business confidence similarly retraced some of its massive loss since March, rising to -20 in May from -65 in March. However, the reading is still below the long-run average, with the figure last seen around the 1990s recession. Employment conditions have also improved slightly from -35 in April to -31 in May.

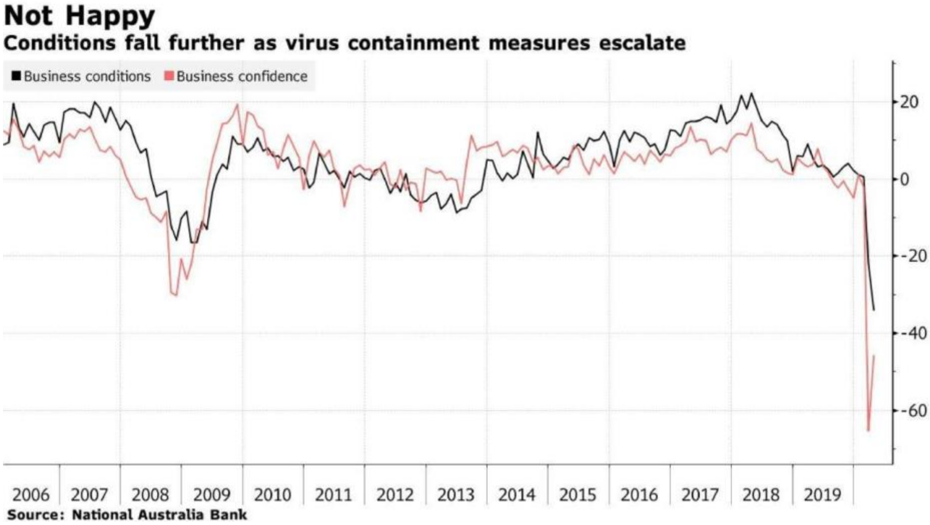

Figure 155: Business Conditions & Business Confidence in Australia (*Source: National Australia Bank*)

The concern is that global demand for goods and services will remain subdued for some time, in particular, if travel restrictions or self-isolation requirements are kept in place. This will put continued pressure on the unemployment rate and the loss of income for Australians. Even before COVID-19, Australian households were among the most indebted in the developed world, with debt almost double disposable income. The threat of unemployment to people's ability to meet their debts is now key, and the RBA has acknowledged it as a major risk facing the economy. While the JobKeeper initiative has prevented the nation from experiencing a 15% unemployment rate, we feel that there will still be a sharp increase in labour market underutilisation in the near term, which will likely take a few years to unwind. This is because businesses are likely to delay rehiring workers until the uncertainty around the outlook has subsided. It will also take time for businesses to retrain workers or find suitable workers from the pool of unemployed. This will exacerbate the impact on consumption and GDP on top of the relatively low confidence, and the severity of impact depends on the extent government transfers to directly affected households and wage subsidies for affected employees can mitigate it.

That being said, amidst the gloomy unemployment data, more timely indicators are painting a better picture. Outside of the small outbreak in Victoria, authorities have flattened the COVID-19 infection curve and are reopening the economy earlier than expected. Philip Lowe also mentioned that the fall in hours worked in Australia was likely to be 10%, rather than the 20% he had earlier feared, showing that the economy is moving in the right direction. As mentioned in earlier paragraphs, business conditions are also seeing an improvement in May. We are expecting a gradual recovery in Australia's unemployment rate but remain mindful that the international travel sector is not going to gain momentum any time soon. The success of recovery also hinges on the government's approach towards fiscal stimulus moving forward, where a "tapering arrangement" is preferred over a sharp cutoff as that would damage the recovery and potentially drive unemployment even higher.

Australia's Trade Balance Suffers by Defying the Dragon

China, the largest trading partner of Australia, has restarted production as reported cases slow to single-digit levels, with no new deaths for more than a week. China's reopening after the February lock-down provided a boost to the trade in goods, with exports increasing by 21.6% and imports rising by 1.3%. Australia's trade windfall increased to a new high as prices and volumes of commodities like iron ore surged, boosting the economy as it headed into the late-March lockdown. Data from ABS showed that the surplus spiked to a record AUD 10.6 billion (USD 6.8 billion) in March, exceeding economists' estimates of AUD 4 billion and up from a downwardly revised AUD 3.9 billion in February (Figure 156). Key to this was the rebound in iron ore production and export shipments post Cyclone Damien. The lift in the iron ore price in Australian dollar terms was also a plus. The trade surplus fell to AUD 8.8 billion in April but remained above market consensus of a surplus of AUD 7.5 billion.

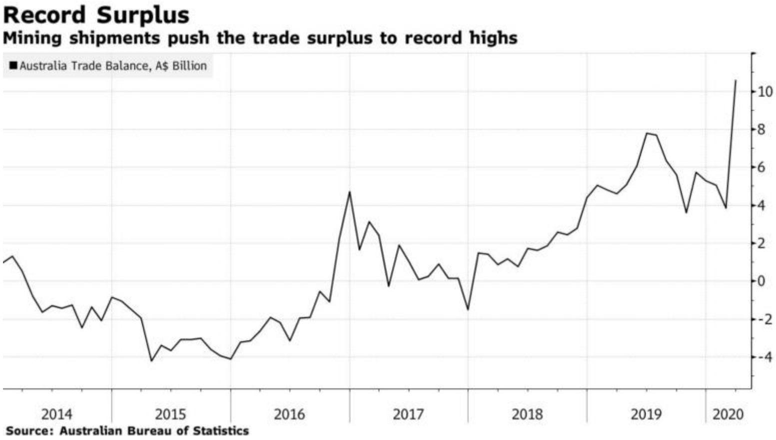

Figure 156: Australia's Trade Balance (*Source: ABS*)

However, while Australia's goods industries are seeing an improvement, activities in the service industries are likely to face a prolonged period of weakness, which is a great concern given that nearly two-thirds of Australia's economic output is from service industries (Figure 157). The COVID-19 pandemic has greatly weighed on service exports, with sales of services having dropped 9%, mainly attributed to travel (-14%) due to the closure of international borders in an attempt to contain the virus. Besides that, the Australian economy has felt the pinch on its tourism sector earlier this year as the bushfires have led to many domestic and overseas travellers cancelling their trips and hotels. Accommodation booking cancellations in non-fire zones exceeded 60% while in fire-affected areas, there were no tourists at all. It was forecasted that it will cost the tourism industry at least AUD 4.5 billion.

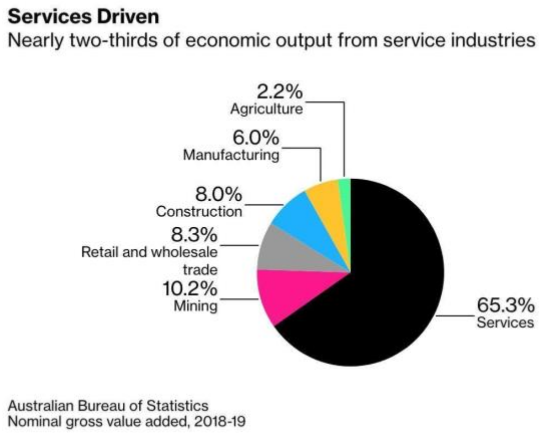

Figure 157: Australia's Economic Output Breakdown (*Source: ABS*)

In addition, the optimism from Australia's commodities exports may not last long and the trade surplus from iron ore may be counteracted as Australia has become embroiled in a diplomatic spat with China after it demanded an international inquiry into the COVID-19 outbreak, which the World Health Organization (WHO) has finally agreed to. Around one-third of Australian exports are shipped to China and it has been the most important export market since overtaking Japan in 2009-10 (Figure 158). Equivalent to about 8% of the entire national economic output (AUD 153.2 billion), these exports are nearly 2.5 times larger than exports to Japan (AUD 61.7 billion). Besides export goods, China also spends billions vacationing in Australia and sends thousands of its middle-class children there to be educated. This leaves Australia, the most China-reliant economy in the developed world, vulnerable to blowback from China.

Beijing has slammed the move as "politically maneuvering" and Chinese Ambassador Jingye Cheng even warned of a potential boycott of Australian products in future. Thus far, Australia's key agricultural exports are being affected, with beef from four Australian processing plants hit with suspensions and barley grains being slapped with anti-dumping duties for five years, fuelling concerns for other potential goods such as wine and dairy. An anti-dumping duty of 73.6% and an anti-subsidy duty of 6.9% on the grain have been effective since 19th May, according to a statement from China's Ministry of Commerce. This is a devastating hit to the Australian agriculture industry and a major loss to rural communities as it could cost the barley industry more than AUD 500 million.

Figure 158: Share of Australian Exports Sent to China (*Source: Bloomberg*)

According to Bloomberg's economist, James McIntyre: "Some of Australia's exports, like iron ore, may be less prone to disruption threats as China needs it to build and fuel its economy. But agricultural and services exports, such as education and tourism, are potent targets given the labour intensity of these sectors and importance to key regions domestically." One consoling factor of this otherwise bad situation is that Australia's exports of iron ore, coal and natural gas account for more than 60% of exports to China. Hence if China opts to stimulate its economy, shutting out the Australian supply of minerals and energy could send prices soaring (Figure 159).

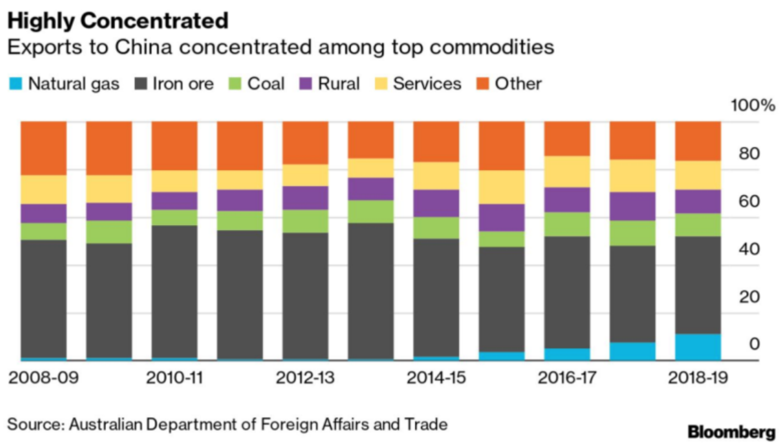

Figure 159: Australia's Top Exports to China (*Source: Bloomberg*)

Regardless, we feel that the timing of Australia's inquiry was particularly poor, given that it came while Trump was seeking to deflect blame from his handling of the U.S. response to the virus onto China's responsibility for its origination. Australia is in a difficult position, as it straddles a close security relationship with the U.S. on one hand, and deep economic and trade ties with China on the other hand that are looking increasingly irreconcilable. One would expect Australia to be doing a lot of diplomatic work in times like these and not to become entangled in the growing feud between the U.S. and China. Additionally, the annual Lowy Institute Poll showed that Australians' trust in China to act in the world's best interests has plummeted, with only 23% trusting China to act responsibly in the world, down from 52% two years ago. This further highlights the Australian government's challenge in mending a worsening diplomatic spat with its largest trading partner.

Adding on to this Australia-China tensions, Australia is facing an internal conflict due to growing divisions between state and federal leaders over how to handle relations with Beijing. Victoria state, led by opposition centre-left Labor Party is pushing ahead with plans to participate in China's Belt and Road initiative, a move that is seen to be "gravely concerning" according to Home Affairs Minister Peter Dutton.

As a matter of fact, Australia depends more on China than China depends on Australia, hence its economic future is deeply tied up with China. With China's track record of using trade as a political lever, it seems that Australia's farmers may now be paying the price for the government defying the dragon.

Rebooting Australia's Crippled Economy

As Australia has managed to flatten the curve of COVID-19 infections, Morrison says that the health system is in a good position to cope as he now turns to resuscitate the economy. He is seeking to thread the needle between containing the virus while lifting restrictions that are costing the economy AUD 4 billion (USD 2.6 billion) a week. On 8th May, Morrison had announced that Australia will open up its crippled economy by July in a three-phase plan and get 850,000 people back in jobs as lockdown restrictions relax. Cafes, restaurants, gyms and cinemas will be incrementally reopened and gatherings of up to 100 people, as well as interstate travel, will be gradually permitted. These easing guidelines will be implemented based on the nation's eight state and territory governments' own pace, depending on the number of COVID-19 infections in their jurisdictions.

In addition, Australia and New Zealand are committed to introducing a shared travel zone as soon as it is safe to do so. As both Australia and New Zealand have success in containing COVID-19 and look to relax lockdown restrictions, the focus has shifted to reigniting their economies and both would benefit if they could open the borders to each other's tourists and business travellers. A trans-Tasman COVID-safe travel zone would be mutually beneficial, assisting trade and economic recovery, as well as kick-starting the tourism and transport sectors.

Being one of the first few countries who have successfully curbed the number of infections, Australia's economy is en-route to its recovery. However, we feel that Australia should not be overly optimistic and confident as the battle against the COVID-19 pandemic is not entirely over; instead, it has just started. As seen earlier from the record one-day spike in COVID-19 cases in two months, it shows that Australia is still very much vulnerable to the virus. With the southern hemisphere heading into winter, the probability of new clusters of infections forming may also be further heightened. Therefore, the success of Australia largely depends on whether Australians will flout the rules during the gradual reopening, and whether the nation could be entering a second wave of infections that would jeopardize a further easing of lockdown restrictions. However, Morrison appears confident in Australia's containment response, mentioning that the new outbreak in Melbourne's suburbs was creating "few challenges" and that the nation was dealing with the virus "better than almost any country in the world".

Overall, while Australia has been extremely successful in its virus containment efforts and has been easing lockdown measures, there still remain many concerns on the long-term recovery of the economy and its relationship with China, given that it is a trade-reliant country. The outlook beyond the June quarter will be shaped by the extent to which activity and the labour market continue to be affected by containment restrictions, and other factors like the responses of households and businesses, as well as the effectiveness of policy support. We must expect that the economic disruption will have long-lasting effects as it will take some time to restore workforces and businesses. In addition, the weak global backdrop may also constrain Australia's economic recovery. More importantly, the revival of Australia's economy boils down to a single most important factor - a COVID-19 vaccine. Philip Lowe has warned that without a COVID-19 vaccine, the economic recovery for Australia will likely be "quite slow" as there would be low consumer confidence, resulting in people remaining nervous about their health and unwilling to spend. Moving into the future after the Australian economy has regained its footing, the focus should then be shifted to how the Australian government can exit the programs seamlessly to prevent a long-term over-reliance on it. The real test for the Australian economy will then begin. We shall look to see the government's update on economic and fiscal outlook on 23rd July that will set out its plans for JobKeeper and other fiscal programs. We acknowledge the fact that Australia is doing better compared to many other countries regarding the fight against COVID-19, but we remain underweight on Australia's economy as the country and its trading partners has dived into a recession and are still fighting COVID-19, hence there is still a long way for adequate recovery to be seen.

FX TRADE IDEA: LONG AUDNZD

Figure 160: AUDNZD 2-Hourly Chart (*Source: TradingView*)

Entry: 1.068
Take profit: 1.079
Stop loss: 1.062
Risk to reward ratio: 1.83

We choose to long the AUDNZD currency pair. From a fundamental analysis point of view, the RBNZ's still dovish policy stance remains a potential source of relative underperformance for the kiwi dollar compared to the aussie dollar. In addition, the New Zealand economy is likely to suffer a bigger economic hit compared to Australia due to its harsher lockdown measures as explained in our analysis of New Zealand below. Commodities exports represent a significant segment of both economies, with the Aussie dollar being driven by exports such as ferrous metals and energy while the kiwi dollar driven by exports like wool, meat and milk. Therefore, the AUDNZD currency pair is able to show the relationship between hard and soft commodities during the COVID-19 pandemic. The Aussie dollar is able to benefit more this time as evident by the increase in iron ore exports to China as the economy started to run again, rendering the Kiwi dollar to be more subdued in comparison.

Looking into technical analysis, the AUDNZD currency pair has recently tested the strong uptrend line and the formation of an ascending triangle can be seen, signalling the continuation of a bullish chart pattern (Figure 160). In addition, two bullish flags can be observed, and we feel that the recent pullback will continue to retest upwards as indicated by the black arrow. As such, we will set the entry level at 1.068 when the currency pair starts gaining upwards momentum again. The take profit level will be at 1.079, just before it breaks through the upper bound of the channel indicated in orange. The stop loss level will be set at 1.062 as bounded by the support level. This will result in a risk-to-reward ratio of 1.83. In addition, we think that it is likely for the 12-days EMA to trend above the 26-days EMA - a buy signal. Lastly, the RSI is low and near the oversold territory, hence it is likely for the AUDNZD currency pair to rise.

Therefore, holding a 6-month view, we are bullish on the AUDNZD currency pair.

NEW ZEALAND (Underweight)

New Zealand, a small neighbouring country of Australia, is also an unfortunate victim of the Coronavirus Disease 2019 (COVID-19) pandemic. Similar to Australia, New Zealand's economy has also been bruised last year due to the ongoing U.S.-Sino trade war, albeit to a smaller extent. 2019 saw New Zealand's Gross Domestic Product (GDP) growing at its slowest pace in five-and-a-half-years and the stability of its trade exports being tested. Although New Zealand has managed to avoid the massive COVID-19 infections as seen in other countries, it has certainly not escaped the contingent effects of economic downturn from its trading partners, due to the nature of its small and open economy. Its strict lockdown also has repercussions on its economy, with the nation expected to brace itself for a recession.

In our previous December 2019 outlook, we mentioned that New Zealand's economy is vulnerable to the uncertain conditions of the trade war and weak household confidence. With that, the Reserve Bank of New Zealand (RBNZ) has agreed upon a dovish stance on the global macroeconomic outlook and conveyed that there remains scope for further monetary stimulus if necessary. With the onset of COVID-19, it has reaffirmed RBNZ's dovish sentiments, and we have downgraded our sentiments from neutral to underweight. The effects of the COVID-19 pandemic on the New Zealand economy will be analyzed in greater details below.

COVID-19 Pandemic

New Zealand, with a population of 4.8 million, had identified its first confirmed case of COVID-19 on 28th February 2020. The number of infections peaked in early April, with 89 new cases recorded per day and 929 active cases. As of 27th June, New Zealand has recorded a total of 1,172 confirmed COVID-19 cases, 22 deaths and 1,484 cases recovered, a successful containment effort led under the effective leadership of Prime Minister Jacinda Ardern. Previously, New Zealand had declared victory against the virus as it enjoyed a 24-day run with no new cases (Figure 161). However, this track record was being broken when two women who recently arrived from Britain were allowed out of quarantine early without being tested for the virus, even though one had mild symptoms. The new infections are a setback to New Zealand, which lifted all social and economic restrictions except border controls. That being said, New Zealand's COVID-19 statistics are still extremely positive, allowing it to be ranked among the world's most successful countries in the global fight against the virus and one of the first few countries to return to pre-pandemic normality.

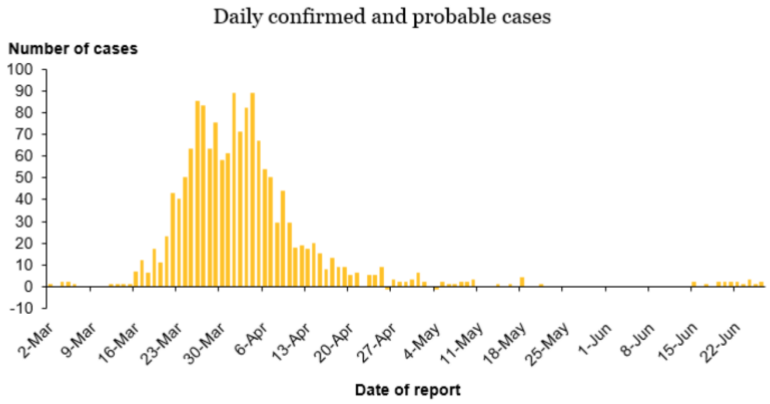

Figure 161: Daily Number of Reported COVID-19 Cases in New Zealand (*Source: Ministry of Health*)

New Zealand's Strategy of Elimination

New Zealand's ability to quickly and effectively flatten the curve of COVID-19 infections has been a collective success, attributing to its geographical location, effective leadership and the ordinary Kiwis' adherence to the rules under lockdown. As countries around the world work to bring the number of COVID-19 cases down, New Zealand has set itself a far more ambitious target since the beginning of the COVID-19 crisis - to wipe out COVID-19 entirely. Its bold plan has drawn admiration from all over the world, but experts say its success will be difficult to replicate elsewhere, especially in countries like the U.S.

Firstly, geography has majorly helped New Zealand's success. The island nation has more control over who can come in compared to a country with large, porous land borders. According to Michael Baker, a professor at the University of Otago's Department of Public Health who advises the government on its COVID-19 response, "an ability to control entry points" is a key feature of the elimination strategy. New Zealand also has the advantage of being relatively isolated, which meant fewer early travellers from China and other infected areas and a longer time before cases started to appear. Moreover, its low population density also points to the fact that it may be physically harder for the virus - which is transmitted via close contact and airborne respiratory droplets - to spread. Only 1.66 million people live in Auckland, New Zealand's biggest city, and its population density is less than one-twentieth of America's biggest urban centre, New York City.

Secondly, the COVID-19 pandemic was well-managed under Ardern's crisis leadership skills, which attracted the most international attention. With the New Zealand elections four months away from now, she has taken a dominant lead in the battle to win re-elections this year as she has won many plaudits for her courageous, firm and humane leadership. Ardern had communicated well with the public in a clear, consistent and reassuring manner, sometimes delivering her messages through engaging Facebook Live sessions from her home. That allowed her to earn the trust of the public and ensure that the public was united with her against the fight of COVID-19 pandemic.

Ardern's decisiveness was first shown through her government banning travellers from China in early February before New Zealand had even registered a single case of the virus. Subsequently, under her hard and firm approach, New Zealand underwent early lockdown efforts on 26th March when only 100 people in the country had tested positive for the virus and no deaths were recorded yet. Ardern mentioned that "we must go hard, and we must go early", describing New Zealand's approach as the world's toughest border restrictions. The lockdown consisted of a four-stage COVID-19 crisis response alert system, starting with the highest tier Level 4 where the entire country was told to stay home unless they worked in essential jobs like healthcare or had to engage in essential activities like visiting the nearby supermarket. Takeaways and interacting with anyone outside of their households were also not allowed. Apart from its strict lockdown efforts, New Zealand has also instituted widespread testing and contact tracing. According to the Department of Health, 387,435 tests have been conducted across New Zealand to date and it conducts 4,233 tests per confirmed COVID-19 case, well exceeding those of Italy and the U.S. (Figure 162).

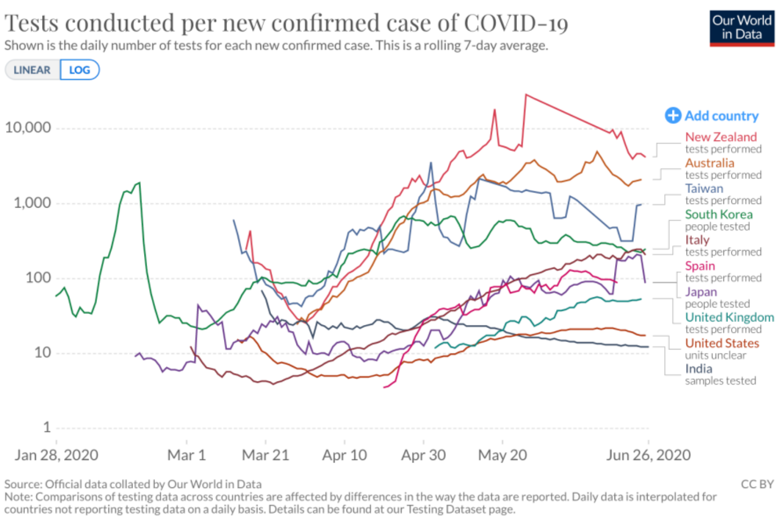

Figure 162: Number of COVID-19 Tests Conducted per Confirmed Case (*Source: Our World in Data*)

Lastly, New Zealanders largely obeyed stay-at-home guidelines, with a high level of behaviour change after the announcement of lockdown measures. According to Google COVID-19 Community Mobility Report data, activity dropped almost instantly, by over 90% from baseline levels in some categories (Figure 163), and by an average of 73% overall during the lockdown period.

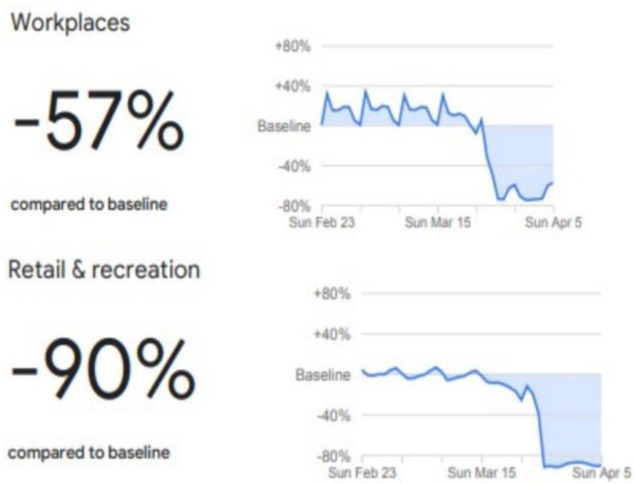

Figure 163: Community Movement Trends Across Different Categories of Places (*Source: Google*)

Comprehensive Package Addressing Impacts of COVID-19

The slowdown in the global economy has acted as a serious headwind for the New Zealand economy. Draconian lockdown measures to limit the spread of the virus had repercussions on New Zealand's trade and travel, affecting both supply and demand channels in the economy. In hopes of resuscitating its faltering economy, RBNZ has implemented several monetary and financial stability measures while Ardern's government has come up with a fiscal response. All these are aimed at keeping the financial system stable, as well as providing support to households and businesses.

On the fiscal front, the New Zealand government had planned for a package which originally cost NZD 12.1 billion, equivalent to around 4% of New Zealand's annual GDP. At this point, the overall size of the fiscal measures amounted up to approximately NZD 22.1 billion (7.1% of GDP). Recently on 14th May, the government has further unveiled a record NZD 50 billion COVID-19 Response and Recovery Fund in its Budget 2020 to be used over a 4-years forecast period, of which NZD 30 billion has already been allocated to this year. The bulk of the package is to support businesses and jobs such as the wage subsidy scheme, as well as increased social benefits payments (Figure 164).

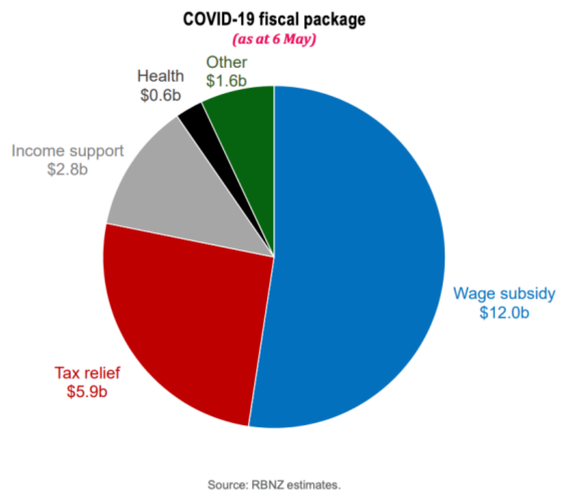

Figure 164: Breakdown of New Zealand's COVID-19 Fiscal Package (*Source: RBNZ Estimates*)

On the monetary front, RBNZ made an emergency official cash rate (OCR) cut on 15th March by slashing 75 basis points to 0.25%, from 1%, and was committed to maintaining the OCR for at least 12 months. According to RBNZ Governor Adrian Orr, the negative economic impacts of the COVID-19 pandemic have continued to rise, thus warranting further monetary stimulus. This was required in order in order to achieve the goals of price stability and maximum sustainable employment. Besides that, additional monetary tools were also said to be best suited to provide additional stimulus. Hence on 20th March, the

RBNZ announced measures to supply banks with more liquidity through both foreign exchange swaps and the reinstated Term Auction Facility, which offers banks term funding of up to one year against a range of collateral. This was closely followed by quantitative easing through the announcement of a Large-Scale Asset Purchase (LSAP) program of New Zealand government bonds on 22nd March. The RBNZ was set to purchase NZD 30 billion worth of government bonds over the secondary market in the next 12 months initially, but this figure was upwardly revised to NZD 60 billion and the scope of asset purchase was expanded to include the government inflation-indexed bonds. The LSAP program supports RBNZ's employment and inflation objectives by lowering interest rates, lowering the NZD exchange rate and increasing inflation expectations. It has since managed to successfully lower interest rates on government bonds by 80 to 100 basis points, through the purchase of NZD 10 million of government bonds (Figure 165). Given that the size of the LSAP program needs to be sufficiently large to keep interest rates lower across the yield curve, we expect that there will be room for scaling up the LSAP program in the months to come.

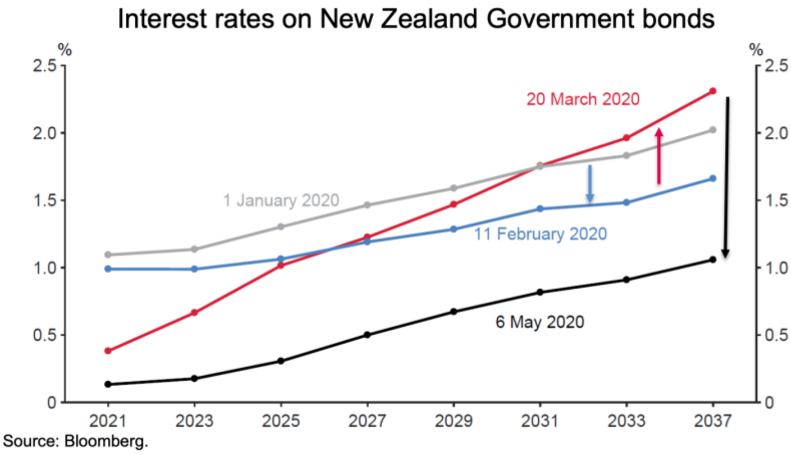

Figure 165: Effect of LSAP on Interest Rates (*Source: Bloomberg*)

However, its effect has not yet seen full pass through retail rates as fixed mortgage rates have fallen only 20 to 30 basis points (Figure 166). As such, there has been pressure on retail banks by RBNZ to lower the mortgage rate, so that the monetary stimulus can be transmitted to the public via lower borrowing costs, which should encourage spending and help to prop up the housing market.

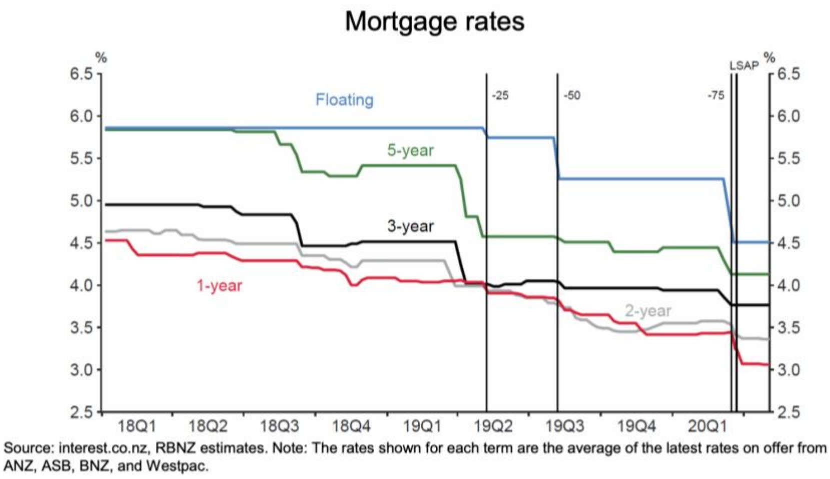

Figure 166: Effects of LSAP on Mortgage Rates (*Source: RBNZ Estimates*)

Apart from its monetary policy, the RBNZ has also postponed the start date of the increased capital requirements for banks initially planned for 1st April by 12 months, to 1st July 2021. To facilitate increased lending, the RBNZ has also reduced the bank's core funding ratios from 75% of assets to 50%. It has also decided to remove mortgage loan-to-value ratio (LVR) restrictions for 12 months starting 1st May.

However, RBNZ has warned that the COVID-19 pandemic presents a significant challenge to the country's financial institutions, which may be stressed by failing businesses or loan defaults. In the semi-annual Financial Stability Report, the central bank cautioned that while the financial system entered the crisis in a good shape, "its capacity to absorb losses is not unlimited" and banks' capital position could come under stress if this economic downturn prolonged. The Monetary Policy Committee is prepared to provide additional stimulus if necessary, including the expansion of the LSAP programme after adequate assessment of its pros and cons, according to the policy committee.

A Trade-Off: Beating the Virus vs Economic Growth

The island nation's lofty goal of elimination is not without critics, who say it is unrealistic and comes at a devastating cost. While New Zealand has been so successful at flattening the curve, its borders will still have to remain closed to much of the world for a considerable period to keep the virus out. That will decimate the tourism industry, its largest source of foreign exchange earnings. Fundamentally, the strict lockdown and disruption have raised alarm over the health of the New Zealand economy. According to the Treasury, New Zealand is likely to see a deeper economic contraction in the June quarter than what has been previously seen in the recorded history. Its economy was already slowing in 4Q2019, with GDP expanding at 0.5% in the December quarter, bringing annual growth to 1.8%, slowing from 2.3% in the prior quarter. This shows that the New Zealand economy was struggling even before the COVID-19 outbreak. To make matters worse, the growth in the December period was led by 0.6% expansion in service industries, something that does not bode well given that services will likely be hammered from the spread of COVID-19.

Compared to Australia, who have managed to get her virus cases down to similarly low numbers in relative terms, New Zealand's future economy is poised to be almost twice as grim as Australia because it has chosen to use a harsher approach in combating the virus. The inability for most people to trade or engage in business activities or household spending has drastically affected the economic activities of New Zealand, sending its gross domestic product (GDP) southwards. The economy has contracted 1.6% in 1Q2020 and economists expect a contraction of as much as 20% in 2Q2020, sending the island nation to recession for the first time in 2010. This reflects both the immediate shock and the more prolonged damage to key industries such as tourism, where job losses are mounting. Accommodation and food services, as well as construction, are also amongst the most heavily affected industries (Figure 167). This disruption ripples back through their supply chains, partially impacting manufacturing, retail and wholesale trade.

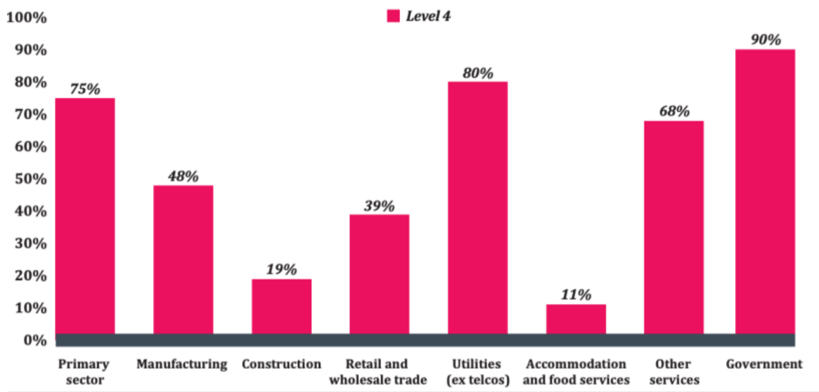

Figure 167: GDP By Industry During Lockdown, As Percentage of Its Pre-COVID Level (*Source: RBNZ*)

With activity levels fallen sharply, it is expected that inflation and employment levels are reduced below the bank's objectives for years. The annual inflation is projected to briefly dip below zero next year, reflecting lower fuel prices and recession, and will likely remain under the Bank's 1-3% target bank until mid-2022 (Figure 168).

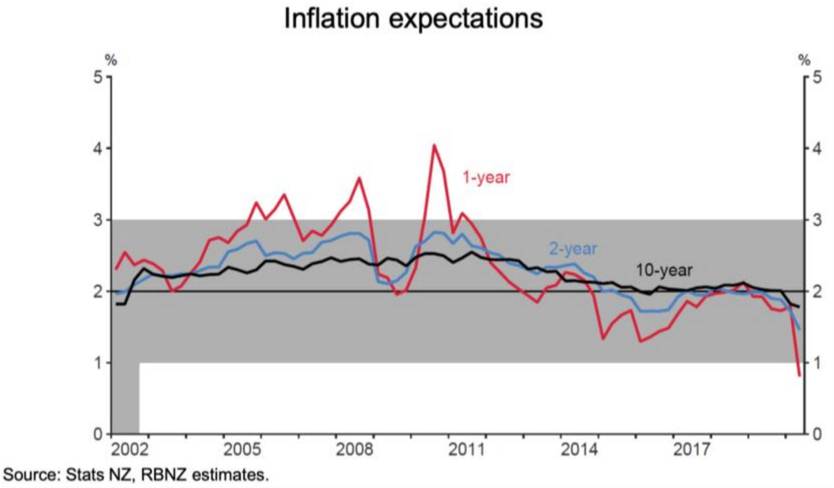

Figure 168: New Zealand Inflation Expectations (*Source: Stats NZ, RBNZ Estimates*)

With regards to New Zealand's suffering economy, while RBNZ has reaffirmed its forward guidance for the cash rate to remain at 0.25% until early 2021, it said that negative rates "will become an option in future." This unprecedented prospect of a shift to negative interest rates comes as investors are increasingly considering the possibility of other central banks to do the same amid falling consumer prices. As such, investors have started to price in a 100% chance of rate cuts for early 2021. We feel that the decision of negative interest rate should be threaded on carefully as negative interest rates often bring more harm than good. The idea of negative interest rate will also signal a sharp turnaround for the kiwi and investment-grade New Zealand bond market, both of which have been classic 'carry' trade, where investors borrow in low-yielding currencies such as the yen or the euro for riskier yet high yielding assets. Therefore, we continue to hold the view that quantitative easing and fiscal stimulus are more effective measures, and at the same time protect New Zealand's bond market scene.

Looking at the brighter picture, New Zealand has completely relaxed its lockdown restrictions. New Zealand's severe lockdown started its relaxation on 28th April as the containment moved to Level 3, where people were still required to stay home unless for essential activities, but it allowed for the reconnection with close family members etc. On 14th May, containment moved to Level 2, which allowed people to go out in groups limited to 10 people while social distancing rules remained in place. Schools and bars have also opened on 18th May and 21st May respectively. By 8th June, Ardern had announced moving back to Level 1. This meant that life in New Zealand has gone back to pre-Covid standards, with a few exceptions, largely related to border closure and contact tracing. Most businesses will open, groups of any size are allowed to gather for public and private events, while public transportation and domestic travel are once again fully open and operational.

While the economic hit may be worse up front, we feel there remains a slight possibility of GDP increasing in 3Q2020 because of the implemented policies, and business activities can resume sooner, and consumption may pick up in 2H2020. However, we believe that the negative impact on the New Zealand economy will continue to be significant, given the high unemployment levels and closed international borders. Soft domestic demand is likely to persist into 2021, due to job losses, lower wage growth, and fewer hours which are likely to reduce household income. Elevated uncertainty about future economic conditions may also encourage some form of precautionary saving. Therefore, there still remains large downside risks to New Zealand's GDP.

New Zealand's Rising Unemployment

Finance Minister Grant Robertson mentioned that the impact of the COVID-19 on jobs would be "significantly worse" than the global financial crisis. With border closures that will decimate the tourism industry, the nation's largest earner of foreign exchange, and a nation lockdown which forced many businesses to close down and make workers redundant, New Zealand is expected to see a surge in its unemployment rate for 1H2020. Coupled to the fact that the global economy has weakened significantly, this inevitably constrained the demand for New Zealand's goods and services and its domestic production.

New Zealand's jobless rate rose, and wage growth slowed in 1Q2020 as the COVID-19 pandemic started to push the economy towards recession. The jobless rate climbed to 4.2% from 4% in 4Q2019, according to Statistics New Zealand (Figure 169). The Labour Cost Index for non-government workers also increased by 0.3% in the quarter, slowing from 0.6% in the previous three months. Unemployment benefit claims have soared, and many business hiring intentions have slumped, suggesting the jobless rate may rise towards 10% over the course of 2020.

Figure 169: New Zealand's Unemployment Rate (*Source: Stats NZ*)

To combat the surge in unemployment, New Zealand unveiled a record NZD 50 billion fund in its budget on 14th May to restore the economy but warned that it may not be enough to stop thousands from losing jobs and businesses shutting. According to Ardern, this package is described as a 'jobs' budget, with its priority focused on stopping massive unemployment and that the budget will be spent over a four-year forecast period. In this plan, the government introduced a 12-week wage subsidy to help cushion the initial impacts of the recession and has paid out NZD 10.6 billion to support about 1.7 million workers. It was estimated that this package would save 140,000 jobs over two years.

With job security taking a huge hit, many households are experiencing the associated losses in income, so consumer spending is expected to be curtailed by a large extent (Figure 170). Uncertainty around future employment and incomes will lead some households to reduce their spending and save money as a precaution. We believe that the ability for consumers spending to increase hinges on the effectiveness of the government's fiscal stimulus package, as well as consumers' confidence in the global outlook. In the near future, we expect consumer and business spending to remain subdued, given the nation is just starting to reboot its economy from a recession.

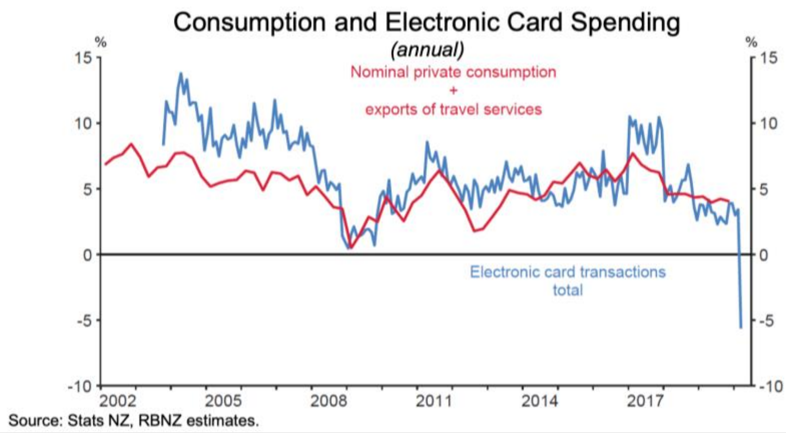

Figure 170: Consumption and Electronic Card Spending (*Source: Stats NZ, RBNZ Estimates*)

New Zealand's Trade Balance Threatened by Strict Lockdown

As a small open economy with open capital markets, global conditions are a major driver of economic conditions in New Zealand. Growth slowdown is broad-based across New Zealand's main trading partners (Figure 171) and with weak economic conditions abroad, it will reduce export income through lower export volumes and lower prices. Disruption to trading-partner economic activity is expected to be at its worst in 2Q2020, except for China where the large impact was seen in 1Q2020, hence we expect it to have a drag on domestic activity.

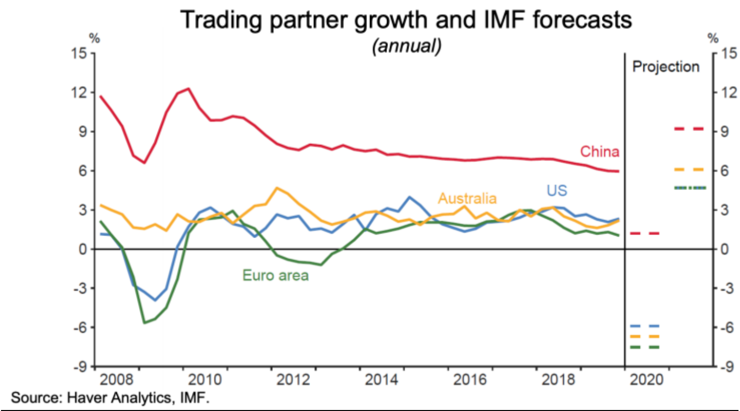

Figure 171: New Zealand's Trading Partner Growth and IMF Forecasts (*Source: Haver Analytics, IMF*)

China is New Zealand's largest trading partner. With China opening up its economy in the past few months, we believe that New Zealand stands to benefit from increasing export goods.

Unfortunately, New Zealand's export and import services will take a backseat this year. International tourism, New Zealand's largest export sector, accounts for around 20% of New Zealand's exports in 2019. However, tourist arrivals have fallen to zero after dropping sharply in March, along with a loss of international students. Tourists who have remained in New Zealand have also spent less because of domestic containment measures.

As a result, the tourism and education sectors have been badly hit.

Looking Ahead of New Zealand's Economy

As the New Zealand economy opened up, investors are beginning to feel optimistic (Figure 172). Low-interest rates have also continued to support the benchmark index, signalling that the economy could be gradually heading northwards.

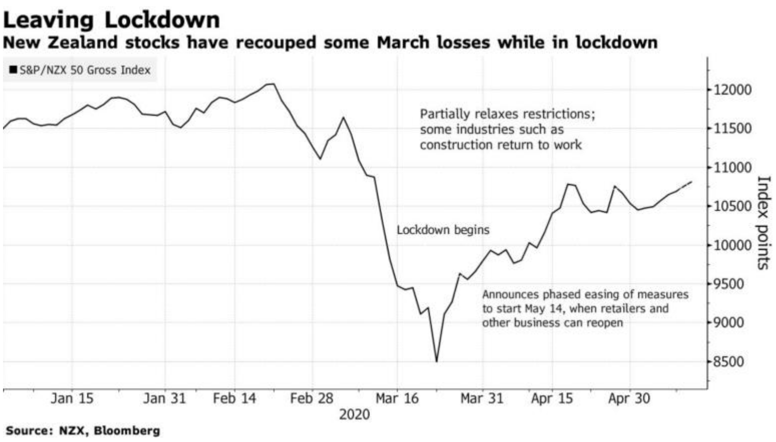

Figure 172: S&P/NZX 50 Gross Index (*Source: Bloomberg*)

Additionally, with a trans-Tasman travel 'bubble' being planned to allow quarantine-free travel between Australia and New Zealand, it represents a head start in the long process of restoring normality for both nations after weeks of extended lockdown measures. By allowing tourists from nearby countries which have managed to contain the virus, it will help New Zealand reboot its trillion-dollar international tourism industry, which is poised for its worst performance since 1950.

The rate of recovery is also dependent on the amount of fiscal stimulus that is being pumped into the economy, and how long will those fiscal stimuli be in place. Additionally, without a vaccine, the chances of a full recovery remain remote. We are hopeful for a U-shape recovery for New Zealand, though we are still cautious about the second wave of infection as New Zealand is not immune to the virus yet. Overall, we remain underweight on New Zealand's economy as the COVID-19 pandemic has caused a severe global economic disruption that could have persisting long-term effects.

FX TRADE IDEA: LONG NZDUSD

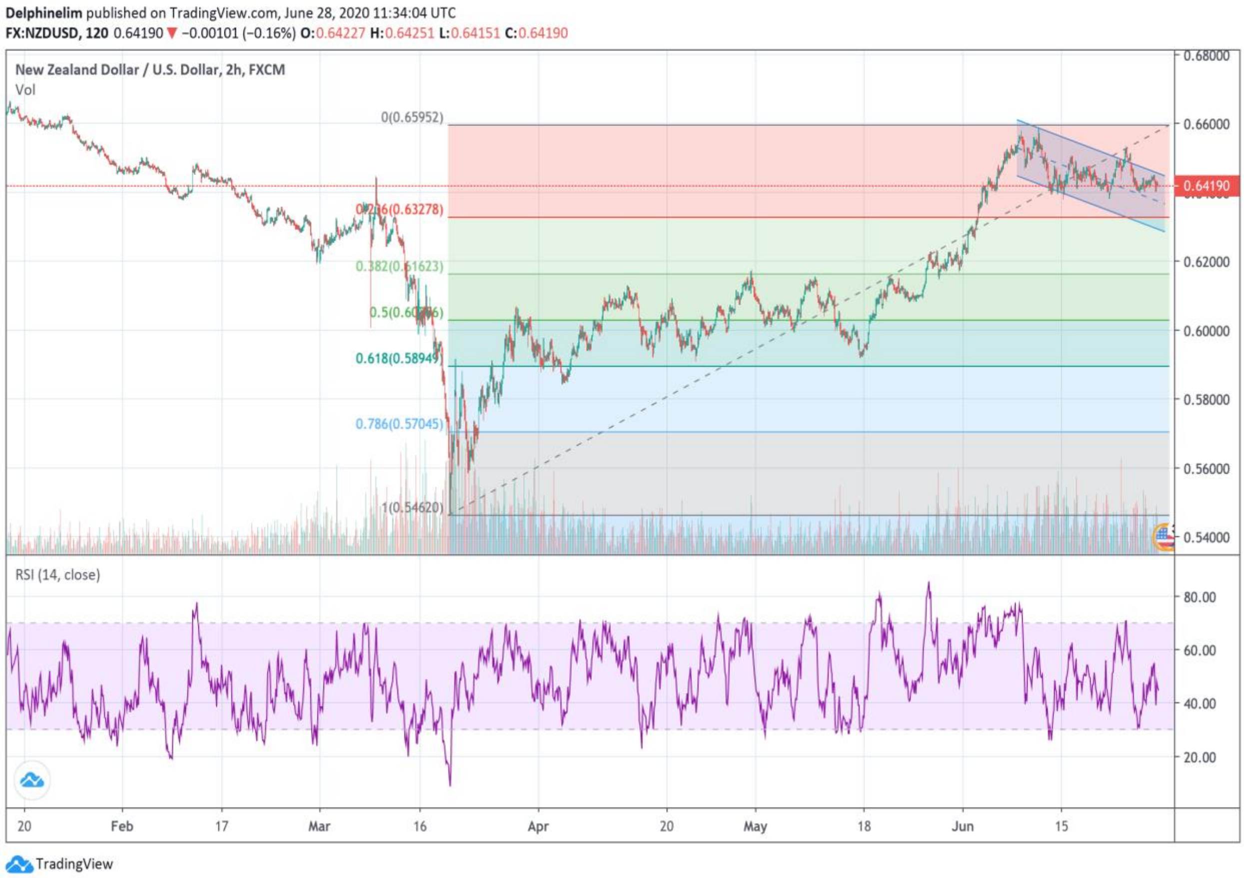

Figure 173: NZDUSD 2-Hourly Chart (*Source: TradingView*)

Entry: 0.6419
Take profit: 0.660
Stop loss: 0.6328
Risk to reward ratio: 2

At the peak of the COVID-19 outbreak, the New Zealand dollar has depreciated against most major currencies, as market participants were moving to holding currencies that are perceived safer, such as the greenback. However, the tables have turned as the Kiwi dollar has been the best performing G10 currency so far this month, strengthening by 2.4% against the USD which helped to lift the NZDUSD currency pair to a recent high of 0.6584 on 10th June. The initial COVID-19 related sell off from March, when the pair hit a low of 0.5470, has also been fully reversed. On the fundamental analysis front, the Kiwi dollar has managed to rally strongly previously as its performance is tightly linked to the risk sentiments against USD. In addition, New Zealand was able to square the COVID-19 pandemic away before most other countries, enabling the economy to reopen earlier than others. Thus, for a long-term view, we expect strong demand for the Kiwi dollar to continue given the fact that it is a commodity currency that would typically perform well in a global economic upturn. However, for a short-term view, the NZDUSD currency pair may be vulnerable to setbacks due to a second wave of pandemic in many U.S. states, resulting in risk-off sentiments for risky assets.

From a technical analysis point of view, there is a formation of a bullish flag with consolidation taking place now (Figure 173), indicating a bullish signal. As such, we are long on NZDUSD as we believe the upward momentum will continue after the consolidation. Using fibonacci retracement, we are able to determine the stop loss level at 0.6328. We place the entry level at 0.6419 due to its strong support level and its take profit level at 0.660 because of the strong resistance level. Besides that, the RSI indicator is near the oversold territory, further anchoring our expectations of a bullish run for the NZDUSD currency pair.

Overall, with a 6-month view, we remain bullish on the NZDUSD currency pair.

CRUDE OIL (Neutral)

Crude oil is a fossil fuel that can be refined to produce a multitude of oil products including gasoline, diesel and petrochemicals. Given its nature as a commodity, its price is heavily influenced by supply and demand fundamentals. While the Coronavirus Disease 2019 (COVID-19) has taken its toll on financial markets, oil has inevitably been the greatest victim of this epidemic. Not only has the energy market suffered a plummet in demand as a result of extended lockdowns, but it was practically blindsided by the breakdown of the OPEC+ coalition after their March meeting.

Riding the Bull into the New Year

In our previous outlook in December 2019, we were moderately bullish on the back of the U.S.-China Phase 1 deal and the deepening in OPEC+ production cuts agreed upon during their December gathering. The market was also supported by an increase in pipeline capacity - relieving a market overhang in Cushing, Oklahoma, and in the Permian Basin, a slowdown in the U.S. shale boom - abating the battle for market share between OPEC and the U.S., and the official implementation of the new International Maritime Organisation (IMO) 2020 regulation which mandated a 0.50% sulphur cap on marine fuel oil - proving a much-needed boost to a sluggish global oil demand.

We managed to hit the take profit level in our recommended trade idea when prices roofed on the first Friday of January (Figure 174). The prompt WTI contract for February delivery traded at an intraday high of USD 64.09/bbl and closed at USD 63.05/bbl. Despite the aforementioned fundamental factors at play, the surge was largely a consequence of the assassination of the Iranian General Qassem Soleimani by a Pentagon-led drone strike in Baghdad.

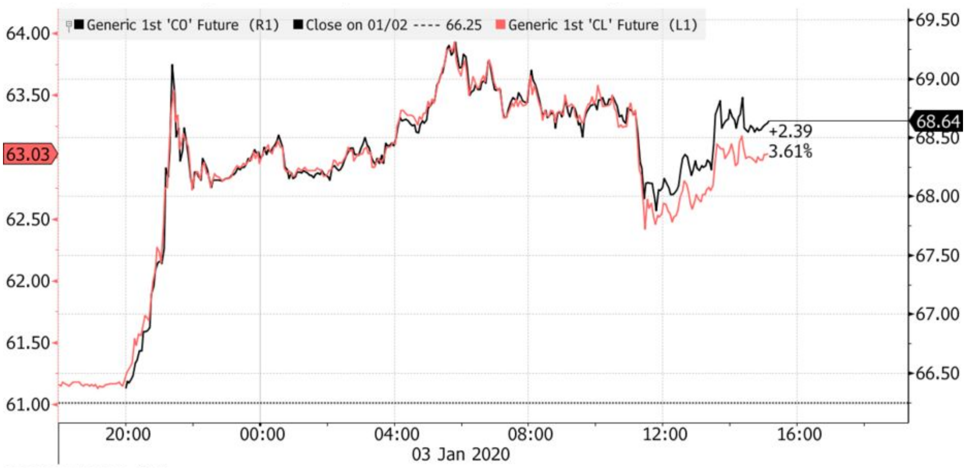

Figure 174: Brent and WTI Intraday Prices on 3rd January 2020 (*Sources: Bloomberg, NYMEX, ICE*)

On the proceeding Wednesday, Iran retaliated with missile attacks on two Iraqi military bases where U.S. troops were stationed, which drove oil prices higher as the market continued to price in a risk premium. However once Trump released a statement that Tehran's attacks did not harm any troops and caused minimal damage on the same day, prices fell sharply below pre-attack levels. This series of events reaffirmed our sentiment, as mentioned in our previous outlook, that the impact of the Persian-Gulf crisis should be increasingly muted in the near term.

Contango Term Structure

Despite the bullish start to the year, the backwardation structures for Brent and WTI flattened in January and flipped into contango territory in February before further widening in March. We saw global oil demand collapse during April when the world went into lockdown to combat the spread of the COVID-19 pandemic. Refinery run cuts and a rapid increase in crude oil stocks, particularly in Cushing, Oklahoma, weighed heavily on prompt prices and exacerbated the move steeper.

May marked a significant recovery in oil prices on the back of stronger fundamentals which tightened the contango structure. As the latest OPEC+ production cuts began taking its course and U.S. oil rigs continued to fall, the market overhang was slightly alleviated from the supply side. Global oil demand seemed to pick up as well with some cities opening up again. Chinese refinery runs also rebounded back to almost pre-lockdown levels, signifying a bright spot for the market.

June saw glimpses of a bullish reversal as the front-month contracts for the pricing benchmarks flipped into backwardation during a few trading sessions. Nevertheless, the market sentiment has evolved away from concerns of negative crude prices due to storage constraints and is now pricing a relatively flat contango structure.

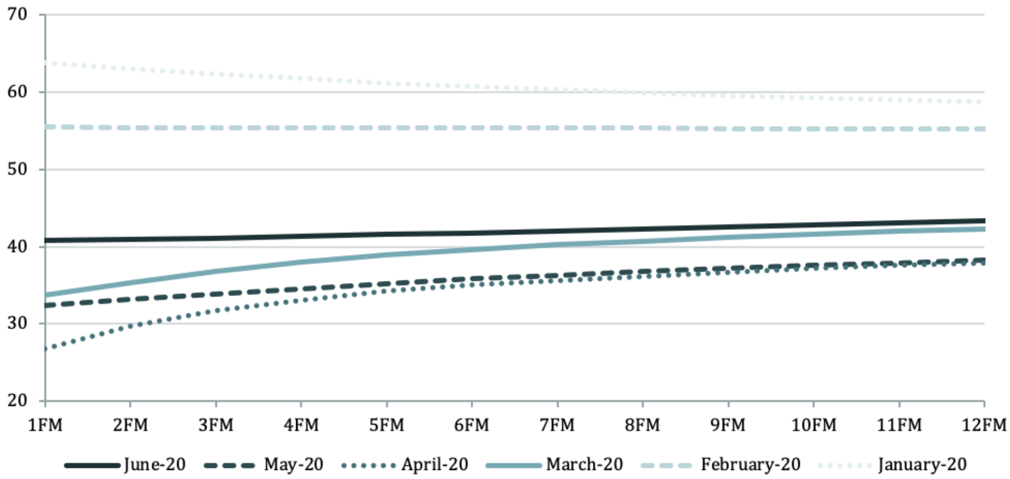

Figure 175: Monthly Average Brent Forward Curves (*Sources: ICE, NUS Investment Society*)

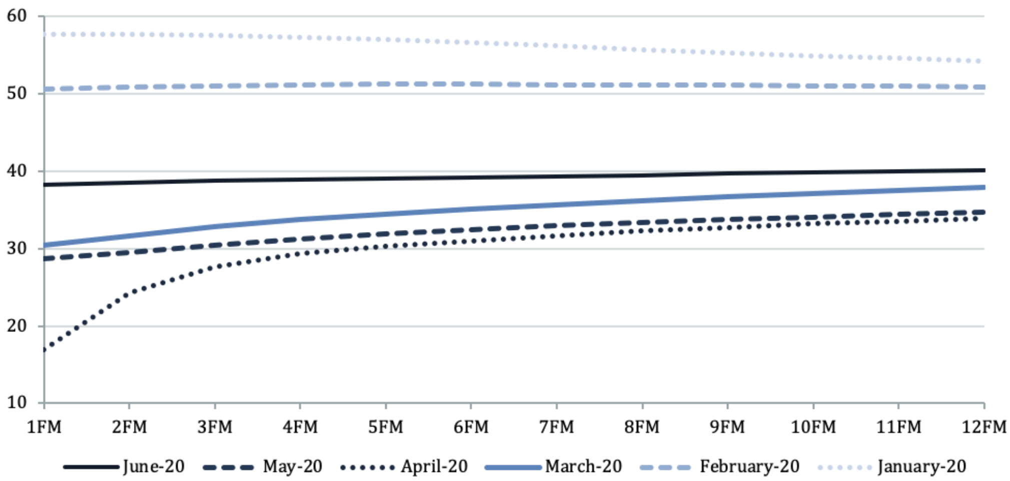

Figure 176: Monthly Average WTI Forward Curves (*Sources: NYMEX, NUS Investment Society*)

Historic OPEC+ Deal to End Saudi-Russia Price War

During the group's meeting on 6th March 2020, Russian Energy Minister, Alexander Novak, refused Saudi Arabia's proposal to prolong and deepen production cuts by another 1.5MMBD. The Kremlin's decision ultimately upended the OPEC+ alliance that has underpinned the oil market for the past three years and signalled the beginning of a month-long price war between Russia and Saudi Arabia, OPEC's de facto leader. The double whammy from the COVID-19 pandemic and the dramatic breakdown of the OPEC+ coalition spooked global markets and inevitably sent oil into a downward spiral.

Saudi Arabia immediately took the offensive by making the deepest cuts to its official selling prices (OSPs) - monthly prices provided by the producers in the Gulf for their crude grades to refiners - in at least 20 years. On the Saturday after the meeting, we witnessed Aramco slashing most OSPs for April by USD 6-8/bbl across all regions (Figure 177) in a bid to entice refiners. Riyadh's decision resonates beyond its borders as other producers in the region often mirror the kingdom's pricing and effectively affects about 14MMBD of oil exports. The kingdom followed up with threats to ramp up production to record levels well above 10MMBD once the previous pact ended at the end of March. Oil prices nosedived the following Monday by another 25% after the 10% plunge on Friday.

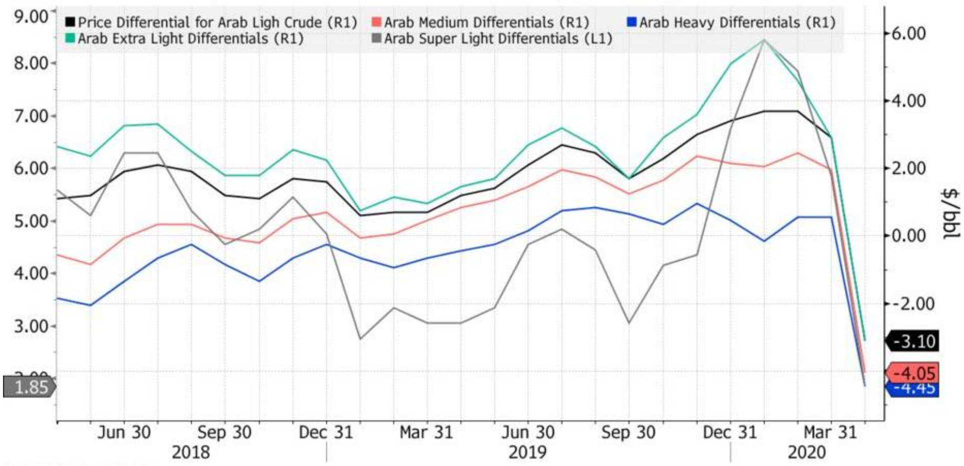

Figure 177: Price Differentials for Arab Crude to Asia (*Source: Bloomberg*)

Unfortunately, the U.S. fell victim to the affairs of OPEC+ despite being an outsider. Cheap crude benefits American consumers, especially when the economy is in dire need for a prompt rebound after the pandemic fades, but it is a double-edged sword as the domestic oil industry, responsible for 10.9 million jobs, requires prices to be high enough to remain afloat. According to the Federal Reserve Bank of Kansas City, almost 40% of U.S. producers face insolvency within the year if prices remain near USD 30/bbl. With the much higher cost of production in the U.S. compared to Saudi Arabia, due to geological differences, Trump was forced to broker a deal between Saudi Arabia's Crown Prince Mohammed bin Salman and Russia's President Vladimir Putin.

The OPEC+ alliance eventually agreed to a historic deal on 13th April 2020 to slash output by 9.7MMBD, nearly 10% of global supply, in May and June. The cuts will ease in July through December to 7.7MMBD, and then further to 5.8MMBD until the end of April 2022. Russia pledged to cut 2MMBD from a February 2020 baseline, capping production at 8.5MMBD. Saudi Arabia is responsible to slash production by 3.8MMBD to 8.492MMBD.

Oil producers in the G-20 were also involved in this fresh round of discussions. The U.S., Brazil and Canada will reduce supply by 3.7MMBD, while other G-20 states will contribute 1.3MMBD. Even though these measures should not be viewed in the same light as the immediate cuts promised by the cartel, we believe that it was remarkable to witness the rest of the world in solidarity with the coalition.

Russian Oil Leading the Charge in the Second Cold War

While the Saudi-Russia price war is indicative of an internal rift in OPEC+, we believe that the dispute serves as a front for the larger narrative that Russia is a part of - an ongoing Second Cold War against the U.S. Washington has held the energy sector over Moscow's head multiple times in the past few years. Nord Stream 2 - a pipeline project connecting Russian gas to Germany via the Baltic Sea - was delayed to spring 2021 from the initially planned mid 2020 as a result of U.S. sanctions imposed back in 2017. The Trump administration also sanctioned a unit of Russia's largest oil producer, Rosneft, in February 2020 for maintaining ties with Venezuela's Nicolas Maduro and state-run oil company PDVSA. Rosneft was discovered handling over half the oil coming from Venezuela and helping the country evade sanctions via ship-to-ship transfers. Igor Senchin, Rosneft's Chief Executive Officer and one of Vladimir Putin's closest allies, has also consistently voiced his concerns over Russia's role in OPEC+. Senchin strongly believes the OPEC+ agreement threatens the Russian oil industry while helping the U.S. increase their market share. Therefore, we see Moscow's willingness to sacrifice OPEC+ as an assertion of its dominance over Washington, by forcing U.S. shale producers to share the pain.

The Trump administration is reportedly considering additional sanctions on Nord Stream 2, according to the outgoing U.S. Ambassador to Germany, Richard Grenell. Options being discussed include threatening trade tariffs on companies assisting the Russian gas giant, Gazprom, with the project, and imposing sanctions on their buyers. Given that Gazprom has vowed to complete the project on its own, Washington will need to directly impose sanctions on them. Washington has previously resisted similar sanctions on Rosneft, Gazprom's oil-producing equivalent, over concerns that the move might rattle the global crude market.

As the saying goes, "the enemy of my enemy is my friend", the Sino-Russian relationship is blossoming amidst the re-escalations in the U.S.-China trade war. Russia overtaking Saudi Arabia as the top crude oil supplier to China in April 2020 pays testament to their trade relations. Russian oil imports averaged 1.75MMBD (Figure 178), compared to 1.66MMBD in March, versus average Saudi oil imports of 1.26MMBD, compared to 1.7MMBD in March. Chinese intake of Russian crude was 18% higher YoY in April and 31% higher YoY in March. Apart from the obvious economic ties, led by close cooperation in the energy sector, Russia and China appear to be consorting on political and military fronts as well. Notwithstanding the earlier mentioned fears of shocking the energy market, we reckon that further escalations between Washington and Moscow is plausible, on the back of warm Sino-Russian ties posing significant challenges to U.S. interests. This could potentially lead to a supply constraint in the near term and a significant tailwind needed to boost the market.

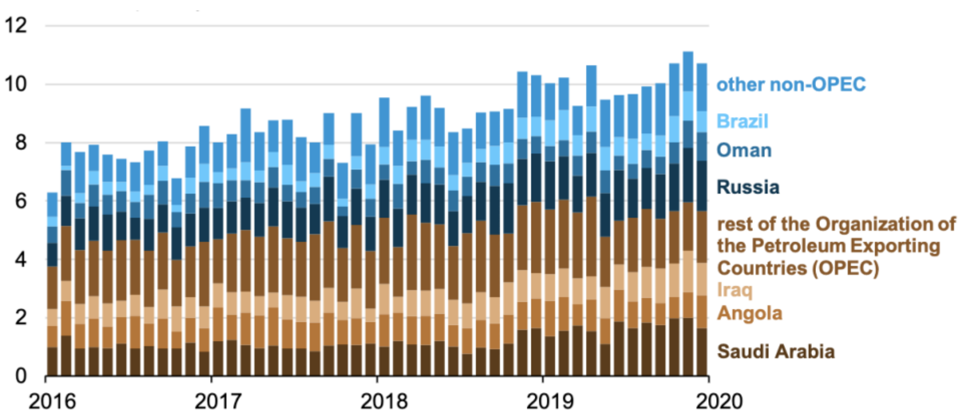

Figure 178: China Monthly Crude Oil Imports by Source (*Source: China General Administration of Customs*)

U.S. Shale Boom Finally Stopped in its Tracks

The number of U.S. oil rigs dropped to 188 units in the week ending 26th June 2020 (Figure 179). The Baker Hughes oil rig count has fallen for 15 consecutive weeks, suggesting that future U.S. crude output will continue to decline. The recent plunge comes from this year's peak in mid-March of 683 active units. The lowest number during the 2010s oil glut was 316 at the end of May 2016, and this previous record was broken at the start of May. However, the dive in the number of rigs is showing signs of slowing down, given that June ended with a 11.5% MoM decrease compared to May's 35.6% MoM decline. Of note, the rig count in the all-important Permian Basin has fallen by 70.3% YoY. and 32.4% MoM to an unprecedented 131 units.

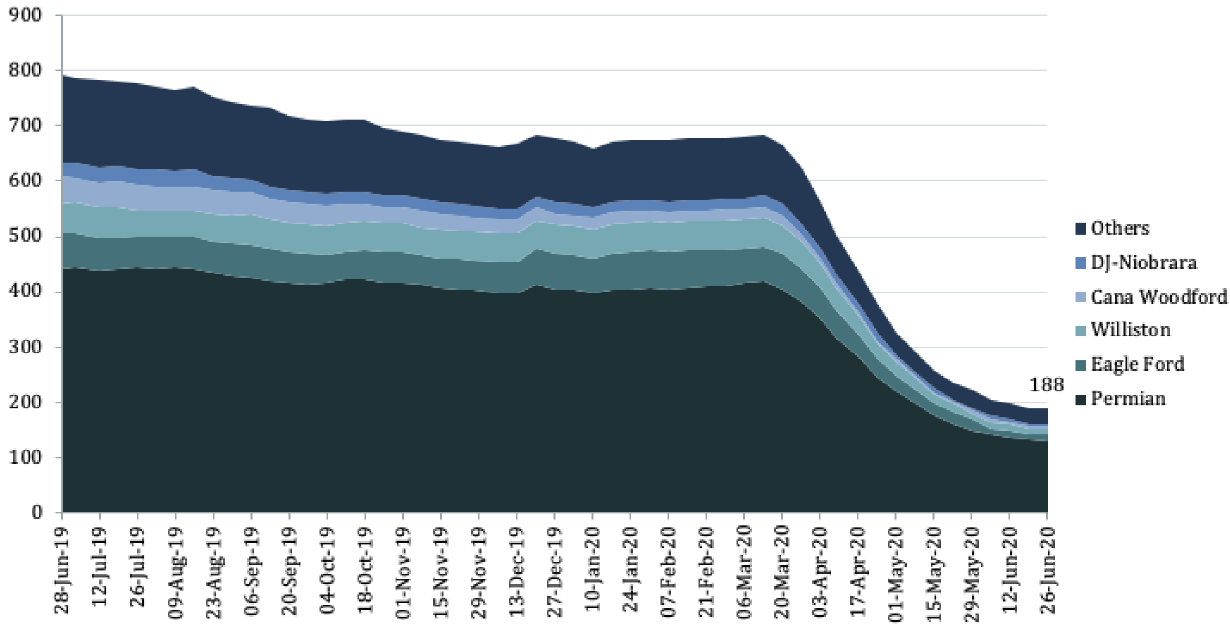

Figure 179: Weekly U.S. Oil Rig Count (*Sources: Baker Hughes, NUS Investment Society*)

The sharp fall in oil rigs has definitely lent support to the market as evidenced by the tanking U.S. crude production since the beginning of April 2020. In the week ending 19th June 2020, the Energy Information Administration (EIA) estimated that weekly crude production stood at 11MMBD and was down -9.1% YoY. We expect production growth to continue being suppressed into early 2021 even as the decrease in rigs plateaus.

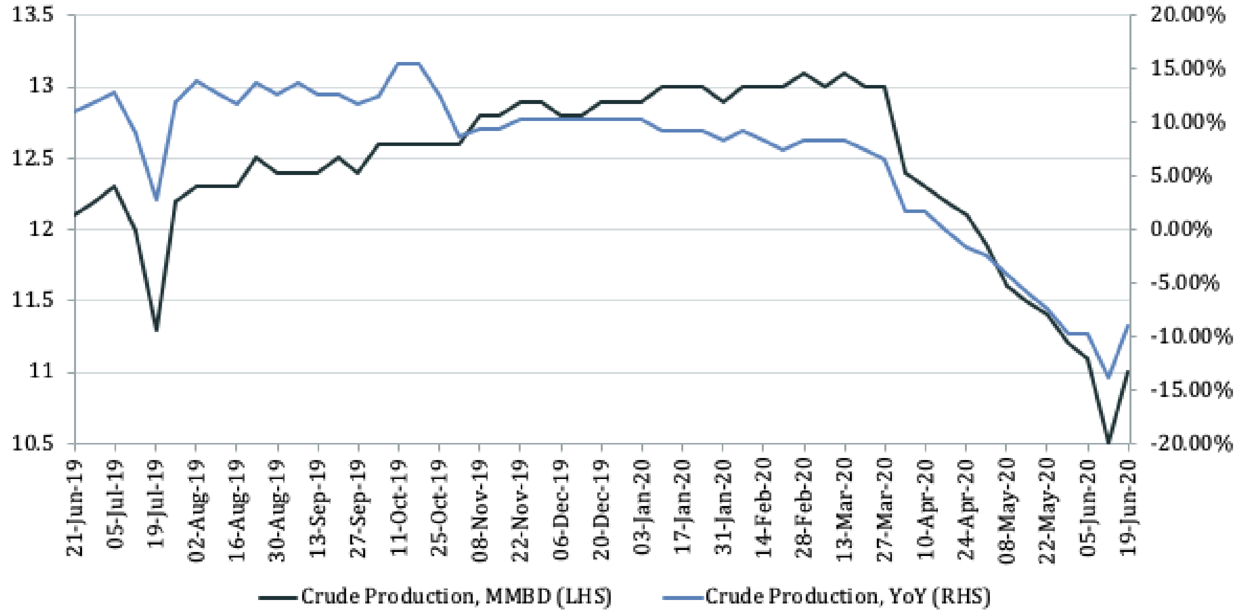

Figure 180: Weekly U.S. Crude Production (*Sources: EIA, NUS Investment Society*)

Even though discussions for the Texas Railroad Commission to limit oil production did not come to fruition, market forces have reduced output at a rate faster than an official mandate could. Most producers have cut their capital budgets by more than 25%, and oil majors ExxonMobil and Chevron are no exception. ExxonMobil reported that it will sideline three quarters of its Permian drilling rigs, while Chevron indicated that it will reduce output by 0.125MMBD from its previous guidance. ConocoPhillips announced the biggest output cut by a U.S. producer for 0.225MMBD - nearly a fifth of its total capacity - and reduced their capital budget by 35%. Permian Basin producers Parsley Energy and Centennial Resources Development have curtailed near term production and slashed capital expenditure for 2020 by 60% to mere maintenance levels. Occidental Petroleum has reported its plans to reduce 2020 capital spending to USD 3.5-3.7 billion from its previous guidance of USD 5.2-5.4 billion.

A report from Deloitte released in June stressed that the U.S. shale sector had already been losing money on average before the pandemic as a result of extensive price swings and loss of capital from Wall Street investors. According to Deloitte, the industry could write down the value of its assets by as much as USD 300 billion, given that approximately 30% of shale operators face insolvency if WTI prices stagnate at USD 35/bbl or lower. Whiting Petroleum's and Chesapeake Energy's Chapter 11 protection filing, in April and June respectively, are clear indicators of the demise in the country's energy industry.

With energy companies focusing on slashing spending to conserve cash, investments in large-scale exploration and production projects should remain dormant through 2021. Our team foresees drilling activities kept to a minimum for the remainder of the year, until the market sees a firm rebound in demand for crude and refined products, and is a significant tailwind needed for a rebound back to pre-COVID-19 prices.

The midstream oil sector in the U.S. is also echoing the shifts in capital spending and cash preservation by its upstream counterparts. Project timelines for numerous crude pipelines have been delayed beyond 2020 or indefinitely, including Plains All American's and MPLX's Capline Pipeline reversal, Energy Transfer's Dakota Access Pipeline expansion, and Phillips 66's Liberty, Red Oak and ACE pipelines. The necessity to adjourn developments in the midstream sector is a clear indicator the country is currently oversupplied unless producers continue to suppress output.

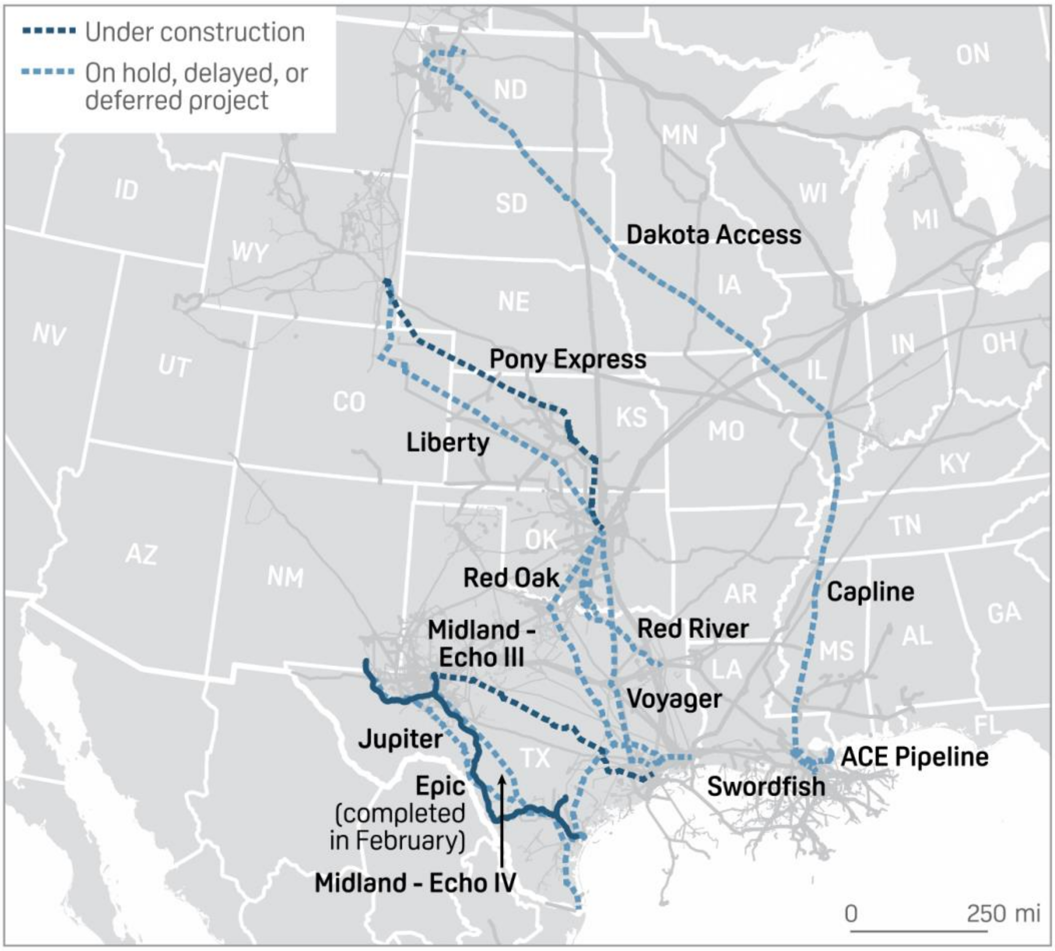

Figure 181: U.S. Crude Oil Midstream Projects (*Source: S&P Global Platts*)

The Future of OPEC+ Supply Cuts

The issue of compliance has been a central argument used by critics against the effectiveness of OPEC+ production cuts. Russia's far-from-perfect track record in adhering with past agreements has left many analysts expecting a similarly lacklustre performance for the new deal signed in April. Contrary to the consensus, production data from Reuters' sources revealed that the Kremlin has shown firm commitment this time around. Russia's crude oil production between 1st May and 19th May 2020 averaged 8.72MMBD - close to the agreed 8.5MMBD quota. Rosneft, which accounts for about 40% of Russia's output, has allegedly only limited oil flows to meet its quota. The oil giant is looking into "full shut-ins and long-term conservation of some of the highest-cost projects" within the next three months, according to the Chief Financial Officer, Pavel Fedorov.

In the coalition's meeting in June, OPEC+ agreed to an additional month of production cuts beyond the initial deal set in April. July output will be slashed by 9.6MMBD, 0.1MMBD lower than June with Mexico's supply constraints ending, compared to the previous agreement's 7.7MMBD curb beginning July to December. The group's Joint Ministerial Monitoring Committee led by Saudi Arabia and Russia will be meeting monthly to assess the supply-demand balance.

Most notably, a stern message regarding non-compliance underscored the ministerial video conference. The concept of compensation was introduced whereby any participating country that failed to achieve their promised quotas in May and June will be required to make up for their shortfall in July through September. While the recently concluded Saudi-Russia price war has beguiled Iraq, Nigeria and other laggards to express their commitment in conforming to their respective quotas, our team firmly believes that these nations will not be able to compensate entirely within the agreed timeframe. Achieving 100% of their pledged cuts by every OPEC+ member has been a rare phenomenon since the establishment of the cartel, and we remain unsympathetic going forward. However, we reckon that the compensation schedule is likely to be discussed and extended past September, thus extending support to supply fundamentals after production cuts taper in August for the rest of the cartel.

Iraq's desolate reality is worth highlighting, with the country ravaged by Middle East tensions, sectarian conflict, a proxy war between the U.S. and Iran, and not to mention COVID-19. Iraq has continuously drawn criticism for failing to adhere to its pledged cuts despite being OPEC's biggest producer after Saudi Arabia. Despite its non-compliance, Iraq has been hit harder by the slump in oil prices than other major producers with its annual budget forecasted to balloon to 22% of its gross domestic product (Figure 182). The country's economy is in shambles as evidenced by the government reportedly having to borrow IQD 3 trillion or USD 2.5 billion from local banks in May to cover salaries. With the nation remaining cash-strapped for the foreseeable future, Baghdad's commitment in fulfilling its OPEC+ responsibilities will be difficult. Mustafa al-Kadhimi's newly formed government in May 2020, after six months of political stalemate, will also risk backlash from politicians and critics for succumbing to foreign pressure. Nevertheless, Ihsan Abdul Jabbar, the latest oil minister appointed in June, has already requested international oil companies operating in Iraq to begin curbing production, including ExxonMobil and Lukoil. At the nation's biggest oil field of Rumaila, British Petroleum was instructed to reduce output by 10%. Even though compliance is in Iraq's best interest, we remain sceptical until we see affirmative results under Jabbar's leadership.

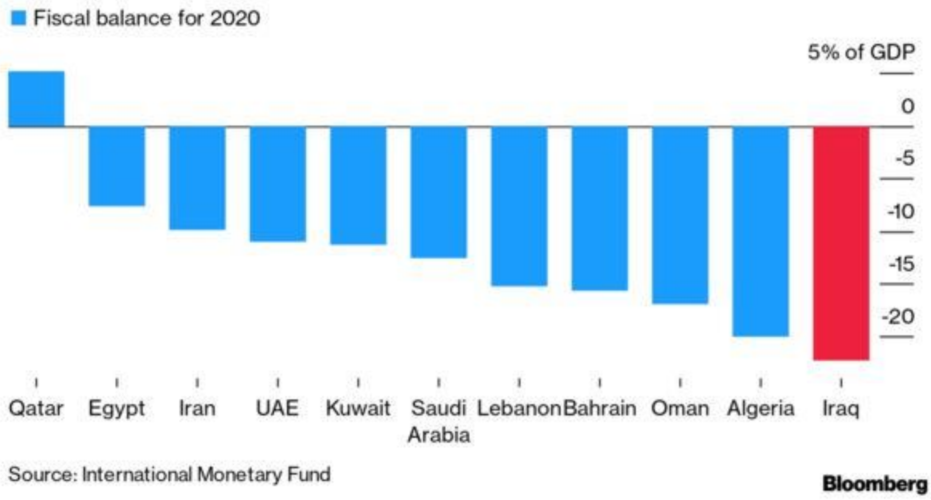

Figure 182: Fiscal Balances in Middle East and North Africa (*Sources: IMF, Bloomberg*)

Saudi Aramco has engaged in a voluntary reduction in June, by another 1MMBD, on top of their previously agreed 3.8MMBD cut. The kingdom's consistent over-compliance, as mentioned in our previous outlook in December 2019, has undeniably aided in propping up prices and especially in the recent rebound. The United Arab Emirates, Kuwait and Oman agreed to additional adjustments as well. Several countries, such as Norway and Canada, have also announced voluntary curtailments. We believe that such concerted efforts should provide some constructive reinforcement for the fragile oil market but is unlikely to lend substantial upside.

Long Road to Recovery for Oil Demand

Rebalancing supply and demand have become an exceptionally tricky affair in a global economy ravaged by the pandemic. While there have been flashes of optimism as the world begins to exit lockdowns, a significant recovery in demand has yet to be observed. The initial euphoria after lifting stay-at-home mandates has now been superseded by the reality of coexisting with COVID-19. The emergence of new clusters in the U.S., Beijing, South Korea and Germany are increasing worries for a second wave and might lead to reversals in reopening's. Evidently, the market is not out of the woods just yet. Gasoline is currently leading the charge for oil bulls, as driving becomes the primary socially distant transportation mode of choice. While diesel, commonly used for industrial power generation and freight transport, is lagging as the world tips into recession.

Chinese demand has been a key bright spot propelling the recovery in the crude oil market. With China being the first to experience the pandemic, the country is also the first to see it abate. The superpower is well poised for a V-shaped recovery amidst policy easing and abundant fiscal stimulus. Of note, China's crude oil imports from Saudi Arabia soared 94.9% YoY to 2.17MMBD in May as a result of the deep cuts in Aramco's OSPs for April exports. Inflows from Saudi Arabia are expected to remain high in June as OSPs for May-loading barrels were further cut. Total imports from the Middle East surged 57% YoY to 6.06MMBD and accounted for 53% of crude deliveries in May. U.S. crude deliveries into China started again in May after a suspension for 5 months, and we expect crude arrivals to increase on the back of renewed confidence in the Phase 1 trade deal that includes energy purchases. Kpler, a provider of cargo-tracking data, suggested that Chinese imports of U.S. crude will rise to 0.865MMBD in July from June's 0.118MMBD. Despite the optimistic sentiment, our team reckons that Chinese crude oil demand will decelerate on the back of rising crude oil prices. Reports from market participants revealed that Chinese refineries took advantage of ultra-cheap crude cargoes over April and May and are unlikely to extend the buying spree due to ample stocks. We also believe that poor refining margins, as a result of tepid refined products demand, should lead refiners to cut run rates and lower crude consumption. The fall turnaround season will also complicate the Chinese crude demand outlook into 3Q20.

Countries across the Arabian Gulf loosened controls and reopened businesses in May, during the Muslim holy month of Ramadan. In spite of the easing of restrictions, oil product inventories at Fujairah are lingering at levels during the peak of the COVID-19 lockdowns (Figure 183). Total stockpiles saw a build in June, averaging 30.4MMBBL compared to 28.3MMBBL in May. While the data seems to contradict the demand recovery narrative that oil bulls are preaching, our team believes that the disappointing numbers are premature. As a result of a rally in crude prices, refinery margins are now under pressure and as a result, we expect run cuts to sustain until inventories begin to dwindle. We also believe that the summer burning demand in full swing will help to drawdown residual fuels stockpiles, which include fuel oil used for power generation.

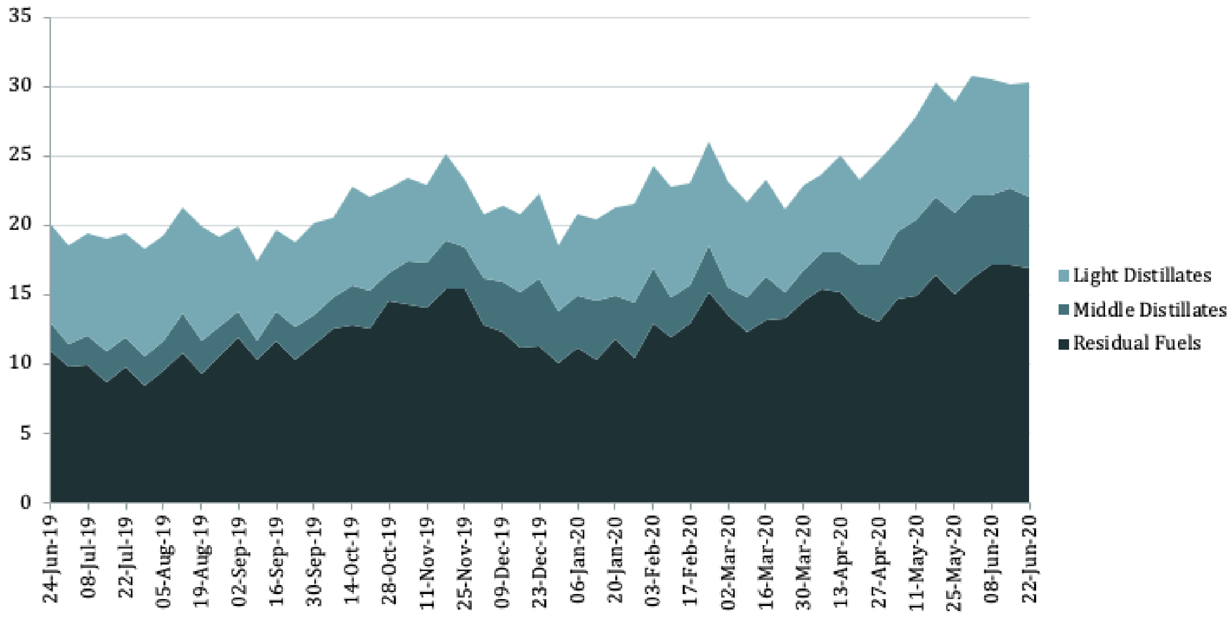

Figure 183: Weekly Fujairah Refined Product Stockpiles (*Sources: S&P Global Platts, NUS Investment Society*)

In contrast, the demand outlook in the U.S. is gloomy as fears of a resurgence in COVID-19 cases has left refiners increasingly cautious of returning to pre-pandemic levels. As a growing number of states are pausing plans to reopen or backtracking, determining the recovery in product demand has been complex. Soft cracking margins are also muddling this process for refiners. While refinery utilisation rates in the U.S. has increased to 75.5% at the end of June from 67.6% in mid-April, it is still a far cry from 94.2% in the same period last year. The predicament is clearly reflected in the crude oil stocks rising to a new record of 540.7MMBBL in the week ending 19th June 2020 (Figure 184).

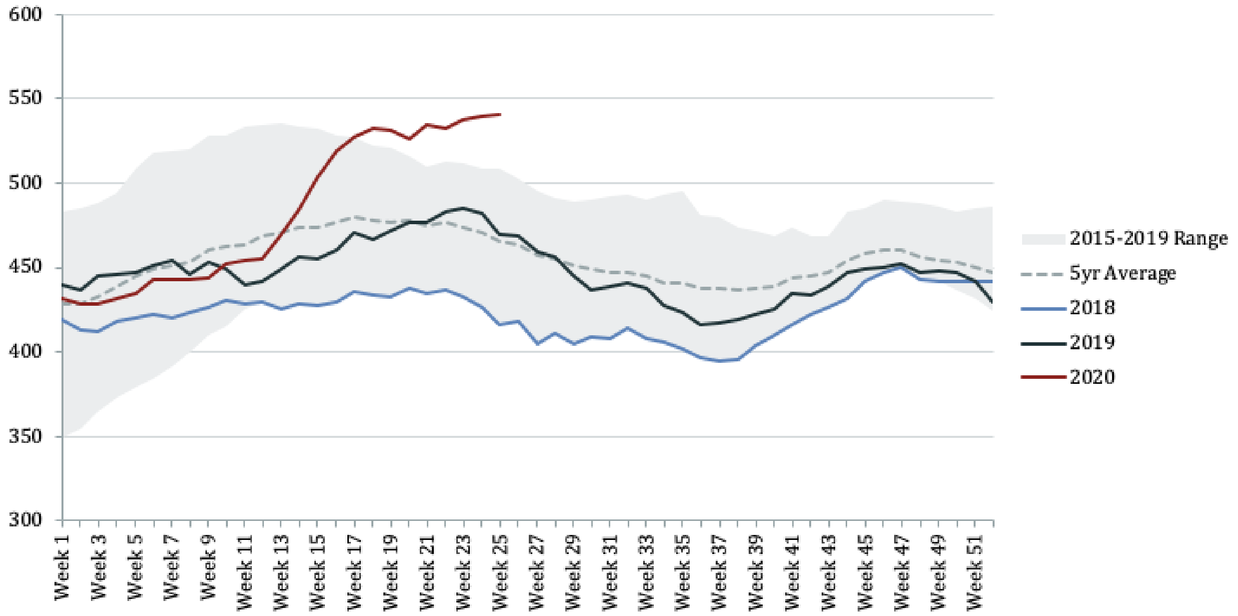

Figure 184: Weekly U.S. Crude Oil Stockpiles (*Sources: EIA, NUS Investment Society*)

Some European refiners are gradually returning back to operations. In France, ExxonMobil's Gravenchon refinery have restarted units, Total's Grandpuits resumed operations in early June while their Feyzin refinery is likely to restart in July after resuming maintenance. In Spain, Repsol is expected to start up production after implementing a suspension for approximately 20 days until mid-July. Eni's Livorno refinery in Italy is running at 50%-60% capacity, while the Sannazzaro and Taranto sites are operating at around 60%. Italy's Sarroch refinery, owned by Saras, has been working at around 70% since March. Russian refineries are ramping up as well amid a resurgence in demand and gasoline shortages, which are supporting cracking margins. We expect crude consumption in Europe to rebound strongly after intensive lockdowns mandated in March and April.

Jet fuel demand remains subdued with rigorous border controls that continue to hamper international air travel. Countries in the Asia-Pacific region, including Taiwan, Singapore, Indonesia and Vietnam, are keeping their borders closed to foreign nationals. Australia is also unlikely to reopen its border to international travellers until 2021, but a trans-Tasman bubble is in the works with neighbouring New Zealand. In China, flight bookings are still depressed and travellers are showing a cautious preference for domestic trips, according to South China Morning Post. As for the European Union, they have approved leisure and business travel from 14 countries beyond its borders. Despite leaving the U.S. out of the list, we reckon that Europe will lead a slight recovery in jet fuel demand, compared to previous expectations. Data from the International Air Transport Association for global air freight markets showed a slight improvement in the air cargo market, with demand falling by 20.3% YoY in May compared to the 25.6% YoY drop in April. Our team believes that it is unlikely to witness a full recovery in jet fuel by the end of the year, and we expect travel restrictions to remain in place until the world manages to effectively contain the virus. Air freight should continue to face a capacity crunch with most of the passenger fleet grounded.

TRADE IDEA: BRENT/WTI SPREAD WIDENER

Figure 185: Brent/WTI January 2021 Futures Spread (*Source: Bloomberg*)

Entry: 2.25
Take profit: 3.64
Stop loss: 1.52
Risk to reward ratio: 1.90

Given our neutral outlook, our team expects the crude market to consolidate as we await concrete developments to determine its next direction. A floor has been established on the back of concerted efforts by producers to limit output, but the threat of a second wave in COVID-19 cases has been heavily weighing down expectations for a V-shaped recovery in demand. U.S.-China trade tensions have also resurfaced to the frontline, further suppressing the potential for a bullish breakout. Therefore, rather than taking an outright risk in trading oil prices, our team prefers an opportunity in trading the price differential between Brent and WTI crude.

We recommend entering a Brent/WTI spread widener, by entering a long Brent and short WTI position for the January 2021 futures contracts. The spread between the two pricing benchmarks' spot prices are currently trading at tights (Figure 185), suggesting that Brent is relatively cheap compared to WTI. Thus, we favour a mean reversion for the price differential, and expect it to eventually widen.

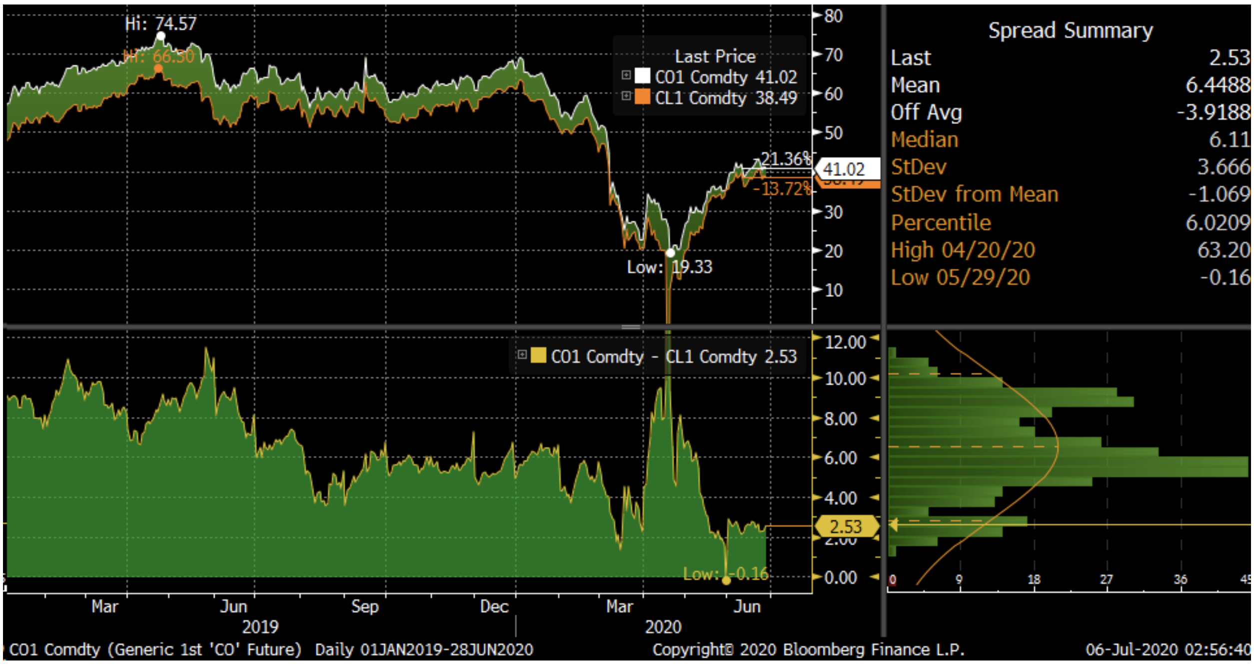

Figure 186: Brent/WTI Front-Month Futures Spread (*Source: Bloomberg*)

A strong bullish divergence signal has developed in the spread between the January 2021 futures contract for Brent and WTI (Figure 187), as observed in both the MACD and RSI oscillators after reaching oversold territories in mid-May. This divergence corroborates our expectations for a mean reversion from present tights.

Figure 187: Brent/WTI January 2021 Futures Spread (*Source: Bloomberg*)

By utilising the Fibonacci Retracement, we have set the take profit level at 3.64. As the spread may continue to tighten following the downward trend without the bullish reversal expected, we propose setting the stop loss level at 1.52. This ultimately represents a risk-to-reward ratio of 1.90.

COAL (Underweight)

Coal is a primary fossil fuel that is rich in carbon and typically found in sedimentary deposits. The commodity plays an indispensable role in meeting the energy requirements of the world and is undoubtedly critical to infrastructure development. There are two main types of coal, namely thermal coal, or steam coal, – which is used for energy generation – and coking coal, also known as met coal, – which is used for steel production.

The thermal coal market has been in a bear market since late 2018 with the world gradually shifting away from coal to more environmentally friendly alternatives for power generation. The COVID-19 pandemic unexpectedly took the front seat away from the U.S.-China trade tensions and Brexit in driving global markets in 1H20, ultimately exacerbating softer fundamentals for steam coal. We witnessed electricity use and industrial production diminish as the global economy was left shuttered and shattered. This led to our short position, recommended in our previous December 2019 outlook, reaching its take profit level when thermal coal prices plunged in late April - albeit a relatively delayed response compared to other commodities.

European Coal Future Subdued by Low LNG Prices

The COVID-19 ordeal has intensified downside risks to European demand. The European Union (EU) was a region that was already in a decline at a rapid pace after deep coal-to-gas switching in 2019 that undermined European coal burn to minimal levels (Figure 188). Milder weather during the past winter has contributed to the decline as well. Net thermal coal imports to the European Union (EU) nosedived by 59% YoY to a mere 3.7MMT in February, a three-decade low, as reported by Eurostat in April. We believe that this data should be viewed as a non-event as it does not reflect the COVID-19 impact on European demand. However, we see it as a precursor to continued price weakness in Europe as dwindling coal burn has hampered any chance for a demand recovery in the short run.

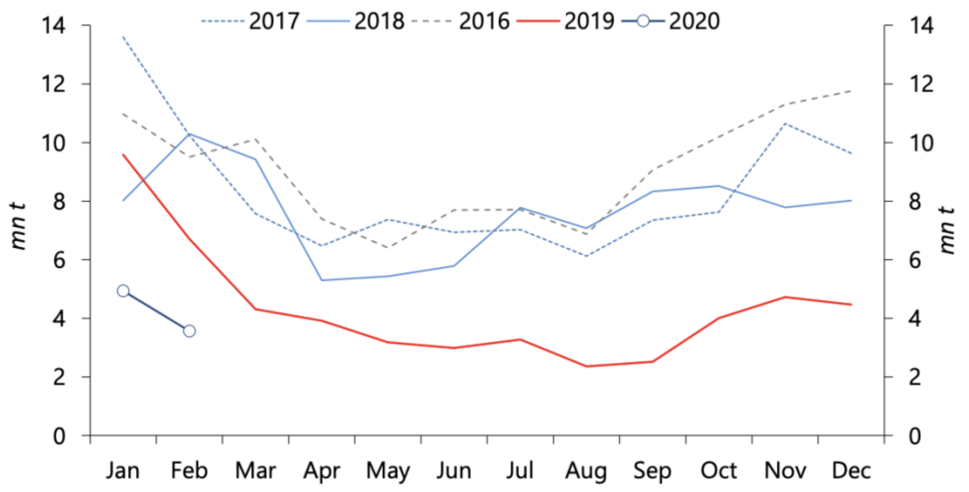

Figure 188: Combined Coal Burn in UK, Spain, Germany, Italy, Portugal, France, Netherlands and Denmark (*Source: Eurostat, Argus*)

Cheaper natural gas prices are cementing Europe's energy transition, as the region is awash with natural gas due to sluggish demand and limited storage capacity. The biggest gas exporter to the continent, Gazprom, saw Russian gas flow to Europe via the Yamal-Europe pipeline fall to zero on 26th May 2020, after a long-term transit deal between Russia and Poland expired. According to Wood Mackenzie, "Europe's vast gas inventories, which currently sit at record seasonal highs, will reduce the continent's ability to absorb global surplus LNG in Q3 2020". A strong contango in the LNG market should lead to further storage builds through the summer season, even though European inventories are already over half full (Figure 189).

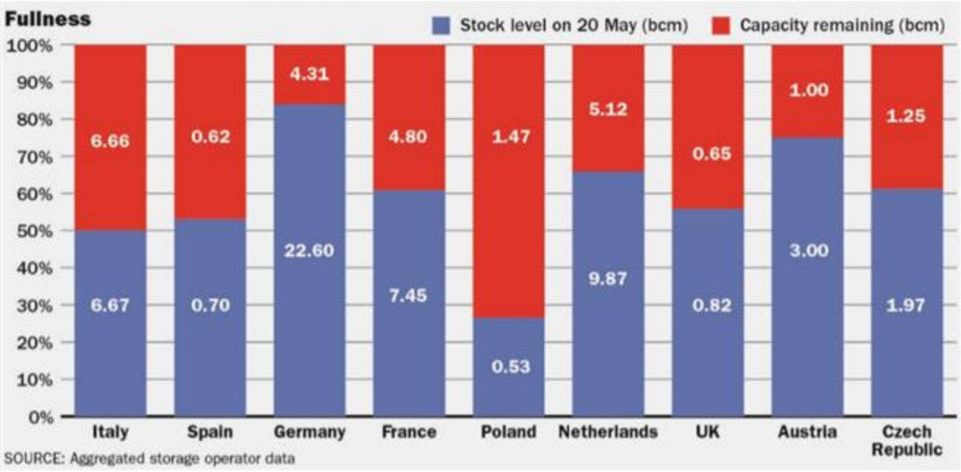

Figure 189: Key European LNG Storage Figures (*Source: ICIS*)

The natural gas glut has suppressed prices at key European hubs as the benchmark Dutch TFF gas futures plummeted at the end of May despite a sizable amount of U.S. LNG being cancelled for July. Market sources reported that poor U.S. LNG export economics have also forced cancellations of 30-40 cargoes for July loading, paying testament to the severity of the LNG surplus in Europe. Despite expectations for a pick-up in power demand, with major European economies emerging from lockdowns, we expect European gas prices to remain under pressure into 2021. In turn, low LNG prices will be a headwind for the steam coal market as power generation via coal-fired plants are viewed as less economically favourable. The coal switching price - the calculated price of gas at which the cost of generating power using coal or gas is equal - is well above current gas prices, suggesting that gas is more attractive (Figure 190). The market is expecting LNG to continue as the energy source of choice well into 2022, as observed by the forward curves, and our team concurs with this projection.

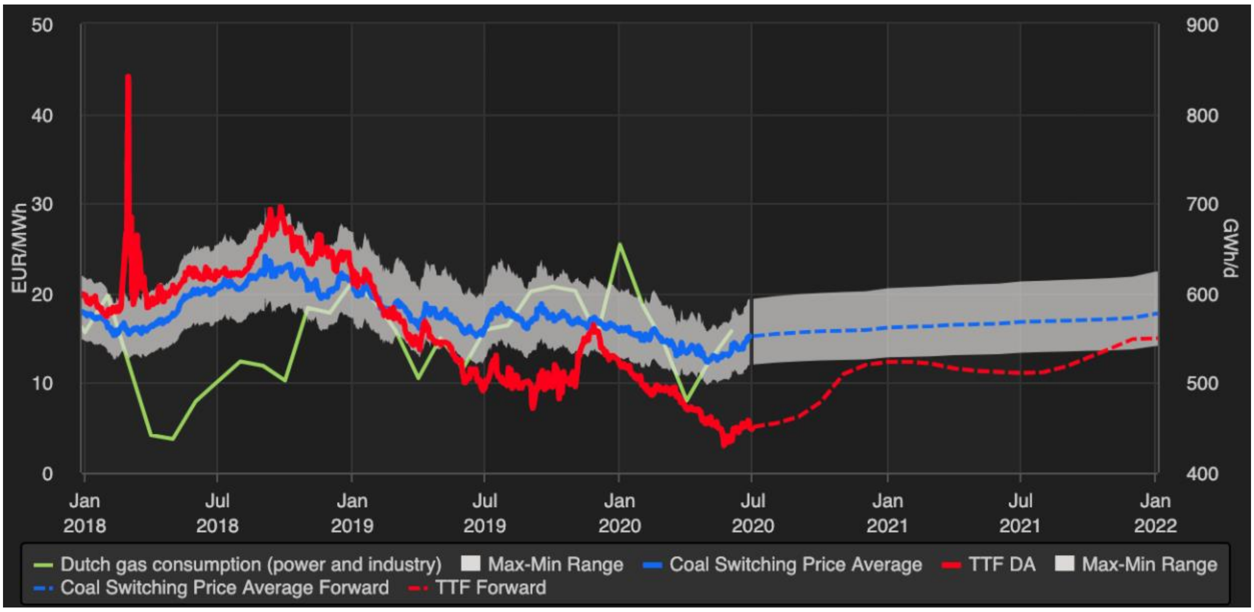

Figure 190: Northwest Continental Europe Coal Switching Price (*Source: Reuters Eikon*)

Muddled Chinese Coal Demand

Coal consumption in China fell by 8% in 1Q20 compared to the same period last year as the economy shrank for the first time on record by 6.8% YoY. The pandemic forced an aggressive nationwide lockdown, causing Chinese industrial production to fall sharply. Both the Official Manufacturing Purchasing Managers Index (PMI) and the Caixin Manufacturing PMI fell to all-time lows of 35.7 and 40.3 respectively in February 2020. Even though a U-shaped recovery is expected for the economy, Chinese coal demand is expected to decline by around 5% according to the IEA.

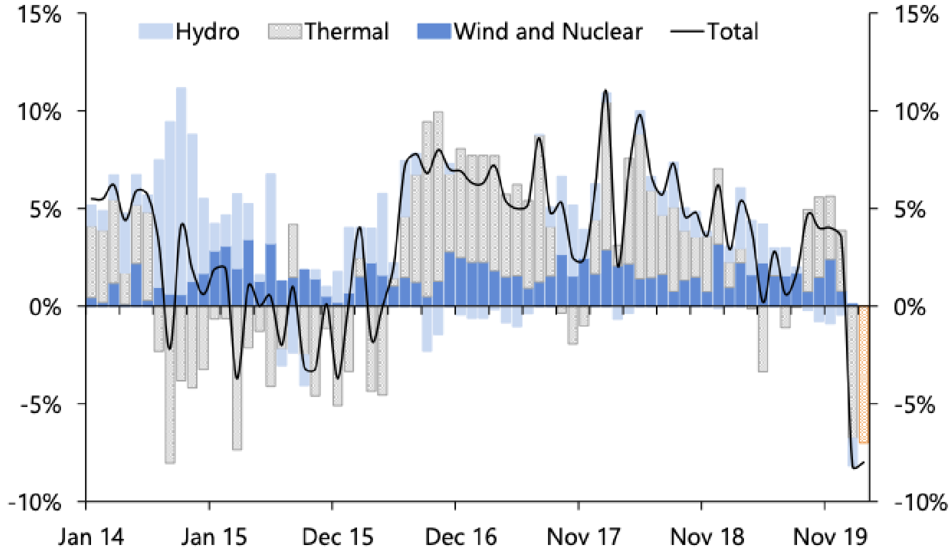

Figure 191: China Power Generation Growth (*Source: NBS, Argus*)

Above all, Beijing will continue to support domestic coal producers by restricting coal imports again and asserting a protectionist narrative. In a bid to alleviate a gutting surplus caused by the aftermath of COVID-19, Chinese coal imports will be largely impaired for the remainder of the year. China has imported 127MMT of coal in the first four months of the year, up 27% YoY, according to official figures. Delayed customs from late 2019 have inflated these numbers but they will still count towards this year's quota. Beijing has yet to set a target for 2020 but market participants are expecting a cap of 280MMT - approximately the same level as 2019. The import strength, seen in the first four months, is likely to fade within the coming months due to weak demand and higher inventories. The slowdown in imports is unlikely to be catastrophic, but we believe it will curb any upside potential.

While import quotas pose significant headwinds for the seaborne coal market, we see a further bearish tilt towards thermal coal compared to the higher-quality coking coal which is more difficult to source domestically. Of the 127MMT in coal imports mentioned above, only 27MMT was coking coal. China's biggest steelmaker, China Baowu Steel Group, and biggest private steelmaker, Jiangsu Shagang, proposed at the nation's annual Two Sessions to increase purchases of coking coal and further control thermal coal imports. If Beijing does not ease import restrictions for coking coal, our team reckons that the share of the remaining yearly quota for met coal will increase while sacrificing steam coal imports.

U.S. Coal Industry Burning Out

Bankruptcies plagued the U.S. coal industry in 2019 - notable companies include Cloud Peak Energy, Blackjewel, Revelation Energy, Murray Energy - and Foresight Energy is the latest victim in this inevitable trend when the St-Louis-based coal producer filed for Chapter 11 bankruptcy in March this year. The industry is under immense pressure by market conditions and will be rendered effectively financially unsustainable. In 2019, the four leading U.S.-focused insurers - Chubb, Axis Capital, Liberty Mutual and The Hartford - announced restrictions on business ties with the coal sector. The rapid adoption of environmental, social and governance (ESG) has made it increasingly difficult for coal companies to access capital markets as well.

With a clear structural shift towards sustainability, U.S. utilities are also committed to transforming to produce and distribute energy while simultaneously lowering their carbon footprint. Back in April 2019, renewable generation surpassed coal for the first time. This groundbreaking phenomenon happened again in February 2020 (Figure 192). The U.S. coal industry has been steadily deteriorating over the past decade - coal supplied 22.7% of utility-scale generation in 2019 compared to 32.8% in 2015 and 44.7% in 2010. Our team believes this decline is primed to accelerate its pace into 2021, as coal continues to struggle to compete with natural gas - especially with low prices due to a global LNG oversupply.

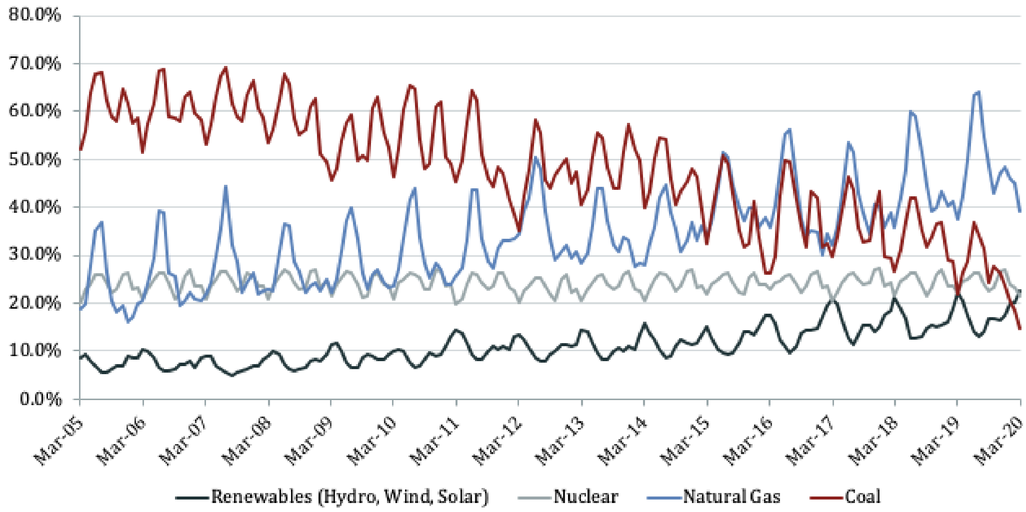

Figure 192: Monthly Share of U.S. Net Generation (*Source: EIA, NUS Investment Society*)

The situation in the Powder River Basin (PRB), which accounts for more than 40% of domestic coal output, epitomises the slump in coal demand. The utilisation rate in the 16 PRB mines stood at a mere 68% in 2018 compared to 97% back in 2008. PRB production fell again last year to below 300MMT from 324MMT in 2018. Producers are slowly realising that they are at the mercy of an economy that is slowly phasing out coal-fired generation.

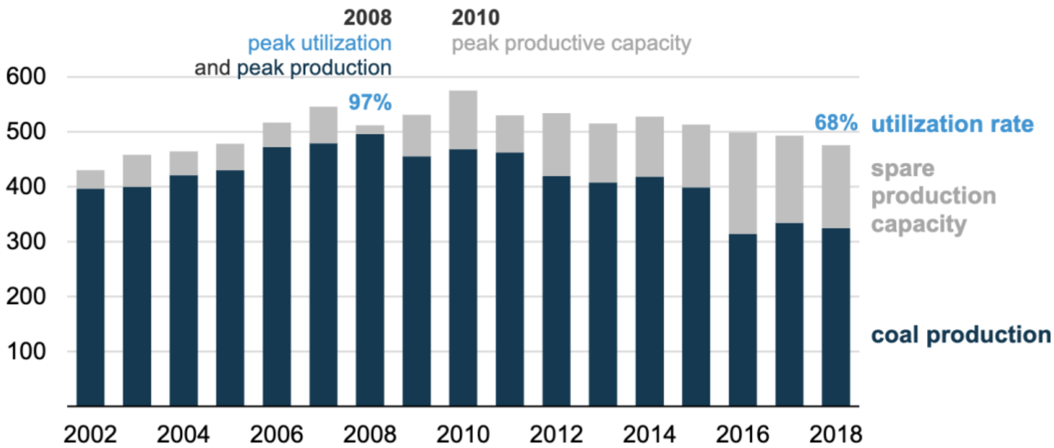

Figure 193: Coal Production and Productive Capacity in Powder River Basin (*Source: EIA*)

In February, U.S. coal mines produced 47.6MMT, down 18.3% YoY, but consumption saw a 27.0% decrease to 35.9MMT. After adjusting for exports and inventory builds, output still far exceeds consumption (Figure 194). The supply glut will continue to suppress prices, and producers are incredibly reluctant to confront the reality of a sunset industry. Our team fails to see any potential for a significant recovery in the U.S. coal market.

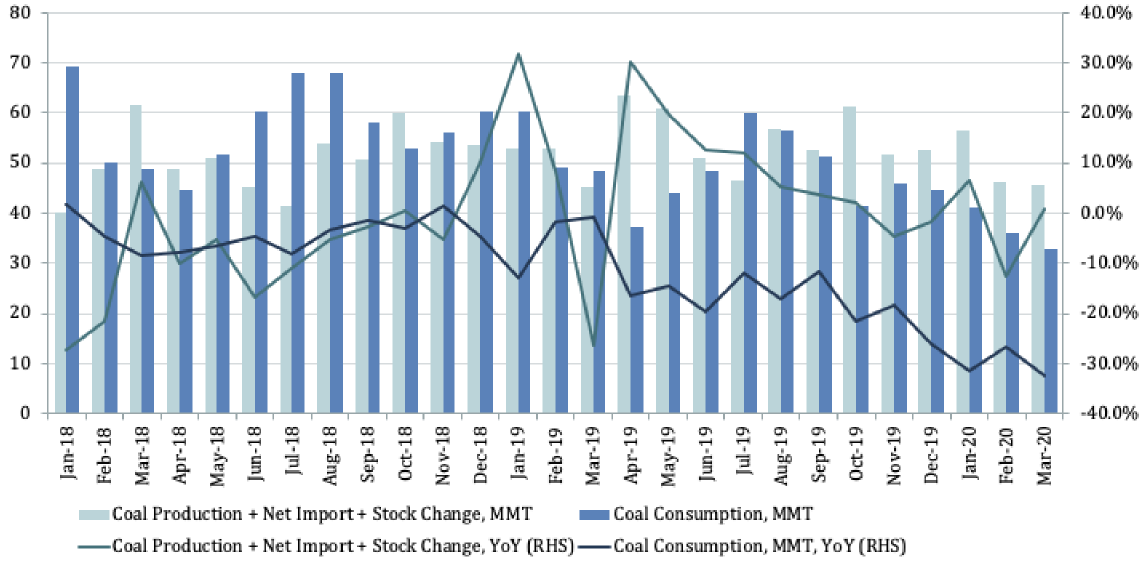

Figure 194: Monthly U.S. Coal Production (*Source: EIA, NUS Investment Society*)

Coal exports from the U.S. declined to 93MMT in 2019 (Figure 195), led primarily by steam coal exports which fell 30% YoY due to the downturn in global steam coal demand. EIA is forecasting exports to fall again in 2020 to 78MMT. We agree that export markets are likely to remain constrained throughout this year. India, the top destination for U.S. coal exports, is slowing down their expansion in coal-fired generation and South Korea, the third-largest importer of U.S. thermal coal, is undergoing a series of organised short-term coal power plant shutdowns as part of its anti-pollution campaign.

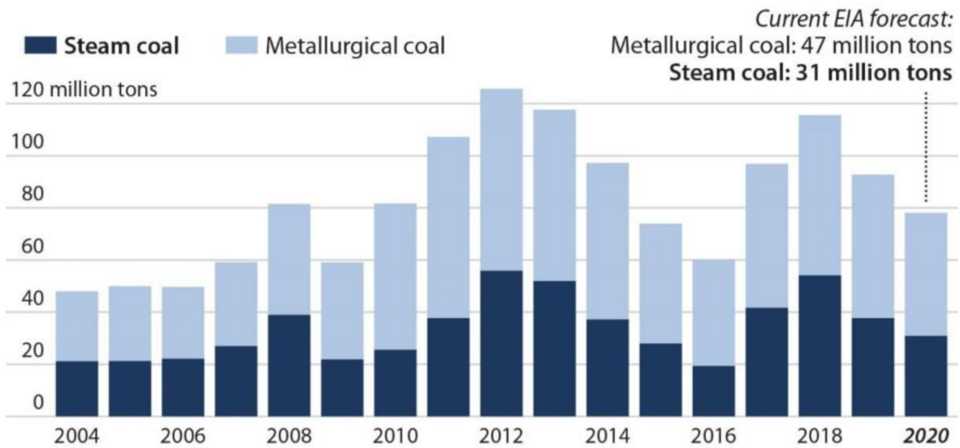

Figure 195: Yearly U.S. Coal Exports (*Source: EIA, IEEFA*)

TRADE IDEA: SHORT ATW1

Figure 196: API2 Rotterdam Coal Front-Month Futures Weekly Chart (*Source: Bloomberg*)

Entry: 56.00
Take profit: 47.00
Stop loss: 61.00
Risk to reward ratio: 1.80

Given our earlier bearish assessment, we recommend entering a short position for the front-month futures contract for API2 Rotterdam Coal at 56.00. Given that prices are currently rebounding from the trough experienced in late April to early May, we would like to wait for further stabilisation in prices before entering the trade.

Prices have been trading in a descending channel since February 2019 and are currently testing the established upper channel line. We expect an upward break beyond the 50-day SMA on the back of the short-term optimism from the reopening of the global economy. We would then expect thermal coal prices to face significant resistance as shown by the dynamic Ichimoku Cloud indicator.

By utilising the Fibonacci Retracement, we have set the take profit level at 47 which is a significant support level. If coal bulls persist and extend the recovery beyond the Ichimoku Cloud, we propose setting the stop loss level at 61. This ultimately represents a risk-to-reward ratio of 1.80.

COPPER (Overweight)

Copper is used in a variety of applications, such as electronics, communications, equipment and infrastructure. Due to copper's widespread applications in the economy, mainly used in the construction of home and transmission of electricity, demand for copper is often viewed as a reliable and key indicator of global economic health.

As copper is an essential raw material in a variety of sectors, including electronics, transport and construction, copper can be used as a leading indicator of the phase of the economy. A downswing in the outlook of copper producers can lead to a notable rippling effect across the global economy. This proves that the copper market can be used as a leading indicator to provide a better outlook on the economic cycle.

Copper prices are reflective of the global economy's health and vulnerable to events all around the globe. COVID-19 is an event that is no exception as this pandemic has brought about unprecedented uncertainty into the global economy. In mid-January 2020, copper prices plunged 12% (Figure 197) after China announced lockdown measures, which kickstarted in Wuhan, reportedly the birthplace of the pandemic and gradually enforced all over the nation. With the Chinese government extending the Lunar New Year break in China, this resulted in a cease of manufacturing and industrial activities which turned to lower demand for copper.

Prices remained relatively stable in February as it seemed that the virus will be contained in China. However, going into March, the pandemic started to spread across international boundaries, it sparked global concerns about safety and health issues in manufacturing and industrial plants and this wiped significant copper demand from the market. Copper prices tanked and dropped more than 15% in March 2020 (Figure 197).

It was only after March, that prices started to recover moderately, and this was attributed to the cautious reopening of the Chinese economy. Fortunately, the copper market experienced an early rebound in Chinese imports of the red metal, indicating the country's manufacturing and construction sector may be emerging faster than anticipated from the COVID-19 slump. This has resulted in a sudden spike in copper prices, up to USD 2.43 a pound on 20th May 2020. In stark comparison to March, the bellwether metal briefly traded below USD 2.00 a pound, levels last seen during the global financial crisis of 2008-2009 but has now recovered by more than 20%.

Figure 197: Copper Prices from January 2018 to April 2020 (*Source: S&P Global Market Intelligence*)

Fiscal Stimulus Driving the Demand Recovery - but is it Enough?

In the previous outlook, we were hopeful that there would be a strong revival for the copper for demand due to easing U.S.-Sino trade tensions and the Phase 1 trade pact signed by the U.S. and China. We were right at the start of the year, as global trade tensions eased, and copper prices were bullish coming into 2020. However, 2020 remained an eventful year for the commodity as the COVID-19 pandemic spread and re-escalating trade tensions have dashed hopes of recovery.

The COVID-19 metals demand shock came in the form of an almost total lockdown of manufacturing and construction activity, first in China and then in the rest of the world. Automotive manufacturers closed their plants and construction projects were ground to a stop, cutting off demand from the major metal users. Copper prices had slid for a record 14 straight days in February amid mounting concerns the virus will aggravate the slowdown in global economic growth, crimping demand for the metal used in cars, electronic gadgets and construction.

Customs data showed that China's refined copper imports in April rose 14% from a year ago to just under 442,000 tonnes, as factories and construction activity continue to ramp up. Also, April imports of global copper concentrate rebounded, topping 2 million tonnes for only the third time. Cargoes for the month soared by 22.5% YoY in May as shipments from South America recovered following production halts and logistics problems. Belief in the restoration of demand in copper is well backed, with China being ahead of the global COVID-19 curve with factories exiting lockdown and government stimulus taps turned on.

Lowered inventories in China, the biggest consumer of copper, have confirmed that demand for copper has been unexpectedly recovering gradually. After surging during China's lockdown, Shanghai Futures Exchange's (ShFE) stocks are now mostly falling just as fast.

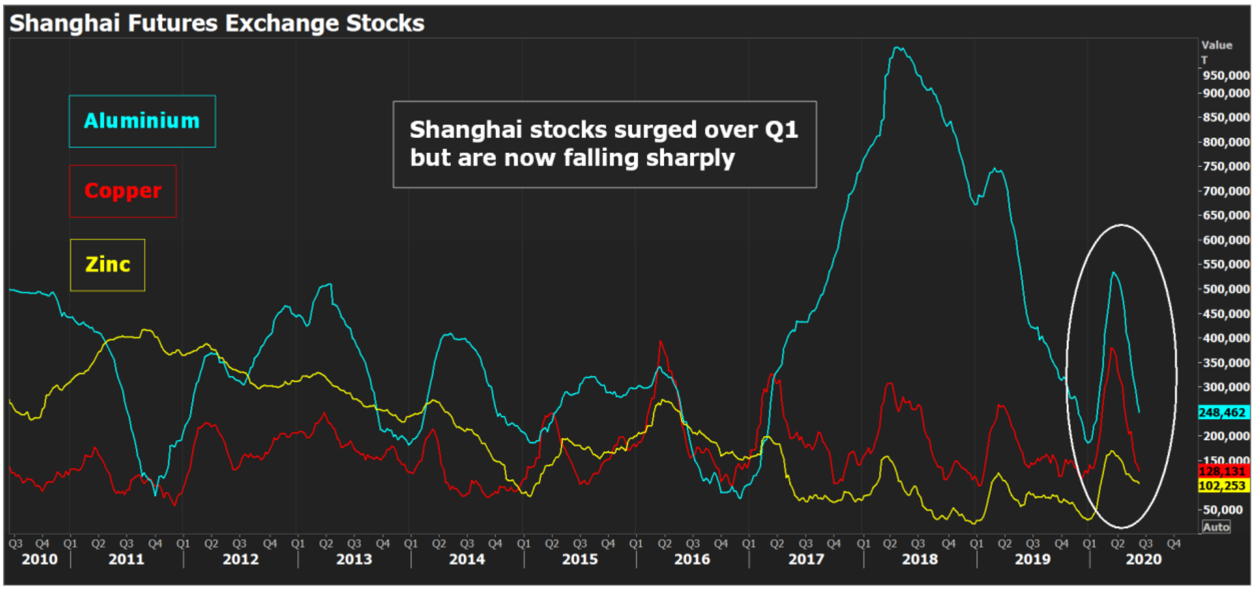

Figure 198: ShFE Metal Stocks (*Source: Mining.com*)

ShFE copper stocks jumped from 124,000 tonnes at the start of January to a March peak of 380,000 tonnes (Figure 198). Inventory always rises over the Lunar New Year holiday but the scale and the speed of the build over China's lockdown seemed an ominous warning of the severity of the COVID-19 demand hit.

However, the subsequent turnaround in inventory has been just as dramatic. Registered copper stocks now total just 128,000 tonnes. From a mid-year perspective, ShFE copper stocks have conformed to the "normal" seasonal Chinese pattern, albeit with sharper accentuation than in the last three years.

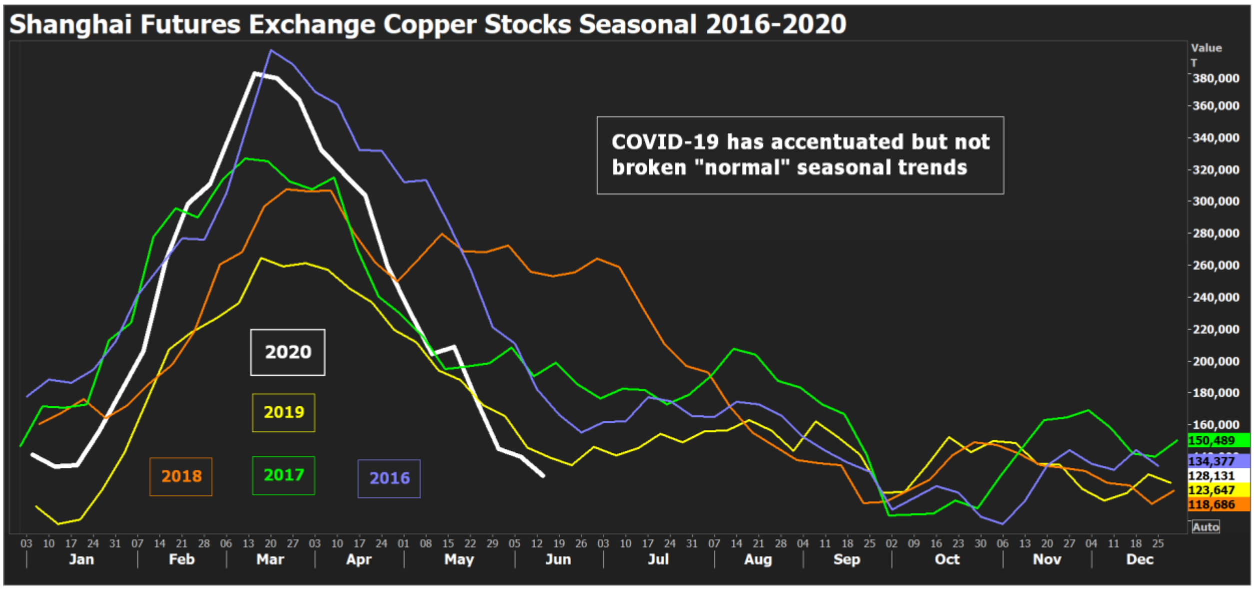

Figure 199: ShFE Copper Stocks from 2016 to 2020 (*Source: Mining.com*)

The drawdown in visible stocks has been mirrored by a decline in the amount of metal sitting in Shanghai's bonded warehouses. Compared to the same month of the past 5 years, copper inventories in June 2020 was the lowest at 128,000 tonnes (Figure 199).

China's factories are humming again as Beijing's stimulus starts to flow through the economy. The country's total social financing credit impulse accelerated to 6.2% annual growth in May, according to analysts at Citi. That has translated into rebounds in activity in key metals usage sectors. Automotive output rose by 19% YoY in May. Fixed asset investment in infrastructure jumped by 11% with core spending channels such as transport and green energy positive for copper's prospects.

According to BMO Capital Markets, data from China's Ministry of Finance showed that the value of special-purpose bonds issued – destined for local government spending on infrastructure – has already surpassed the full-year total in 2019. China's fiscal stimulus will include plans relating to "new urbanization", which is refurbishing old urban housing stock, railways, airports, and upgrades to power grids and local utilities and "new infrastructure" which includes 5G networks, ultra-high voltage power grids, EV charging stations, and data centres. Beijing's stimulus package centered on these new initiatives should be positive for copper demand.

Needless to say, all of these investments require massive amounts of copper. China already consumes more than half of the world's copper and its refineries are sucking in concentrate at higher rates than the record-setting 2019 total of 22 million tonnes. Now the country is going into overdrive. The latest Shanghai Metals Market (SMM) survey of copper wire and cable fabricators shows a rise in operating rates in May to 101.7%, the highest level in the history of this survey. This is mainly attributed to purchases from the world's largest buyer of copper – China's State Grid – after Beijing massively inflated its budget.

It is not just the Chinese government planning to use fiscal spending on infrastructure to revive its economy amid the global economic slowdown. In June 2020, it was also announced that the Trump administration was preparing a near USD 1 trillion infrastructure proposal as part of its push to spur the world's largest economy back to life. A preliminary version being prepared by the Department of Transportation would reserve most of the money for traditional infrastructure work, like roads and bridges, but would also set aside funds for 5G wireless infrastructure and rural broadband. House Democrats have offered their own USD 500 billion proposal to renew infrastructure funding over five years. The Democratic bill to reauthorize the current infrastructure program was unveiled and it includes investments in roads and bridges, funding to make certain projects more resilient to climate change, and funding for public transit and Amtrak, among other priorities. Our team believes that this will boost demand for the red metal that is essential in infrastructure and transportation projects.

However, the magnitude of recovery may not be enough to bring prices back to pre-virus levels. Fitch expects global copper consumption to decline by 1.1% YoY in 2020, compared to the previous forecast of a 1.6% YoY growth. The agency revised down 2020 copper consumption growth forecasts for the two largest consuming countries, China and the U.S., from 2.5% and 1.5% growth YoY to declines of 1.5% and 4.5% YoY, respectively.

Additionally, mutual funds are not buying the recovery story, indicating growing fears that the increased level of demand is short-lived. There has been a pairing of speculative short positions on both the CME and the LME, but any sign of a buy-in to the recovery narrative is absent.

The money manager's net short position on the CME's HG copper contract fell further last week to 16,043 contracts from a February peak of 58,557.

Figure 200: Net Short Position on Copper (*Source: Mining.com*)

Outright bear bets have been trimmed to 48,310 contracts from a high of almost 101,000 over the same period (Figure 200). The lack of enthusiasm about any price upside suggests that fund managers are leaving the copper market as long positions have failed to build up in any meaningful way from the four-year lows. This could indicate that the overall market is sceptical about the recovery in demand of copper over fears of a COVID-19 relapse in the form of a second wave hit to manufacturing demand and recovery may not be on the horizon as it seems. The possibility of this just being a short-term recovery in demand remains very real.

Furthermore, China's move to tighten its grip on Hong Kong torpedoed any hopes of a promised phase two trade scheduled for later this year, and instead, a new set of sanctions is now likely in response. This will, if escalated, massively deteriorate any hopes of a swift recovery of demand for the base metal. Any escalation of the current tensions could evolve into a full-blown trade war that will hurt investor's and manufacturer's sentiments and copper demand, known for being a reliable leading indicator of global economic health, will bear the brunt of the souring relationship between the two biggest economies.

With that being said, we remain in the view that the relationship between China and the U.S., and the possibility of the second wave of COVID-19 will have a lesser impact on the copper market, as compared to the positive effects of rising demand. The stimulus packages aimed at infrastructure and transportation spending, as well as the reopening of many of the global economies after months of lockdown, will boost manufacturers' confidence and in turn result in soaring demand for the base metal.

Copper Mines Resuming Operations after COVID-19 Fears

The infamously volatile supply of copper has been always resultant due to spate of protests at copper mines all over the globe, often worker unions protesting for more favourable working conditions and benefits. This year, copper supply will remain to be uncertain, but for another reason - the devastating pandemic that is rampaging through the world. Production of metals took a toll when mines halted production in efforts to curb the spread of COVID-19. This wiped a substantial amount of metal off the market as the supply of these metal to refineries was reduced.

Coming into March 2020, a recovery of supply seems to be on the horizon as copper mines have resumed production. Chile's top copper mines ramped up production in March even as the COVID-19 outbreak took hold, boosted by a sharp spike in output from state miner Codelco. Chile's copper output remained higher in the first four months of 2020 compared to 2019 (Figure 201). Production at Codelco, the world's largest copper mining company, rose 14.8% YoY in March to 147,600 tonnes and their output jumped 4.2% to 386,600 tonnes in the first quarter. In spite of the global pandemic, Codelco remains confident that it can still maintain its production and shipments according to its 2020 plan.

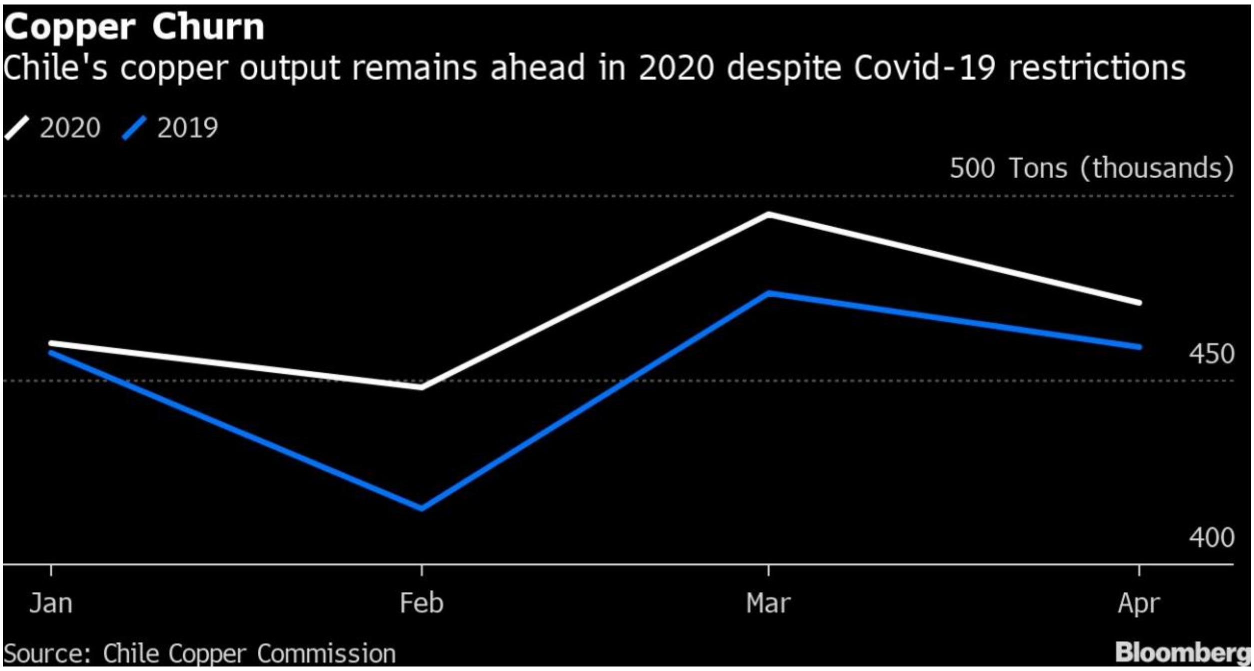

Figure 201: Chile's Copper Output in the First Four Months of 2019 and 2020 (*Source: Bloomberg*)

Chile opted to continue mining as the virus hit, implementing safety measures and demobilizing non-essential staff without sacrificing much output. For Chile's Mining Minister Baldo Prokurica, it's a balancing act of keeping workers healthy and much-needed export revenue flowing. Prokurica said the industry is taking extraordinary measures to safeguard staff, including testing, distancing and demobilizing about half the total workforce. While infections are rising in the nation, mining has done better than other industries, with just 0.5% of the workforce falling ill

BHP's Escondida, the world's largest copper mine, saw production in March climb 0.9% to 101,800 tonnes. The massive Collahuasi copper mine in northern Chile, a joint venture between Anglo American PLC and Glencore, also saw its March production jump 6.8% over 2019 to 50,400 tonnes.

This can be credited to the public and private measures aimed at protecting workers with the industry's resilience even as the virus has hit other parts of Chile's economy. Chile's copper industry has maintained operations even as COVID-19 has ravaged the country's economy and shut down many other non-essential businesses.

The recovery is boosted as other countries allowed a resumption in mining operations as well. Through supreme decree N° 080-2020-PCM, the Peruvian government authorized mining operators to resume activities as of 2 May 2020. According to the decree, miners are allowed to exploit, refine, store and transport minerals and metals, as well as go on with construction projects and mine closures. The resumption of operations, which was halted in mid-March, is going to be done gradually, with the first phase starting in May and ending in August. Bearing in mind that Peru is the world's second-largest copper producer and is responsible for 60% of all copper exports, this is positive news for the copper supply in times of dire uncertainty.

However, copper output will face slow recovery as mines might not reopen quickly due to fears of the pandemic spreading once again and will most probably be enforced by government and health officials. Thus, operating capacity will remain depressed for the time being.

We remain in the view that that supply for copper in 2020 will be bullish. This is because mines all around the globe are resuming operations after halting production in fear that the virus will spread. The resumption of mining activities, especially in Chile and Peru, the two largest suppliers of copper in the seaborne market will be the main drivers of copper supply. However, we do not expect operating capacity to reach pre-pandemic levels as governments will ensure that mines will only operate under safe circumstances.

Electric Vehicles Remain Resilient and Provides Boost for Long-Term Copper Demand

Since last year, the growing market for electric vehicles (EVs) has been supporting the demand for copper. This year will be no different as the battle against environmental changes continues despite the ongoing pandemic and geopolitical tensions.

While electric car sales were crashing in China, the world's largest electric vehicle market by a country mile, customers were still busy kicking tires in Western Europe. Year-to-date sales of battery-powered vehicles in the world's second-largest car market surged 37% compared to last year to 142,000 units, according to Schmidt, a market researcher. Preliminary data from Schmidt show EVs made up 6.7% of total car sales on the continent in April – in countries like Norway, seven out of 10 new cars sold are now electric, mostly thanks to radical incentives such as paying half-price for ferry rides and free parking. In the UK, it was one in three.

Total auto sales in Europe, excluding the UK, fell by 80% with cities under lockdown. However, in comparison, EV sales only dropped by a healthy 30%. Sales of these vehicles in China also slumped by almost a third during April, but that figure constitutes a bounce-back as sales of electric cars slumped 80% compared to 2019 the month before. Recovery in the Chinese auto market looks increasingly V-shaped.

An abrupt change to incentives mid-2019 knee-capped the electric vehicle market in China, but Beijing has since brought certainty to the subsidy regime for what it terms new energy vehicles (NEVs). Some provinces have instituted their own schemes and auto manufacturing is destined to be a favoured recipient of stimulus to kickstart China's post-COVID-19 recovery.

In the U.S. and Europe, EVs may escape the worst of the overall auto downturn, which even before the pandemic looked set for a dismal year. Europe's green car incentives remain generous and a cash-for-clunkers program favouring EVs may well be on the cards.

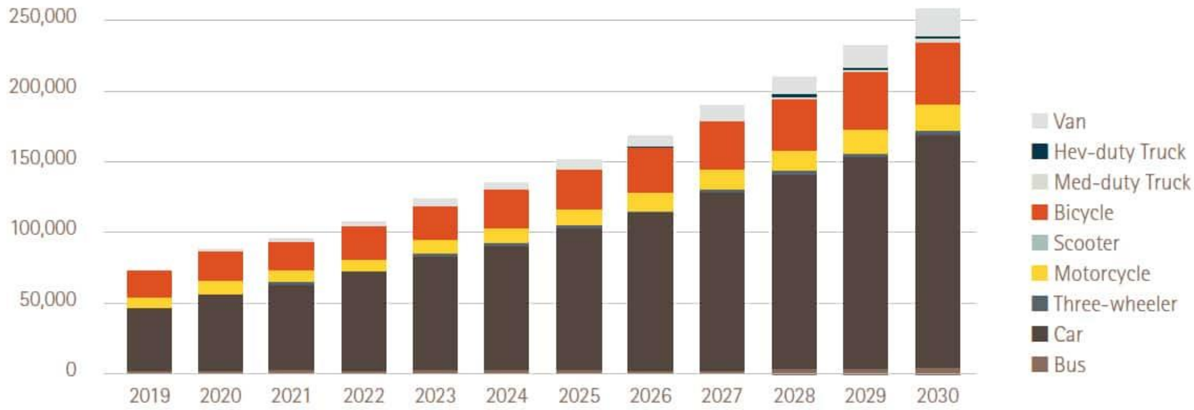

Figure 202: Forecasted Copper Demand from Electric Vehicles (*Source: International Copper Association*)

Over the next 10 years, the widespread adoption of electric traction motors in on-road vehicles will yield a significant increase in copper demand, according to new findings by IDTechEx. The research, commissioned by the International Copper Association (ICA), found that by 2030 more than 250,000 tonnes per annum of copper will be used within the windings of electric traction motors of on-road electric vehicles (Figure 202).

Furthermore, Eurogroup President Mário Centeno suggests the COVID-19 crisis has given the European Union a historic opportunity to bring about economic structural change, especially concerning green and digital technologies. Structural changes to global supply chains that were heavily disrupted or even halted due to the pandemic could possibly lead to greater demand for copper as there are greater incentives to use green technology in revamped supply chains.

We expect the increasingly popular theme of EVs around the globe to be favourable for the demand for copper as it is one of the key metals used in the manufacturing of EVs. Possible revolutions of supply chains to incorporate more green technology will also induce more demand for copper.

TRADE IDEA: LONG HG1! COPPER FUTURES

Fundamentally, we believe that copper prices will remain bullish in the near future as demand for copper will be restored. This restoration will be a resultant of the gradual reopening of economies and increased appetite from the U.S. and Chinese economies, stimulated by government fiscal packages that are aimed at infrastructure and transportation spending. Stockpiles and inventories of copper dwindling in Chinese warehouses have highlighted that Chinese demand for copper has roared back to life and we believe that this will cause copper prices to be in an uptrend in the near future. However, we remain cautious about any rally of copper prices due to the possibility of a second wave of COVID-19 after the reopening of economies. If there were to be a second wave of the pandemic, we will see demand for the base metal take a hit from both wary consumers and slowing manufacturing activities.

Although there will be a presence of increased copper supply in the global economy as copper mines all over the world are resuming operations and maximising operating capacity, the supply effect will be overshadowed by the strengthening demand that was badly hurt during the first half of 2020. This is because mines will still reopen in a cautious and gradual manner, and we will not see production attain capacity levels before the pandemic. We foresee a tight copper market where increased supply might not be able to match the bullish demand for the red metal.

This pandemic will also bring about unprecedented structural change to global supply chains and we will likely see more investments into green technology to battle against climate change. This will lead to increased copper demand in the long term and may boost prices in the shorter term. The electric vehicles industry remains an area that will be promising for copper demand as well.

Technically, we expect copper ore future prices to trade higher. Current prices are trading above the 20-SMA, 50-SMA and 100-SMA, suggesting an uptrend in prices. The 20-SMA has crossed both the 50-SMA and 100-SMA in early May and early June respectively. Furthermore, the 50-SMA has crossed the 100-SMA in the past week, suggesting that there is strong upward momentum in prices.

Figure 203: HG1! Copper Future Contract Daily Chart (*Source: TradingView*)

Spot price: 2.659
Take profit: 2.891
Stop loss: 2.542
Risk to reward ratio: 1.98

Prices have also been trading above the Ichimoku Cloud, suggesting an uptrend in prices. RSI levels are not in overbought conditions, suggesting upward momentum remains strong and not out of steam as of yet. Prices and RSI have been printing higher lows, the lack of divergence suggests that any reversal of prices is not imminent.

We foresee the bullish demand for copper to support prices and set our take profit level at the January 2020 high price of 2.891. On the other hand, we set the stop loss level at the 61.8% retracement level from this price at 2.542.

IRON (Overweight)

Iron, just like copper, has widespread usage in the economy but is mainly used for infrastructure and industrial purposes in the form of steel. Movement in the steel markets has a significant impact on any movement in the iron markets. Steel is essential for many industries as it is used in engineering applications, repair and construction of maritime equipment and vessels, automobile manufacture, construction and general industrial activities. A key ingredient of steel, iron ore remains to be one of the most important base metals in the global economy.

China, Australia and Brazil are the largest producers of iron. China is also the biggest importer of iron, due to its large steel-making industry that accounts for 56% of the world's total steel production.

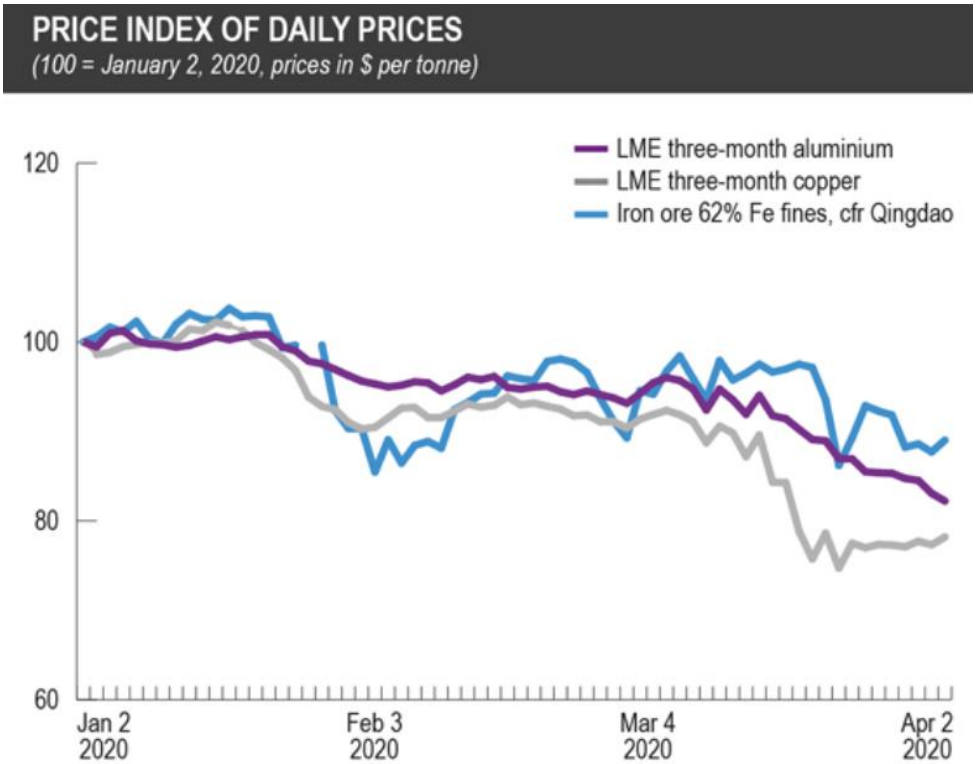

Figure 204: Iron Ore Prices in 2020 (*Source: Fastmarkets*)

No market has been left untouched by the escalating COVID-19 pandemic, but iron ore prices have proved relatively buoyant in 2020 compared with the price plunges seen in other commodities. While copper and aluminium prices fell to four-year lows, the iron ore benchmark only dipped to a three-month low.

Similar to the copper market, iron prices took a plunge as China imposed a nationwide lockdown and extended its Lunar New Year holidays in a bid to curb the spread of COVID-19. However, iron prices remained relatively resilient. The iron ore benchmark first dipped to nearly USD 80 per tonne in the beginning of February and rose to nearly USD 90 per tonne again two weeks later (Figure 204).

Ever since February, iron ore prices have been supported by confidence in the recovery of the Chinese market. The restrictions in Wuhan province, where the virus was first recognized, have now been lifted and most of China is expected to return to normal activity with a consequent rise in steel production. Sentiment has also been boosted by the government's promises of stimulus. It has also been supported by supply disruptions in the global seaborne supply chain for iron ore as a result of the pandemic. This will be further elaborated in the report later.

Strengthening Iron Demand Defying Global Economic Downturn

In the previous outlook, we were in the view that China's determined campaign against carbon emissions that would have weakened iron demand. However, in light of COVID-19 and the resultant declining economic environment, China's main objective seemed to have turned to economic recovery and this would mean massive fiscal spending on construction. This will be one of the paths that the Chinese government will take to meet this objective, and this will result in bullish demand for iron ores.

Fitch analysts maintain their iron ore price forecast for 2020 at USD 85/tonne, as prices remain resilient despite the COVID-19 backdrop that has resulted in the decline of other metal prices and expects prices to further recover from spot levels in H220 as steel production in China gears up. On the demand side, Fitch analysts expect stronger steel production by H220 to sustain iron ore demand and support prices, with steel demand growth to pick up pace by H220 and average 5.0% YoY in 2020. However, Europe's steel demand will be weak in Q220 and could drag iron ore demand lower as well should companies declare force majeure.

Vale, the biggest iron ore exporter in the market, is expecting a "very vigorous" economic rebound in China. They claimed that industrial activities in China are practically at their normal levels and that civil construction is also rising daily and steel and iron ore stocks are falling

Iron ore prices have been underpinned by hopes that China, responsible for more than 70% of the world's seaborne iron ore trade, will spend massively on infrastructure and construction to revive an economy devastated by COVID-19.

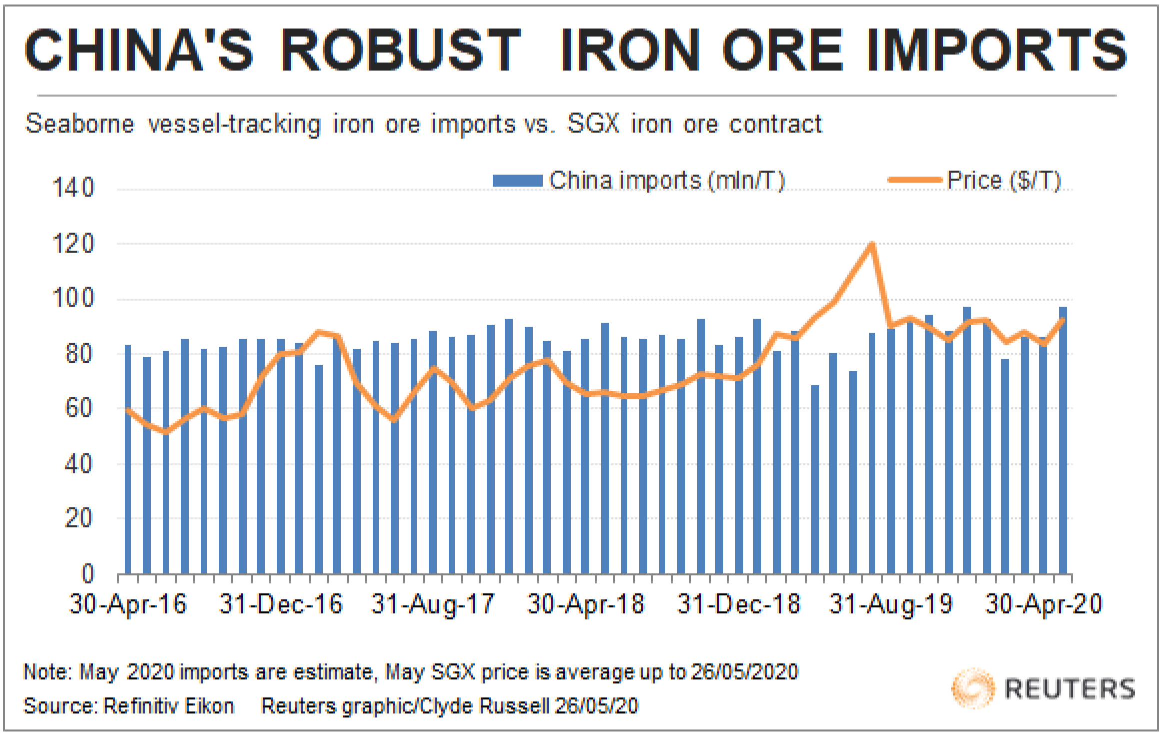

Figure 205: China's Iron Ore Imports (*Source: Reuters*)

China, which buys about two-thirds of global seaborne iron ore supplies, looks to be keeping the demand side rolling along, with May imports estimated at a strong 96.8 million tonnes, up from 86.4 million in April (Figure 205).

Much of the bullish narrative is built around China's seeming rapid recovery from COVID-19 and expectations that Beijing will continue to prime infrastructure and construction spending, the two biggest steel-consuming sectors. Premier Li Keqiang has announced an RMB 6.1 trillion (USD 853 billion) stimulus package to stabilise the economy following COVID-19 disruptions. This is equivalent to 6.1% of the nominal

GDP of China. The new stimulus measures will increase demand for raw materials in key sectors such as construction and transport. This will ensure that demand for base metals like iron will remain resilient.

China has picked up the pace of new infrastructure project approvals in 2020, with more support expected to be announced to drive steel demand. Over January-April, China approved nine airport projects with a total investment of RMB 100.16 billion (USD 14.1 billion), equivalent to 55% of total approvals in 2019, according to S&P Global Platts analysis. Furthermore, 13 railway and urban rail transport projects were approved over the same period, with eight more expected to be approved soon. The length of these projects combined is 3,641 km, equivalent to 61% of the total length approved last year. Work will start on most of the projects this year. Platts estimates the projects will require 19.56 million mt of steel, already 63% of the steel used by similar projects approved in 2019 (Figure 206).

	2018 (mainly in 2018-2025)	2019 (mainly in 2019-2025)	January-April 2020 (mainly in 2020-2025)
Approved length of railway/urban rail traffic projects	5753 km	6014 km	3641 km
Approved investment value of airport projects	Yuan 43.94 billion	Yuan 182.68 billion	Yuan 100.16 billion ($14.1 billion)
Steel consumption of the approved projects	25.22 million mt	31.14 million mt	19.56 million mt
	2018	2019	2020
Issuance of new local government special bonds	Yuan 1.35 trillion	Yuan 2.15 trillion (64% found its way to property)	Market expectation: Yuan 3 trillion-3.5 trillion
Infrastructure fixed asset investment y-o-y change	3.8%	3.80%	Market expectation: 7% -10%

Figure 206: Comparison of Infrastructure Spending and Steel Consumption from 2018 – 2020 (*Source: National Development and Reform Commission (NDRC), China's Ministry of Finance, National Bureau of Statistics of China (NBS), S&P Global Platts*)

The boost to new airport, railway and urban rail transport projects is a sign of China moving back to traditional infrastructure construction in a bid to cushion the slowing economy and support. China has also been boosting its financial support to speed up infrastructure construction, through measures such as raising the local government special bonds quota and pushing forward the establishment of real estate investment trust funds, or REITs, in the infrastructure sector.

China's infrastructure investment growth rate may reach around 7% in 2020 if fiscal stimulus stays at current levels. However, if other measures are announced, such as allowing the government to directly borrow from the central bank, the infrastructure growth rate may reach 10% or even higher. The growing pressure of unemployment could see the Chinese government boost fiscal support despite already soaring local government debts, falling revenues due to tax cuts and the hit of the COVID-19 pandemic. As a result, we expect the growth rate of infrastructure investment in 2020 was expected to be closer to 10% than to 7%.

In addition to government-related spending on fixed assets, steel demand will be well-backed as the early resumption of industrial operations in China fueled a recovery in downstream activity and steel mills continue to increase output to meet manufacturer's demand. According to SteelHome consultancy data, drawdowns have brought port stockpiles to just over 109 million tonnes in May, the lowest since November 2016.

We remain in the view that demand for iron ore will be sustained throughout the year as manufacturing activities in China pick up the pace after being left in the slump at the start of the year. Chinese government stimulus will also induce demand for the base metal. With the goal of the Chinese government to cushion the economy from the dire impacts of the pandemic, we believe that steel will be greatly in demand as there will be large spending on infrastructures and fixed assets, and this will cause demand for iron ores to be well-supported.

The Pandemic in Brazil Stalling Any Recovery After Supply Shock

The supply deficit in the iron market will stay in 2020 due to the new COVID-19. As expected in 2019, the supply in the iron market remained tight, after a deadly tailings dam burst at Vale's Brumadinho complex in January 2019 prompted several dams and mines shutdowns for safety checks. This theme will continue to be prevalent in 2020.

Fitch forecasts iron ore production to grow by 0.8% YoY in 2020 compared with 4.7% YoY in 2019, as a result of government lockdowns around the world causing operational disruptions. Supply has been disrupted in H120 so far by forced mine shuts in Canada, South Africa, Peru and India, and seasonal weather also impacted Brazil and Australia. Chinese domestic iron ore production has been impacted by logistical issues, which has temporarily increased China's demand for seaborne iron ore in Q120.

Brazil, the world's number two shipper of iron ore, has recently become the newest epicentre of the pandemic and has the second greatest number of confirmed cases and deaths due to the virus in the globe. The pandemic is expanding through the state of Para, which accounts for about one-third of the South American country's exports. There is already some evidence of slower Brazilian exports, with vessel-tracking and port data compiled by Refinitiv pointing to low shipments in May. To put things into perspective, in 2019, Brazil exported around 350 million tonnes of iron ore which comes down to 6.5 million tonnes a week. However, in 2020, Brazil had only one week where it exported above 6 million tonnes.

With the virus still spreading rapidly in Brazil, and Brazil's health system under massive pressure, this could lead to further suspensions in mining activities to curb the spread, which will ultimately lead to lowered productions and exports. This has even led to China's steel association and major steelmakers to call for an increase in domestic iron ore production as well as greater investment in exploration overseas to ensure supplies and rely less on imports. China should set a "national strategic goal" of keeping its domestic iron ore output at more than 20% of total demand.

Mining operations in Brazil have been heavily disrupted. A Brazilian judge ordered the closure of the Conceição, Cauê and Periquito mines after 188 workers tested positive for COVID-19, putting more than 10% of the firm's iron ore output offline. The halt is in place until a final court ruling or until Vale satisfies labor inspectors on its control measures, with a daily fine set at BRL 500,000. If the closure is sustained, iron ore supply disruptions could be larger than last year after the tailings dam disaster in Brumadinho.
Vale has reaffirmed its iron ore output guidance and said it is keeping its monthly production forecast at Itabira at 2.7 million tonnes for the coming months. In spite of this, the temporary closing of these mines could result in a shortage of pellet feeds destined for the domestic market, Vale said.
We expect that the supply's path to recovery will be stalled as the pandemic continues to spread in Brazil, one of the main exporters of iron ore. With the health system on the verge of collapsing, social distancing guidelines and lockdowns will still be present in the country which will reduce the chances of recovery of iron supply. It will take a considerable amount of time before mines can safely resume operations to meet the rising global demand for iron ores.

A Base Metal Caught in the Crossfire of Growing Diplomatic Tensions

In the past two decades, China has conquered the stainless-steel market. Stainless steel is vital to virtually every other sector, and production is growing faster than that of other metals such as lead, copper, and aluminium. Weaponry, pipelines, ships, and washing machines all contain stainless steel. In the past couple of decades, the production of steel, the main component of the stainless kind, has shifted dramatically to China.

One of the largest valued items of China's trade with Australia is iron ore, with China importing 232.7 million tonnes from Australia in the first four months of the year, about 68% of its total. The other major supplier is Brazil, currently battling mining disruptions caused by the COVID-19 pandemic, and other than the South American country, there is no nation that can come close to meeting China's needs. According to China customs data, 65% of China's iron ore imports in 2020 came from Australia. China, the world's top iron ore consumer, brought in 358.4 million tonnes in the first four months of 2020, boosted by robust demand at mills.

China's customs authorities have issued a notice over the new supervising rules, to take effect from 1st June 2020, which will oblige customs officials to inspect iron ore at the request of the trader or importer. This replaces the previous system where customs officers conducted mandatory on-site inspections of iron ore batch by batch. The announcement comes at a delicate time when the China-Australia relations have ebbed because of Canberra's incessant efforts to spearhead an independent probe of the COVID-19 outbreak in China to stigmatize the country.

This announcement will fuel any souring relationship as it is feared the change will mean Brazil's exports may pass through Chinese ports swiftly without any inspection, while Australian exports languish on the docks. Australia is reliant on the world's second largest economy, China, for trade. However, this may be the reverse when it comes to iron ore. If Canberra banned iron ore exports, even for a short period of three months, or placed a substantial export tax on shipments on China, this will deal a huge blow to China. It will pose a significant threat to China's 1 billion-tonne-a-year steel industry that is heavily dependent on Australian ore, a raw material it cannot get elsewhere, and of which it would rapidly run out given any kind of stoppage.

In other words, in the unlikely event of a massive escalation, Australia does hold some cards in its relationship with China, having the ability to devastate not just the steel industry, but all the downstream sectors reliant on it, such as construction, infrastructure and manufacturing. It is likely that neither country wants to escalate the tariffs much beyond barley, and the issue may fizzle out, especially if Beijing thinks its bully-boy tactics have worked, and Canberra thinks it has stood up to China without inflicting too much damage on itself. Beijing may have to tread carefully on iron ore, given the lack of options beyond Australia, although Canberra would be probably only using the threat of taxing or limiting exports of its top money-spinner as a last resort.

We remain in the view that exports of iron ore from Australia to China will be left on the side-lines amidst the worsening diplomatic relationship due to the strong national security issue of China's steel industry, as well as possible military or trade retaliation if there was to be a ban on exports of iron ores to China. However, we should remain cautious about this matter and closely monitor any growing developments regarding the iron ore trade between these two countries. If Australia decides to stop sales of iron ore to China, we will probably see iron ore prices skyrocket as the demand for iron from the Chinese economy will have to be met to complete infrastructure and construction projects, regardless of the country of source for iron ores. Whatever the case, iron ore remains a valuable commodity for China as it attempts to reverse the impacts of the pandemic on its economy. We expect iron ore prices to remain well supported.

TRADE IDEA: LONG FEF1! IRON ORE FUTURES (TSI IRON ORE CFR CHINA (62% FE FINES) INDEX FUTURES)

Fundamentally, we foresee iron ore future prices to increase due to upwards iron demand from the Chinese fiscal stimulus package, which will include spending on infrastructure and construction, and this requires massive amounts of steel and iron. Expected fiscal spending and investments on fixed assets are also likely to increase through the year. On top of the demand from iron ore to manufacture steel, we also believe that the revival of demand for iron ores will arise from other downstream manufacturing activities to consumers and this will sustain bullish prices for ores.

Just like for the copper market, the iron market experienced a supply shock when the pandemic started to hit the South American nations. However, for the iron market, chances of recovery look even slimmer, as Brazil has yet to face the peak of the virus. With poor health infrastructure in place to deal with the pandemic, we foresee the virus having an even more dire consequence on the nation and this will further delay any resumption of mining activities. The seaborne iron market is heavily dependent on the supply from Brazil, and this disruption in mining operations will lead to a severely tight iron ore market.

Diplomatic tensions between Australia and China will be a very relevant theme for the iron market as well. We are unlikely to see any severe escalations of tensions that will lead to a cease in the sales of iron ore, but if that happens, we believe that iron ore prices will be elevated as well. It is important to monitor the diplomatic situation between these two countries.

Figure 207: FEF1! Daily Chart (*Source: TradingView*)

Technically, there are indicators suggesting taking a long position in iron ore futures. Prices are trading above the 20-SMA, 50-SMA, and 100-SMA (Figure 207), with all of these moving averages pointing upwards and thus, signalling a strong buy call. The 20-SMA has also recently crossed above 50-SMA and 100-SMA, in mid-May and late May respectively, confirming that prices are currently in a strong uptrend.

Figure 208: FEF1! Daily Chart (*Source: TradingView*)

Spot price: 103.04
Take profit: 105.91
Stop loss: 102
Risk to reward ratio: 2.76

Prices are also currently trading above the Ichimoku Cloud, suggesting that prices will remain in an uptrend. RSI indicator also shows that prices are not yet at overbought territories, although there will be a need to keep a close eye if the RSI surpasses the 70 level. The RSI remains flat for the past week (Figure 208).

The stop loss level is determined by a strong support level that has been tested repeatedly during the past two weeks at 102, while the take profit level is determined by the almost 11-month high that was attained in mid-June at 105.91 (Figure 208). This leaves a risk to reward ratio of 2.76.

GOLD & SILVER (Overweight)

In the first quarter of 2020, Gold has been able to retain its gains in 2019 and end the period more than 1% higher than its starting value. 2020 began with geopolitical tensions between the U.S. and Iran, which soon gave way to the spread of the COVID-19 around the world. Travel bans and country lockdowns led to economic turmoil in March, while governments responded with record breaking quantitative easing packages. Economic uncertainty and a sharp fall in real interest rates have resulted in the price of gold to grow more than 12% YTD.

Often dubbed "poor man's gold", silver is also a precious metal and shares the same price drivers as gold. However, approximately 50% of silver supply is used for industrial purposes, ranging from solar panels to medical equipment. This results in a higher volatility of the price of silver compared to the price of gold. Thus, the performance of silver has been dismal at -2.8% YTD, due to the COVID-19 pandemic that has led to a fall in manufacturing and industrial demand for silver.

In our previous outlook, we expected the price of gold and silver to be supported by the FED's monetary policy of easing and increased geopolitical uncertainty. Indeed, this has turned out to be true as the FED had cut its target rate to zero. On the geopolitical front, many issues still remain to be resolved between China and the U.S.

Looking forward, bullish tailwinds for gold and silver will include the Federal Reserve's policy to the zero-lower bound (ZLB), a new wave of quantitative easing (QE) and geopolitical uncertainty.

Inflationary Environment Post COVID-19 Conducive for Higher Gold Prices

Real yields have been suppressed by the FED with QE, in the hope of boosting inflation expectations. Currently, Treasury Inflation-Protected Securities (TIPS) yields have fallen to -0.5 % while U.S. 10Y Treasury yields stand at 0.65%. This has been a key reason to the superior performance of gold in 2020 so far as higher inflation expectations boost demand for gold due to its traditional role as a hedge against inflation. As shown in (Figure 209), real yields and gold prices exhibit a strong negative correlation.

Figure 209: Gold Price vs Real Yields (*Source: Federal Reserve Of St. Louis*)

We are of the view that a sustainable rebound in oil prices and wider breakeven rates would lead to the next leg lower in real yields (higher inflation). Rising oil prices are an example of cost-push inflation as the costs of basic goods and services generally increase. On the demand side of the inflation equation, the increase in money supply is unlikely to be met with a corresponding increase in the production of goods and services. The recovery in demand will be much swifter than the recovery in supply. As lockdowns around the world begin to be lifted, we expect to see households flocking to shops and malls, to escape the homes that they have been confined in. In many cases, households would have built up savings to fund such a spending spree. As shown in (Figure 210), personal savings rates in the U.S. skyrocketed in April to a record 33%. On the other hand, firms will likely be unable to meet this increase in demand. For example, firms who laid off a percentage of their workforce during the recession would consequently see a fall in output even when the economy has recovered. As different countries are affected by COVID-19 by varying degrees, the dislocation to global supply chains will also take time to heal. Thus, demand-pull inflation will occur as "too much money chases too few goods".

On this note, silver is expected to outperform gold when higher inflation is accompanied with economic growth. As explained earlier, at least half of silver supply is leveraged to industrial consumption. In contrast, industrial demand for gold constitutes less than 10% of gold output. Hence, we can expect silver to outperform gold should the current macroeconomic recovery maintain its strong momentum.

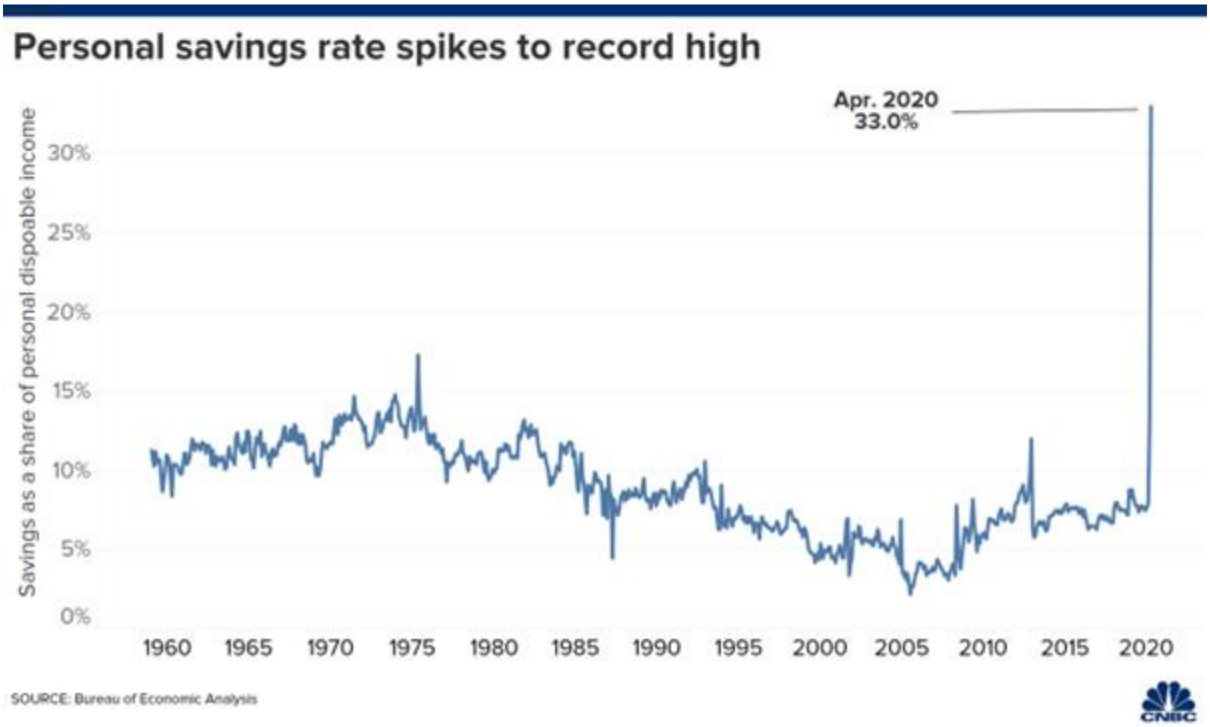

Figure 210: Personal Savings Rates (*Source: Bureau of Economic Analysis*)

"Lower for Longer" Interest Rates

The current rates and monetary policy environment are key drivers behind our bullish gold outlook. We expect policy accommodation this time round versus post GFC (Great Financial Crisis) to be bullish for gold. An environment of low rates is bullish for precious metals as it reduces the opportunity costs of holding non-interest-bearing instruments like gold and silver.

With more than USD 5.5 trillion in securities purchased, central bank balance sheets globally have exploded to record levels. Unwinding these balance sheets look unlikely in the short to medium term, and with debt-to-GDP ratios standing at record levels, monetary policy will likely have an important role to play in helping governments cope with the debt. However, with Fed Funds futures pricing in negative rates (which we do not expect the FED to go to), the FED would have to use other monetary tools at their disposal. Such tools include further asset purchases and yield curve control. These measures would thus keep real interest rates even lower for longer. In this "new normal" of depressed yields and loose monetary policy, concerns on currency debasement are also likely to worsen, which would provide a further boost to gold and silver prices, as investors seek to hedge against unfettered currency printing.

Geopolitical Risks Remain on the Horizon

Although we saw a signing of the Phase One deal between the U.S. and China at the beginning of 2020, ensuing events arguably overturned any de-escalation of tensions between the 2 countries that was a result of the Phase One deal. Firstly, the spread of COVID-19 had severely limited China's ability to commit to its purchase of USD 200 billion worth of U.S. goods, causing President Trump to be unhappy with China. The devastating effect of the virus in the U.S. has also pressured President Trump to harden its stance against China, as he levied accusations that the virus had originated from China. This has led to retaliatory measures such as China threatening to "reconsider" the Phase One deal.

With the November election looming, this further complicates ties between the 2 countries as a tough stance against China is popular. The decision to remove Hong Kong's special trade status with the U.S. in response to China's tightening grip on Hong Kong is arguably an example of political showmanship. President Trump has yet to maintain a fine balancing act between shoring up the economy and being tough on China, as the U.S. and China cannot afford to fight a trade war, not in the wake of COVID-19.

With China's unpredictable behaviour, the geopolitical outlook is uncertain, with risks tilted to the downside. Hence the geopolitical situation is likely to be bullish for gold and silver due to their "safe-haven" status. However, silver is likely to lag gold in performance, as gold remains the preferred metal when investors are driven by panic and fear.

Capital Inflows into Gold and Silver-Backed ETFs

According to a report by the World Gold Council, globally, gold-backed ETFs added 170 tonnes in April, boosting holdings to a new all-time high of 3,355 tonnes. Assets under management (AUM) also reached a new record high of USD 184 billion as gold in USD moved higher by 5.8%. Similarly, demand for silver-backed ETFs have reached all-time highs, having added 42 million oz in Q1, of which 30.3 million oz were added in March. As the price of silver suffered a decline of 13% for April YTD, this capital inflow implied that investors were buying the dip in silver prices.

The buying is a clear indication of the increasing prominence of gold and silver in investors' portfolios as such ETFs provide exposure to the price of gold and silver.

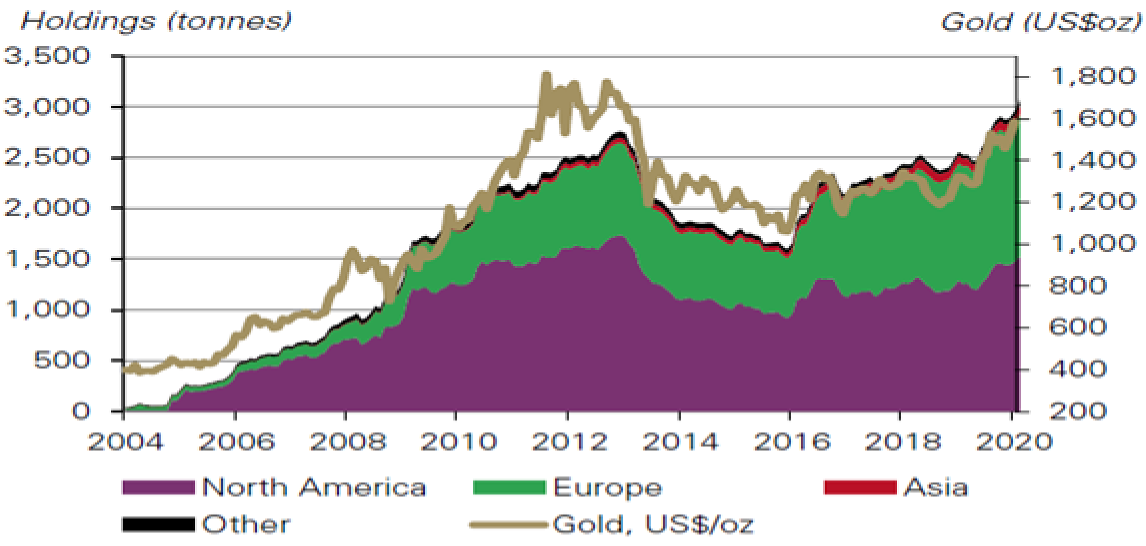

Figure 211: Price of Gold Against ETF Holdings (*Source Gold.org*)

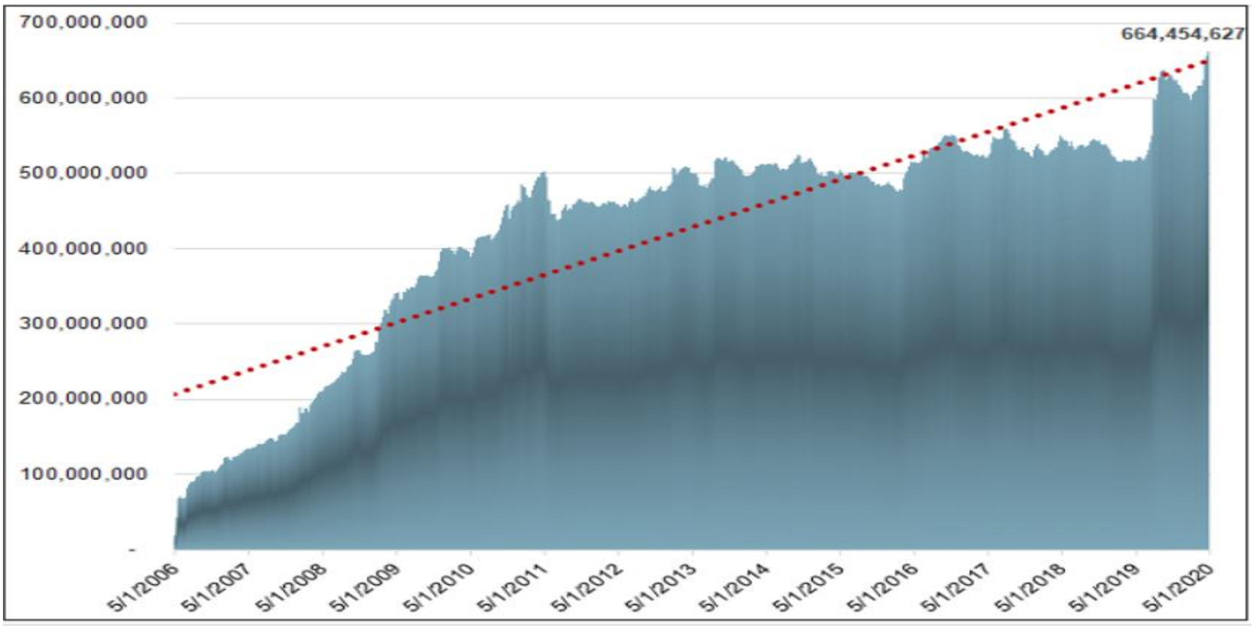

Figure 212: Silver ETF Holdings (*Source: Bloomberg*)

Gold EFP Market Not Out of the Woods Yet

An EFP (Exchange for Physical) is an agreement between 2 parties to trade a futures position for the underlying asset, which in this case is gold. In the gold market, banks and other institutions trade physical gold that sits in London, due to the fact that London is the global hub for the physical (and spot) gold market. On the other side of the world, COMEX futures contracts are fulfilled by a delivery of physical gold to the CME (Chicago Mercantile Exchange) in New York. A price differential exists between the futures and spot price due to the shipping, insurance and the storage costs of physical gold.

The two prices, on average, are only a few dollars within each other. However, in March 2020, this spread elevated to 80/oz. This was due to 2 reasons. Firstly, while the spread of COVID-19 was accelerating quickly, a ban on international flights was one of the first few measures that were implemented by governments across the world. This meant that transatlantic flights were affected, and so was the amount of physical gold that could have been transported from the gold market in London to New York for delivery against futures contracts. Thus, this created a perceived shortage of physical gold, which elevated the price of futures contracts.

Secondly, the COVID-19 resulted in a bottleneck in the delivery of physical gold to fulfil the futures contracts. While the physical gold in London was stored in the form of 400 oz bars, the size stipulated for delivery in the COMEX futures contracts was in 100 oz bars. As countries in Europe began to lockdown, refineries in Switzerland and Germany reduced their capacity to convert the 400 oz bars to 100 oz bars, resulting in a fewer supply of 100 oz bars to New York. Such an anomaly in the futures market has contributed to the price of gold rising to above 1600 in late March, as it had a psychological effect on influencing investors to wrongly perceive that there is a shortage of physical gold.

With commercial flights set to resume in the near future, the restart of the Swiss refining capacity, along with the CME Group's launch of a new gold futures contract that has expanded delivery options which includes delivery in kilo bars, 100 oz bars or 400 oz bars, the EFP spread has been reduced to under 10/oz. However, this could widen again if fears over a second wave of infections materialise, causing disruptions to supply chains and affecting the delivery of physical gold.

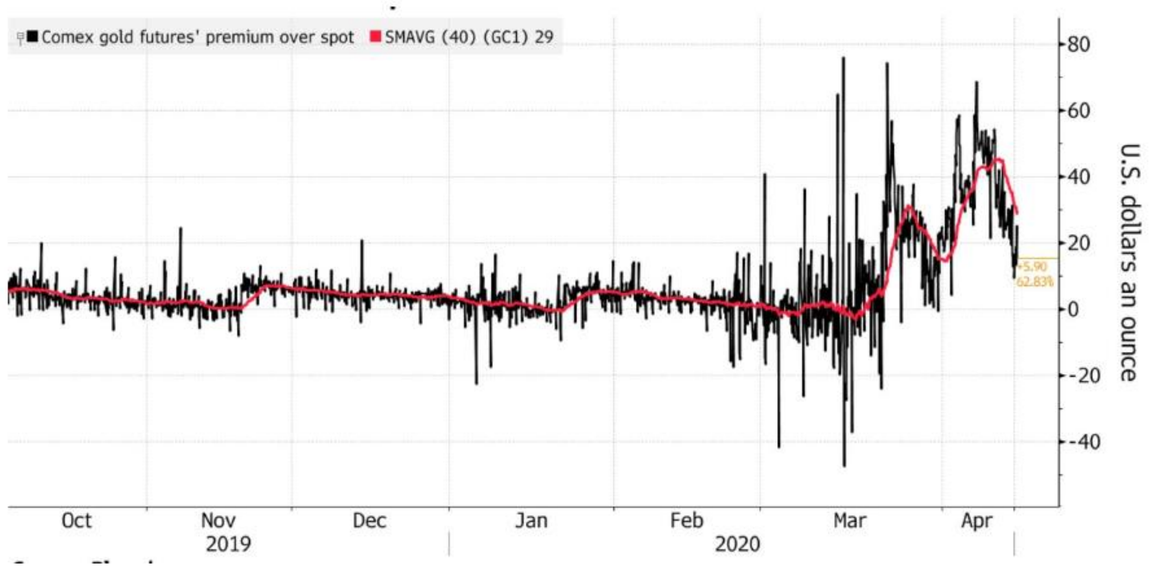

Figure 213: Comex Gold Futures' Premium Over Spot (*Source: Gold.org*)

TRADE IDEA: LONG XAUUSD

While we maintain an overall bullish thesis, as explained above, we expect gold prices to be volatile moving forward.

In the short term, the USD is expected to remain strong. Gold prices are already at record levels for every major currency save for the USD. This points to strong external demand for the greenback as a hard fiat currency. While FED swap lines and repo facilities have eased dollar funding pressure and weakened the USD from March peaks, the dollar index still remains historically high, hovering around the 100 mark. Due to the inverse USD – gold relationship, this could limit the surge in gold prices in the immediate term. However, in the longer term ahead, the USD is expected to undergo a pro-cyclical weakening once economies have fully reopened, giving way for gold to break out of its current range. This is because when global trade rebounds, more USD will enter the market as the USD accounts for approximately 88% of all foreign exchange transactions. Hence, we would see a marked increase in USD liquidity resulting in its weakening.

Thus, due to this headwind, we recommend "buying the dip" in gold prices.

Figure 214: XAUUSD Weekly Chart (*Source: Oanda*)

Entry: 1771
Take profit: 1900
Stop loss: 1725
Risk to reward ratio: 2.8

Currently, the price of gold has broken out from its previous trading range between 1670 to 1735. A "rounding" chart pattern is also observed which signifies a reversal in price movement. A bullish hammer pattern has formed on the weekly chart, signalling that price has completed its pullback and is ready to resume its uptrend. The candlestick is called a hammer as it hammers out a base at the bottom of the downtrend, or in this case a pullback. The pattern has also coincided with a level of support at 1728, adding more validity to the bullishness of the candlestick pattern. We recommend going long at the current market price of 1771 due to current bullish momentum. A stop loss at 1725 will be used in view of market volatility. In return we expect a sizeable take profit of 1900 to obtain a decent risk to reward ratio of 2.8.

TRADE IDEA: LONG XAGUSD

The Gold/Silver Ratio is often used as a tool for investors to decide if they should overweight Gold or Silver within their portfolio that is dedicated to investing in precious metals. It is calculated by dividing the price of Gold over Silver. For example, if the price of Gold is USD 1600 and the price of Silver is USD 20, the Gold/Silver Ratio will be 80. Historically, investors should look to long or overweight Silver when the ratio hits 80 and long or overweight Gold when the ratio hits 50.

The effectiveness of the Gold/Silver Ratio lies in the historically close positive correlation between Gold and Silver. From 2012, this correlation still remains above 90%. However, due to the volatile nature of the price of Silver, it might diverge from the price of Gold for periods of time.

We are of the view that the Gold/Silver Ratio has already peaked at 124x, reached at the height of the COVID-19 financial markets shock in March. As economies reopen and industrial demand for silver recovers, we expect the Gold/Silver ratio to revert to its mean of 75-85x.

Figure 215: Gold/Silver Ratio (*Source: Oanda*)

Our bullish thesis for gold is similar to that of silver, with the additional expectation that the current economic rebound is sustained moving forward. With the Gold/Silver ratio still remaining high at around 100x, there is sizeable room for downside momentum, for it to normalise at the 75-85x range. Hence while we are bullish on gold, we are even more bullish on silver.

Figure 216: XAGUSD Weekly Chart (*Source: Oanda*)

Entry: 17.80
Take profit: 21.00
Stop loss: 17.00
Risk to reward ratio: 4

A bullish hammer pattern has formed on the weekly chart, signalling that price has completed its pullback and is ready to resume its uptrend. The candlestick is called a hammer as it hammers out a base at the bottom of the downtrend, or in this case a pullback. The pattern has also coincided with a level of support at 17.40, adding more validity to the bullishness of the candlestick pattern. Additionally, a 20 and 50 EMA crossover is observed, providing another bullish signal.

We thus recommend going long silver at the current market price of 17.80. With a contraction in the Gold/Silver ratio, price is expected to break through the 3-year strong resistance zone at 18 to 18.50. The bullish momentum from the expected breakout at this significant level of resistance should pave the way for price to reach its 3 year - high of 21, which is our proposed profit target.