NUS INVESTMENT SOCIETY

Global Macro Department – European Union (Underweight) Date: 27th December 2020

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Basic Information

Real GDP(USD Billion)	13.34
M2(€ Billion)	13.51
CPI	104.8
PPI	102.1
Con. Confidence	-13.9
Currency	Euro (EUR)

Chart info

Overview of the European Union

- The European Union (EU) currently consists of 27 members. Of these 27 members, 19 use the Euro as the official currency. These 19 countries are classified in a smaller subset known as the Eurozone or Euro area. The Euro is the world's second reserve currency.

- The Central Bank of the EU is the European Central Bank (ECB). Christine Lagarde is the current President of the ECB. The ECB is tasked with ensuring price stability across the 19 countries that use the Euro. The ECB can manage and implement monetary policy for the Eurozone, as well as manage foreign reserves.

- The European Commission can be thought of as the legislative body of the EU. Ursala von der Leyen is the current president of the European Commission. The Commission handles legislative matters for all 27 members. It has recently been involved in the negotiations of the Recovery Bill which has since concluded and the ongoing negotiations of Brexit.

- The main driver of growth in the EU is the Services sector. It makes up 70% of GDP. Manufacturing makes up 25%.

- Within the EU, there are 4 main economies. In order of GDP, they are Germany, France, Italy and Spain. They each contribute 25%, 17%, 13% and 9% to EU GDP respectively. Our focus will thus be on these 4 countries.

- The main trading partners of the EU are the U.S., the UK and China. The U.S. is the biggest export partner, followed by the UK and China, while China is the largest import partner, followed by the U.S. and the UK.

Summary of Events in the Past 6 Months

Fiscal Policy

- 21st July 2020: EU leaders agreed on a €750 billion recovery effort to help the EU tackle the crisis caused by the Covid-19 pandemic and on a €1074 billion long-term EU budget for 2021-2027.

- 10th December 2020: The EU's €1.8tn seven-year budget and Covid-19 recovery fund were unblocked after Hungary and Poland lifted their objections to a link between payments and maintaining the rule of law. This allows the EU to disburse the funds under the budget, previously blocked by Hungary and Poland due to a rule-of-law condition.

Monetary Policy

- 18th March 2020: The ECB announced a new temporary asset purchase programme of private and public sector securities with an envelope of €750 billion called the Pandemic Emergency Purchase Programme (PEPP). The PEPP will assist in stabilizing liquidity conditions and also help bring inflation back to pre- Covid-19 levels.

- 30th April 2020: The interest rate on all targeted longer-term refinancing operations (TLTRO III) reduced by 25 bps to -0.5% from June 2020 to June 2021, with a minimum of -1.0% if banks meet the lending threshold.

- 30th April 2020: A new series of non-targeted pandemic emergency longer-term refinancing operations (PELTROs) was introduced to support liquidity conditions in the euro area financial system and contribute to preserving the smooth functioning of money markets by providing an effective liquidity backstop. They will be carried out with an interest rate that is 25bps below the average rate on the MRO.

- 4th June 2020: The envelope for the PEPP was increased by €600 billion to a total of €1,350 billion. The horizon for net purchases under the PEPP was extended to at least the end of June 2021

- 10th December 2020: The envelope of the PEPP was increased by €500 billion to a total of €1,850 billion. The horizon for net purchases under the PEPP was extended to at least the end of March 2022. The ECB will conduct net purchases until it judges that the Covid-19 crisis phase is over.

- 10th December 2020: For TLTRO III, the ECB will extend the period over which considerably more favourable terms will apply by twelve months, to June 2022. Three additional operations will also be conducted between June and December 2021. The total amount that counterparties will be entitled to borrow in TLTRO III operations will be raised from 50% to 55% of their stock of eligible loans.

- 10th December 2020: The ECB will offer four additional pandemic emergency longer-term refinancing operations (PELTROs) in 2021, which will continue to provide an effective liquidity backstop.

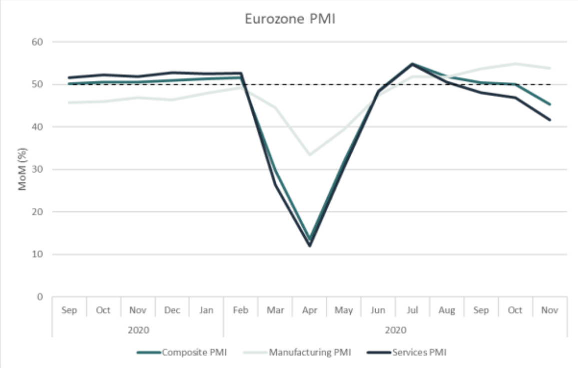
Geopolitical Events

- 6th November 2020: The EU announced tariffs of $3.99 billion on U.S. aircraft, as well as a range of agricultural and industrial goods over the long-standing dispute over the subsidizing of aircraft production.

- 24th December 2020: The EU and the UK finally reached an agreement, putting the Brexit issue to rest after more than 4 years. It has yet to be ratified by both British and European Parliaments, and some finer details have yet to be ironed out but the main points of contention have been resolved, including fishing grounds and the level playing field.

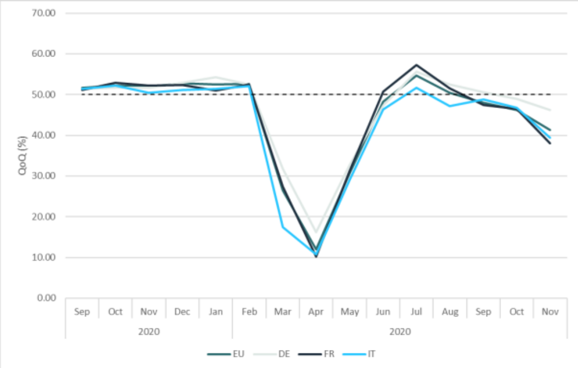
European Union

Figure 1: Eurozone PMIs



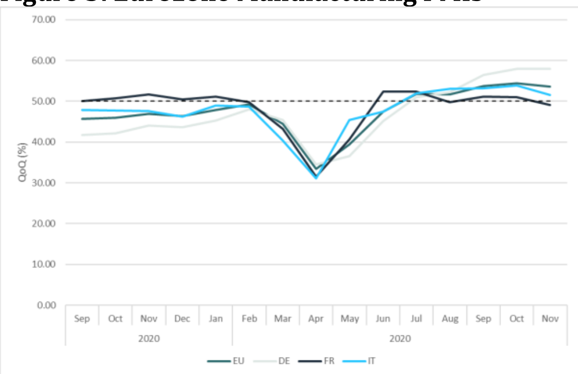
Source: Thompson Reuters

Figure 2: Eurozone Services PMIs



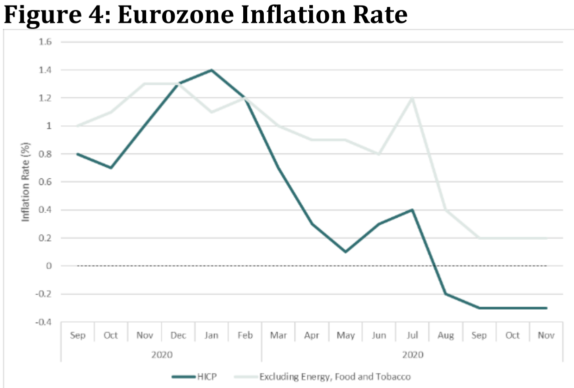
Source: Thompson Reuters

Figure 3: Eurozone Manufacturing PMIs



Source: Thompson Reuters

Figure 4: Eurozone Inflation Rate



Source: Thompson Reuters

Double Dipping

After stringent lockdowns in 2Q20, the European Union ("EU") seems to be recovering and on an upwards trajectory. PMI readings have made a V-shaped recovery, with the turnaround coming in April 2020 and readings finally in expansionary territory in June 2020. Following a second wave of Covid-19 across Europe, with the new surge of cases seemingly more serious than in the 1st wave, numerous countries are once again going into various levels of lockdowns. The all-important Services PMI dipped below 50 again in August 2020, ahead of the announcement of lockdowns. It is now in contractionary territory, dashing any hopes of a reflation story. However, we see a divergence between Manufacturing and Services PMI numbers (Fig. 1). The current wave of restrictions are aimed at minimising social interaction while still allowing the economy to function. China's strong rebound could also have contributed to the stronger recovery in Manufacturing as exports remain supported.

Focusing on the major economies of the Eurozone, German, French and Italian readings show a divergence between Manufacturing and Services PMI. German Services PMI dipped below 50 in October (Fig. 2) but has seen the highest expansion in Manufacturing relative to other countries. French Manufacturing PMI has stayed barely above 50 since August (Fig. 3), dipping below 50 in November. We expect both Services and Manufacturing stay below 50 at least till Feb 2021 given a new wave of lockdowns in the EU on the back of a new, more transmissible virus strain in the UK. We also expect this strain to be present in the EU, necessitating more stringent lockdowns if the current restrictions do not curb the spread.

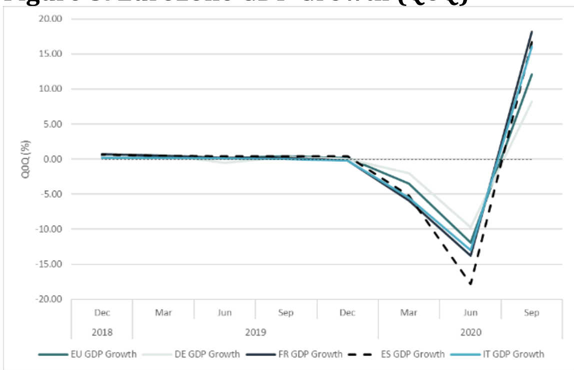
Inflation numbers are also very worrying. The EU has had a long history of failing to hit its 2% inflation target. Following the pandemic and lockdowns, the HICP has fallen through the floor (Fig. 4). Despite extensive amounts of stimulus provided by the ECB and the subsequent reopening of businesses across Europe, the HICP has continued its downwards trends. Other than the slight bounce in July 2020, probably the result of reopening and optimism, it seems that we might enter a period of deflation as PMIs continue to decrease and new restrictions are announced. The HICP finally dipped below 0.0% in August 2020. We have not seen a pickup in inflation from its low of -0.3% since September 2020.

Looking past PMIs, other indicators of household and retail spending does not look good either. Most of these indicators have fallen into contractionary territory. With a large part of the economy being driven by the services sector, the weak handoff to Q4 makes the case of negative growth increasingly likely, with a possibility of extended weakness into 1Q21 amidst broadening lockdowns.

Eurozone GDP fell by 14.7% Y-o-Y in June 2020 (Fig. 5), the largest contraction on record as it pushed the economy to a recession. Germany saw the smallest decrease in GDP, while Spain saw a larger decrease. The EU economy saw record growth in Q3 as the economy slowly reopened, but it has to be noted that the small base will make any recovery seem large. Of note will be Spain's recovery relative to the other economies. Despite the larger contraction in Q2, the Q3 recovery was in line with other economies. Spain's growth is lagging the main economies in the EU.

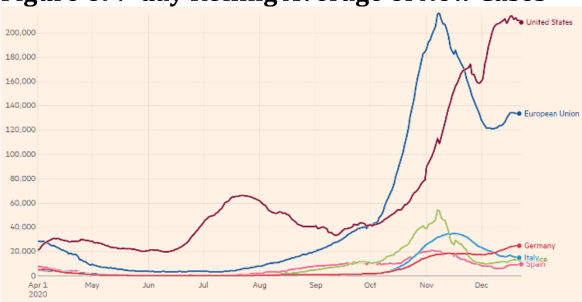
A weak start to Q4, coupled with lockdowns opens the doors to a double-dip in GDP. The respective governments in the EU have recently given guidance in early November that they expect flat or even negative GDP growth in Q4. The weaker than expected inflation and PMI readings have increased the possibility of a double-dip, but the

Figure 5: Eurozone GDP Growth (QoQ)



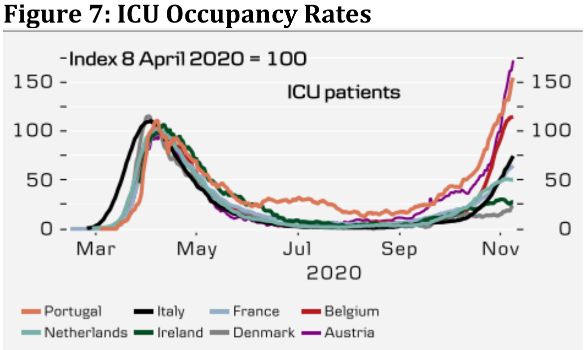
Source: Thompson Reuters

Figure 6: 7-day Rolling Average of New Cases



Source: Financial Times

Figure 7: ICU Occupancy Rates



Source: Danske Bank

current bright spot is the Manufacturing sector which looks to be recovering and riding on the coattails of China's recovery.

Winter is Coming

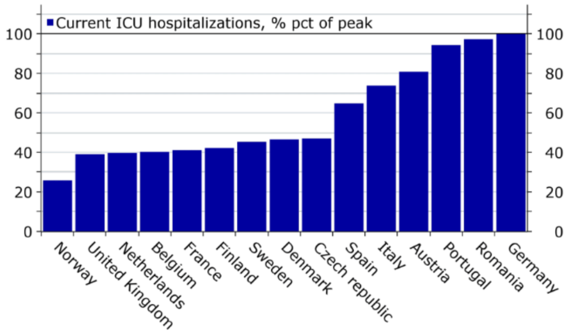
The second wave is definitely hitting Europe hard. Referring to Tomas Pueyo's "The Hammer and the Dance", Europe successfully implemented the hammer in the first wave in March and April, and then 'danced' its way around the virus throughout the summer period. As we entered Fall, the virus came back and reared its ugly head. The situation is much worse than that in the first wave, with all countries except Germany setting new records and exceeding the highest number of new cases in the first wave (Fig. 6).

Sectors that will be affected include restaurants, leisure, accommodation and retail. If the first wave is anything to go by, we could potentially see restrictions similar to the first wave if the situation worsens further. European governments are for now trying out new measures, aimed at social distancing rather than total lockdowns. Governments know that their economy cannot sustain another period of protracted inactivity by keeping everyone at home. There is only so much the government can provide in terms of fiscal support and unemployment checks before fiscal deficits get too high. Protests against lockdowns are also occurring, albeit these are rare, but the government knows the population won't take protracted lockdowns happily and may start pushing back. Footfall in workplaces seems to be unaffected by the new wave of restrictions, and thus we believe that the resulting impact of the virus will be small for now. Lockdown policies across the EU sing the same tune. Restaurants and bars are by and large still open for businesses. Travel bans with Britain have been initiated, but France is reopening borders.

	Germany	France	Italy	Spain	Netherlands	Belgium	Portugal	Ireland
Restaurants & bars closed	Yes	Yes	Yellow regions open until 6pm, orange regions only takeaway and home delivery	No, with regional exceptions	Yes	Yes	No	No
Schools closed	Yes	No	Only secondary schools are closed (to partially re-open 7 Jan)	No	Yes	Holiday period now, schools reopen in January	No	No
Curfew	Regional level, 9pm to 5am	Yes	Yes	Yes	No	Yes	Yes	No, but limited non-essential travel (temporarily lifted for Christmas)
Non-essential retail closed	Yes	No	No, except for weekends and (pre-) holidays	Differs by region	Yes	No (put some services like hairdressers are closed)	No, with regional exceptions for certain days	No
End of measures	Jan 10	Jan 20	Jan 15	May 9, with regional flexibility in between	Jan 18	Jan 15, until further notice	Jan 7	Data dependent

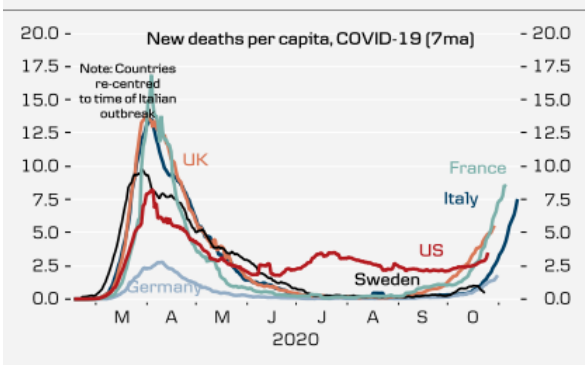
ICU ("Intensive Care Units") occupancy rates are also starting to rise, and some regions are reporting significant strain on ICU capacity. The silver lining is that lockdowns are starting to take effect and new infection numbers have stabilised. Hospitalisation lags infections, and if the reproduction rate of Covid-19 is indeed under control, we will see the peak in hospitalisation soon. The number of people dying from Covid-19 also remains far below its spring level (Fig. 9). The experience gained from the first wave has prepared medical staff to be prepared for a potential next wave. It has also shown which groups are most vulnerable within the population.

Figure 8: ICU Occupancy Rates



Source: Nordea

Figure 9: 7-day Rolling Average New Deaths per capita



Source: Danske Bank

A major concern in the first wave was a lack of hospital beds and medical facilities to house patients. We believe that the trigger for a full lockdown would be the availability of such facilities. If medical services start to get strained once again, there may be no choice but mandatory lockdowns. ICU occupancy rates have gradually fallen, but we remain cognizant of another shortage due to the new strain from the UK. In the meantime, while markets may be moved by headlines regarding new cases, the medium-term implications are still the same, a slow recovery. This will change once death numbers start rising again.

Despite efforts to stop the spread, citizens in the EU will not have a very merry Christmas, and even a New Year. We expect restrictions to be put in place throughout winter, possibly extending past January 2021.

As a final note, it could be a coincidence that the virus is rearing its head as we approach winter. There has been no research yet on the virus and its virility in colder temperatures, yet the possibility that winter will worsen the situation should not be ruled out. It has been proven that there are at least 6 strains of Covid-19, with varying degrees of infectiousness in different climates and temperatures. It may not be a failure of social distancing that led to another wave, but purely an increased infection rate. This however does not ameliorate the government's predicament if things take a turn for the worse. The most effective solution is still lockdowns. As we enter the last quarter of the year, head the words of House Stark. Winter is coming.

It's Not A Handout

EU's Fiscal Push

On 17th July 2020, EU leaders in Brussels finally agreed on a landmark fiscal deal to help with recovery efforts, dubbed the Next Generation EU (NGEU). EU leaders also agreed on the Multiannual Financial Framework (MFF), a 7-year framework that regulates its annual budget.

The NGEU, which totals €750 billion, will be funded by the European Commission which will be authorised to borrow funds in capital markets. The funds will be distributed by 31st Dec 2026. Of greatest importance is the Recovery and Resilience Facility (RRF), which totals €672.5 billion and represents the bulk of the NGEU. It will consist of €360 billion worth of loans and €312.5 billion worth of grants. The disbursement of grants to member states will depend on numerous factors which depend on the year of commitment.

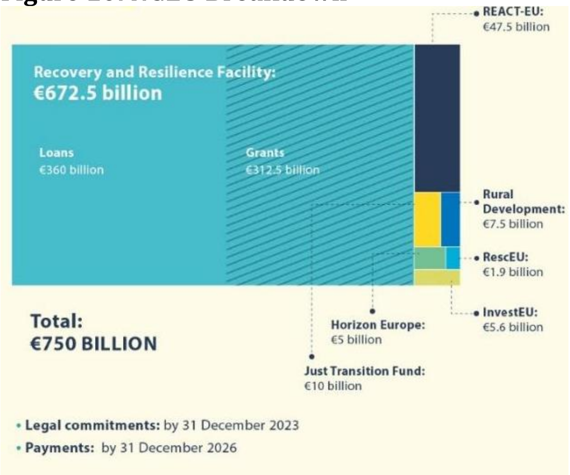
Countries will also have to prepare national recovery and resilience plans which are subject to approval by the Council. The criteria set includes:

- consistency with the **country-specific recommendations** of the European Semester
- strengthening the **growth potential, job creation and economic and social resilience** of the member state
- effective contribution to the **green and digital transitions**

Of the core economies in the EU, Germany and France would be net providers of the grants. Italy and Spain would be the main beneficiaries of the NGEU, ignoring smaller, periphery countries. Yet the amount of support that Italy would receive looks to be insufficient, receiving grants net of repayments at 2% of GDP based on 2019 figures (Fig. 12). Arguably, Italy is one of the harder-hit countries especially due to its debt burden.

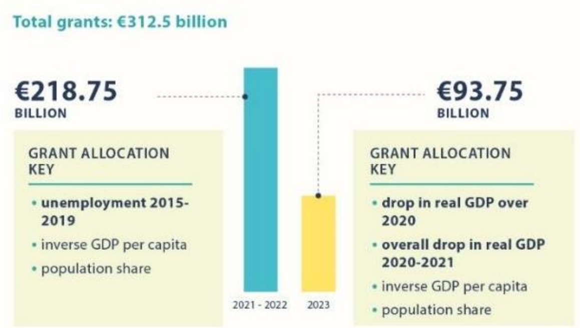
The disbursements of the grants and loans will not occur as a lump sum payment but would be disbursed over the course of 6 years to 2026. The earliest payment would occur in 2021, which arguably might be a little late for Italy and Spain.

Figure 10: NGEU Breakdown



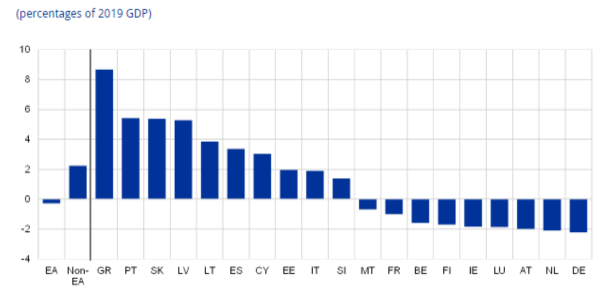
Source: European Council

Figure 11: RRF Grants Breakdown



Source: European Council

Figure 12: RRF Allocation of Grants, Net of Expected Repayments (% GDP)



Source: European Council

United We Stand, Divided We Fall

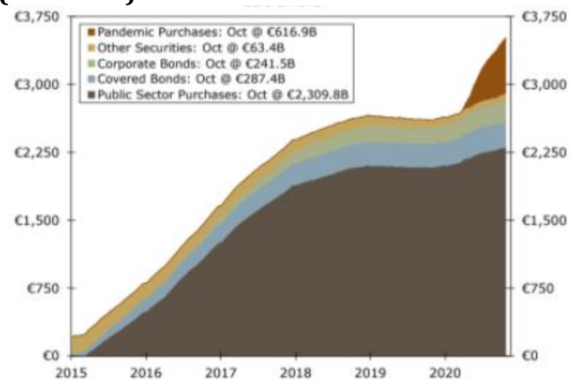
The approval of the NGEU has reduced the tail-end risk of a monetary union breakup. The monetary union had always been characterised by certain countries achieving stronger domestic growth whilst trying to deny fiscal support to weaker countries. An ongoing discussion during the NGEU talks was how the Frugal Four opposed the amount of grants given to weaker economies. The Frugal Four consists of the Netherlands, Denmark, Austria and Sweden, all countries that do well on their own. Their reluctance to agree to a higher amount of grants, essential transfer payments, is understandable, as there is nothing to gain for these economies, other than goodwill. Germany was previously part of the Frugal Five before dropping out and siding with Macron, and the reason for this is understandable. A large portion of Italian debt is held by French and German banks. If insufficient support were to be given to the Southern countries, a default of Italian debt will send shockwaves through the French and German economies. Angela Merkel, which has been running tight fiscal policy since her election as Chancellor has now opened its coffers to assist the Southern nations. At its core however, the decision is still centred on national interests.

Despite the passing of the NGEU in the European Council, the bill still has to be ratified by each individual parliament, which means passing each country's unique constitutional laws. One risk we were cognizant of was Hungary and Poland not ratifying the bill due to a rule-of-law condition. On 24th December 2020 however, both governments reached an agreement with the European Council, allowing for the disbursements of funds.

The monetary union is moving towards a union of fiscal transfer, which is an achievement a quasi-federation required to ensure longevity. The EU has shown that it is willing to support peripheries that are lagging. The tail-end risk of a breakup has thus lessened, lending strength to the Euro. Time will tell if this small, albeit important, step is temporary and necessitated by national interests. As the second wave hits Europe again, the Frugal Four might not be willing to concede anymore and may leave the Southern countries to fail. Additionally, Italy has had fundamental debt issues since 2019. In the event of a protracted period of lockdowns and negative growth, Italy may not be able to save its economy, inevitably dragging the rest of Europe down with it.

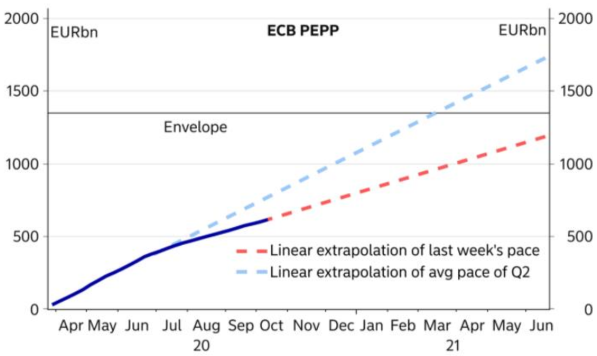
European Central Bank

Figure 13: ECB Cumulative Asset Purchases (€ Billions)



Source: European Central Bank

Figure 14: ECB PEPP Purchase Rate



Source: Nordea

Whatever It Takes Part II

With the major economies, France, Germany, Italy and Spain, going back into lockdown again, more stimulus might be on the tables. Couple this with extremely weak inflation and the case is even stronger.

The ECB conducts quantitative easing (QE) through the purchase of bonds on the open market through the Asset Purchase Programme (APP) and more recently through the Pandemic Emergency Purchase Programme (PEPP) in another envelope.

During the October meeting, the ECB announced that net purchases under the APP envelope will continue at a monthly pace of €20 billion, along with purchases under the additional €120 billion envelope till the end of the year in response to the Covid-19 situation. If the ECB were to end the extra €120 billion asset purchase envelope as planned at the end of the year, the PEPP would need to take up this extra €13 billion per month in order to keep the total monthly purchases unchanged. This would mean €83 billion PEPP purchases per month in 1H21 which would imply that the PEPP will run out around mid-next year exactly as planned.

At the October meeting, the ECB did not increase the envelope of the PEPP, maintaining the current envelope of €1.35 trillion. The current macro environment in the EU is plagued by the pandemic and a second lockdown. More stimulus would be needed, and thus calls for a possible extension of the PEPP till end-2021. The PEPP has two goals, to introduce liquidity and prevent fragmentation of the market and to bring inflation back to pre- Covid-19 levels. It has achieved the former but not the latter. Based on the additional €83 billion monthly purchases for till end 2021, that would entail an expansion of the PEPP envelope by €500 billion to €1.85 trillion. Alternatively, the PSPP envelope could be expanded by the same amount.

In the December meeting, the ECB indeed expanded the PEPP €500 billion as expected. The horizon for net purchases under the PEPP was also extended to at least the end of March 2022. The ECB has the flexibility to adjust the use of the envelope so the decision to expand the envelope is a pre-emptive one which would also tamper some EUR strength that would hurt the recovery. The ECB need not use the full amount of the envelope.

TLTRO IV

Another option that has been floated is a new series of Targeted Longer-Term Refinancing Operations (TLTROs) to increase lending to the economy. TLTROs function by offering long term funding to banks at an attractive rate dependent on the loans banks issue to non-financial corporations and households. There have been 3 issuances of TLTROs, with the latest issuance of TLTRO III in March 2019. Current interest rates on the TLTRO III are set as the average of the rates on main refinancing operations (MROs) over the life of the relevant TLTRO III operation (except the period from 24th June 2020 to 23rd June 2021, when it will be 50 bps lower than that average). TLTROs provide more than half of the excess liquidity in the Eurosystem, and thus it forms a core part of the policy mix of the ECB. The current series of TLTRO III had only 2 allotments left, which raised the chances of a new series of TLTROs being introduced.

The December meeting saw the ECB adding 3 allotments instead of introducing a new series of TLTROs. The period over which considerably more favourable terms will apply was also extended by 12 months, to June 2022.

In addition to more support from TLTROs, the ECB also offered 4 additional pandemic emergency longer-term refinancing operations (PELTROs) in 2021, which will continue to provide an effective liquidity backstop.

Can We Go Lower?

The last tool in the toolbox would be a further cut in rates. The current deposit rate sits at -50bps and in our opinion would not be the policy tool of choice for the ECB in the short term. The ECB did not cut rates as expected in the December meeting. Moving forward, the ECB would probably avoid rate cuts given its negligible impact on the economy. Markets, however, are pricing in another -10bps till at least next autumn in 2021, which in our opinion is possible. A rate cut would directly feed into the funding cost of TLTROs, allowing banks to borrow at a better rate.

Tiering

The tiering multiplier currently sits at six. This means that reserves as much as six times the minimum amount a bank is required to hold will be exempt from the ECB's current deposit rate and interest to be charged at the MRO rate. Any reserves beyond that mark will be subject to the ECB's current deposit rate. The reason behind the introduction of tiering was that banks profitability was hurt by NIRP. By excluding an amount of reserves from being subject to NIRP, it was hoped that bank profitability would not be affected while still incentivizing banks to lend to the economy and also to make cross-border transactions.

The tiering multiplier could be increased to defend against further unprofitability as excess liquidity increases in the coming months as more stimulus is given.

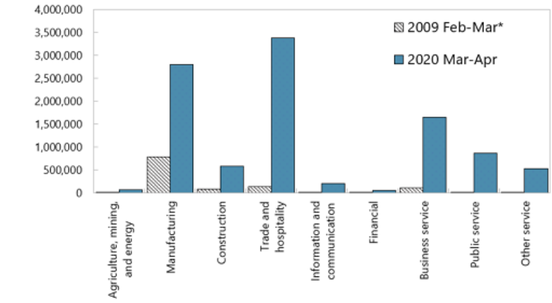
Hawks v Doves

The hallmark of Draghi's era was the rift between the doves and hawks in the ECB. Lagarde stated before taking the helm of the ECB that she would bring together both sides, and she did, at least in her first year as President. Fractures are starting to form as the pandemic wears on and this was apparent during the September meeting.

The recent economic data would support the doves. The doves have asked for even more stimulus in the face of deflationary pressures, a fear that is now realised as we head into winter. The hawks, however, counter that any 'dip' is temporary, caused by one-off factors and thus requires no intervention. They argue that the ECB has done more than enough and has already created more zombie companies in this extremely liquid monetary environment. Doing more would risk putting the economy at risk by further leveraging it.

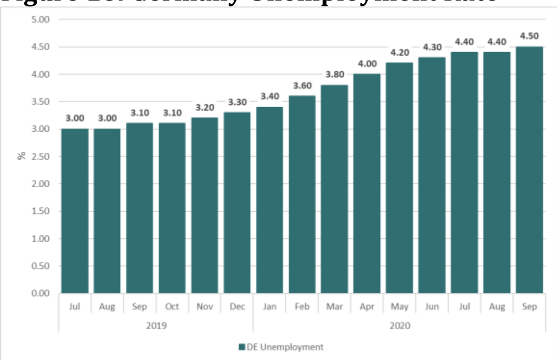
The September meeting also saw the word Euro mentioned 28 times, hinting that the ECB has been discussing its recent strength. Some ECB board members have spoken that they are more concerned with the macroeconomic environment rather than currency strength at this point, downplaying intervention to bring it down. However, it is in our view that the ECB will have to reconsider its stance given a new wave of lockdowns which will ultimately hurt inflation and growth in Q4.

Figure 15: Kurzabeit Applications



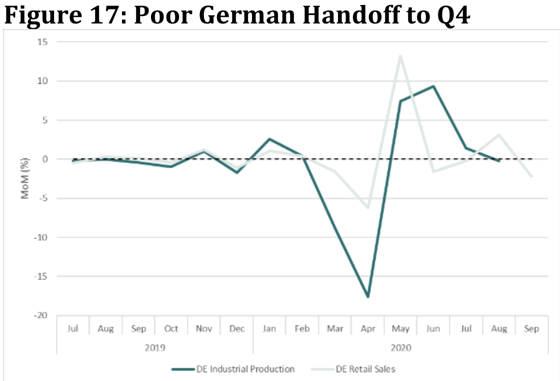
Source: FSO, IMF

Figure 16: Germany Unemployment Rate



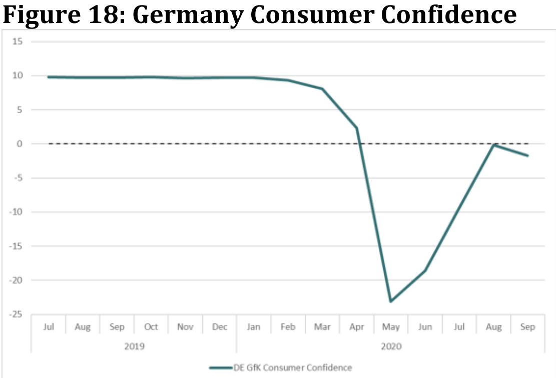
Source: Thompson Reuters

Figure 17: Poor German Handoff to Q4



Source: Thompson Reuters

Figure 18: Germany Consumer Confidence



Source: Thompson Reuters

Germany

To combat the Covid-19 crisis and subsequently support the recovery, the German government has adopted two supplementary budgets: €156 billion (4.9% of GDP) in March and €130 billion (4% of GDP) in June. The total plan will total 8.9% of GDP.

To finance this plan, the German government will issue €218.5 billion in debt this year. The stimulus package in June comprises a temporary VAT reduction, which would subsequently affect HICP inflation in Germany and in the EU. Adjusting for the VAT reduction, inflation would actually sit at 0.3%, which subsequently means that core inflation is not yet affected by the second wave. Provided inflation does not continue downwards, HICP should be positive in January 2021 as German VAT cuts are expected to end on 1st January 2021. The countercyclical capital buffer for banks has also been reduced from 0.25% to 0.00%.

Unemployment Levels Stable

The unemployment level in Germany has not increased significantly since July 2020 but is still at a 4 ½ year high. The German government pays companies to keep workers on their payrolls through its "Kurzarbeit, or "short-time work" program.

Previously, the government paid 60% of a worker's wages but has allowed benefits to rise to as much as 80% under its fiscal program. The Kurzarbeit program has also been extended to last 21 months. Workers who are told not to come to work are still counted as employed because the government pays companies to continue giving those workers most of their wages, thus unemployment levels have stayed stable at 4.5% (Fig. 16). Unemployment numbers are not a proper indicator of the health of the German economy given most of these workers are not engaged in productive activities and continue to stay at home.

Yet Worrying Signs Ahead

Even before the lockdown, German Industrial Production had been declining after June's recovery (Fig. 17). Retail sales have recovered to pre- Covid-19 levels but has worryingly dipped below negative in September. Germany's ability to see better growth will be dependent on retail sales, especially as we head into the holiday season. Yet consumer confidence is still below 0 (Fig. 18). Despite the stimulus that has been given to German citizens, consumers still seem unwilling to spend. The outlook for the German economy does not look good.

Poison is Super Effective

On 20th August 2020, Russian opposition figure and anti-corruption activist Alexei Navalny was poisoned by a nerve agent and was hospitalized in a serious condition. On 2nd September 2020, the German government said that it had "unequivocal evidence" that Navalny was poisoned by a Novichok agent and had called on the Russian government for an explanation. The EU and the UK imposed sanctions over Navalny's poisoning on FSB director Alexander Bortnikov and five other senior Russian officials and a state chemical centre.

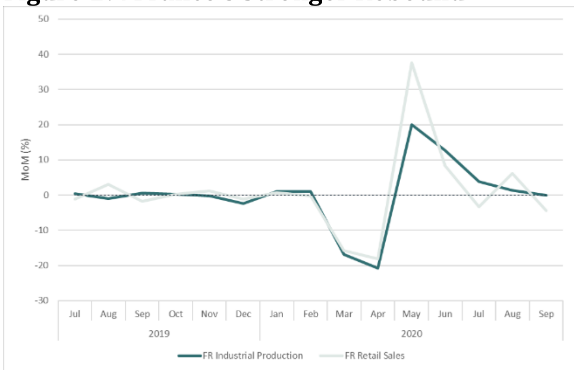
Directly as an impact of the Navalny poisoning, Germany has had to reconsider the pipeline. Merkel has decided that any decision regarding Nord Stream 2 will have to be agreed with the rest of the EU members, and thus Nord Stream 2 has been put on hold. Nord Stream 2 would double the capacity of the gas corridor via the Baltic Sea to Germany to 110 Bcm/year.

Nord Stream 2 would be crucial in Germany's plan to greener energy alternatives and would increase the supply of natural gas while reducing costs. The involvement of European oil majors with stakes in Nord Stream 2, although Gazprom has the largest stake, also makes this a particularly sensitive topic since so much has already been invested into the project. Only 150km worth of pipe is left to be laid.

Nord Stream 2 also has the potential to tie not only Germany but also the EU, closer to Russia and increase its dependence on Russia for its energy needs. Russia is currently the largest supplier of natural gas to the EU. The U.S. has sanctioned Russian companies and threatened further sanctions on other companies that help with laying the remaining pipe. The U.S. would stand to gain from denying the project to completion as the next alternative for EU to solve its natural gas shortage would be purchasing from the U.S.. While there are no direct impacts on the EUR in the short-term, we believe this development is one to keep an eye on as it will determine how Germany, and the larger EU, swings in its choice of energy provider in the future. This will then equate to Germany's and EU's positioning in future geopolitical discussions especially if its energy source is at stake.

France

Figure 19: France's Stronger Rebound



Source: Thompson Reuters

Macron has already introduced three amending budget laws between March and July 2020 increasing the fiscal envelope devoted to addressing the crisis to about €135 billion (6% of GDP, including liquidity measures). This adds to a package of public guarantees of €327 billion (15% of GDP), including €315 billion in guarantees for bank loans and credit reinsurance schemes.

On 3rd September 2020, the government announced a new fiscal package to support the recovery of the French economy ("Plan de Relance"). The plan includes measures amounting to about €100 billion over two years. About €40 billion of this envelope is expected to be covered by grants from the EU Recovery Fund. Other measures include reducing the counter-cyclical bank capital buffer to 0%.

We see similar trends in Industrial Production and Retail Sales as in Germany. The worst will be in November. President Macron announced that new lockdown measures will come into effect on 30 October for at least a month. As in the spring, the population must stay at home and teleworking is compulsory whenever possible. Bars, restaurants, non-essential shops and cultural and leisure centres will be closed. Private travel (and from one region to another) is prohibited, except to work, go to school or for essential shopping.

In contrast to the spring lockdown, schools can remain open (except for universities that must offer distance learning) and work remains possible in areas not specifically targeted by the restrictive measures. That implies that industry and construction, which had to stop largely during the spring lockdown should be able to continue to operate in a relatively normal way.

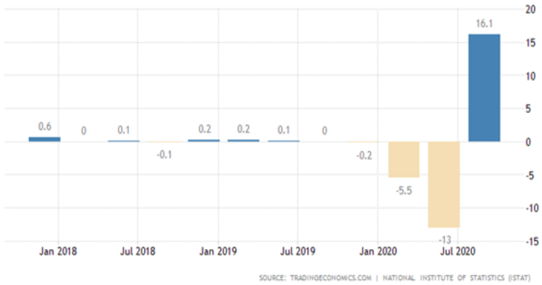
Nevertheless, with the closure of non-essential shops, merchant services (which accounts for 56% of GDP) are likely to be affected similarly in November as they were in April. Retail sales growth was already showing signs of weakening in September. The silver lining is that the contraction during the lockdown period was not as severe as in Germany, and the rebound was much sharper too. France might be better poised to recover faster than Germany once lockdowns are over.

Italy

Good News Finally

The Italian GDP rose 16.1% quarter-on-quarter in 3Q20 after contracting 13% in 2Q20 (Fig. 20), showing how measures like lockdowns can paralyse the economy. This increase in quarterly GDP was brought about by increased exports, domestic consumption and production (agriculture and services inclusive). On the manufacturing side, August production levels increased by 7.7% in August compared to a 7.0% month-on-month increase in July, beating expectations and building on an upward trend. Increased production in consumer goods, capital goods, intermediate goods and energy was at the forefront of increased production levels. Based on the statistics released, 3Q20 industrial production would have increased a whopping 31% compared to the previous quarter even without counting for the month of September.

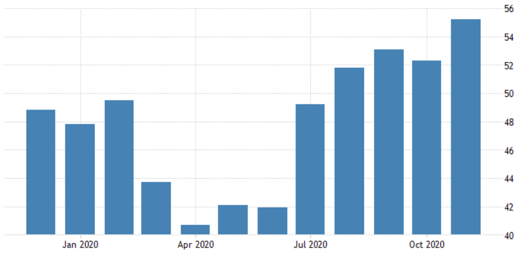
Figure 20: Italian GDP Growth



Source: Trading Economics

However, this positivity was short-lived in the face of the worsening pandemic situation in Italy. Production dipped by 5.7% in September but increased very slightly in October, just 1.3%, due to increased production of investment goods (+2.6%), intermediate goods (+1.3%) and consumer goods (+0.7%) although energy production dipped by 3% month-on-month.

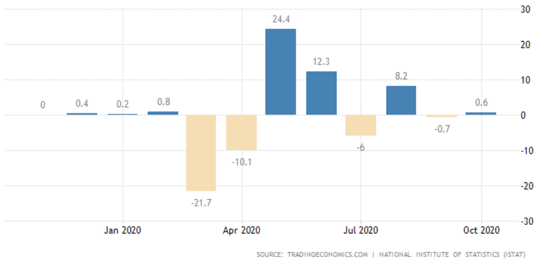
Figure 21: Italian PMI



Source: Trading Economics

Correspondingly, Italian PMI rose from 53.2 to 53.8 in October, beating forecasts of 53.5 (Fig. 21). This was the fourth consecutive month of manufacturing growth, boosted in part by the largest increase in foreign order book volumes since January 2018. PMI growth in October was also spurred by a slight increase in demand stemming from retailers decreasing prices in a bid to attract more customers. We believe this increase in manufacturing was in part a reaction to the 8.2% increase in retail sales in August. November's PMI rose further to 55.2, higher than the 51.3 that was expected in the market, largely seen as a positive development amidst the pandemic.

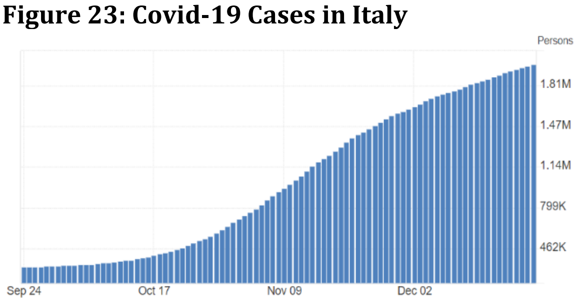
Figure 22: Italian Retail Sales



Source: Trading Economics

The increase in retail sales was short-lived as September brought about a 0.7% month-on-month decline (Fig. 22). This was driven largely by a 1.3% dip in non-food sales, a stark contrast to the 13.7% gain the month before. Food sales remained stagnant across the two months. November brought about a brief reprieve, with retail sales rising 0.6%, driven by 0.3% and 0.8% increases in food and non-food sales respectively. This was the third month of back-to-back growth in retail trade. Figures for December were not released at the time of writing, though tightened restrictions announced in November are expected to cause a dip in December.

Figure 23: Covid-19 Cases in Italy

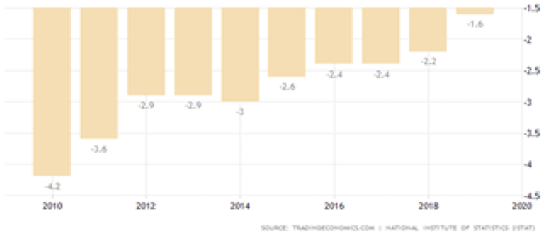


Source: Trading Economics, World Health Organisation

Worsening infection data across Italy and Europe cast a shadow on the positive developments highlighted above (Fig. 23). Among the worst affected by the first wave of the Covid-19 cases started to soar once again towards the tail end of October and into November. Consequently, the Italian government reintroduced harsher measures, announcing a nationwide curfew from 10 pm to 5 am and closure of food and beverage outlets at 6 pm. Full lockdowns were also reintroduced to regions hit worse by the pandemic. These measures proved insufficient as cases continued to soar. The government then announced a temporary lockdown from 24 December to 6 January to prevent further spread of the virus in 2021. Should infection numbers continue to rise after this period, Italy could re-impose a full nationwide lockdown once again as it mulls over its vaccination rollout strategy. This points towards a bleak showing for 4Q20 which will likely carry forward till 2021. The vaccines will most likely spur recovery in 2021, but likely towards the second half of the year.

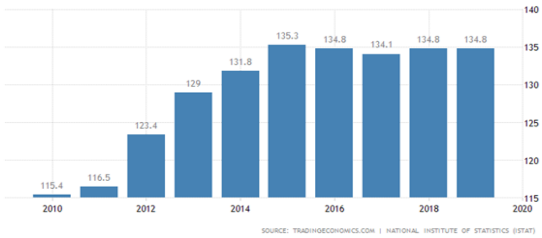
To cushion the impact of these new measures, the Italian government announced a fourth stimulus package worth €8 billion package of compensatory measures on 30th November, inclusive of tax cuts and

Figure 24: Italian Budget Deficit



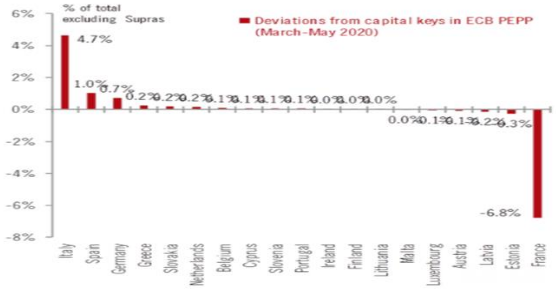
Source: Trading Economics

Figure 25: Italian Government Debt to GDP Ratio (%)



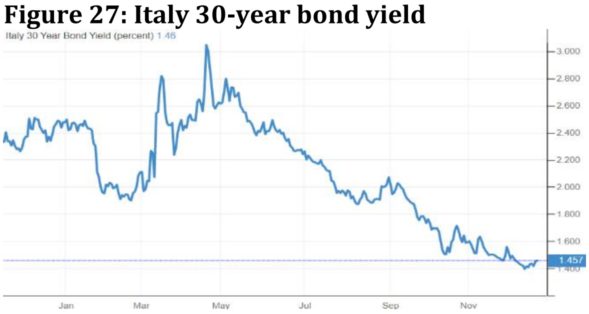
Source: Trading Economics

Figure 26: ECB Deviation From Capital Key



Source: MarketWatch

Figure 27: Italy 30-year bond yield



Source: Trading Economics

Figure 28: BTP-Bund Spread Chart

Source: TradingView

providing workers in badly hit industries with pay-outs. However, considering the extent of damage the lockdown has proven to cost the Italian economy (as depicted in the previous lockdown), the government will have to continue providing more stimulus in the near future to provide an effective economic buffer, which could in-turn worsen their budget deficit.

Italy's Debt Affair

Italy has long struggled to solve their issues with high debts and budget deficits. It already has a budget deficit of 1.6% (Fig. 24), which could balloon to 10% this year due to attempts to stimulate the economy. Italy's current debt is 134.8% of GDP (Fig. 25), with some analysts predicting it could rise to 170% due to stimulus spending and other measures to deal with the pandemic. Fortunately for Italy, the Pandemic Emergency Purchase Programme (PEPP) has helped to prevent this debt from soaring even further. The ECB has spent most of the €750 billion envelopes on government bonds, with Italian debt making up a disproportionately large amount of that debt. The ECB has deviated from its capital key by 4.7% with Italy (Fig. 26), much higher than the next highest deviation of 1.0% with Spain. Fortunately for Italy, the ECB announced that it would supplement the PEPP programme by €500 billion, taking the total PEPP envelope to €1850 billion. Italy is poised to continue benefitting from this decision. The ECB will proceed with the PEPP until March 2022 at the very least but has made the commitment to persist with the programme for as long as it deems necessary.

Nevertheless, with the unwanted title of having the world's 3rd highest debt, Italy was already struggling to find buyers for their debt before the pandemic. Hence, this raises questions on finding a sustainable way to ensure buyers for their debt after the PEPP and to reduce reliance on the ECB even without the pandemic.

There have been calls within Italy to look to emulate Japan in managing to retain investor confidence despite having debt that is an enormous 240% of its GDP. However, this would be difficult for Italy as most of the Japanese debt is locally owned, with 40% of its debt being owned by their central bank. Italy's membership in the monetary union makes this impossible to emulate. Moreover, Japan is seen as much more politically stable than Italy. Italy has had 61 governments since World War 2.

Helped in part by the ECB's PEPP, Italian 30-year bond yield has dropped significantly (Fig. 27). Italy's borrowing costs usually rise in tandem with market uncertainty. These lows come as Italy attempts to increase its average debt maturity by buying back old debt and issuing newer 30-year bonds. The lowered yields are good news to Italy, who are looking to lock in lowered borrowing costs amidst the pandemic in an attempt to take advantage of these lowered borrowing costs.

Strong demand for the newly issued €8bn worth of 30-year debt was supported by a general boost in appetite for Eurozone debt. This comes as S&P upgraded the Italian debt outlook from negative to stable while maintaining the bond rating at BBB. Moody's and Fitch Ratings already have Italian debt at just one rating above junk. A downgrade to junk would have removed this Italian debt from many bond indices and sparked a major sell-off.

This has positively impacted the BTP, the Italian government securities indexed to inflation rates. The increased confidence in Italian debt has led to the spread between the BTP and German Bund yields, viewed as the risk premium on Italian debt, narrowing to 134bp from the previous high of 144bp (Fig. 28), which is good news for Eurozone stability.

Figure 29: EURAUD Weekly Chart

Source: Tradingview

Figure 30: EURAUD Daily Chart

Source: Tradingview

Trade Idea: Short EURAUD

Fundamental Analysis

We believe that the Euro is still relatively strong despite the negative news that has surrounded the EU lately. EURUSD has moved decisively past 1.20 and is now testing 1.22. While lockdowns are not as severe as what was seen in the 1st wave, we believe that the EU's respective governments will have to take more preventive action sooner or later or risk letting the virus get out of hand. The new strain from the UK is in our opinion already in the EU which would necessitate further lockdowns given higher transmissibility. We expect the dip in GDP in 4Q20 to be deeper than expected, and a negative effect in growth in 1Q21.

Services PMI continues to contract while the Manufacturing sector remains resilient. Due to the Services sector contributing a large component to GDP, we believe our case for a dip in GDP in 4Q20 and 1Q21 is justified.

The ECB has announced a new round of stimulus in its December meeting, coupled with additional allocations of TLTROs to stimulate lending. Despite this, however, EURUSD has continued to make new highs since 2019, and we believe this is attributed largely to Dollar weakness, much like the consensus on the street and in the ECB. Despite this consensus, we believe that the ECB will be forced to intervene and tamper the rally to stimulate growth.

We are bullish on the Aussie as we believe that a commodity led charge due to Keynesian like stimulus will be positive for the Aussie. China's rise as a growing superpower is also supportive for the Aussie. Iron ore and copper futures have rallied substantially since the start of the pandemic, and we believe this commodity super-cycle is only just beginning. The Aussie has also been resilient in the face of increasing tensions between Australia and China.

Technical Analysis
EURAUD has traded between 1.65 and 1.60 since May 2019. This range was broken during the pandemic, but it has since traded within this range again. EURAUD failed to break through the 1.65 resistance in October 2020. It currently trades below the 50EMA on the weekly chart, and also below the Ichimoku Cloud which is bearish indicators.

On the daily chart, EURAUD is below the 50 and 200 EMA, and also the Ichimoku Cloud.

We would thus like to initiate a short on the break of the range at 1.60, preferably with strong bearish momentum. The weekly 200EMA is also at the 1.60 level, thus clearing this hurdle will be extremely bearish.

We set out stop loss at 1.635, slightly above the weekly candle, and our take profit at 1.510.

Entry: 1.600
Take Profit: 1.510
Stop Loss: 1.635
Risk Reward Ratio: 1 : 2.43

Global Macro Department –Switzerland (NEUTRAL)

Date: 27th December 2020

Analysts

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Lead Analyst
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Analyst
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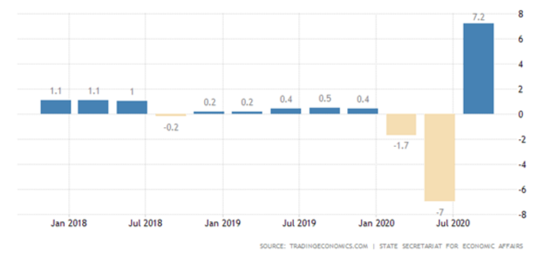
Basic Information

Real GDP(USD)	705 billion
CPI	100.96
Con. Confidence	-12.8
SMI	10411
Currency	Swiss Franc (CHF)

Chart info

Figure 1: GDP Growth



Source: Trading Economics

Overview of Switzerland

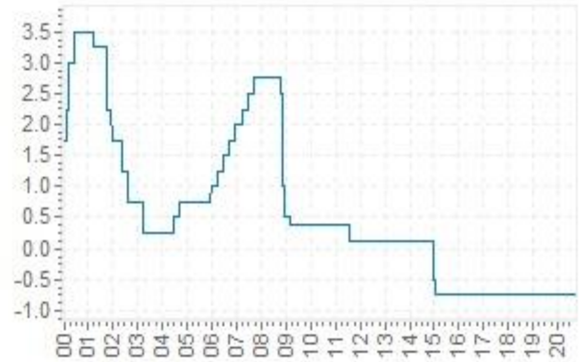
- Known for its high standard of living and neutrality, Switzerland is a prosperous nation despite having a small population of 8.5 million people. Latest IMF estimates indicate that the Switzerland now has the 18th largest nominal GDP and 2nd highest nominal GDP per capita in the world. With an advanced free market economy, Switzerland consistently ranks highly in economic ranking indexes, and was rated 1st in the Global Innovation Index and 3rd in the Global Competitiveness Report.

- The large number of reputable companies that this efficient system churns out has resulted in the Swiss brand being recognised as the 3rd most reputable in the world according to the FutureBrand Country Index 2019. The largest component of Switzerland's economy is its service industry (73.7%), of which financial services and tourism are the major constituents. Other major industries include industry (25.6%) and agriculture (0.7%). With a trade-to-GDP ratio of 118.9%, Switzerland is a relatively open economy.

- The European Union (EU) is Switzerland's largest trading partner, contributing to 78% of Swiss imports and is the destination of 43% of Swiss exports. To gain access to the common European market, Switzerland has agreed to follow certain provisions of European Common Law without being a full member of the EU. Switzerland has managed to prevent heavy dependence on the EU by diversifying its trading partners, with U.S., UK and China being the EU's 2nd, 3rd and 4th largest trading partners respectively. Switzerland mainly exports gold, packaged medicaments, antisera, watches and jewellery to these countries.

- The CHF is often considered a safe haven currency due to Switzerland's stability and political neutrality. Having been ranked 2nd in the world for trust in its stability and reputation, coupled with investor confidence in its robust political and economic systems, the CHF is often used as a hedge against market volatility.

Figure 2: SNB Policy Rate



Source: Global Rates

Figure 3: SNB Forecasted Inflation Table (SNB Meetings)

2020 Inflation	2021 Inflation	2022 Inflation
June: 0.7%	June: -0.2%	June: 0.2%
September: -0.6%	September: 0.1%	September: 0.2%
December: -0.7%	December: 0%	December: 0.2%

Figure 4: SECO Economic Forecasts (October)

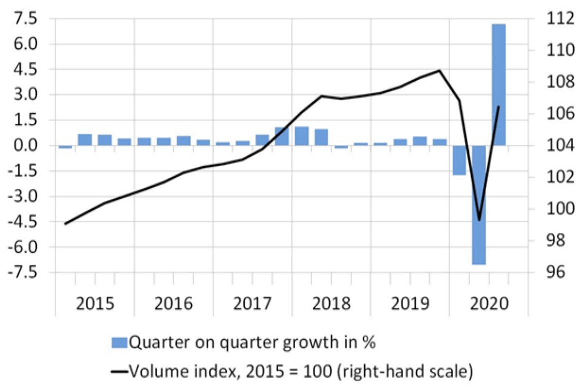
Selected forecasts, Swiss economy
Comparison of forecasts of October 20 and June 20
Year-to-year variation in %, quotas

forecasts for:	2020		2021	
date of forecasts:	Oct. 20	June 20	Oct. 20	June 20
GDP sport event adjusted[1]	**-3.8%**	-6.2%	**3.8%**	4.9%
GDP[1]	**-3.8%**	-6.2%	**4.2%**	5.3%
Consumption expenditure:				
Personal Consumption	**-4.4%**	-7.2%	**5.3%**	6.5%
Government Consumption	**1.8%**	2.2%	**1.8%**	0.7%
Construction Investment	**-1.5%**	-1.5%	**0.0%**	0.0%
Investment in Equipment and software	**-6.0%**	-14.0%	**3.0%**	3.0%
Exports[2]	**-6.6%**	-8.6%	**7.0%**	7.2%
Imports[2]	**-9.9%**	-10.1%	**7.3%**	6.0%
Employment (full time equivalents)	**-0.4%**	-1.5%	**0.3%**	0.2%
Rate of unemployment	**3.2%**	3.8%	**3.4%**	4.1%
Consumer price index	**-0.7%**	-0.9%	**-0.1%**	-0.3%

[1] Forecasts, seasonally and calendar adjusted
[2] Without valuables
Source: Federal Expert Group on Business Cycles

Source: SECO

Figure 5: Quarter-on-Quarter Growth



Source: SECO

SNB: More Of The Same

The Swiss National Bank (SNB)'s mandate of ensuring price stability while considering economic developments remains unchanged. Despite the economic downturn brought about by the Covid-19 pandemic, the SNB has stuck with its dovish stance by maintaining interest rates at -0.75% (Fig. 2), the rate it has maintained since 2015.

During the September meeting, some analysts had predicted a further reduction in interest rates to stimulate the economy given the extraordinary circumstances. This was expected particularly against the backdrop of the Federal Reserve adjusting its rates and the ECB studying a possible revision. However, given that the CHF had appreciated against the dollar but depreciated against the Euro since the previous June meeting, the SNB instead announced it believed the CHF is still "highly valued", while reiterating that foreign exchange intervention rather than interest rate revision would continue to be its main monetary policy tool in the foreseeable future. This message was reaffirmed in the December meeting.

Nevertheless, the SNB did revise growth and inflation forecasts during the September meeting. Underlying assumptions on the state of the economy remained status quo, with these forecasts largely stemming from technical revisions. The SNB announced that Swiss GDP contracted 5% GDP in 2020, compared to the 6% contraction forecasted at the June meeting. This was due to the smaller than expected contraction in GDP figures in the second quarter of 2020. Inflation-wise, the SNB revised its outlook slightly upwards, forecasting -0.6% for 2020, 0.1% for 2021 and 0.2% for 2022 (compared with -0.7%, -0.2% and 0.2% respectively in June) (Fig. 3).

This optimism stemming from this better-than-expected recovery was corroborated by forecasts released the Switzerland's State Secretariat for Economic Affairs (SECO). Figures released by SECO in October indicated an upward revision of GDP figures from -6.2% to -3.8% (Fig. 4). This was partly driven by an increase in manufacturing, with Swiss PMI steadily increasing from July to September 2020.

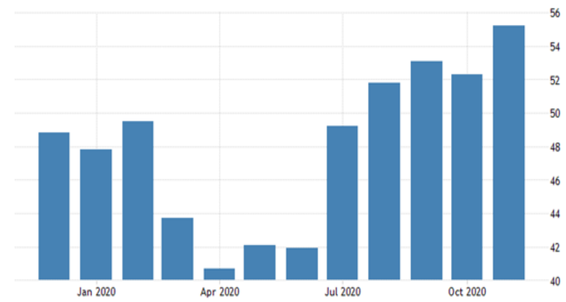
Data released in December confirmed the economic impacts of this better-than-expected recovery, which stemmed largely from the lifting of Covid-19 restrictions in June. Swiss GDP increased by 7.2% quarter-on-quarter in 3Q20 (Fig. 5), putting the Swiss economy at just 2% lower than before the pandemic and outdoing most European countries. The relaxation of lockdown restrictions spurred an 11.9% increase in consumption levels in 3Q20, coupled with 8.8% and 5.1% growths in capital goods and construction investments respectively. This increased demand caused 1.2% and 9.9% increases in imported goods and services respectively, although exports in services grew a meagre 1.4% due to the reduced number of foreign tourists.

This good news was factored into the SNB's revised forecasts which were announced during its December meeting. GDP contraction is now estimated to hover at 3%. SECO too corroborated this optimism – revising their year-on-year contraction to 3.3% in December rather than the 3.8% in October. However, the SNB's inflation forecasts were tweaked lower to reflect the strength of the CHF. Inflation is now expected to be –0.7% in 2020 and 0% in 2021, with 2022's forecasts remaining unchanged at 0.2%. Interestingly, the SNB predicts that inflation will not exceed 0.5% even in the first three quarters of 2021.

Low inflation levels have been attributed to the strength of the CHF, which has made imports cheaper. This is one key reason behind the SNB's large currency interventions. The SNB's conservative outlook on inflation numbers suggest that it would likely continue with these interventions in the coming months despite mounting U.S. pressure.

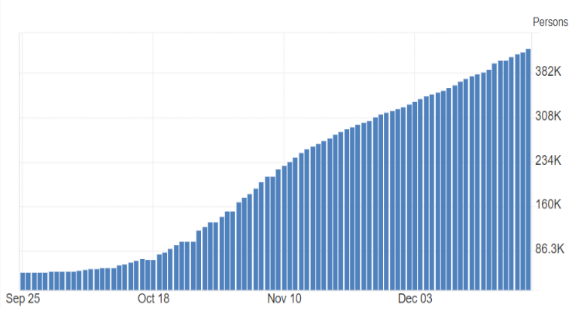
The slight drop in PMI in October (Fig. 6) did little to dampen the recovery in production as PMI rose to 55.2 in November, a reflection of increased demand largely driven from the relaxation of measures. However, worsening infection rates reported in late October and early November (Fig. 7) prompted the Swiss government to announce indefinite nationwide restrictions from 29 October. These restrictions broadly include limiting private gatherings to 10 people, closing food and beverage outlets by 10pm and stopping face-to-face university lessons. These measures proved insufficient in the face of the worsening situation, prompting the government to announce further restrictions in December to prevent further spread during the festive Christmas and New Year periods. Retail stores are now to close after 7pm, on Sundays and public holidays. Together with the temporary closure of food and beverage outlets, sporting facilities and cultural premises, this move is poised to lower consumption over the traditionally busy festive period.

Figure 6: Switzerland PMI



Source: Trading Economics

Figure 7: Switzerland Covid-19 Cases



Source: Trading Economics

Switzerland's stance on trying to avoid nationwide lockdowns while maintaining certain levels of restrictions have caused businesses in the country to be affected slowly but for lengthened periods. This "middle ground" approach is likely to continue in the foreseeable future, which means that local SMEs are likely to continue "bleeding slowly" in the coming months. Infection data does not look promising at the end of December, largely hovering between 3,000-5,000 cases daily. Much like the rest of Europe, Switzerland has been affected tremendously by the second wave of the Covirs-19 and uncertainty over the virus' trajectory remains. The first half of 2021 will most likely see a conservative economic recovery at best with the latter half of 2021 seeing a stronger economic rebound, contingent on an effective vaccination rollout preventing a third wave of the pandemic. This has led to a conservative SNB forecast of GDP growth between 2.5% and 3% in 2021. Nevertheless, Switzerland's economy has consistently fared better than most of its European counterparts thus maintaining its appeal as a lucrative investment destination, adding to the list of factors placing upward pressure on the CHF.

Injection of Much-Needed Liquidity

To counter the economic effects of the Covid-19 pandemic, the Swiss government announced a CHF60 billion stimulus package in 2Q20. The primary goal of the package was to safeguard jobs, allow companies to continue to pay wages, prevent bankruptcies and provide assistance to self-employed individuals. These were done through a slew of different measures. Some noteworthy measures include waiving taxes and social security payments; employment-related measures like allowances for individuals who lost jobs or wages; supporting SMEs by supplying them with credit; and suspending bankruptcy proceedings.

Despite worsening infection rates, the Swiss government will not be supplementing the aforementioned CHF60 billion stimulus package it has already put in place in the near future, as it is of the opinion that existing programmes are adequate to mitigate the economic impact of the Covid-19.

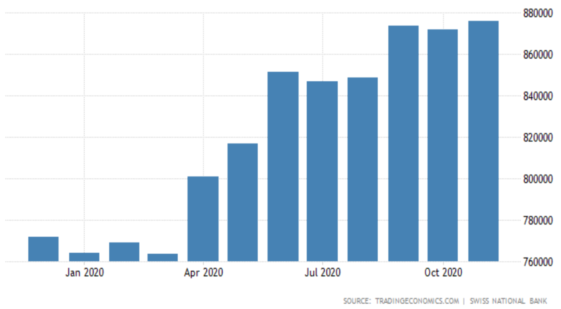
Any hopes for a future stimulus package will be contingent on infection data in the coming months. Based on previous announcements, it is likely that the SNB will not further lower interest rates in the near future but will continue to engage in foreign exchange interventions, although continued foreign exchange interventions of large volumes could irk U.S. authorities and potentially sour relations.

In addition to the CHF60 billion stimulus package, the Swiss Federal government and the SNB have worked together to introduce multiple measures aimed at injecting liquidity into the market during the COVID-19 pandemic. The first of these is a temporary standing facility – the Covid-19 Refinancing Facility (CRF). The SNB has not announced an end date to the policy and the refinancing interest rate corresponds to SNB's policy rate. The aim of the CRF is to strengthen the supply of credit to the Swiss economy by providing the banking system with additional liquidity with no upper limit set on the facility yet. The facility allows for banks to obtain liquidity from the SNB, which is secured by federally guaranteed loans. This enables banks to both access additional funds and increase their lending capacity to other companies.

Additionally, the Federal government has approved the SNB's request to reduce the countercyclical buffer needed to be held by banks to 0%. Typically, all banks needed to comply with regulations to hold extra capital for mortgage loans, to act as an economic buffer against the potential overheating of the mortgage and real estate markets. The deactivation of the countercyclical buffer complements the CRF by ensuring banks now have added flexibility in lending activities, further boosting liquidity in the market. These measures reaffirm the federal government and SNB's willingness to taking appropriate measures to mitigate the impacts of economic downturns and is one of the reasons investors often place confidence in the CHF in times of uncertainty.

FX "Manipulation"

Figure 8: Switzerland Foreign Reserve Holdings



Source: Trading Economics

Economic uncertainty and a lowered risk appetite in 2020 have led to a "risk off" environment, which has placed upward pressure on safe-haven currencies like the CHF. As mentioned previously, the SNB has persisted with foreign exchange interventions as its main source of monetary policy to counteract this upward pressure on the CHF. The SNB revealed that it executed CHF 90billion worth of currency interventions in the first half of 2020 alone, equivalent to 13% of Swiss GDP. The SNB also engaged in net purchasing of foreign currencies for more than half of the 12 months from June 2019 to June 2020. As of November 2020, Switzerland's total foreign reserve holdings stand at CHF 876 billion (Fig. 8).

Figure 9: 'Currency Manipulator' Criteria

These large volumes of currency interventions have irked U.S. authorities, who placed Switzerland on the 'currency manipulator' watchlist in January, when it fulfilled two out of the three criteria outlined by the U.S. Treasury. Continued extensive FX interventions described above means that Switzerland now fulfils all three criteria to be labelled a currency manipulator by the US (Fig. 9 & 10).

Criteria	Benchmark	Threshold
Significant Bilateral Trade Surplus with the United States	Goods Surplus with the United States	$20 billion
Material Current Account Surplus	Current Account Balance	2% of GDP
Persistent One-Sided Intervention in Foreign Exchange Markets	Net FX Purchases	2% of GDP
	Persistence of Net FX Purchases (months)	6 of 12 months

Source: ING, US Treasury

Figure 10: Switzerland Meeting FX Manipulation Criteria

	Bilateral Trade*	Current Account*	Foreign Exchange Intervention*	
	Goods Surplus with US (USD bn)	Balance (% of GDP)	Net Purchases (% of GDP, Trailing 4Q)	Net Purchases (6 of 12 Months)
Switzerland	47	8.9	13%	Yes

*Data for July 2019 - June 2020
Values in red exceed the thresholds

Source: ING

There was initially scepticism over USA's willingness to officially label Switzerland as a currency manipulator. Being labelled a currency manipulator is a political move that needs to take into account geopolitical tensions. China was labelled despite breaching only one out of the three conditions while Taiwan, Thailand and Vietnam were not labelled currency manipulators despite meeting the three criteria in 2019. There were sentiments lingering that if Switzerland were to be accorded this label, the SNB would have to change its upper-bound of its tolerance band and allow a further appreciation of the CHF. Hence as the SNB persisted with FX manipulation despite being on the watchlist, there were fears that some would place bullish bets on the CHF, leading to concerns that the SNB would then have to further engage in large volumes of foreign exchange interventions to curb the upward pressure despite being accorded the label. In response, the SNB announced that it would start publishing data on foreign exchange volumes quarterly instead of annually to provide clarity to U.S. authorities.

However, the U.S. Treasury designated Switzerland a currency manipulator on 16th December 2020. Despite that, the SNB reaffirmed its commitment to continue using FX interventions as its primary monetary policy tool. Given inflation levels, the SNB does not appear to have much of a choice but to continue these strong interventions. Politically, the Swiss know that the U.S. would be wary of losing a key ally, given that the Swiss represent the U.S. in Iran, and Swiss mediation may have been the factor that helped prevent further conflict when U.S.-Iran tensions soared in early 2020. Moreover, a seemingly more Europe-friendly Biden administration could ease pressure on the Swiss, especially in comparison to the notoriously protectionist Donald Trump. Hence, this news is unlikely to change the SNB's stance. The SNB will continue to place downward pressure on the CHF during rallies and is unlikely to review the upper bound.

Figure 11: USDCHF Chart

Source: Tradingview

Trade Idea: Short USDCHF

The Swiss calendar is relatively empty, with Covid-19 and the ensuing 'risk-off' climate being the primary mover of the CHF. The risk-averse climate that the pandemic has induced has prodded many investors to invest in Swiss-denominated assets and put money on Swiss banks despite the negative interest rates, placing considerable upward pressure on the CHF. The uncertainty surrounding U.S. and UK politics has further strengthened this upward pressure. However, the SNB chairman has reaffirmed the SNB's commitment to intervene and counteract this upward pressure with large volumes of foreign exchange interventions and keeping interest rates negative, irrespective of criticism from the U.S. In fact, Biden's likely softer stance towards Swiss' foreign currency interventions could give the SNB more freedom to apply downward pressure on the CHF during rallies. This means that the CHF will continue to remain beneath an undisclosed upper bound despite the upward pressure.

Despite the absence of the 'Blue Wave', Biden's election as the 46th President of the United States has sparked hopes of a less protectionist policy that would spur global trade once again, with such a trade-friendly poised to boost the rest of the world's economy. This is particularly so as most countries seek to bounce back from the economic woes that the pandemic has wrecked on their economies, aided by the vaccine. This has led to a broad-based dollar sell-off, a trend that will likely continue early next year.

We are of the view that the USD will undo much of the gains it made under the Trump administration. The USD gained strength under Trump due to the tax cuts and trade wars that Trump started. It is unlikely that this environment will persist under Biden. Money is expected to flow out of the U.S. with the Fed seemingly willing to keep interest rates low for longer periods of time.

The USDCHF has largely been trading sideways, within the 0.8821 support and 0.8941 resistance from 9 December to today, 26 December. This is after it stumbled significantly from levels above 0.9000 at the end of November. The USDCHF has come close to testing the support on 3 occasions within this period. Taking into consideration how the USD is expected to continue weakening in 2021 while the SNB persists with aggressive interventions that are likely to cap the CHF at an undisclosed upper bound, we recommend going short on USDCHF during a downward rally. We are of the opinion that the Biden administration will likely see through a further weakening of the USD, which will see the USDCHF break the 0.8821 support in a downward trend. The USDCHF is currently trading above the 50, 100 and 200-day Moving Averages, and we expect the USDCHF to drop below all 3 Moving Averages due to the reasons above. We recommend taking profit at 0.88750.

Entry: 0.88750

Take Profit: 0.88300

Stop Loss: 0.89130

Risk Reward Ratio: 1:1.8

NUS INVESTMENT SOCIETY

Analysts

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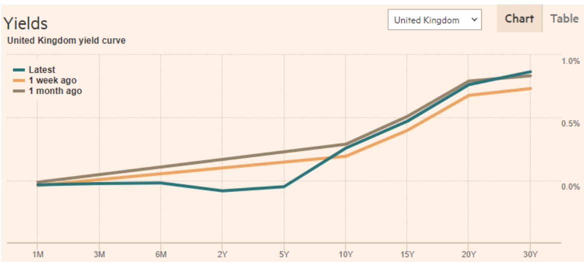
Basic Information

Real GDP (US$ Trillion)	523
M2(US$ Trillion)	3.539
CPI	0.4%
PPI	-0.1%
Con. Confidence	-31
Building Permits	-0.909
Stock Index	FTSE 100 Index
Currency	Pound Sterling (GBP)

Chart info

Figure 1: UK Yield Curve



Source: Financial Times

Overview of United Kingdom

The United Kingdom 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 has the 6th largest nominal GDP in the world (USD 2,83 trillion in 2020). The EU (taken as a block) is the largest trading partner, which accounted for 43% of total exports and 49% of total imports in 2019.

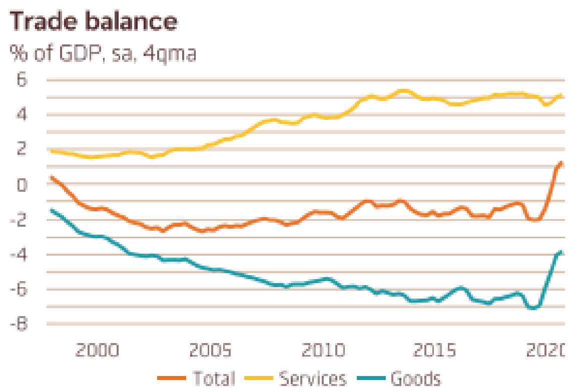
The UK economy is mainly driven by the service sector which accounts for more than 79% of the total GDP. Government, Health and education as having the highest weight in the service sector of about 20%. The UK is a major global hub for international wholesale finance and is the leading foreign exchange market, nearly twice as many US dollars are traded in the UK as in the US. Exports accounts for 30% of the UK's total GDP and some of the main export items are vehicles, machinery, and precious metals. machinery is the largest export in 2019 accounting for USD 73.3 billion (15.6%), followed by cars (USD 50.7 billion 10.8%) where 81.5% of all vehicles made in Britain are exported. In 2019, the UK exported GBP 42.4 bn (9%) of precious metals.

After a blistering summer, the clouds have started to gather over the UK's economic recovery. An increasing Covid-19 caseload, tightening restrictions and rising unemployment will probably mean the economy experiences a sharp loss of momentum in the final months of the year. The Bank of England is likely to expand its asset purchase program in response. Successful containment of the virus and the arrival of a vaccine should see the recovery pick up again in 2021. That view assumes that the UK and the EU strike a trade deal by the year-end. Inevitably, the economy will suffer some long-term scarring, especially in contact intensive areas such as hospitality and leisure. The output is 3% below the pre-crisis forecast by the end of 2022.

Data available through Sept. 18 show the UK economy was making up some lost ground, with demand for electricity and restaurant bookings at around normal levels for this time of year. That was before the government decided to tighten restrictions in an effort to control the spread of Covid-a9. The measures, alongside the growing risk of infection, will slow the recovery. The demand for electricity, a key indicator for tracking economic activity, has returned to where it would normally be at this time of the year. We expect the economy to rebound by 17% in 3Q, we now see it expanding by just 1% in 4Q, down from 2.5 % previously. we also forecast an expansion in 1Q21 will be significantly slower, with output rising 0.5%. That would leave output 7.5% below its pre-virus level in 1Q21.

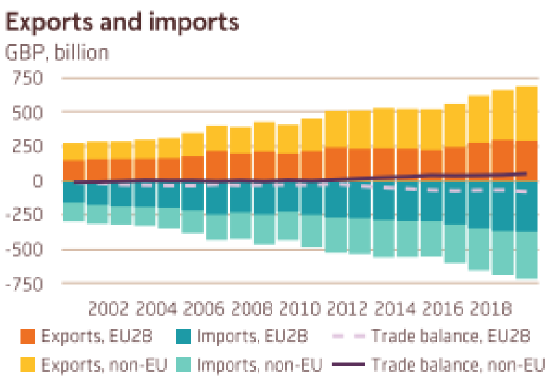
Financial market conditions have been positive recently. Near record-low bond yields are unfazed at the prospect of more borrowing. Still, the recent widening in the 2 y and 10 y gilt spread (Figure 1) coincided with a slackening pace for the Bank of England's asset purchase program.

Figure 2: UK Trade Balance



Source: Swedbank Research & Macrobond

Figure 3: UK Export and Import with EU



Source: Swedbank Research & Macrobond

Brexit

Britain's protracted divorce from the European Union happened on Jan 31. That does not mark the end but the start of the battle over how the separation will work in reality. Prime Minister Boris Johnson said major changes are coming in the UK as the result of the trade deal his government negotiated with the European Union, completing the country's separation from the bloc. The UK post-Brexit trade deal will leave businesses facing more barriers to trade than they did while Britain was a member of the European Union.

That's the price of reclaiming sovereignty. While the UK can claim to have taken back control of Britain's domestic fishing waters and ended the role of the European Court of Justice, businesses and consumers will face a slew of additional barriers to trade after Dec 31.

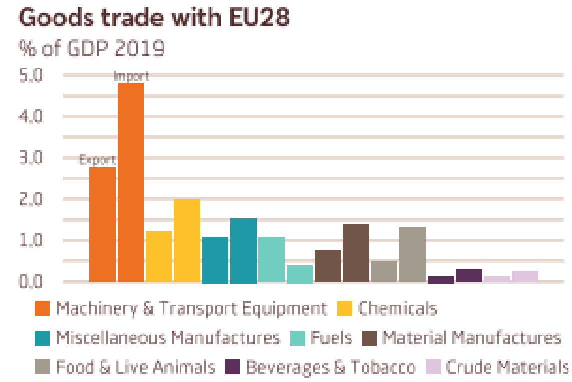
On Christmas Eve, the EU and UK finally agreed on a free trade agreement, four and a half years after the referendum and with only a week left before the UK's exit from the Single Market and Customs Union. As of January 1, the EU and UK have been trading under the terms of this agreement. Importantly, the agreement provides for no tariffs or quotas on goods that fulfil all rules of origin requirements, and the agreement also contains some additional facilitations. However, extensive non-tariff barriers to trade will still come into effect and reduce trade between the EU and the UK. The costs incurred by British traders will differ between sectors and will likely be largest for agricultural and food product exporting, which only constitutes a smaller share of aggregate trade (Figure 2). In addition to introducing goods trade barriers, the agreement is also thin with respect to services, which will weigh on British trade. In the short run, we expect the negative effect on British trade and the economy to mainly follow from disruptions and frictions introduced by the non-tariff barriers. The UK's decision to phase in customs checks during the first six months will ease import disruptions relative to those to exports, however, and trade facilitating measures are also expected to limit the damage somewhat (Figure 3). The removal of some uncertainty could furthermore help to alleviate the negative short-run impact of the exit. In the longer run, trade effects will follow more from reallocation of investments and production, and we expect EU-UK trade frictions to reduce British involvement in cross-European supply chains. Some loss of productivity will ensue, and also from reduced EU labour supply, while deregulation and growth-stimulating policies will offset some of the negative effects. The UK will partially mitigate the trade contraction by entering into new free trade agreements with third countries, but in due course we expect the EU and UK to resume negotiations to further enhance economic integration.

No tariffs or quotas, but non-tariff barriers and small provisions will weigh on trade

The EU UK trade agreement most importantly provides for zero tariffs and quotas on all goods that fulfil rules of origin requirements. While this benefits all UK exporters compared to trading on WTO-terms, car manufacturing products, which are the UK's most important exports, critically avoid losing competitiveness from relatively high EU tariffs. This also holds for other types of manufactures and chemicals, which constitute a large share of British goods exports to the EU. Agricultural exports will avoid tariffs of above 30%, although these traded goods are less economically significant. (Figure 4)

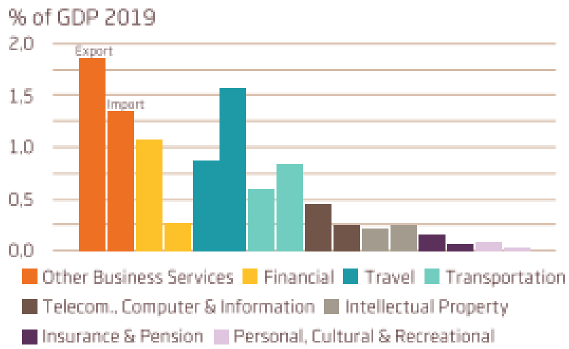
Besides conditionally eliminating goods tariffs and quotas, the agreement also facilitates trade by removing some non-tariff barriers. British traders may self-certify origins of goods as well as cumulate parts and processing to count towards origins requirements, which simplifies qualification for preferential access to the Single Market. Certain exporters will also benefit from smoother customs procedures under the Trusted Trader Schemes, as well as some streamlined technical compliance processes and sanitary controls.

Figure 4: Goods traded with EU



Source: Swedbank Research & Macrobond

Figure 5: Services trade with EU



Source: Swedbank Research & Macrobond

Considerable non-tariff barriers still come into effect during 2021, however, and will weigh on UK goods exports going forward. Relatively high requirements on goods content originating in the EU or UK will block certain British products from tariff-free access. Food exports may be particularly adversely affected, while effects will differ among sectors. Despite some facilitation measures, agricultural and food products will also face extensive sanitary border controls, which incurs further costs to traders. British exporters will also need to complete customs declarations and other paperwork, while customs procedures for British imports will be phased in over six months.

The costs of the non-tariff barriers to British goods traders will differ between sectors, with the largest costs likely incurred by agricultural and animal exporting firms. These may even exceed the potential costs from tariffs and could discourage small and medium-sized enterprises from market entry.

While the agreement removes tariffs and quotas on goods, provisions for services are as expected limited, however. Given that the UK is a service economy with approx. 80% of pre-Covid GDP consisting of services, and has a surplus in services trade with the EU, this will have adverse effects on the UK. (Figure 5)

Regrettably for British service suppliers, there will be no mutual recognition of professional qualifications, which limits the provision of services to the Single Market by for example business and financial firms. For services performed in the UK but received in the EU, British law will also not be applicable. In addition, the end of free movement will affect some types of service exports, most notably travel services.

For financial services, the lack of regulatory equivalence acknowledgement from the EU will likely weigh somewhat on exports ahead. There will be no passporting rights for British firms providing financial services to the EU, but many firms have in anticipation of this, set up subsidiaries in EU member states. Some financial sector jobs consequently have and will continue to disappear from London, but it is less likely that this will remove London from being Europe's financial centre for the foreseeable future.

Short-run effects will be limited despite trade frictions and disruptions

The most immediate impact on the British economy from the exit will follow from border disruptions with the imposition of customs and border controls. These effects will likely be amplified by the other non-tariff barriers left undealt within the agreement. While the changes to EU-UK trade as of 2021 have been known for quite some time, the National Audit Office has pointed to flaws in the preparations which have undeniably been complicated by the pandemic and uncertainty regarding the trade negotiation outcome.

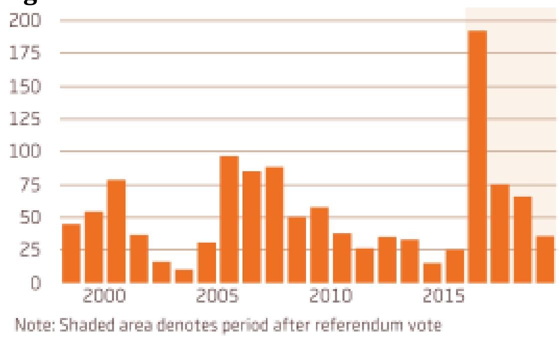
While the EU has decided to impose full customs checks from the beginning of 2021, the trade facilitating measures in the agreement will to some extent help in alleviating short-run trade frictions. As a consequence of the UK's decision to phase in customs requirements over six months, British importers are due to face fewer initial disruptions than exporting businesses, which contributes to limiting supply shortages to primarily Northern Ireland. In contrast to a no-deal exit, this implies that consumer prices will increase only modestly, but still increase since importing firms will nonetheless incur additional costs.

One benefit of the trade agreement is that it reduces uncertainty regarding the UK's future relationship with the EU, which has previously delayed business investment decisions. Despite some remaining uncertainties, we expect parts of the postponed investment by British firms to be realized in the near term given the conclusion of the trade agreement. This might also hold for the foreign investors who have awaited clarity on the EU-UK future relationship, although FDI flows could be delayed by the global economic recovery and recent GBP appreciation. (Figure 6)

Although sizable, we believe that the initial impact on trade from the UK's exit from the Single Market and Customs Union will be small relative to the fluctuations seen during the pandemic. It is however possible that global supply chain adjustments during the economic recovery could accelerate trade diversion away from the UK and ultimately cause larger reductions in trade flows more rapidly.

Diverted trade in the long run, but increased integration with the EU may again follow.

Figure 6: UK FDI flows



Source: Swedbank Research & Macrobond

While the short-run effect of the British exit will mainly concern trade contraction from the immediate imposition of non-tariff barriers, the longer-run consequences for UK trade will tend to follow more from reallocation of investments and production in response to trade frictions. It is likely that some producers will eventually relocate from the UK to the EU to benefit from barrier-free access to the Single Market.

Consequently, we expect this to reduce British involvement in cross-European supply chains and weigh on productivity growth in the future.

Some loss of productivity will likely also follow from the end of free movement, as EU citizens are unable to freely settle for work in the UK. This reduction in EU labour supply also risks impeding economic recovery from the pandemic as employment demand rebounds, though this will to some extent be mitigated by non-EU migration. However, the UK will be able to increase productivity from some deregulation and growth-stimulating policies within the level playing field framework outlined in the EU-UK trade agreement.

The reduced trade with the EU may be partially offset by increased economic integration with third countries and trading blocs. During the transition period, the UK has entered into several trade agreements, mainly by rolling over existing EU agreements with third countries or applying some adjustments to these, such as with Japan. In addition, the UK is prioritising starting trade agreement negotiations with Australia, New Zealand and the US, while also considering joining the Trans-Pacific Partnership (CPTPP). Outside the EU, the UK may benefit from being able to faster conclude trade agreements, albeit from a considerably weaker negotiating position. Deepening trade relations with these countries, and most notably the US, will be important for mitigating trade losses with the EU. (Figure 8)

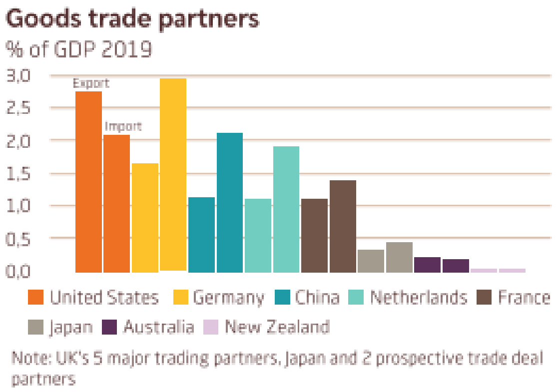
Still, the British dependence on EU trade and preferential access to the Single Market will remain significant going forward despite the exit. With this in mind, the UK will presumably want to eventually develop the parts of the EU-UK trade agreement that fall short of facilitating trade sufficiently in the areas most important to the UK, mainly services. We, therefore, believe that trade negotiations will in due course resume between the EU and UK, with the purpose of enhancing economic integration although a British re-joining of the EU for now seems less likely.

The following encapsulated the main points of the agreement.

Trade-in Goods

<u>Summary</u>: The agreement ensures that most goods traded between the EU and the UK won't face new tariffs or quotas. However, British exporters will face an array of regulatory hurdles that will make it more costly and burdensome to do business in Europe.

Figure 7: UK Trading Partners



Source: Swedbank Research & Macrobond

- Rules of origin: UK firms will have to certify the origin of their exports to quality for tariff-free access to the EU. There will be limits on what proportion of goods can be assembled from parts made overseas to qualify for tariff-free access.

- Cumulative: EU parts will count as local content.

- Cars will face special restrictions. Gasoline or diesel vehicles will need to be made with at least 55% local content to escape tariffs.

- Electric transition: electric and hybrid vehicles will be allowed to contain 60% overseas content - but that will fall to 55% by 2026. Batteries will be allowed to contain 70% international content, but that will drop over the same period of time to 50%.

Financial Services

Summary: The deal offers little clarity for financial firms. There is no decision on so-called equivalence, which would allow firms to sell their services into a single market from the City of London. The agreement only features standard provisions on financial services, meaning it doesn't include commitments on market access.

- The UK and EU will discuss how to move forward on specific equivalence decisions. The European Commission, which is in charge of allowing access to the EU's market, said it needs more information from the UK and it does not plan to adopt any more equivalence decisions at this point.

- Regulatory cooperation: the two sides made a joint declaration to support enhanced cooperation on financial oversight. They aim to agree on a Memorandum of understanding by March.

Level Playing Field

Summary: this was one of the thorniest parts of the negotiation. Both sides committed to upholding their environment, social, labour and tax transparency standards to make sure they don't undercut each other.

- The deal does not include ratchet clauses that would force the Uk to stiffen rules in lockstep with the EU. Instead, it includes a re-balancing mechanism: either side will be able to retaliate with tariffs if they diverge too much.

- Any retaliatory measures will also be subject to arbitration by an independent panel - not the European Court of Justice.

- Both sides will be prevented from giving an unlimited state guarantee to cover a company's debts or liabilities. In line with the EU restructuring plan, and any aid to failing banks will have to be the minimum necessary to help it wind down.

- The UK and the EU will have to disclose the subsidies they award.

Fishing Rules

Summary: This was one of the most contentious areas after disputes over the control of British fishing grounds came to symbolise the country's desire to leave the EU.

- UK fleets will take 25% of the current EU catch in British waters, worth 146the million pounds, phased in over five years. Britain's opening negotiating position called for an 80% increase, so this represents a significant compromise.

- There is a transition period of five-and-a-half years during which reciprocal access rights to each other's waters remain unchanged.

- After that point, British officials stress, the Uk will be in control of its own waters - but the EU would be able to impose tariffs on fish if its access to British waters was limited.

Economic Impact of Brexit

In order to quantify the impact of Brexit on the UK economy, we will look at how other economies have performed over the period since the referendum. We have exploited the close historical correlation between the UK. and the remaining G7 countries, using it to project how the UK might have performed had the relationship held over the past three years. That's equivalent to slightly more than 70 billion pounds a year in today's money.

By the end of 2019, the UK economy was 3% smaller than it could have been had it followed its historical relationship with the rest of the G7. Heightened Brexit uncertainty has acted as an enormous headwind to business investment over the past 3.5 years.

Uncertainty about the outlook for productivity growth is complicated by Brexit. Leaving the biggest single market in the world will almost certainly reduce the economy's trade intensity, which is likely to have implications for productivity growth. That's because trade leads to greater economies of scale, increased competition and exposure to innovations in technology.

The UK's departure from the EU will end the free movement of labour for EU citizens and reduce the annual rate of net migration. ONS's low migration forecasts see net inward migration declining from more than 200,000 a year to about 90,000. Under the ONS's core projection, inward migration stabilises at 190,000 a year.

If there are about 100,000 fewer migrants arriving in the UK every year that will have two consequences. First, it will slow the pace of population growth. Second, it will weigh on the participation rate since migrants are more likely to be active in the labour force.

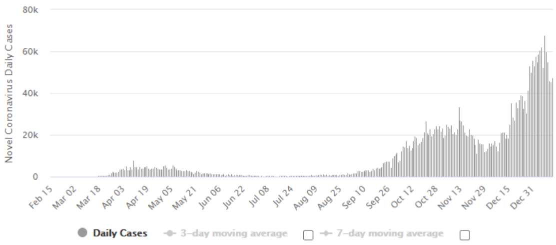
Covid-19

The virus looks to have hit the UK harder than other European countries. Britain went into lockdown on March 23, later than neighbouring nations, and the progress toward easing restrictions had also been slower. The disease has killed more than 46,000 Britons and created a massive health crisis.

Saving Christmas

Boris Johnson had to face facts after data showed the pandemic exceeding even the worst-case projections of his scientific advisers, threatening to overwhelm hospitals. Boris Johnson's top medical adviser said England's looming lockdown offers a 'realistic possibility' of allowing England to return to looser social-distancing restrictions in December if people obey the rules. The second wave of coronavirus

Figure 8: UK Covid-19 Daily New Cases



Source: Worldometers

Under the New Restrictions:
Non-essential shops, leisure and entertainment venues will close
All pubs and restaurants will close, though takeaways and deliveries will be allowed
Schools, colleges and universities will remain open
People should only leave their homes for work, exercise, medical reasons, emergencies and to shop for food
Different households won't be allowed to mix except for care needs and in support bubbles.
Travel abroad and within England is allowed only for work
The state will pay furloughed workers as much as 80% of their wages

defeated Johnson after modelling by his advisers showed the National Health Service risked becoming overwhelmed by early December. That forced him into the latest series of partial lockdowns in England, closing pubs, restaurants and nonessential shops for 28 days.

Ministers have cited the potential cost of another lockdown as another reason to persist with a more localised approach. The bill for government measures to help business and workers so far likely exceeds 200 billion pounds. The new measures threaten to derail, or even revere, the nation’s already sluggish recovery from the impact of the first wave of the virus, which has caused the deepest and sharpest recession in three centuries.

Lockdown Measures

Winter is coming. Covid cases are spiking again and tougher lockdown rules are being reintroduced, including 10 pm curfews on pubs and restaurants and telling people to work from home where possible for six more months. The tighter the lockdown, the greater the damage the economy. The Government is trying to prevent a second wave of infections though new restrictions and local lockdowns. while the latest rules are nowhere near as draconian as those in March, they are likely to hit consumer sentiment and the ‘lunchtime economy’ of cities.

As per Dec 20, new UK Covid-19 cases had increased by a further 36,084. Britain already has the highest official coronavirus death count in Europe.

How Vaccine Shapes Outlook

Prime Minister Boris Johnson has flagged mid-February as the point when lockdown restrictions could start to be lifted. But a more infectious strain of Covid-19 means if his ambitious 15 million vaccinations target is met, that will be risky. Going too fast could cause a catastrophic rise in hospitalisations for younger cohorts still waiting for their shot.

As a result, we see lockdowns lasting longer and a meaning recovery delayed until May. That cuts our 2021 GDP growth forecast to 4.2% from 6% before the new strain swept across Britain.

Bank of England

The Bank of England's response to the coronavirus outbreak has been significant. It has cut rates by 65bps to 0.1% and restarted the Term Funding Scheme. The UK government and central bank unleashed a fresh wave of stimulus into the struggling economy on Thursday, acting in conjunction and more aggressively than predicted as the coronavirus forces another lockdown. It has also increased to the total stock of assets by 450 billion pounds to 895 billion pounds

The BOE also has the option of cutting its benchmark interest rates to zero or below from the current 0.1%. That's largely seen as an option for the future as the bank considers the operational implications.

Monetary Policy

The Bank of England boosted its bond-buying program by a larger-than-expected 150 billion pounds, flooding the economy with funds to spur demand and lower government borrowing costs. It plans to complete the final 150 billion pounds of asset purchases by the end of 2021. We don't expect the BOE to ease again in 2021, but it's likely to reduce its estimate of the lower bound for interest rates into negative territory. This will give policymakers more scope to jaw-bone market expectations lower and give its asset purchases more bang for their buck. The low rates also give the government room to increase crisis spending without worrying about spiralling debt costs.

The BOE plans to purchase 150 billion pounds of gilts in 2021, completing the program by year-end. Our Base case is that the BOE maintains the current pace of bond-buying until the end of 1Q and then slow it over the rest of the year. We also expect the central bank to reduce its estimate of the lower bound for interest rates into its toolbox does beg the question what the marginal policy tool would be if more stimulus was required.

The source of the shock is likely to be the BOE's guide. An unexpected tightening of financial conditions would likely be met with more QR. But if the recovery needs a helping hand, the BOE is more likely to take the historic step of sending rates below zero.

Fiscal Policy

The UK budget deficit is likely to soar to a little under 400 billion pounds (19% GDP) in 2020-21. The rise reflects a combination of economic weakness and the enormous policy response, which totals 280 billion pounds. Chancellor of the Exchequer Rishi Sunak has also extended some support into 2021-22. In the longer term, the deficit is likely to settle at around 4% of GDP, or 100 billion pounds, assuming a permanent hit of 3% GDP.

Our view is that there is a strong case for allowing the deficit to narrow naturally in coming years rather than hampering growth by tightening policy prematurely. Measures of debt servicing are at historic lows which gives Sunak time to assess the permanent hit to output before announcing any necessary consolidation. There's a big risk he doesn't wait and announces tax rises that slow the recovery.

Term Funding Scheme

The TFSME is designed to ensure pass-through of lower policy rates to households and businesses while providing incentives to lend, particularly to small and medium-sized companies.

When interest rates are low, it is likely to be difficult for some banks and building societies to reduce deposit rates much further, which in turn could limit their ability to cut their lending rates. In order to mitigate these pressures and maximise the effectiveness of the monetary policy, the TFSME will, over the next 12 months, offer four-year funding of at least 10% of participants' stock of real economy lending at interest rates at, or very close to, Bank Rate. Additional funding will be available for banks that increase lending, especially to small and medium-sized enterprises (SMEs).

The TFSME will:

1) Help reinforce the transmission of the reduction in Bank Rate to the real economy to ensure that businesses and households benefit from the MPC's actions.

2) provide participants with a cost-effective source of funding to support additional lending to the real economy, providing insurance against adverse conditions in bank funding markets.

3) incentivise banks to provide credit to businesses and households to bridge through a period of economic disruption.

4) provide additional incentives for banks to support lending to SMEs that typically bear the brunt of contractions in the supply of credit during periods of heightened risk aversion and economic downturns.

Figure 9: GBPUSD Daily Chart

Source: Tradingview

Trade Idea: Long GBPUSD

Fundamental Analysis

For now, we continue to believe in the latter if some sort of a last-minute Brexit deal can be reached and the latest virus mutation proves not to be a game-changer. Yet the highly uncertain nature of both makes sterling exposure a risk-laden endeavour.

Sterling's binary outlook is more compelling than ever, and while the upside risk toward 1.35 and higher was clearly in the limelight a week ago, this weekend's UK virus and Brexit developments flag 1.25-1.20 GBPUSD risk again. In this context holding a very short-term sterling view has become a random exercise. The short-term pound dynamics have turned bearish now, but it could all change again very swiftly should our last-minute Brexit-deal assumption come to fruition after all, or should the virus predicament improve as vaccine deployment runs through successfully.

Covid-19 has come back to haunt the pound this week, with soaring cases and new strains prompting an emergency London lockdown, with the associated border closure by several European countries fuelling supply-chain jitters and triggering a near-term change in fortunes for sterling. This border closing will likely be temporary, and the virus mutation should not alter vaccine-deployment schedules, but extended lockdown concerns have returned as a driver in G10FX, reviving the appetite for an underweight dollar. While the latest UK news has given sterling bears short-term ammunition, there are no game-changers for the pound in the medium term, in our view.

In the year of the pandemic, and of the UK's exit from the EU, Sterling has been hit harder by the virus than by uncertainty on the outcome of post-Brexit negotiations. If the agreement is achieved (in the version 'hoped for' by the UK), sterling may strengthen, but probably only to a limited extent. In case of no deal, on the other hand, it would depreciate especially against the dollar. Sterling's impact reaction to the announcement - when it will come - will be opposite but not symmetrical.

If an agreement is reached, the pound should strengthen, but only moderately (target against the dollar at GBPUSD 1.36-1.38, and in any case within the GBPUSD 1.40 mark), both because the market has kept a non-neutral, moderately optimistic stance on the talks, and because the near-term growth outlook is, in any case, marred - as mentioned above - by twofold weakness (evolution of the pandemic - especially following the worrying discovery of a new strain of the virus in the UK, and the ensuing introduction of new restrictions - and adjustment to the new rules governing trade with the (EU). In the course 2021, on a par with the euro, sterling should stay mostly range-bound against the dollar, generally between GBPUSD 1.30-1.32 and GBPUSD 1.35-1.38. The prospect of an only partial post-pandemic recovery in the United States, should help prevent an upside acceleration of the pound. On its part, the BE would keep rates unchanged for at least all of next year, and ultra-accommodative monetary conditions in place indefinitely.

Technical Analysis

GBPUSD entered the 1.3200-1.355 level for the whole of November. This range was challenged on 16 Dec and finally broken the next day following the news of new lockdown measures to control the spread of a new variant of the virus. It currently trades below the 50EMA on the weekly chart and on the daily chart it is trading below the 50 and 200 EMA. The RSI was at 28, below the 30, indicating that the FX pair was oversold. Lastly, we see that there were three red candles and hope that this signifies a trend reversal of a downtrend.

We would like to initiate a long on the break of the 1.3350 mark. We set out stop loss around the December support level at 1.3200 and take profit at the month high of 1.3600.

Entry: 1.3350

Take Profit: 1.3600

Stop Loss: 1.3200

Risk Reward Ratio: 1 : 1.667

Global Macro Department – Russia (Underweight)

27th December 2020

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Basic Information

Real GDP(US$)	1.658 trillion USD
M2(US$)	754.83 bn USD
CPI	4.40%
PPI	0.1%
Con. Confidence	-22
Mortgage Rate	9%
Stock Index	MOEX Russia Index
Currency	Russian Ruble (₽)

Overview of Russia

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 and banking sectors. The 1990s was a rough period for its economy since it inherited a devastated industrial and agricultural sector along with the fundamentals of a centrally planned economy. During the next decade, Russia witnessed growth at a healthy pace of 7%. However, this growth was led by the commodity boom.

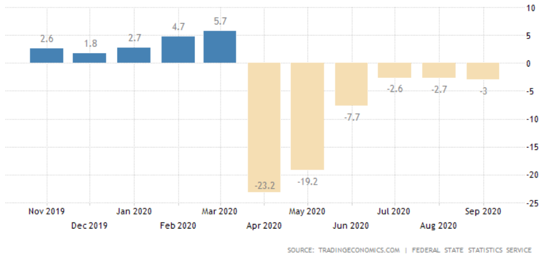
Russia is the 11th largest economy based on GDP in 2019 (USD 1.64 Trillion). It is located in Eastern Europe and Northern Asia, bordering the Arctic and North Pacific Oceans. The country's natural resources include a wide natural resource base including major deposits of oil, natural gas, coal, strategic minerals, and timber. 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 US and Saudi Arabia and has the eighth largest oil reserves in the world. In 2019, oil exports amounted to US$ 220.8 billion, which contributed to about 52.2% of total exports. This is why there is a strong correlation between ruble and oil price.

The Russian economy is mainly driven by the service sector which accounts for about 62% of the total GDP. Important segments include Real Estate, Wholesale and retail trade and Public Administration and defence. The Industrial Sector contributed about 32% to GDP. Important segments include manufacturing, mining and quarrying and these industries provide jobs to about 27% of the Russian population. A small agriculture sector accounts for 5% of the country's GDP and provides employment to 6% of the population.

Russia's economy has looked more resilient than expected in the face of the pandemic and low oil prices. Yet shocks are still rippling through the system, and a resurgence in COVID-19 is threatening to derail the recovery. In the background, political uncertainty has also risen across multiple channels - from sanctions to domestic unrest and conflicts in Russia's so-called near abroad. A steady slide in the ruble is stoking price rescue and prompting stability concerns, which may discourage further monetary easing.

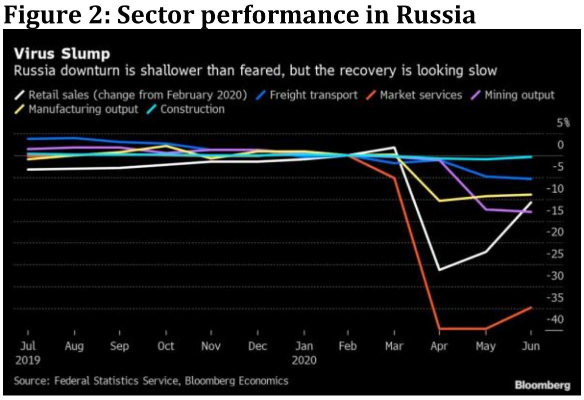
The virus is the bigger concern for now, as policymakers tighten restrictions and demand suffers. Yet political tensions add to long-term drag and could be a source of disruption. We expect the recovery to keep some momentum, but risks tilt toward greater economic damage in 4Q and a softer start to 2021.

Figure 1: Retail Sales



Source: Trading Economics

Figure 2: Sector performance in Russia



Source: Bloomberg

Resurging Virus, Slowing Recovery

The resurgence in Covid-19 continues to weigh on Russia's economy. Russia's rate of new Covid-19 infections picked up again last week, with the count jumping by 198,447. The second wave has been less severe than in Western Europe, adjusted for population, but Russia's first wave never really ended. Deaths are still soaring, and the official toll of 54,559 significantly understates the human cost.

Russia has begun mass vaccinations against the virus, this week expanding the program beyond key workers to people over the age of 60. There's still uncertainty about the numbers. Even if the sputnik V is more than 90% effective, as phase 3 trials suggest, the country faces challenges in ramping up production and in convincing a sceptical public to come forward for inoculation. Authorities are targeting coverage of 70% of the population by November 2021.

Efforts to contain the virus became more stringent from late March as Putin declared a nationwide lockdown through April, later extending this to May 11, with some severe restrictions remaining in place into June. After months of loosening, authorities tightened measures in late September and early October. Second-wave restrictions have been incremental. Moscow Mayor Sergei Sobyanin ordered companies to keep at least 30% of their workers home while closing the city's schools for an extra week of October holidays. The government has issued a nationwide mask mandate while recommending restaurants and bars close early.

The Kremlin has avoided another national lockdown. Second-wave restrictions have been incremental and locally focused. Moscow extended its latest measures to Jan 15 - requiring self-isolation for residents above the age of 65 or those dealing with chronic illness and asking companies to keep at least 30% of staff working remotely.

Assessing the Impact

In official economic data, Russia performed better than expected. But the darkening outlook in 4Q is threatening another contraction on a quarterly basis. We expect a hit to GDP of about 3.6% for the year, a little less severe than what the central bank has pencilled in.

Services have suffered the most. The volume of footfall in Moscow's shopping malls fell about 70% on average in April from comparable periods of 2019, according to a Shopping Index from Market research provider Watcom.

Industrial activity has been trickier to assess. Electricity demand has bounced back considerably, relative to what we might expect based on weather and calendar effects. Mining activity contracted further, with extended cuts to crude production. The rebound in manufacturing has been weak. (Figure 2)

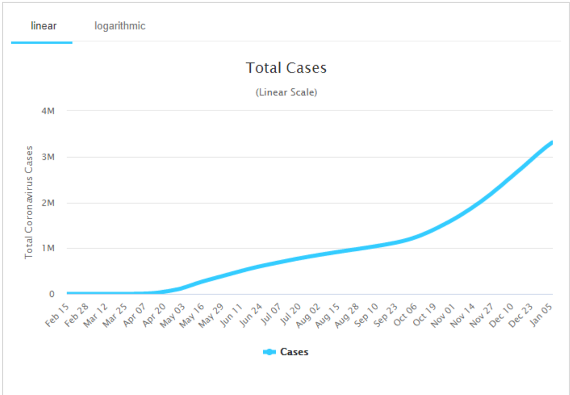
A good signal to look at is the flows into the Bank of Russia's payment system may provide the most holistic picture. The central bank sees payments below normal in external-facing sectors, offset by firmer activity in household and government consumption. Recent reports have pointed to 'near-zero' dynamics for the fourth quarter but also noted a kindling of investment demand.

Financial markets fast-tracked shocks for Russia's economy in the early days of the crisis. The bounce-back in crude prices supported a partial rebound in the ruble into the summer, but conditions have been tenuous.

Figure 2: Russia Inflation Rate

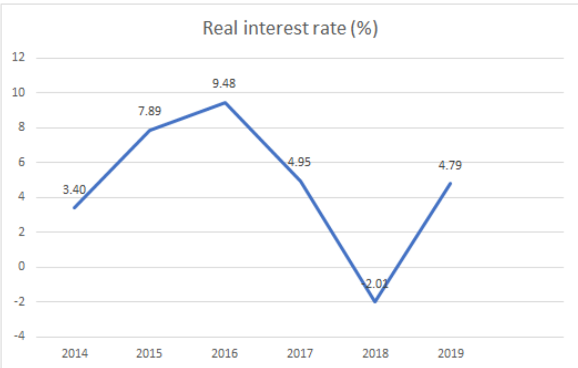
Source: Trading Economics

Figure 3: COVID-19 cases in Russia



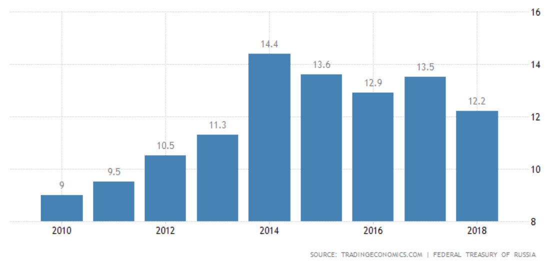
Source: Worldometers

Figure 4: Russia's Real Interest Rate



Source: World Bank Group

Figure 5: Government Debt to GDP



Source: Trading Economics

Central Bank of Russia

Policymakers left the key rate unchanged for a third straight month at 4.25%, while signalling enough uncertainty about inflation to damp prospects for future easing. The central bank delivered 175 bps of rate cuts in April through July to support the economy, with an eye toward cushioning the blow when fiscal stimulus is withdrawn next year. The uptick in inflation and concerns about the ruble then put easing on hold for three straight meetings. We think the central bank will be able to ease a little further next year but will need to see at least a few more months of data in the meantime.

Headline inflation jumped to 4.4% in November. That's already above what policymaker previously predicted for year-end (3.9-4.2%), and we expect further acceleration in the flash reading on Dec 31.

The Ruble slid 7% since June, stoking price pressure. Inflation currently below the central bank's 4% target, looks set to rise to about 5% in early 2021. (Figure 2)

With regards to the economic recovery, there's a risk of backsliding in 4Q as the second wave of Covid-19 forces new restrictions and weighs on demand.dFor the most part, inflation has accelerated since March because of pandemic-related factors, consumer stockpiling, supply-chain disruptions and ruble depreciation earlier in the year.

'If the population develops in line with the baseline forecast, the Bank of Russia will consider the necessity of further key rate reduction at its upcoming meetings'

The policy statement left the door open to another reduction in the near term. During her press conference, Nabiullina reiterated that the medium-termination outlook still creates 'room' for more easing. But she warned that cutting rates in an 'unstable situation in financial markets' could be destabilizing, perhaps leading to excessive ruble depreciation and a tightening in monetary conditions. Overall, the tone is cautious, but in the policy statement and Nabiullin's comment, we see a slightly stronger signal of more easing to come.

Debt

As a steadily rising coronavirus infection rate threatens new lockdown restrictions. The finance ministry aims to sell 2 trillion rubles(US$26 billion) in local currency government debt in the final three months of the year, almost double the record it set in the third quarter. The borrowing will help plug Russia's first budget deficit in three years, forecast at 4.4% of gross domestic product. This year's borrowing boom is uncharacteristic for Russia, which has one of the lowest levels of outstanding debt in emerging markets. But extra spending to prop up the economy during the virus lockdowns in the spring coincided with a slump in demand for oil exports, leaving the government reluctant to run down its $178 billion rainy-day funds.

Fiscal Policy

Like most major economies, Russia has seen a surge in fiscal spending, even as the pandemic has hit tax revenue. The federal budget looks likely to plunge into a deficit of 4.4 % of GDP in 2020. Remarkably, the government has mustered a substantial rescue even with the collapse in oil prices. That's because it entered the crisis with significant fiscal space, allowing it to dip into reserves and borrow more to bridge the gap.

At the end of March, the Russian government announced a RUB 1.3 trillion (approximately USD 18.3 billion) economic support package to combat the fallout from the Covid-19 pandemic. The fiscal stimulus, which amounts to just 1.2% of national GDP, largely focuses on supporting households and small- and medium-sized enterprises

(SMEs) and comes as the government rolls out extended lockdown measures in the form of paid national holiday—de-facto quarantine—until 30 April amid the intensifying virus outbreak. Nevertheless, the economy's relative immunity to external shocks after years of Western sanctions and substantial cash reserves mean Russia is in a relatively strong position to weather out the global downturn.

Russia's likely temporary relaxation of its fiscal rule as part of its coronavirus response is not expected to damage recent progress in improving macroeconomic stability and reducing oil dependence.

The current rule has been more effective than previous ones in delinking Russia's economic growth and public finances from oil price movements. It has helped underpin an improved policy mix incorporating exchange-rate flexibility and a strong commitment to inflation targeting and has boosted Russia's resilience to shocks compared with the oil price fall of 2014/2015. More credible and consistent policymaking, resulting in improved macroeconomic stability, together with a stronger sovereign balance sheet as well.

Russia's fiscal rule links budget expenditures to a conservative oil price of $40 a barrel, obliging the government to save windfall oil revenues in the National Wealth Fund and invest them in foreign assets. The rule also stipulates that any additional spending can only be financed from non-oil revenue gains. Once the liquid part of the NWF reaches a 7% of GDP threshold, the government is allowed to consider investment options other than low-risk external assets, but it cannot use NWF funds to finance additional budget spending unless the oil price falls below the benchmark price.

Outlook

Caution favoured remaining on hold today. Ruble depreciation is stoking near-term inflationary risk and raising concerns about stability. Political uncertainty for Russia has widened on multiple fonts, including relations with the US and Europe, domestic unrest in the east and regional tensions from Belarus to Nagomo-Karabakh. Nabiullina specifically mentioned trade tensions, Brexit and the US election.

December should bring more clarity, at least on the direction of demand and price pressure. We expect the central bank to pull the trigger with a 25 bp reduction, as long as broader market conditions stabilize. If the economic outlook darkens considerable, there's also room to cut further next year, though an extended hold is more likely.

Political Scene

Political uncertainty for Russia has widened on multiple fonts, including relations with the US and Europe, domestic unrest in the east and regional tensions from Belarus to Nagorno-Karabakh.

Sweeping changes to Russia's constitution allow President Vladimir Putin to hold on power beyond the end of his term in 2024. For the economy, this means continuity - for better or worse. We expect more progress on growth-enhancing reform, but stability will remain the primary objective. This means a largely technocratic government will favour longer-term development while preserving policies that have insulated the country from crisis.

Sanctions

Russia faces threats of tighter US Sanctions across multiple channels – over elections hacking, the Nord Stream 2 pipeline, bounties to kill American soldiers and the poisoning of opposition leader Alexey Navalny, just to name a few. There hasn't been enough support for draconian measures in recent years, but that could change under President-elect Joe Biden. Sanctions uncertainty weighed on the ruble since June. Risks have risen, particularly for government debt, the financial and energy sectors, and companies tied to the Kremlin. Existing sanctions also remain a drag on investment and trade, at a time when the economy needs all the help it can get.

Armenia-Azerbaijan Conflict

Fighting over Nagorno-Karabakh has broken out repeatedly since Armenians seized control of the territory and surrounding areas from Azerbaijan in a war that started soon after the 1991 collapse of the former Soviet Union. That conflict killed more than 30,000 people and displaced another 1 million. Despite decades of mediation by the US, Russia and France, a solution remained elusive. The latest bout of fighting, a 44-day battle that started Sept 27, was the worst in decades, much broader and more geopolitically fraught than the previous skirmishes that had broken out since the end of the war in 1994. This time, Turkish President Recep Tayyip Erdogan gave unreserved backing to his country's ally Azerbaijan, raising the stake significantly and tipping the military balance. Russian President Vladimir Putin brokered a peace deal after Armenians, facing defeat at the hands of the Azerbaijan army, agreed to stop fighting and withdraw their forces.

As a nuclear superpower and former overlord, Russia has leverage with both countries. It has a defence pact with Armenia and, while that doesn't cover Nagorno-Karabakh, the peace accord has now ended an anomaly in which the enclave was a so-called frozen conflict on former Soviet territory where Russia did not have troops on the ground able to determine the outcome. Armenia also hosts a large Russian military base and is now more dependent than ever on the ultimate guarantee that provides. Since 1994, Azerbaijan's oil and gas wealth have allowed it to substantially increase its military spending- much of which has gone to purchasing weapons from Russia, which arms both sides.

Sensitive to the threat of wider confrontation, Russia is now limiting involvement in the Nagorno-Karabakh conflict to providing humanitarian assistance and some military aid. Moscow is determined to defend its own interests in the South Caucasus.

Russia, which has a defence pact with Armenia, also has good relations with Azerbaijan and is unlikely to become directly involved militarily unless Azerbaijan launches a deliberate attack on Armenia, they said.

Russia is Armenia's main arms supplier though it also sells weapons to Azerbaijan which, like Armenia, was for decades part of the Soviet Union. Russia has said it will give "all assistance required" should the conflict spill onto "the territory of Armenia". Razoux said deeper Russian involvement would be possible were Azerbaijan to attack Yerevan or Russia's military base in Gyumri, northwest of the capital.

Moscow has a pragmatic relationship with Ankara that has overcome past crises, and both worry about the security of oil and gas pipelines in Azerbaijan. The Baku-Tbilisi-Ceyhan oil pipeline has a capacity of 1.2 million barrels per day but normally operates at half that level. With surpluses available on the global market, any threat of a stoppage did not seem to be sufficient to significantly disrupt the oil market amid soft demand.

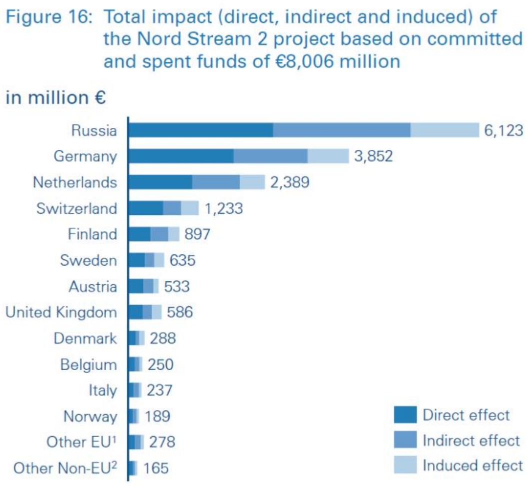
Figure 7: Overall impact on the Russian economy

Impact type	FTEs created (over 5 years)	Value added to GDP	Output
Direct effect	75,190	962 M€	2,534 M€
Indirect effect	36,850	1,078 M€	2,399 M€
Commercial services and legal	9,920	367 M€	618 M€
Corporate services	1,090	25 M€	48 M€
Construction	3,460	52 M€	144 M€
Finance, insurance, real estate, rental and leasing	2,050	79 M€	117 M€
Manufacturing	10,650	110 M€	411 M€
Public services	330	2 M€	4 M€
Raw materials	2,910	164 M€	420 M€
Transportation and warehousing	5,350	122 M€	289 M€
Utilities	800	93 M€	273 M€
Wholesale and retail trade	280	9 M€	18 M€
Other	0	56 M€	56 M€
Induced effect	32,070	652 M€	1,190 M€
Commercial services and legal	5,050	151 M€	256 M€
Corporate services	550	18 M€	32 M€
Construction	870	16 M€	39 M€
Finance, insurance, real estate, rental and leasing	1,230	80 M€	115 M€
Manufacturing	3,500	45 M€	167 M€
Public services	16,010	120 M€	216 M€
Raw materials	3,270	56 M€	118 M€
Transportation and warehousing	1,290	29 M€	70 M€
Utilities	170	19 M€	57 M€
Wholesale and retail trade	140	4 M€	9 M€
Other	0	112 M€	112 M€
Total	144,110	2,693 M€	6,123 M€

Source: Arthur D. Little calculations using the IMPLAN modeling system (OECD database)
Note: Compared to the other countries investigated, the effects categorized as "public services" are higher for Russia, as the degree of privatization in Russia is lower, e.g., whether "public services" include certification services. 1) FTE = Full-time equivalents, a task that would take one person one year to complete, based on standard working hours

Source: Arthur D Little

Figure 8: Total impact of Nord Stream 2 project based on committed and spent funds of EUR 8 million



Source: Arthur D Little

Nord Stream 2

Nord Stream 2 is a 1200km-long offshore natural gas pipeline being constructed to connect Europe to the world's largest reserves in Northern Russia. Russia state-owned Gazprom will own and operate the pipeline through its wholly-owned subsidiary Nord Stream 2.

The budget for the construction of the pipeline was estimated to be €9.5bn ($11bn), with Gazprom investing more than half, and the remaining to be financed by Engie, OMV, Royal Dutch Shell, Uniper, and Wintershall. Nord Stream 2 is an expansion of the existing Nord Stream pipeline and is expected to supply energy to approximately 26 million households a year, with a capacity of 55 billion cubic metres (bcm). The energy delivered by the proposed infrastructure project will be equivalent to the amount of energy transported using between 600 and 700 liquified natural gas (LNG) tankers.

Benefits

The direct impact on the Russian economy of the currently committed CAPEX investments is over €2,500 million, the largest single allocation, both relative and absolute, to any country so far. It is equivalent to 32 percent of the total committed investment expenditure to date. The overall impact on the Russian economy from Nord Stream 2 is equivalent to economic output of more than €6,100 million, adding nearly €2,700 million to GDP and creating more than 144,000 full-time equivalents, spread over many different sectors (Figure 7).

It should be noted that the multiplier impact on Russia is far higher than for EU countries, primarily due to the difference in labour cost. This means that every euro spent in investment will create three times more full-time equivalents in Russia than in, for example, Germany.

Going forward, Nord Stream 2 will doubtlessly lower gas transport costs, thereby improving the balance sheet of Russia.

What is often overlooked in the Nord Stream 2 context is that Russia itself has been a supporter of more competition and diversification in gas distribution over the past years. In this regard, Nord Stream 2 is only one element. Russia is gradually breaking up the export monopoly of Gazprom. Thanks to the development of an efficient liquefied natural gas infrastructure, the production of LNG tankers that can also be operated in arctic regions, and the permission to domestic competitor Novatek to export LNG from the Yamal peninsula in Siberia's Arctic Sea, competition and - hopefully – also efficiency in Russian gas industry is increasing.

Opponents of the project (such as gas supplier Norway and the other important East European transit countries alongside Ukraine, namely Poland, Slovakia and the Baltic countries) argue that Nord Stream 2 will undermine supply security. The opposite is true, though. For more than 40 years, Russian gas supplies to Western Europe have been flowing uninterrupted, even in times of the Iron Curtain, which were as frosty at times as in the face of the EU/US conflict surrounding the Crimea. As the new gas transport affects only a limited number of countries, it is even more secure than in the recent past.

Contrary to fears of some critics, Nord Stream 2 will not lead to a gas market divide between Eastern and Western Europe. After completion of EUGAL 2020, up to 50 billion cubic metres of gas can be transported eastwards, from Greifswald via the Czech Republic, which will boost security there. Furthermore, Europe will be faced with a supply gap in the future, given the imminent decline in domestic gas production (e.g., in the Netherlands). The large Russian gas capacities and the pipes are ideally suited to make a significant contribution to closing this gap.

With respect to competition, an argument voiced by some critics is that Russia's market position could be excessively strengthened. This point, however, is no longer convincing, as the relevant market is meanwhile ripe for redefinition from a competitive standpoint. In the decades ahead, all major energy institutes (e.g., the IEA) expect global gas volumes and shares to rise across highly different regions. 19 countries worldwide are already exporting LNG. A wide variety of addresses such as Qatar, Indonesia, Australia, which is gaining in importance, and recently also the USA are putting the global gas markets into balance and enhance the security of supply.

With the climate footprint disappointing of late, natural gas is becoming attractive bridging energy, not only in Germany. Even in China, the focus is shifting to gas and massive investments are flowing into its energy transformation away from coal. In 2017, China's LNG imports soared by 46%. Europe ought to be pleased that it is facing less competition from the energy-hungry emerging markets in Asia, thanks to the Baltic Sea pipelines.

Thanks to the imminent continuation of Russian gas transit through the Ukraine, which has always been a German condition for Nord Stream 2, future gas shipments to Europe will exceed volumes in 2017, which marked an all-time high in Russian gas exports to Europe. Led by large resp. rising volumes, margins in European gas trading will be put under pressure, which, in turn, ought to benefit the typical buyers of gas, namely consumers, industrial clients and operators of gas-fired power plants. For all those who are not on principle opposed to gas as bridging energy, this should be good news. Let us hope that Russia will find its way back into the international community in future. Greater flexibility in the gas conflict is the first sign of hope.

Controversies around Nord Stream 2 pipeline project

The project has been surrounded by controversies since its inception. Ukraine filed a lawsuit with the Energy Community Secretariat seeking action against the construction of the pipeline. It also appealed to the European Commission to terminate the gas project as it is against Ukraine's interest. The route of the pipeline circumvents certain nations such as Ukraine, which stand to lose high-transit fees.

The governments of ten European countries sent a letter to the European Commission stating that the pipeline project is against the interests of the EU. The countries involved are Bulgaria, Czech Republic, Estonia, Greece, Hungary, Latvia, Lithuania, Poland, Romania, and Slovakia.

The U.S. is broadening the sanctions against service providers and those funding vessels involved in the construction of Nord Stream 2 in a fresh attempt to prevent the Russia-led gas pipeline project from completing, the U.S. Department of State said in new guidance on Tuesday. The sanctions are a follow-up to U.S. sanctions on the Nord Stream 2 project from December 2019, which resulted in Western vessel and technology providers pulling out of the project.

Following the announcement of the sanctions last December, Switzerland-based offshore pipelay and subsea construction company Allseas immediately suspended Nord Stream 2 pipelay activities.

Now the United States is including in the sanction's companies "providing services or facilities for upgrades or installation of equipment for those vessels, or funding for upgrades or installation of equipment for those vessels," according to the latest guidance.

It is sometimes argued that the reason behind the United States' opposition to Nord Stream 2 is not the stabilisation of Ukraine but the economic interests of the US gas industry. According to the rationale, gas prices in Europe are likely to rise if the pipeline is abandoned. For the US gas sector, this would have a two-fold benefit: Firstly, because LNG export revenues in Europe would go up and secondly, because fewer imports would be added to abundant supply in the US market, which would enable domestic gas companies to raise prices. As regards this argumentation, it is certainly correct that the United States is readjusting its energy policy and expects to be an energy superpower and a net energy exporter in the future. But the new global gas market has its own laws. Hence, future US LNG supplies to Europe will not be driven by Russia sanctions respectively. the abandonment of Nord Stream 2, but by the laws of economics which are observed by all honest merchants. Going forward, the LNG US export infrastructure, which has undergone massive expansion in recent years, will be used for shipments to Europe, when the price spreads between the European trading markets (e.g. TTF, NBP) and the US Henry Hub point to reasonable yields (albeit inclusive of costs for liquefaction, long-distance transport and regasification).

The pipeline faces fierce resistance, particularly in some Eastern European countries such as the Baltic States, Ukraine and Poland. Ukraine fears that it will become less relevant as an important transit country for natural gas supplies from Russia and come under greater Russian influence. this argument can also be heard from the US. The USA is also critical of Germany's increasing dependence on Russian natural gas. Around one-third of German natural gas imports currently come from Russia. This share is likely to rise as natural gas production in the Netherlands declines. However, the fact that the USA would like to sell its own natural gas to Europe may also play an important role in the US government's rejection of Nordstream 2. The USA is therefore trying to thwart the completion of NordStream 2 with the threat of Sanctions. The construction of the pipeline is currently suspended.

Figure 13: USDRUB Daily Chart

Source: Tradingview

Trade Idea: Long USDRUB

Following the corona outbreak in spring. USDRUB rose to a higher 75.00-80.00 range but came down to a lower range in the following months, as the first set of lockdowns around Europe successfully deflected the pandemic. It is no surprise then that the USDRUB has risen again to the higher level. The oil price has not collapsed as it had done in March-April, but it has turned softer and the risk to its outlook has multiplied. The rouble is also afflicted by the lingering risk of western sanctions on the back of geopolitical development at home as well as in Belarus and Armenia. A Democrat victory in the US elections also raises the risk of stricter US sanctions as Russia is viewed to have been a Trump ally.

The ruble fell close to the four-year low set amid the financial-market turmoil of March. Though rebounding recently, it's down about 22% against the dollar year to date. Oil has been a recent trigger. Prices dropped to the lowest in five months with a surge in Libyan production boosting supply and renewed lockdowns weighing on demand. Indications that the OPEC+ group of producers will delay an easing of output cuts have since lent some support to crude.

All is said; however, the Russian central bank has solid credibility and maintains a neutral-to-positive interest rate. This combined with eventual economic recovery from the pandemic by H2 2021 is likely to result in a moderate decline in USDRUB to 70.00 by the end of next year. If the oil price were to, however, return to a higher range sooner, this would help USDRUB decline faster as well.

GDP outlook damaged but slowly recovering

Russian GDP growth was already a weak 1.3% last year. But there was a tendency towards recovery during H2 2019. 2020 growth forecasts had been revised up as the government moved closer to implementing its delayed national infrastructure projects. But of course, the economy contracted sharply in Q2 2020 as we might expect due to the pandemic: we estimate a 5.7% q/q contraction. We had anticipated a punchy quarter-on-quarter rebound in Q3, but at this time, we assume a relatively cautious 3%q/q increase. GDP growth will likely slow down by 4% this year. In 2021, we forecast a rather weak 1.4% growth from this low base - we do not forecast the punchy rebound in 2021 which the market consensus does. It is worth noting that real GDP data do not directly reflect changes in the oil price - real GDP calculation uses fixed prices from the past - hence, GDP will not fall simply because the value of oil sales will fall. Nevertheless, consumption, investment and other GDP components will suffer the negative multiplier-effects of reduced value of oil sales.

For the economy, depreciation serves as a shock absorber - at least in normal times. It also boosts the local-currency value of government energy earnings. But higher import prices stoke inflation, weighing on demand, and market instability has forced the central bank to delay adding stimulus.

Deteriorating Demand

Russia is also in the throes of a worsening outbreak, which looks set to derail the economic recovery. Adjusted for population, the country's second wave is less severe than in Western Europe, where governments have announced new lockdowns.

But the trajectory is worrying. Daily new cases and deaths far exceed the first-wave peaks of May and June. Russia has begun rolling out its sputnik V vaccine, but testing is incomplete, and production is already well behind target

So far, the Kremlin is resisting major lockdown restrictions. Even without severe constraints on supply, demand is taking a hit. High-frequency indicators point to a stalling recovery. Our October forecasts of slight in 4Q now seem overly optimistic. A quarterly contraction looks increasingly likely

CBR rate-cutting cycle near end

Russian inflation has slightly accelerated in recent months, partly because of the weaker exchange rate and partly because of supply rationing in the aftermath of Covid-19, similar to what had pushed up inflation rates in other CEE countries. Going forward, weaker growth and a still-low oil price will dampen inflation, although a second-round of lockdown can extend high inflation for slightly longer: the oil price is forecast to be about 25% lower by the end of 2020 compared to the end of 2019. The depreciation of the rouble on the other hand, from 65.00 to 80.00, will not produce enough FX pass through to counter this. Hence, inflation is likely to eventually moderate.

In June 2020, the CB issued a large 100bp reduction because the exchange rate was appreciating too rapidly. During September and October, the exact opposite happened: a weak exchange rate and high FX volatility made CBR abandon its rate-cutting cycle for now. This shows that CBR is a cautious central bank and would be reluctant to lower rates too far below the 4% inflation target. We expect CBR to cut rates a little lower below this level because of the extreme economic situation but not by much, we forecast the policy rate to bottom out at 3.50% around the end of H1 2021. The real interest rate of Russia will still continue to be positive at a time when growth and inflation are low and falling - this will produce some residual appreciation pressure on the rouble, which we see strengthening even in 2021.

Stabilise, then support

Rising external risk and deteriorating demand present a difficult trade-off for policymakers, particularly the Bank of Russia. In March, most major central banks announced dramatic monetary easing Russia's stayed on hold to avoid spurring capital outflows amid a plunge in oil prices and the ruble.

Instead, the central bank focused on keeping banks lending, and its propped up the exchange rate by front-loading sales of foreign currency related to the government's use of fiscal reserves. In April, once markets had stabilised, easing resumed

We expect policymakers to follow a similar approach if conditions worsen - the central bank is already on hold, despite seeing room to loosen further. Another rate cut should still be on the agenda for December if uncertainty fades.

What about fiscal support? Ample reserves and low public debt give the Finance Ministry space to spend a little more if needed. But comments from the Kremlin suggest the guidance will be cautious in the meantime, especially with a decline in oil prices putting renewed pressure on the budget and the potential for new sanctions to curtail borrowing.

Political Risk Factors

The biggest driver has probably been a resurfacing of political risk across multiple channels.

The US continues to accuse Russia of meddling in its election. President Donald Trump has downplayed the threat. The election isn't the only potential flashpoint. Others include the Nord stream 2 pipeline - which both Biden and Trump oppose - and alleged bounties on US soldiers in Afghanistan.

The poisoning of opposition leader Alexey Navalny has soured relations with Europe. So far sanctions have mainly targeted individuals. But a Biden win that sees the US repair transatlantic alliances might present a more unified challenge to President Vladimir Putin on a host of geopolitical issues.

Regional tensions are also high, from continuing protests in Belarus to the armed conflict between Armenia and Azerbaijan.
More recent swings in the exchange rate partly reflect allegations of hacking in the US, which could draw a response including fresh sanctions from the incoming administration.

In March, rouble volatility shot up to level last seen in the aftermath of Crimea Sanctions: this was triggered not only by the drop in the oil price but also amplified by the market perception that Russia was locked in a strategic battle to bankrupt US shale companies This gave rise to a perception that economic warfare between Russia and the US would soon heat up, with hatch US sanctions on Russian oil and gas the inevitable next step. This situation alleviated after Russia agreed to cut production alongside Saudi Arabia and a new OPEC+ deal is in place.

But next came a major domestic political development: Constitutional changes were launched and eventually allowing President Putin to remain in position until 2036. The changes were controversial, of course, but ultimately didn't to have discernible market impact perhaps because Putin is anyway viewed to enjoy the actual public mandate.

More recently, volatility has re-surfaced because of the threat of fresh US and EU sanctions. The dual theatres of recent developments are Germany and Belarus. The alleged poisoning of Kremlin dissident, Alexei Navalny, who was brought to Berlin for medical treatment, has re-ignited the stand-off between Angela Merkel and Russian President Vladimir Putin. The US will also likely to impose additional sanctions if the poisoning accusation is confirmed: a statement released following discussions between Moscow officials and US Deputy Secretary over interference in US elections. In Belarus, the Russian administration got dragged into opposing pro-democracy protests, which came in the wake of alleged rigged elections on 9 August. Incumbent President Lukashenko called in the security forces to crush protestors, which was obviously met with strong criticism from the west - the Russian side is backing Lukashenko and condemning the protest movement, hence is viewed as a facilitator by the west. More recently, Russia has got dragged in the Armenia-Azerbaijan conflict which jeopardises its relations with Turkey.

What are the practical implications? We note that even the harsh US sanctions imposed in the wake of election interference were not rigorously implemented. US political priorities shifted away. Most subsequent sanctions were specific to Russian individuals and not very broad-based, although in recent months, Nord Stream 2 targeting sanctions have been relatively strict. Similarly, western countries only made noises but did not impose sanctions on Russia for the persecution of domestic Kremlin critics such as Boris Nemtsoc, Vladimir Kara-Mirza, the journalist Anna Politkovskaya or activist Peter Verzilov. Hence, while some caution may be prudent, the base case remains that the storm will pass with only symbolic sanctions being imposed. Whether Joe Biden will re-activate harsher sanctions remains to be seen; our base-case remains that this is not the first priority of the new US Administration.

Russia's ruble fell the most in nine months as oil tumbled on concern the pandemic is worsening and a report suggested the U.S. may impose sanctions on the country in response to cyber-attacks.

The currency of the world’s biggest energy exporter led its emerging-market peers lower as Brent crude slumped after a faster-spreading mutation of the Covid-19 virus was detected in the U.K.

“The Russian ruble is the main victim of rapidly escalating risk aversion,” said Piotr Matys, a strategist at Rabobank in London. “In addition to rising tensions between the U.S. and Russia over allegations of a cyber-attack, the markets are also concerned about the latest developments in the U.K.”

The ruble had rallied since the U.S. election in early November as concern about possible penalties from the incoming Biden administration eased. However, the market mood shifted last week as the hacking reports brought the prospect of tougher sanctions back to the fore.

Technical Analysis

There was a downtrend following the second quarter high at 80.50. The trend was challenged on the last day of Nov but didn't cut through but was finally broken on the 21st Dec. Looking at the daily candle chart, we can note an Inverted Hammer on the 16 Dec, a bullish signal, which shows that the market was attempting to determine a bottom. The three white soldiers confirm that there was a reversal in the market and the bulls have managed to take over the rally for three consecutive sessions.

Looking at the EMA of USDRUB would also point to a reversal in the November-December downtrend as the price point finally crossed the 20, 50 and 200 EMA. This is a bullish signal.

We would like to initiate a long immediately and ride the uptrend reversal. We set our stop loss at the December low of 73.0000 and take profit at the October high at 80.0000.

Entry: 75.90

Take Profit: 80.00

Stop Loss: 73.00

Risk Reward Ratio: 1: 1.41

NUS INVESTMENT SOCIETY

Global Macro Department – Norway (NEUTRAL)

Date: 27th December 2020

Analysts

Yeo Shi Jie
Global Macro Analyst
yeoshijie@u.nus.edu

Basic Information

GDP(NOK bn)	3549.4
GDP Mainland Norway (NOK bn)	3038.6

Economic indicators (%, yoy)

Unemployment	1.6
Annual Wages	2.3
Consumer Prices	3.5
Core Inflation	2.2
Housing Prices	2.5

Chart info

Overview of Norway

- Norway is a rich country, with one of the highest GDP per capita in the world. The country also scores at the top of the United Nations Development Programme's Human Development Index ranking. Unemployment, which had reached an eleven-year high in 2016, was expected to have declined to 3.7% (3.9% according to Statistics Norway). However, the IMF expects this trend to be heavily affected by the negative economic impact of the COVID-19 pandemic, the rate being currently estimated to increase to 13% in 2020 and decrease to 7% in 2021.

- Norway's economy depends on its natural resources and energy sources (oil, gas, hydraulic energy, forests and minerals). It has the largest sovereign wealth fund in the world (valued at over USD 1.14 trillion at the end of 2019).

- Inflation rate lasted above targets - at 2.2% in 2019 - prompting the central bank of Norway to hike interest rates. IMF expects the inflation to remain stable to 2.4% in 2020 and to 2.2% in 2021.

- Traditionally, the country exports energy-intensive products and imports high-technology items. The country is among the top 20 exporters of oil and the second largest natural gas and seafood exporter in the world. Overall, Norway ranks among the 25 biggest global exporters (excluding inter-EU trade). Industrial products (ships, oil platforms, etc.) constitute close to 10% of total exports. Norway mainly imports manufactured items (machinery, transporters, information technology), which account for 40% of all imports.

Summary/Recap of events in the past 6 months

- In February 2020, Norway updated its commitment under the Paris Agreement to reduce 50%-55% in emissions by 2030 compared to 1990 levels. It has also established a 2030 climate neutrality target.

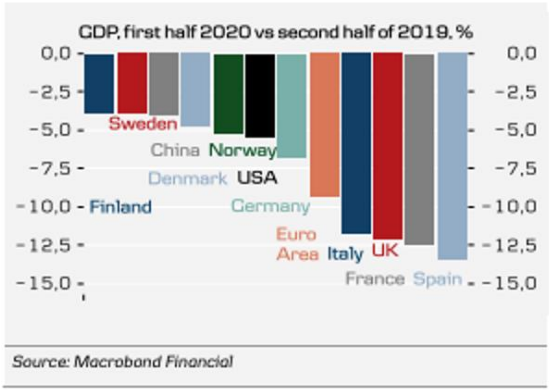
- Norwegian government has implemented and proposed fiscal measures (discretionary measures close to NOK 160 billion, or 5.5% of 2019 mainland GDP per the authorities' estimates)

- Norges Bank (NB) has also implemented monetary policies by reducing the policy rate by 1.5% to 0.0% while also providing additional liquidity to banks in form of loans of differing maturities.

- Norwegian oil firms struck a wage bargain with labour union officials on 9th October, ending a 10-day strike that had threatened to cut the country's oil and gas output by close to 25% the week after.

- The Norges Bank has been widely considered to be the most hike-prone central bank in the G10 FX space, but the cautious verbal forward guidance points to the contrary, with the Norges Bank saying rates will stay ‘’at the current level over the next couple of years.”

Figure 1: Gross Domestic Product

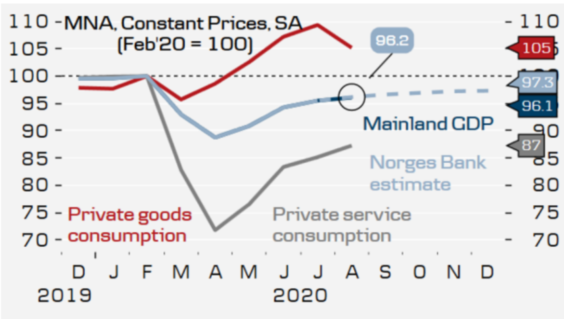


Source: Macrobond Financial

Figure 2: Covid-19 Cases (Adj for population)

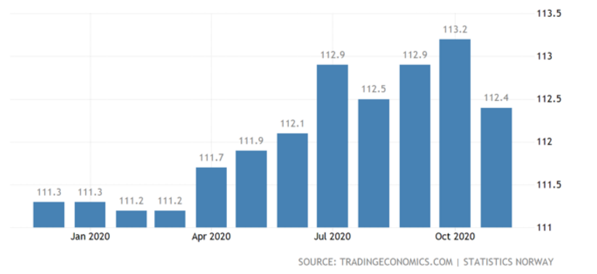
Source: Macrobond Financial

Figure 3: Monthly National Account



Source: Danske Bank

Figure 4: Consumer Price Index



Source: Tradingeconomics

Impact of Covid-19

Along with many other countries, the Nordics took a severe economic hit in March and April. As COVID-19 spread, consumers reacted, and governments shut down activity.

The economy of Norway had one of the worst contractions in 2Q20, performing almost three times as bad as the worst quarter during the financial crisis. Norway's mainland GDP fell 6.3% while the overall unemployment skyrocketed to 15.5% in the same quarter, the highest it has been in Norway since World War II. Oil prices have also reached a low of USD$25/barrel in March.

Nordics are relatively less damaged by the Pandemic

While the Nordic regions suffered a severe economic crisis caused by Covid-19 pandemic, economic consequences have been relatively less severe when compared to neighbouring countries in Europe. This is largely due to the shorter lockdowns implemented in these regions; the Nordic countries have largely allowed the workforce to continue working, allowing trading, production and construction to be able to continue throughout the crisis. This has resulted in a less dramatic drop in its economy compared to the rest of Europe (Fig. 1). In addition, Norway has been among the first countries to reopen the economy, thus allowing economic activity to resume more quickly than the rest of Europe.

Currently, Norway is still among the European countries with the lowest official COVID19 cases adjusted for population size (Fig. 2). Market tends to favour countries that have managed to curb or limit the spread of this pandemic and thus this further supports the recovery narrative that Norway will outdo its peers in terms of economic recovery.

Covid-19 Measures

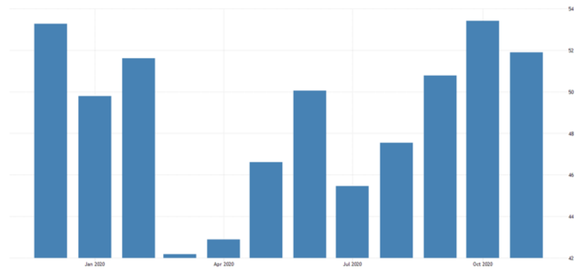
With its $1.2 trillion wealth fund, Norway has been able to bankroll record stimulus close to NOK 160billion (5.5 % of GDP), with plans to withdraw a record of $43 billion this year, without tapping into debt markets. This makes it a relative safe-haven against "debasement" concerns. The majority of stimulus is bank loans to small and medium-sized enterprises suffering losses as a result of the extraordinary situation arising from the spread of covid-19. The Norwegian Government has also proposed temporary tax stimulus measures for the oil and gas companies.

Norges Bank has had its policy rate reduced from 1.5% to 0% and has remained at that level since the Covid-19 crisis hit in March.

Norges Bank implemented a number of measures to improve market liquidity: Norges Bank offered banks extraordinary F-loans. The maturity of these loans was longer than normal, up to one year, and banks could borrow the amount they wanted at a rate equal to or slightly above the policy rate. Norges Bank also eased collateral requirements.

Norges Bank announced its readiness to purchase NOK to support the currency. The aim was to ensure that the market functioned normally. The Norwegian krone has appreciated since those

Figure 5: Manufacturing PMI

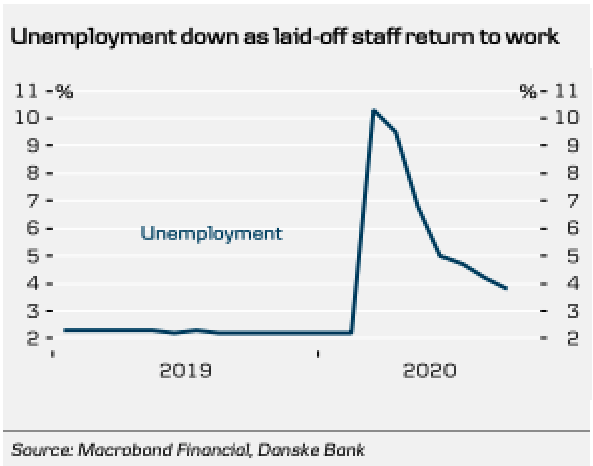


Source: Tradingeconomics

Figure 6: Industrial Confidence Indicator

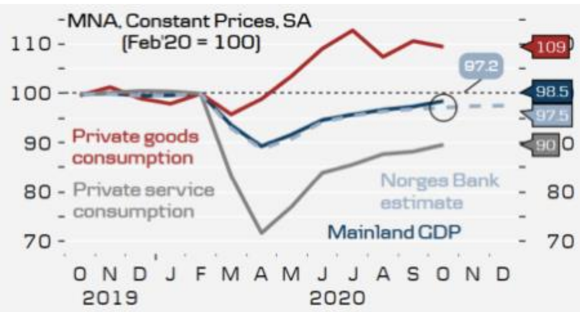
Source: Danske Bank

Figure 7: Unemployment Rate



Source: Danske Bank

Figure 8: Mainland GDP



Source: NorgesBank

dramatic days in March, against the background of abating uncertainty in global financial markets and rising oil prices.

However, Norges Bank has not made substantial purchases of government bonds and other assets via QE measure as it has deemed QE to not be an appropriate option in Norway. The reasons are that Norway's government bond market is much thinner than in other countries, and the share of fixed-rate loans is relatively low. The Bank's assessment is that the costs of adopting such instruments could outweigh the benefits.

Recovery seems to be on track in Q3 2020

Monthly national account figures show a GDP growth of 0.6% month on month in August (Fig. 3). Norway's GDP is now 4% below pre-Covid levels; The extensive monetary and fiscal policies implemented has helped to negate most of the negative effects caused by the Covid-19 Pandemic and its economic recovery looks set to continue, in line with expectations. Private consumption of goods held up particularly well throughout the period and consumption of services grew rapidly over the summer.

Norway's Consumer Price Inflation (CPI) (Fig. 4) rose 1.6% year-on-year in September, after a 1.7% increase in August. However, this falls under economist expectations of a 2% rise.

The outlook for Norway's manufacturing industries continued to improve for the third consecutive month since July. Manufacturing PMI surprises positively with rise from 50.7 to 53.4 (consensus 50.5) driven by new orders & employment (as shown in Fig. 5).

Industrial confidence indicator (Fig. 6) has returned to positive territory for the first time since Q3 2019, showing rapid improvements of business conditions in Norway. Consumer goods are performing the best while results from intermediate goods have caught most by surprise.

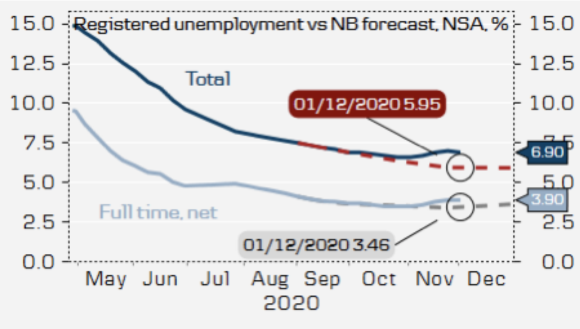
While overall unemployment continues to fall, it is still at a very high level when seen in historical context; The overall unemployment rate currently at 7.1% down from a record 15.5% in June (Fig. 7), when a shutdown of parts of the economy resulted in mass furloughs and layoffs.

And looks to be resilient going into 2021

Mainland GDP rose 1.2% MoM in Oct which was significantly stronger than expected (prior consensus was a gain of 0.4%). That in turn means mainland GDP ran only 1.5% below pre-Covid levels when new restrictions were introduced late October-early November.

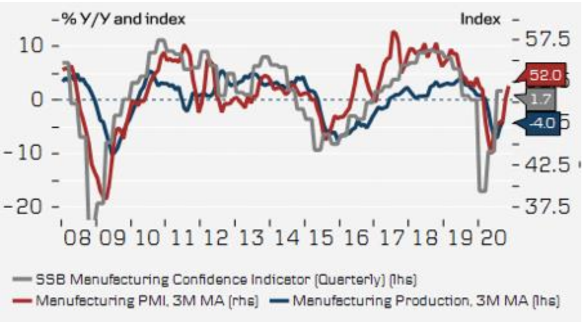
There is also positive news from Norwegian Labour and Welfare Administration (NAV) as weekly unemployment report shows new drop (albeit modest) in unemployment in the first week of December. This could suggest that the negative impact on the labour market from new restrictions will prove limited and short-lived. We believe that the unemployment levels can quickly fall back when economy fully reopens.

Figure 9: Unemployment level (%)



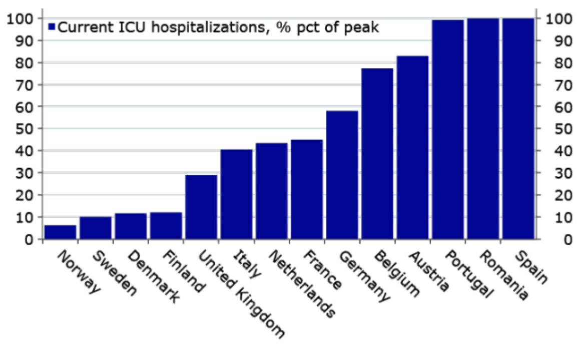
Source: NorgesBank

Figure 10: Manufacturing PMI



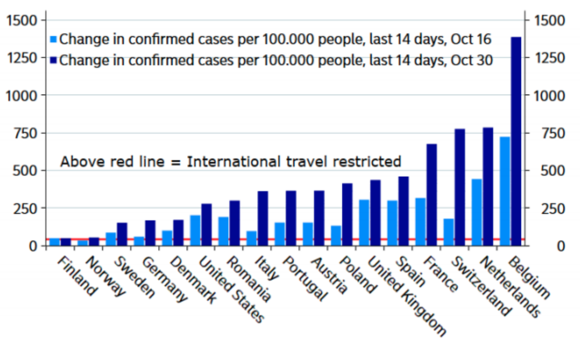
Source: Danske Bank

Figure 11: Current ICU Hospitalisation (% of peak)



Source: Macrobond and Nordea

Figure 12: Change in confirmed cases



Source: Macrobond and Nordea

While November manufacturing PMI falls a little short of expectations, it paints a picture of a recovering hard-hit sector. For now, we believe Norway's recovery depends on vaccines, 2021-reopening outlook and oil prices.

The Q4 Regional Network, Norges Bank`s trusted business survey, shows that activity has flattened out during the past three months. Moreover, Norwegian business also expect a sideways movement in activity ahead. However, it is very important to note that the interviews were conducted in the last week of October and the first two weeks of November when infection rates began to rise in Norway and some business were forced to close fully or partially. Furthermore, data is usually backward looking and since then we have received uplifting vaccine news, which points to a sooner normalisation than previously expected.

Uncertain period ahead

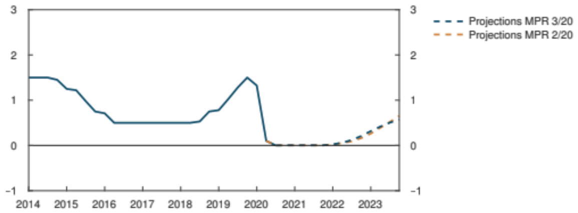
Norway has a very open economy, with trade representing 71% of its GDP and its main trading partners include the United Kingdom (U.K.) and Germany, when combined contributes to more than a third of its exports. Countries around the EU are experiencing fresh spikes in infections (Fig. 11 & 12), with both the U.K and Germany recording the highest number of cases in recent days. We are also approaching winter where according to Akiko Iwasaki, a professor of immunobiology at the Yale University School of Medicine, tend to have a surge in the cases of respiratory infection, including influenza viruses, and coupled with an increasing strain on hospitals, we believe that broadened restrictions will remain in place in Europe for many months and this would mean a less than stable demand for Norway's exports during this period.

Oil slipped from its highest level in almost 10 months after an industry report pointed to an increase in U.S. crude stockpiles, taking some of the steam out of a vaccine and stimulus-driven rally in the recent weeks. In addition, especially in the near term, Oil may face further headwinds from a stronger U.S. dollar or a breakdown in the OPEC+ output agreement.

Expectations in the future

Norges Bank has kept its policy rate at 0.00% since May (Fig. 13). Norges Bank has been widely considered to be the most hike-prone central bank in the G10 FX space, with the Norges Bank writing in its November 2020 rate decision report that "In the Committee's assessment, the sharp economic downturn and considerable uncertainty surrounding the outlook suggest keeping the policy rate on hold until there are clear signs that economic conditions are normalising." And with the expectations of a vaccine to roll out by early next year, we would expect the pandemic situation to ease swiftly, causing a global economic recovery. And with Norges Bank being ahead in the interest rate cycle, we expect Norges Bank to raise its policy rates in the event of a global economic recovery in 2021. In his speech, Governor Oeystein Olsen said "The policy rate forecast implies a rate at the current level for over a year ahead, followed by a gradual rise from the first half of 2022 as activity approaches a normal level."

Figure 13: Policy Rate



Source: Norges Bank

There was a modest hawkish surprise in the most recent meeting on December 17, where Norges Bank brought forward the first planned hike to 2Q22 from 4Q22 on the back of uplifting vaccine news which will lead to a faster normalization of the economy and a total of 4 rate hikes by end-2023. We believe that there is a good chance Norges Bank will become even more hawkish ahead when they are assured that the vaccine rollout goes as planned.

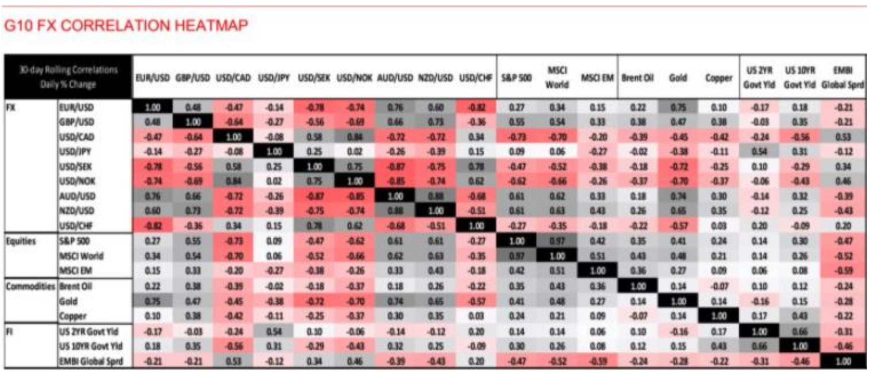
There has been a strong correlation between unemployment and wage growth in Norway, even in the years after the financial crisis. And thus in light of the new infections around Europe, the current high jobless levels should therefore spell moderate wage growth for the next few years, which is in line with Norges Bank's expectations.

Looking forward, a successful vaccine rollout will further boost Norway's economy in 2021. Norway will use the three vaccines developed by Moderna, AstraZeneca, Pfizer and BioNTech in its first push to inoculate its population against Covid-19, the country's health minister said on Friday. In the first quarter of 2021, Oslo expects to receive a total of 2.5 million doses, covering 1.25 million people.

Figure 14: EURNOK Daily Chart

Source: Tradingview

Figure 15: G10 FX Correlation Heatmap

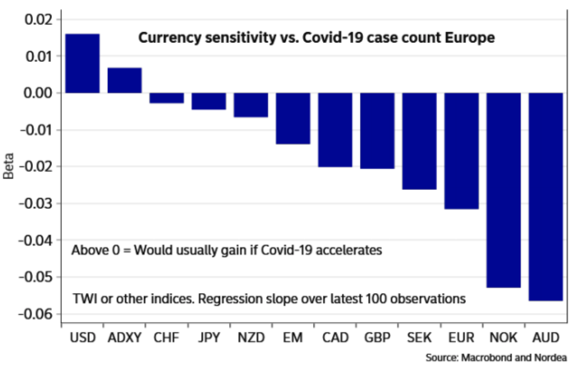


G10 FX CORRELATION HEATMAP

30-day Rolling Correlations Daily % Change		EUR/USD	GBP/USD	USD/CAD	USD/JPY	USD/SEK	USD/NOK	AUD/USD	NZD/USD	USD/CHF	S&P 500	MSCI World	MSCI EM	Brent Oil	Gold	Copper	US 2YR Govt Yld	US 10YR Govt Yld	EMBI Global Sprd
FX	EUR/USD	1.00	0.48	-0.47	-0.14	-0.78	-0.74	0.76	0.60	-0.82	0.27	0.34	0.15	0.22	0.75	0.10	-0.17	0.18	-0.21
	GBP/USD	0.48	1.00	-0.64	-0.27	-0.56	-0.69	0.66	0.73	-0.36	0.55	0.54	0.33	0.38	0.47	0.38	-0.03	0.35	-0.21
	USD/CAD	-0.47	-0.64	1.00	-0.08	0.58	0.84	-0.72	-0.72	0.34	-0.73	-0.70	-0.20	-0.39	-0.45	-0.42	-0.24	-0.56	0.53
	USD/JPY	-0.14	-0.27	-0.08	1.00	0.25	0.02	-0.26	-0.39	0.15	0.09	0.06	-0.27	-0.02	-0.38	-0.11	0.54	0.31	-0.12
	USD/SEK	-0.78	-0.56	0.58	0.25	1.00	0.75	-0.87	-0.75	0.78	-0.47	-0.52	-0.38	-0.18	-0.72	-0.25	0.10	-0.29	0.34
	USD/NOK	-0.74	-0.69	0.84	0.02	0.75	1.00	-0.85	-0.74	0.62	-0.62	-0.66	-0.26	-0.37	-0.70	-0.37	-0.06	-0.43	0.46
	AUD/USD	0.76	0.66	-0.72	-0.26	-0.87	-0.85	1.00	0.88	-0.68	0.61	0.62	0.33	0.18	0.74	0.30	-0.14	0.32	-0.39
	NZD/USD	0.60	0.73	-0.72	-0.39	-0.75	-0.74	0.88	1.00	-0.51	0.61	0.63	0.43	0.26	0.65	0.35	-0.12	0.25	-0.43
	USD/CHF	-0.82	-0.36	0.34	0.15	0.78	0.62	-0.68	-0.51	1.00	-0.27	-0.35	-0.18	-0.22	-0.57	0.03	0.20	-0.09	0.20
Equities	S&P 500	0.27	0.55	-0.73	0.09	-0.47	-0.62	0.61	0.61	-0.27	1.00	0.97	0.42	0.35	0.41	0.24	0.14	0.30	-0.47
	MSCI World	0.34	0.54	-0.70	0.06	-0.52	-0.66	0.62	0.63	-0.35	0.97	1.00	0.51	0.43	0.48	0.21	0.14	0.26	-0.52
	MSCI EM	0.15	0.33	-0.20	-0.27	-0.38	-0.26	0.33	0.43	-0.18	0.42	0.51	1.00	0.36	0.27	0.09	0.06	0.08	-0.59
Commodities	Brent Oil	0.22	0.38	-0.39	-0.02	-0.18	-0.37	0.18	0.26	-0.22	0.35	0.43	0.36	1.00	0.14	-0.07	0.10	0.12	-0.24
	Gold	0.75	0.47	-0.45	-0.38	-0.72	-0.70	0.74	0.65	-0.57	0.41	0.48	0.27	0.14	1.00	0.14	-0.16	0.15	-0.28
	Copper	0.10	0.38	-0.42	-0.11	-0.25	-0.37	0.30	0.35	0.03	0.24	0.21	0.09	-0.07	0.14	1.00	0.17	0.43	-0.22
FI	US 2YR Govt Yld	-0.17	-0.03	-0.24	0.54	0.10	-0.06	-0.14	-0.12	0.20	0.14	0.14	0.06	0.10	-0.16	0.17	1.00	0.66	-0.31
	US 10YR Govt Yld	0.18	0.35	-0.56	0.31	-0.29	-0.43	0.32	0.25	-0.09	0.30	0.26	0.08	0.12	0.15	0.43	0.66	1.00	-0.46
	EMBI Global Sprd	-0.21	-0.21	0.53	-0.12	0.34	0.46	-0.39	-0.43	0.20	-0.47	-0.52	-0.59	-0.24	-0.28	-0.22	-0.31	-0.46	1.00

Source: Bloomberg

Figure 16: FX Sensitivity to EU Covid-19 cases



Source: Macrobond and Nordea

Trade Idea: Short EURNOK

Scandinavian currencies remain primarily driven by global risk appetite, with NOK continuing exerting the highest correlation with risk in the G10 FX space. (Fig. 15)

The NOK outlook is reliant on the reflation narrative generally, especially on EU outlook improvement beyond the Covid-19 disaster. It's thus worth keeping a lookout for further developments in EU and Norway.

Norges Bank's hawkish turn may boost the currency. Together with a global economic recovery as vaccines start to roll out, and a potential bounce back in the demand for oil (a key Norwegian export) could help the Norwegian krone escape a bearish trend that has been in place since early 2013.

The continued expansionary monetary and fiscal policy might help bolster the NOK. Norges Bank being well ahead in the interest rate cycle will also support the narrative of a positive outlook of NOK in the event of a global recovery.

We also believe that the EU's respective governments will have to take more preventive action sooner or later or risk letting the virus get out of hand. The new strain from the UK is in our opinion already in the EU which would necessitate further lockdowns given higher transmissibility. We expect the dip in GDP in 4Q20 to be deeper than expected, and a negative effect in growth in 1Q21.

Technical Analysis

EURNOK has traded between 10.5 and 10.6 since December and is still in a long term descending channel. On the daily chart, EURNOK is below the 50 and 200 EMA

We would thus like to initiate a short when it breaks the 10.5 support level, preferably with strong bearish momentum. We set out stop loss at the top of the channel and our take profit at bottom.

Entry: 10.49900

Take Profit: 10.404535

Stop Loss: 10.531169

Risk Reward Ratio: 3.07

NUS INVESTMENT SOCIETY

Global Macro Department – Sweden (OVERWEIGHT)

Date: 27th December 2020

Analysts

Yeo Shi Jie

Global Macro Analyst

yeoshijie@u.nus.edu

Basic Information

GDP (SEK bn)	5020.8
Trade Balance (SEK bn)	176.331
Current Account (SEK bn)	224.8
Public Debt Ratio (% of GDP)	35
Unemployment (% of labour force)	6.8
Consumer prices (%, Y-o-Y)	2.6
House Prices (%, Y-o-Y)	2.0

Chart info

Figure 1: Riksbank's Covid-19 Measures

Measure	Scope	So far purchased/used
Programme for loans to banks for onward lending to companies	Up to SEK 500 billion	164.5 billion
The framework for the Riksbank's asset purchases	Up to SEK 500 billion	190.4 billion
Within the framework: Purchases of government bonds, municipal bonds and covered bonds		Total of 188.8 billion, of which 23.5 billion government bonds, 25.3 billion municipal bonds and 140 billion covered bonds.
Within the framework: Purchases of corporate securities	The Riksbank is offering to make weekly purchases of commercial paper up to a maximum holding of SEK 32 billion up to 30 September and purchases of corporate bonds of 10 billon up to 30 June 2020.	Current holdings of commercial paper 1.48 billion and corporate bonds 0.15 billion.
Reduced the lending rate in the standing facility	Cut from 0.75 to 0.10 percentage points. This creates a narrow symmetrical interest rate corridor around the Riksbank's repo rate.	
Weekly extraordinary market operations to increase access to liquidity	Unlimited	28.7 billion
Easing of the requirements regarding the collateral when borrowing from the Riksbank	–	
Loans in US dollars	Up to USD 60 billion	USD 2 billion

Source: Sveriges Riksbank

Overview of Sweden

- Sweden is one of the few rare advanced economies to show both a current account surplus and low public debt in Europe. Gross debt was forecast to have fallen to 36.9% in 2019 and is expected to continue its decline in the next couple of years, reaching 35.4% in 2020 and 33.8% in 2021. This allows the government to maintain a strong expansionary fiscal position as it has already introduced tax cuts for high-level income households. The 2020 budget also included higher social, health and education expenditure as well as support for green investments.

- The industrial sector contributes to 22.6% of the GDP and employs nearly 18% of the workforce. It is dominated by groups such as Volvo, Saab, Ericsson, ABB, AstraZeneca, Electrolux, Ikea, H&M, etc. The tertiary sector, driven by telecommunications and IT equipment, employs 80.4% of the active workforce and contributes to 65.2% of the GDP.

- Swedish economy is very open to foreign trade, which represented 89% of its GDP in 2018 (World Bank). Automobile and petroleum products were among Sweden's top exports (5.9% and 5.1% respectively), followed by medicine, auto parts and telecommunication devices. Automobile and petroleum products were also among Sweden's top imports (7% and 6% respectively). Germany is Sweden's top trading partner, both for imports (17.9%) and exports (10.6%).

Summary/Recap of events in the past 6 months

- The Swedish Government has announced and implemented fiscal measures for 2020 including capital injections, liquidity support and guarantees amount to SEK 566 billion to SEK 854 billion (11.3 to 17.0% of 2019 GDP, respectively)

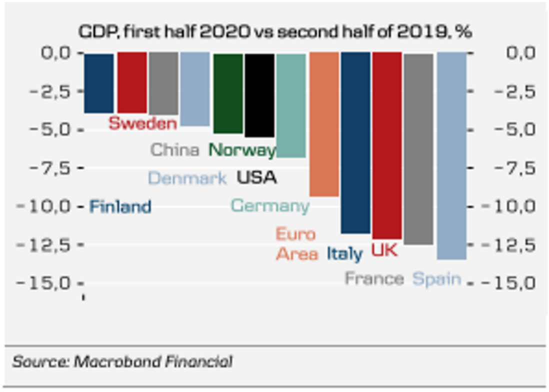
- Sveriges Riksbank has also implemented measures to negate the effects of Covid 19 by reducing of the lending rate for overnight loans by 65bps to 0.1% (leaving the repo rate unchanged at 0% up until 4Q23) and at the same time increasing the purchases of securities from SEK 500 billion to up to 700 billion until 31 December 2021.

- With infections rising in Europe, the key question is whether we see a renewed, serious spike in Sweden? There's little doubt this is going to be the source of considerable interest over coming months, given the debate surrounding the herd immunity concept which still has scientists divided.

- Sweden's major trading partners are currently experiencing higher cases of Covid-19 in relative terms. That suggests a less stable demand environment for Swedish exports over the winter and into 1Q21.

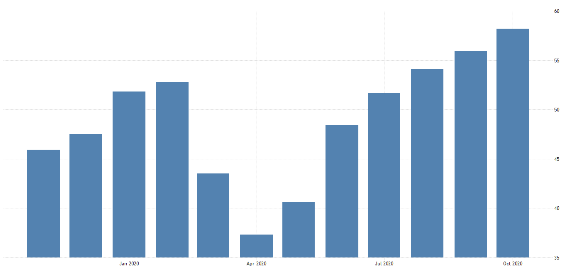
- Sweden has announced the least green stimulus among the Nordics. Sweden is also amongst the 3 Nordic countries who will receive a share of the EU recovery fund in 2021-2023, of which one-third must be allocated to climate spending. This will mean an addition of around SEK 10 billion in Sweden's green stimulus.

Figure 2: Gross Domestic Product



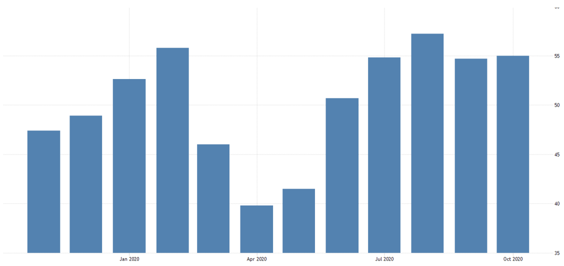
Source: Macrobond Financial

Figure 3: Sweden Manufacturing PMI



Source: Tradingeconomics

Figure 4: Sweden Services PMI



Source: Tradingeconomic

Impact of Covid-19

Sweden, which avoided a lockdown during the height of the Covid-19 pandemic, saw its economy shrink 8.6% in the April-to-June period from the previous three months. While the country had fared better than other EU nations which took stricter measures (Spain saw a 18.5% contraction, while the French and Italian economies shrank by 13.8% and 12.4% respectively), it was still the largest quarterly fall for at least 40 years. Unemployment is projected to rise to almost 10% in the beginning of next year.

The impact of Covid-19 is less severe compared to other countries. This is largely due to a less restrictive containment strategy (Fig. 2). And while Sweden's strategy indeed likely helped the economy, it came at a high cost. In late October, the cumulative number of deaths from Covid-19 infections per million people was 582 in Sweden. This number is extremely high when you compare deaths in neighbouring Nordic regions: 52 in Norway, 64 in Finland, and 118 in Denmark, according to Johns Hopkins University.

Comparisons of infection rates are less reliable because of differences in the testing volume, but Sweden underperforms its neighbours in this area as well. Registered cases in Sweden are slightly above 106,300, compared with around 13,800 in Finland and 16,600 in Norway even though both countries have approximately half the population of Sweden.

Covid-19 Measures

In Sweden, there is strong emphasis on sustainability for the Covid-19 regulations implemented: if someone is infected in the household, the children can still go to school. Moreover, residents isolate for a week instead of 2 weeks, and this is something that Britain and other countries in Europe that are aiming to emulate.

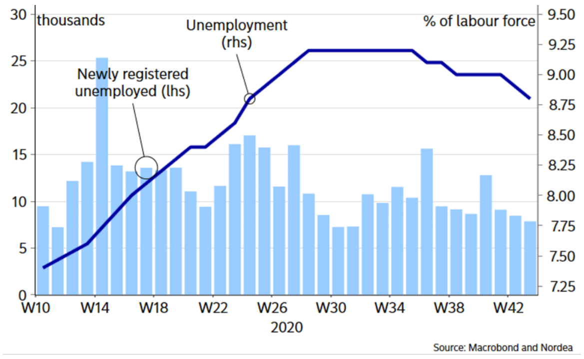
Sweden has also announced "very comprehensive" measures as number of Covid-19 cases continues to rise during 4Q20, according to local media. Sweden bans alcohol sales after 8 pm, limits the number of people in stores, and recommends face masks on public transport.

Although not quite as stringent as the measures taken elsewhere on the continent, Swedish Prime Minister Stefan Lofven has urged the public to avoid gyms, libraries and restaurants and cut the limit on public gatherings from 50 to 8.

The Swedish government has announced plans to implement fiscal measures amounting from SEK 566 billion to SEK 854 billion (11.3% to 17.0% of 2019 GDP, respectively) to help combat the effects caused by the Covid-19 pandemic.

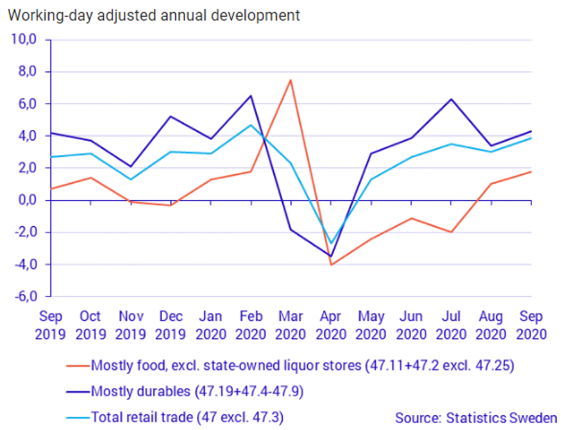
A particularly important scheme for households' finances implemented by the Swedish government is the scheme of temporary layoffs. The scheme implies that households keep 90% of their income while being temporarily laid off, with the government covering 70% of the cost. Household Consumption accounts for 45.35% of its GDP, thus putting money in the hands of the consumers would allow consumption to remain at current levels and not cause a further dip in its economy.

Figure 5: Unemployment Rate



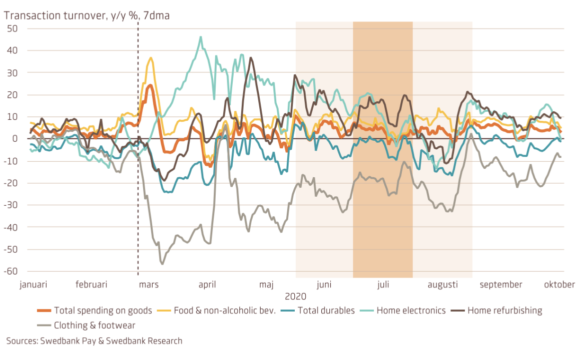
Source: Macrobond and Nordea

Figure 6: Monthly Retail Sales



Source: Statistics Sweden

Figure 7: Daily spending in retail trade sectors



Source: Swedbank Research

Sveriges Riksbank has also implemented measures to negate the effects of Covid-19 (Fig. 1), such as reducing of the lending rate for overnight loans by 65bps to 0.1% (leaving the repo rate unchanged at 0%) and at the same time increasing the purchases of securities of up to SEK 700 billion until 31 December 2021. In the latest meeting on the 24th November 2020, Riksbank will speed up purchases for 1Q21 compared to 4Q20 and will extend the QE programme by SEK 200bn for 2H20. The Riksbank also included sustainability as a part of the programmes.

Overall, the message from the Riksbank was more dovish than expected, as the QE programme was increased. The Riksbank is pessimistic on the economy and apparently also on the effects of the vaccine. Preventing the SEK from strengthening too fast is most likely an important reason for the Riksbank's rather aggressive moves, and probably more important than the Riksbank communicates. We don't expect the Riksbank to take any further monetary policy measures during the coming six months. However, further rate cuts cannot be ruled out completely.

Rapid Rebound in the third quarter

While there is limited data to gauge the business sector's investments in machinery and transportation, NIER's monthly data for investment goods production turned positive in September.

The latest PMI data showed a continued recovery in manufacturing sentiment from 55.9 to 58.2 (Fig. 3), but the service index fell and pushed the Composite PMI slightly lower. It is still unclear to what extent Covid-19 might affect supply and services industry but so far there's no evidence of any supply disturbances given the spike of Covid-19 cases in Europe (Fig. 4).

There are several positive signs in the labour market as well: the initial shock in the labour market has subsided and the labour market is stabilizing.

Unemployment continued down to 8.8% in August (Fig. 5). More importantly, the number of new job vacancies continued up and even surpassed last year's level. This data underlines a strong recovery in Sweden especially given the recent uncertainty.

Industrial orders rose strongly in August suggesting strong production in September. The retail trade sales volume increased by 3.9% in September 2020 compared with the same month a year ago. Retail sales in durables increased by 4.3%, while retail sales in consumables increased by 1.8%, implying a further rise in consumption (Fig. 6 & Fig. 7)

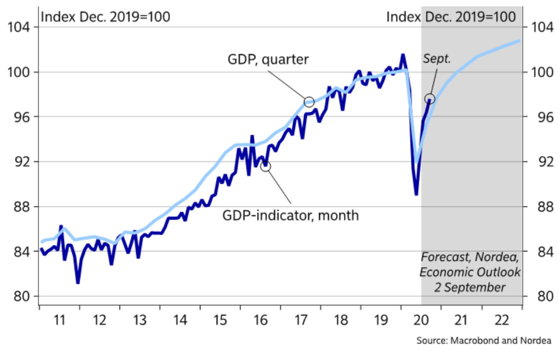
Sweden's current account has turned positive, resulting in supportive SEK inflow. This is an indication that international demand for Swedish goods is recovering to the benefit of Swedish exporters and, not least, GDP growth.

Relatively Resilient in the last quarter

Various indicators show a continued recovery in Q4 for Sweden.

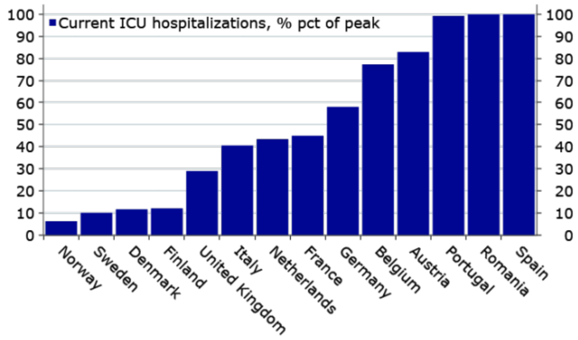
Statistics Sweden's monthly indicator for GDP shows an increase of 0.5% MoM and a decrease of 2.2% YoY in October. According to the

Figure 8: GDP flash Indicator



Source: Macrobond and Nordea

Figure 9: Current ICU Hospitalisation (% of peak)

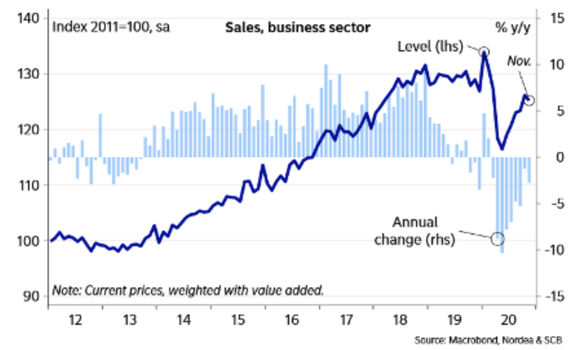


Source: Macrobond and Nordea

Figure 10: Change in confirmed cases

Source: Macrobond and Nordea

Figure 11: Business Sales



indicator, GDP has risen by 10% since the trough in May and was 2% below pre-crisis levels in October.

Total business sector sales declined in November by 0.7% m/m and was down 2.8% over the year (Fig. 11), according to Statistics Sweden (current prices). The downturn was probably due to certain sectors such as hotels, restaurants and transport being hit by the second wave of the virus, while other sectors did much better.

Retail sales rose swiftly in November, by 0.8% MoM and by a full 5.7% YoY (Fig. 12), up from upward revised 4.2% YoY in October. Retail sales only represent 35% of total household consumption. Coupled with improving consumer confidence and a stable financial situation, conditions are in place for a continued recovery in household consumption heading into the new year.

Producer prices edged up on the month in November but was 4.4% lower than a year ago (Fig. 13), reflecting the stronger SEK. The focus is on the drop in import prices for consumption goods, which indicates low inflation going forward.

Unemployment decreased to 8.3% in November from 8.6% in October, much lower than consensus. Layoffs are at normal levels and new vacancies were almost back to last year's level in November. To date, there are no indications of any impact of a second wave on the labour market.

The manufacturing PMI industry rose further in November to the multi-year high of 59.1, which is encouraging. All sub-indices rose in November, except for production which fell to a still good 61.

Exports of goods are already back at decent levels, while exports of services have hardly recovered at all, mainly due to the sharp reduction in tourism. Investment activity remained at a relatively healthy level in Q2 and rose during the autumn.

Energy prices have risen lately, and CPIF-inflation will probably rise somewhat in December. The Prospera's quarterly survey, including money market players, labour market parties as well as purchase managers, is mixed. Long-term inflation expectations (5 years) declined for CPI while they rose as for CPIF.

Outlook and Sentiment going into 2021

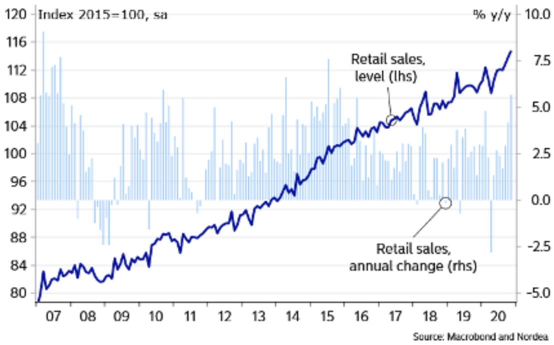
The Economic Sentiment Indicator (ESI) declined somewhat in December to 95.6. The survey for companies was conducted 27 November – 15 December, and for households 30 November – 15 December. The consumer confidence rose to 92.3 from 88.8 previously, the highest reading since before the crisis and probably boosted by good news about the vaccines.

The Exporting Manager Index (EMI) increased by 11.5 points to 48.7 in the third quarter from 37.2 in the second quarter. However, the index is still just below the 50-mark which indicates that sentiment among export companies continues to be somewhat more gloomy than normal.

SEB's CFO survey shows a clear turnaround in the financial outlook. The upturn is strongest in the industries that were initially hit hardest

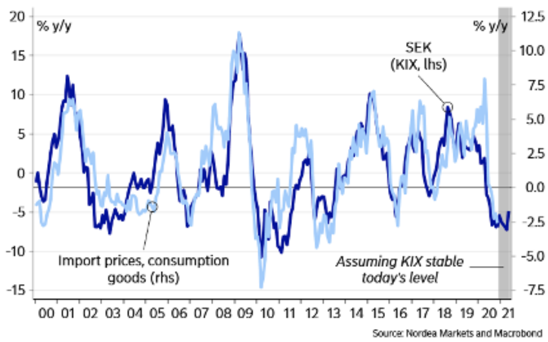
Source: Macrobond

Figure 12: Retail Sales



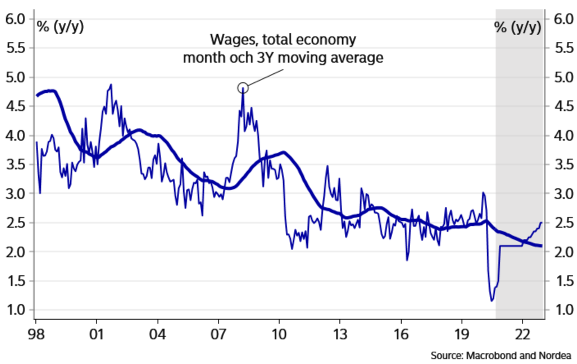
Source: Macrobond

Figure 13: Import Prices



Source: Nordea Markets and Macrobond

Figure 14: Wage growth



Source: Statistics Sweden

by the crisis: the turnaround in Sweden is significantly stronger than in the rest of the EU.

Covid-19 infection rates are high and the death toll remains high, too. But thanks to the promising results of several vaccine tests there is light at the end of the tunnel. In addition, the Swedish economy appears to be resilient. The situation is uncertain, but there are reasons to be optimistic about 2021. The current restrictions will likely reduce infection rates in Sweden in the coming months, just as we have seen in several other European countries. The government plans to vaccinate 2-3 million people in the vulnerable groups during 1H21.

All in all, confidence has been resilient for the second half of 2020. However, there has been bad news about the virus situation and various mutation of the virus in the UK and other parts of Europe in recent weeks, which will probably weigh on sentiment in the coming months. Thus, the recovery might lose steam going forward.

Factors that will dampen recovery

Europe second wave

Swedish economy is very open to foreign trade, which represented 89% of its GDP in 2018. Swedish economy is very open to foreign trade, which represented 89% of its GDP in 2018. Germany is Sweden's top trading partner, both for imports (17.9%) and exports (10.6%).

With a resurgence in cases in Europe, the new covid-19 strain from the UK, and Germany's Merkel going for a partial national shutdown, this would mean a less than stable demand for Sweden's exports going into the winter period which might slow down its economic recovery.

Sweden has hit new all time highs in daily cases in December while taking its total death tally to 8279, which is several times higher than that of its Nordic neighbours, according to the Health Agency statistics. However, despite the spike, it's relatively in a better situation as seen from the current hospitalisations as well as change in number of confirmed cases when compared to other countries in the EU (Fig. 9 and 10). Thus, while countries in Europe are introducing draconian measures like partial lockdowns or curfews to curb the spread of the virus, Sweden is sticking to its guns and insisting coercive methods are not the way to go.

Wage growth and inflation expected to remain low

The Swedish industrial relations model, which is based on a traditionally strong social partnership between employers and trade unions, differs from that found elsewhere in the European Economic Area. Wage rates are, in principle, set without interference from the political establishment and the regulatory focus is on collective agreements negotiated by the organisations concerned.

The Industrial Agreement is renewed, agreeing to a yearly wage increase of around 2% (Fig. 14). The new wage agreement poses substantial challenges to the Riksbank when the economic situation normalizes. The new wage agreement reaffirms that cost pressures in the Swedish economy will remain low for many years to come.

It’s hard to see any increase in wages in this uncertain economy, and thus the domestic wage cost, a prime driver of domestic inflation, is expected to remain depressed. In summary, CPIF and CPIF excluding energy inflation are on average set to fall below expectations of 2% in the coming years.

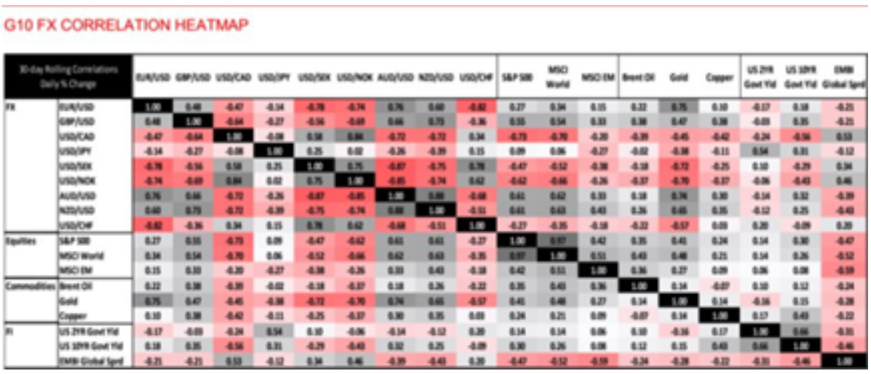
Climate Commitment

The Swedish government wants to be at the forefront of global climate leadership and, just like Finland, become the world’s first fossil-free welfare society. The long-term climate target is to achieve a net zero emissions society by 2045. Its main focus would be to achieve ambitious transportation targets with increasing electrification & biofuel use, invest in break-through technologies to decarbonise industrial processes and continue its fast growth in wind power generation.

Figure 11: USDSEK Daily Chart

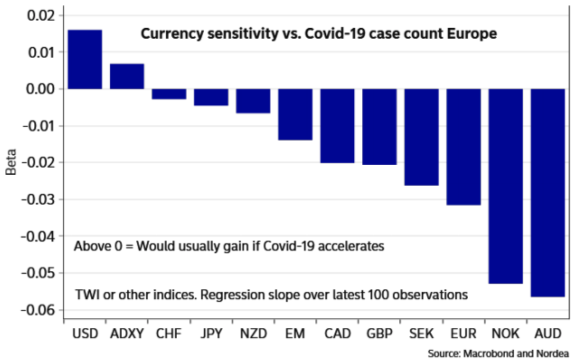
Source: Tradingview

Figure 12: G10 FX Correlation Heatmap



Source: Bloomberg

Figure 13: FX Sensitivity to EU Covid-19 cases



Source: Macrobond and Nordea

Trade Idea: Short USDSEK

Scandinavian currencies remain primarily driven by global risk appetite.

The fresh outbreaks of infection in recent weeks with news of a virus mutation have increased the risk of further economic setbacks. However, from our research, the Swedish economy appears to be resilient and a global recovery in 2021 should be beneficial for cyclical SEK.

The new U.S. administration should move away from the strategy of unpredictable trade wars. With Sweden being a small open economy dependent on global trade, less downside risk to the trade outlook should be beneficial for SEK.

Moreover, A Biden and Republican Senate outcome gave a much smaller fiscal stimulus due to policy gridlocks and because of the smaller fiscal stimulus, Feds may be forced to step up. While the Feds are likely to hold off any immediate easing action for now, they probably would be willing to at least consider an increase in its bond purchase program if push comes to shove. This would lead to some USD weakness as QE increases money supply in the economy.

The pair is currently trading in a descending channel with RSI nearing oversold region and MACD nearing a bullish cross over; the technical indicators now signal a buy, and with prevailing risk off sentiment supporting the USD, and being negative to SEK, it would be prudent to wait for a better entry point.

Given the developments in both the USA and Sweden, we expect the price action to continue in the downward channel. We would thus expect to enter this particular trade at the support level of the channel while still watching the price movement to see if there is a decisive break of the channel to the downside with strong bearish momentum, which can be another trigger to be short.

Entry: 8.32113

Take Profit: 8.19680

Stop Loss: 8.135345

Risk Reward Ratio: 3.85

NUS INVESTMENT SOCIETY

Global Macro Department – Turkey (Overweight)

Date: 27th December 2020

Analysts

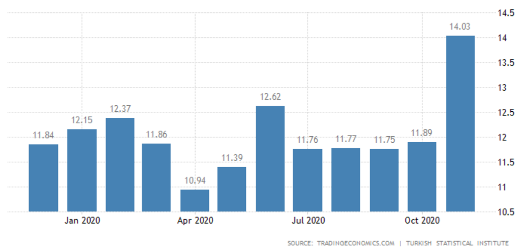
Tan Yii Ling
Global Macro Analyst
tanyiiling@u.nus.edu

Basic Information

Real GDP (US$ billion, 2019)	754.41
Currency	7.547
Interest Rate	17.0%
Inflation Rate(Nov)	14.0%
Unemployment	12.7%
Con. Confidence	80.1
Bus. Confidence	106.8

Chart info

Figure 1: Inflation Levels in Turkey



Source: Trading Economics

Overview of Turkey

- The economy of Turkey is considered an emerging market economy as defined by the IMF
- One long standing characteristic would be the low savings rate and the economy runs a huge current account deficit.
- Part of the "Fragile Five", a term coined to represent emerging economies that rely too heavily on foreign investments for growth
- The economy just went through a currency and debt crisis in 2018 where Lira plunged by more than 30% against the dollar.
- Unconventional interest rate policy coupled with a lack of central bank independence: President Erdogan's unorthodox belief that higher interest rate causes higher inflation levels – prefers to keep rates low
- Based on 2019's numbers, the top exports of Turkey include: Vehicles US$26.2 billion (15.3% of total exports), Machinery including computers $16.5 billion (9.6%), Iron, steel $9.9 billion (5.8%)

Summary/Recap of events in the past 6 months

- Under Erdogan's leadership, Turkey has been increasingly involved in geographical spats.
- In December, U.S. sanctioned Turkey for purchase of S-400 missile system
- Lira hit a record low against the dollar where its value depreciated about 30% against the dollar.
- Attempts to curb free-falling Lira, such as burning through their reserves to conduct foreign exchange intervention and stealth-tightening measures have been largely ineffective.
- Inflationary pressure: In the past 6-month, inflation rates were all more than 11% and it was seen past the 14% level in November. (Fig. 1) The central bank raised year-end inflation forecasts to 12.1% instead of the initial forecast of 8.9%.
- Leadership Upheaval: New central bank governor and finance minister
- New Era of tightening: raised interest rates by 475bps and 200bps in November and December respectively
- Lira remain the second-worst performing emerging market currency even after trimming the losses

Mounting Geopolitical Tension

Turkey has been under mounting geographical risk with President Erdogan's increasingly aggressive foreign policy.

Erdogan's call for Turks to boycott French goods and his personal attack on Macron has led to France withdrawing its ambassador from Turkey. EU leaders, meanwhile, has started to discuss calls from Greece and Cyprus—strongly backed by France—to sanction Turkey over its energy exploration in waters they claim in the Eastern Mediterranean. They are also increasingly at odds with Russia for conflicts such as the proxy wars in Middle East and the Armenia-Azerbaijan conflict. In December, EU pledged to expand Turkey sanctions list in measured warning against the controversial energy exploration. Most recently, Washington has imposed sanctions on Turkey after Turkey tested the Russian-made S400 air defence system.

In the past, Erdogan has been able to get away with his foreign policy as Trump who shared a personal relation with Erdogan has avoided stern measures against Turkey. However, this may not be the case under Biden's administration. In an interview with the NY Times, Biden called Erdogan an "autocrat" and said the U.S. should back opponents to oust him.

While the case for ejecting Turkey is compelling, the North Atlantic Treaty Organization (NATO) alliance is reluctant to do so due to Erdogan's counter threat to unleash waves of refugees westward and the possibility of Turkey going nuclear. Despite multiple calls for sanctions, the EU bloc remains divided and are unable to summon collective will to follow on threats to punish Turkey. The recent summit outcome of sanctions list marks a hard-fought compromise between a group of EU countries including Greece, Cyprus and France that want to pursue a harder line against Turkey and a Germany-led faction keen to tread more carefully. The measure still falls short of Greek demands for an arms embargo and the explicit threat of additional measures, such as a ban on transactions between European institutions and Turkish companies. Over the years, impunity from punishment has emboldened Erdogan in being more aggressive with his foreign pursuits and similar behaviours can be expected moving forward.

However, Erdogan started sounding conciliatory as he said, "We don't have issues with any country or institution that cannot be solved through politics, dialogue and negotiation".

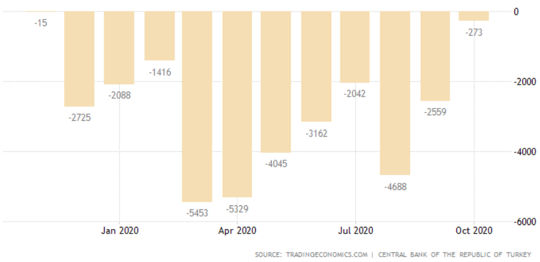
External Vulnerabilities

Moody's warns of a possible balance of payment crisis in Turkey as it cuts Turkey debt ratings deeper into junk. With a worsening current account balance coupled with subdued capital flows, this points to a widening external imbalance.

Turkey persistently runs current account deficit and relies heavily on large external financing.

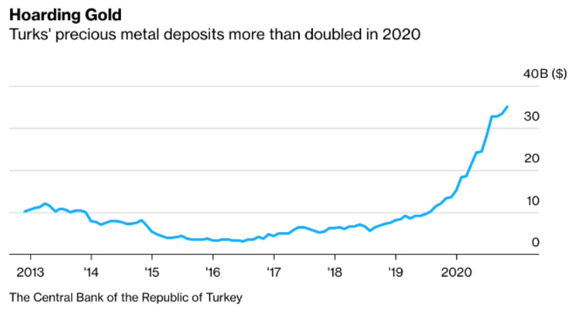
Current Account Deficit
Overall, Turkey's current account deficit in October stood at US$0.273 billion, the 11th consecutive month to record a current account deficit.

Figure 2: Current Account Balance in Turkey



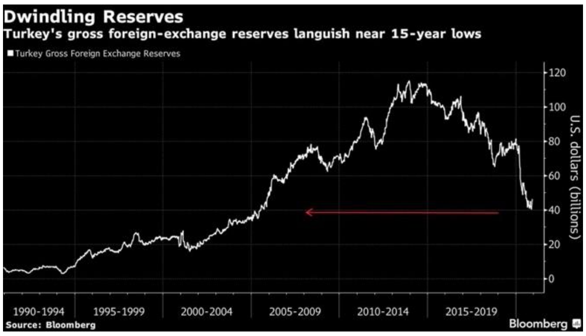
Source: Trading Economics

Figure 3: Level of Turks' Precious Metal Deposits



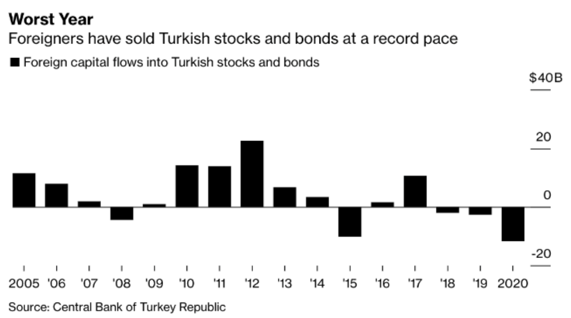
Source: CBRT, Bloomberg

Figure 4: Level of Gross Foreign-Exchange Reserves in Turkey



Source: Bloomberg

Figure 5: Level of Foreign Capital Flows into Turkish Stocks and Bonds



Source: CBRT, Bloomberg

(Figure 2) In the same period in 2019, the figure stood at a US$2.7 billion surplus. The 12-month cumulative figure reached US$33.8 billion (4.7% of GDP), up from 4.2% of GDP in September.

With coronavirus, the current account deficit has deteriorated rapidly from a worsening trade deficit and a fall in service income from tourism and transportation.

The goods balance has worsened largely due to the credit-driven growth which has increased imports demand and a fuelled demand for haven gold for hedging purposes. Turks' precious metal deposits more than doubled in 2020. (Figure 3) The plunge in service balance is attributed to effects of both transport revenue and tourism revenue. Turkish Minister of Culture and Tourism shared that the tourism sector to plummet by 70% this year due to the pandemic – receiving over 15 million travellers compared to 51.9 million visitors in 2019.

Overall, Finance Minister Berat Albayrak said that overall, Ankara expects a current account deficit of $24.4 billion, or 3.5% of GDP this year.

<u>Depleting Foreign Reserves</u>

They can no longer finance the external debt obligations with foreign reserves which has been depleted through costly FX interventions. Goldman Sachs estimates that the central bank has spent $101 billion on supporting the currency so far this year. Turkey has spent its foreign-currency holdings faster than any other major developing economy this year and has declined to a 15-year-low. (Figure 4)

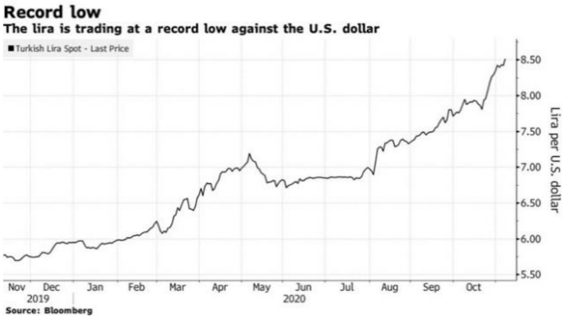
<u>Massive capital outflow</u>

Dwindling reserves contributed to downgrades by international rating agencies and alarmed foreign investors, who pulled roughly $11.5 billion from Turkish stocks and bonds in the first 10 months of 2020. (Figure 5) Furthermore, Turkey's main share index may possibly be downgraded by MSCI and reclassified as a "frontier" market which is perceived to be of higher risk.

They have options such as borrowing from the IMF (International Monetary Fund) or to introduce capital control. Finance Minister Berat Albayrak said it is out of the question for Turkey to even consider capital controls and Erdogan has publicly opposed asking for an IMF loan which often comes with strict covenants.

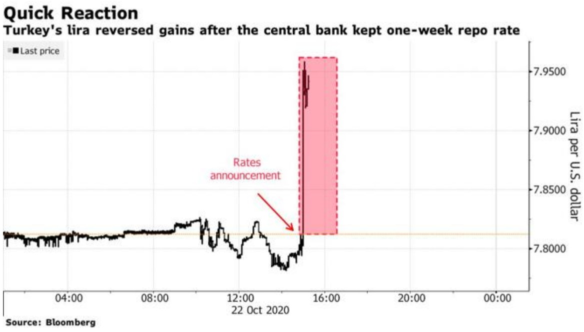
Even though their recent gas finds may help reduce dependence on fuel imports and provide relief for the current account balance, this is likely to take a while to be realised.

Figure 6: Turkish Lira Spot (Lira Per U.S. Dollar)



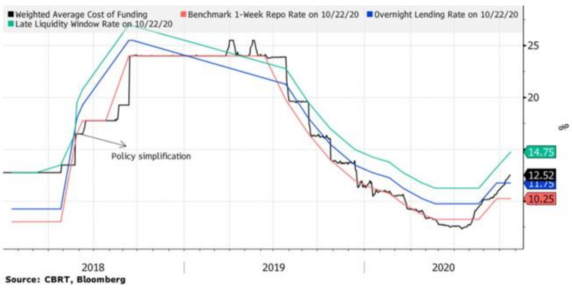
Source: Bloomberg

Figure 7: Turkish Lira Spot (Lira per U.S. dollar) after October's Meeting



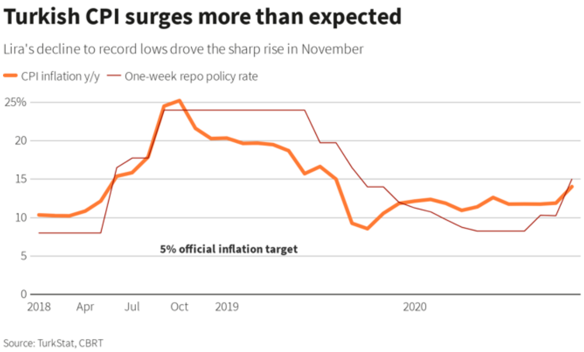
Source: Bloomberg

Figure 8: Turkey Rate-Corridor Structure after October's Meeting



Source: CBRT, Bloomberg

Figure 9: Turkey CPI Year-on-Year



Source: TurkStat, CBRT, Reuters

Lira: Battered Currency – 2nd Currency Crisis?

In early November, Lira has weakened to a record low and passed the psychological level of 8 per dollar. (Figure 6)

Given that they have burned through their foreign reserves in an attempt to prop up the currency, the viable option is a decisive move on the interest rate front. But central to the currency's weakness is a long history of lack of credibility and commitment by the central bank to stem Lira's depreciation and an inconsistent monetary policy framework criticised to be too loose. The central bank is seen to be less independent over the years as President Erdogan who is a firm believer of low interest rate, continues to cast a long shadow over the monetary policy. The most recent bout of lira weakness was triggered when the central bank stunned traders in October by keeping one-week repo rate on hold at 10.25% instead of delivering a hike. (Figure 7)

Instead, the central bank uses stealth tightening as they decide to expand the rates corridor and raise the late liquidity lending rate to 14.75% from 13.25%. The government has tightened policy further by restricting funding at the benchmark rate, forcing lenders to borrow from costlier options. Using backdoor channels to contain the currency weakness, they have raised the weighted average cost of funding to 12.52%. (Figure 8) The complex rate-corridor structure has been criticized for its use of multiple rates and lack of transparency. This damages their inflation-fighting credibility and raises risk for more abrupt fall in the currency.

Lira's fall is compounded by the growing list of geographical spats and waning foreign investors' confidence.

Inflationary Pressure

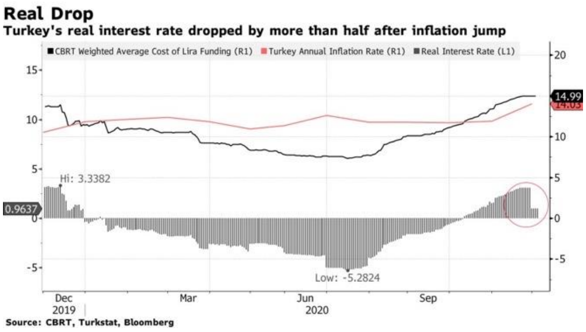
With the rapidly weakening currency, this worsens the burden of foreign-denominated debt and intensifies inflationary pressure. The Lira's slide has kept Turkey's inflation in double digits this year, well above the official target of 5% set in 2012. (Figure 9) Inflation in November was higher than expected as Lira's decline filtered through to prices, cutting the real interest rate by more than half to about one percentage point and curbing the lira's appeal as a carry trade. (Figure 10) Consumer prices increased an annual 14% in November, the fastest rise in over a year and higher than every forecast in a Bloomberg survey of 18 economists, whose median estimate was 12.7%.

Double-digit price increase and negative real rates that lasted till October drove greater depreciative pressure on Lira.

Dollarization Trend

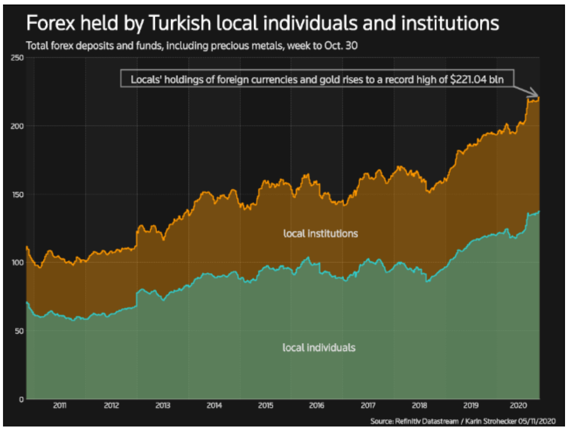
Hoarding gold and foreign currencies is a method popular among Turks trying to protect value of assets at times of currency volatility and elevated levels of inflation. (Figure 11) This is despite efforts to stem dollarization such as introducing a tax on foreign exchange transactions.

Figure 10: Turkey Real Interest Rate



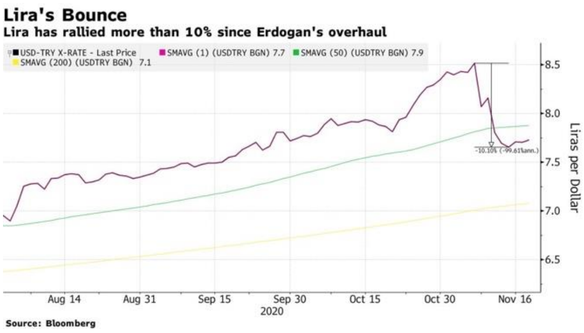
Source: CBRT, TurkStat, Bloomberg

Figure 11: Level of Forex held by Turkish Local Individuals and Institutions



Source: Reuters

Figure 12: Lira Response to Leadership Overhaul and the 475bps Rate Hike



Source: Bloomberg

Market-Friendly U-turn

Leadership Overhaul

In November, there has been upheaval in the economic leadership in Turkey as President Erdogan fired the Central Bank governor, Murat Uysal, the second change of central-bank chief in 16 months and the sudden resignation of the finance minister, Berat Albayrak. This sent the Lira rallying over 10%. (Figure 12)

The new central bank governor, Agbal is known to be more orthodoxy and since his appointment, he has mentioned that the central bank "will decisively use all policy tools in pursuit of its price stability objective." Investors saw the upheaval in leadership as a sign of dramatic shift in strategy. Erdogan has also voiced his support for the new economic team and for more orthodox, market-friendly efforts to protect Lira and curb inflation. Agbal further pledged to tighten stance until it sees "a permanent fall in inflation."

Interest Rate Policy

In November, the Monetary Policy Committee led by Governor Naci Agbal on Thursday lifted the one-week repo rate to 15% from 10.25%, the most in 2 years - taking a major step into mainstream policy. Lira appreciated as much as 2.5% following the decision.

In addition, the central bank said all funding will be provided through the main policy rate, ending a complex structure criticized by investors for its lack of transparency. "The Committee has decided to implement a transparent and strong monetary tightening in order to eliminate risks to the inflation outlook, contain inflation expectations and restore the disinflation process," the central bank said in a statement.

In December, one-week repo rate was lifted further from 15% to 17% beating the 150bps hike predicted by Bloomberg analysts. With another hefty interest-rate hike and a clearer monetary policy, this partially restored the shattered credibility of Turkey's central bank.

Rebuilding Reserves

A key element of next year's policy mix is to increase foreign reserves without derailing Lira. A detailed plan about the reserves policy will be unveiled later but the bank will be on the lookout for a change in the dollarization trend in bank deposits as well as stable capital flows into Turkey's economy before direct FX purchases can be considered.

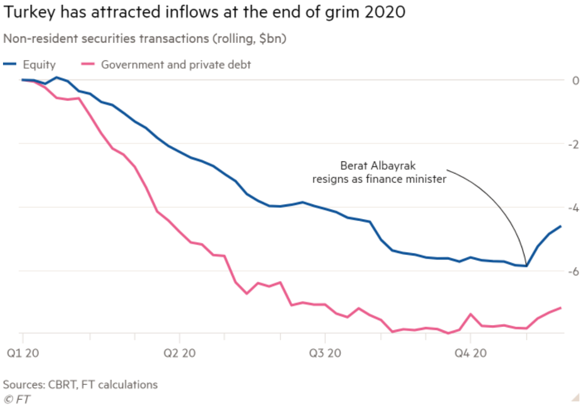
However, rebuilding reserves means weakening the Lira, all else equal. Economists warn that it may still be too early, pointing to the trend of dollarization of the economy and the relatively small size of recent foreign inflows.

On the bright side, the leadership upheaval has lured back some foreign fund flows, with $1.9bn shifting back into Turkish assets in the three weeks after Mr Albayrak's departure. (Figure 13) This could be open the windows for Turkey to restore foreign reserves.

Old Habits: Gold Craze and Dollarization

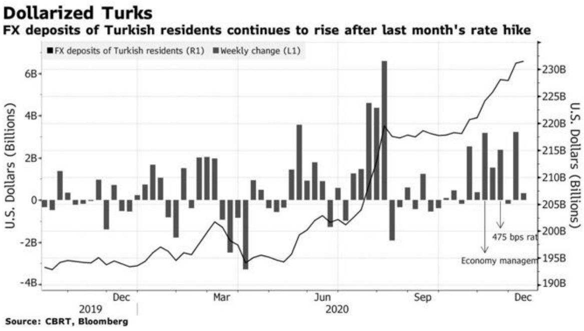
Despite the authorities adopting more market-friendly policies and a decline in bullion prices, Turks continue piling into gold. In the 2 weeks after Erdogan revamped the economic team, Turkish retail investors have increased their gold holdings by $2.2 billion to $36.4 billion, almost triple the level they were at in 2019.

Figure 13: Non-Resident Securities Transactions



Source: CBRT, Financial Times

Figure 14: FX Deposits of Turkish Residents



Source: CBRT, Bloomberg

But with gold imports now accounting for most of the current-account deficit, the purchases are getting in the way of mending Turkey's external imbalances and becomes a drag on Lira recovery.

Furthermore, the trend of dollarization may prove to be a slow one to reverse. The FX deposits of Turkey residents continue to rise in December, even after the 475bps rate hike, as Turks remain reluctant to convert their savings to Lira. (Figure 14) By Dec. 4, Turkish residents' FX deposits had risen by almost 19% this year to $231 billion.

This reflect that a lack of trust in Lira as investors remain wary about monetary policy credibility given the years of policy missteps. There is a risk that Erdogan may attempt to change the policy direction and revert to a more accommodative and pro-growth stance when things normalize.

Lira remains fragile as it would be a long-term process and continuous consistent effort to undo the damage to credibility – 2021 will be mostly about follow-on actions after the latest promises. We need to monitor how good it is at guiding the inflation rate back to target. Furthermore, the average cost of funding is already 14.8%, so the central bank's rate hike to 15% translates into an effective increase of just 20 basis points. The net tightening is minimal and somewhat symbolic.

Figure 15: USDTRY Daily Chart

Source: TradingView

Trade Idea: Short USDTRY

The latest hike of repo-rate by 200bps was 50bps higher than the consensus. With the central bank providing a slightly stronger push to rates coupled with their pledge on adjusting rates according to price development, it shows that they are getting serious about inflation and are not doing just the bare minimum.

We believe that this shift to orthodoxy will continue for some time as there are no reserves left to burn and no elections approaching. The market is likely to give the Lira the benefit of doubt due to broader dollar bearish environment. A recovering global economy and the rollout of vaccines will likely undermine the demand for safe-haven US dollar and fuel appetite for riskier assets such as Lira. In addition, if Washington and Ankara can improve relations after US imposed sanctions, this can prompt a fresh rally.

However, while the move is "lira positive", it is too soon to say if the effort by the central bank is sufficient to stabilise the lira as it depends on the inflation development. Furthermore, given the long history of policy U-turns, many investors remain cautious. Hence, it is likely for the actions to result in a "stable currency path" than an outright strength against USD given the still high inflation and political risks. Especially in November when inflation rate ended up much higher than expected, this placed more pressure on central bank tightening – a bitter pill that Erdogan may not readily swallow. As such, 7.50 is a relatively conservative level for take-profit.

The MACD line has crossed below the signal line and has remained below since, signalling a downtrend. This is further supported by the graph crossing below the moving averages. The stop loss is placed at 7.60407, a level tested twice in Mid-Nov and in December. The take profit is set at the level of 7.5000.

Entry: 7.56297

Take Profit: 7.50000

Stop Loss: 7.60407

Risk Reward Ratio: 1.53

NUS INVESTMENT SOCIETY

Global Macro Department – South Africa

Date: 27 December 2020

Analysts

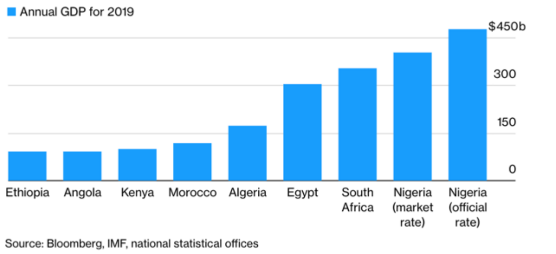
Tan Yii Ling
Global Macro Analyst
tanyiiling@u.nus.edu

Basic Information

Real GDP (US$ billion, 2019)	351.43
Currency	14.5945
Unemployment(Q3)	30.8%
Inflation Rate	3.2%
Interest Rate	3.5%
Con. Confidence	-12
Bus. Confidence	40

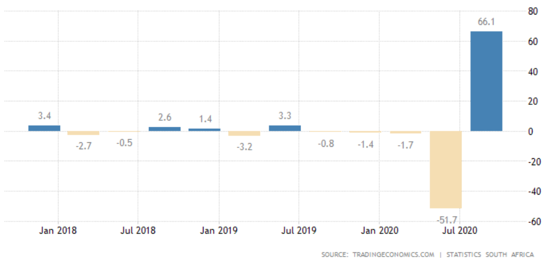
Chart info

Figure 1: Annual GDP for 2019 for African Countries



Source: Bloomberg, IMF, National Statistical Offices

Figure 2: Quarterly GDP for South Africa



Source: Trading Economics, Statistics South Africa

Overview of South Africa

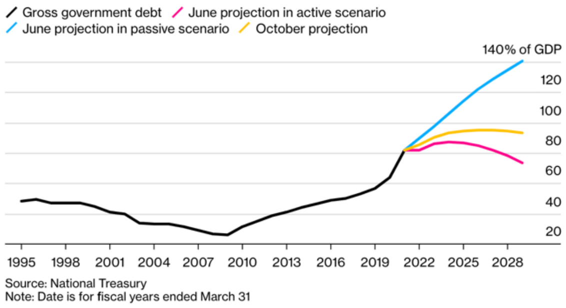
- 2nd largest economy in Africa after Nigeria based on annual GDP 2019 and both economies make up half of Sub-Saharan Africa's GDP
- Africa's most industrialized economy
- Inflation-targeting regime: 3% - 6% target band
- Based on 2019's numbers, the top exports of South Africa includes: Gems, precious metals US$15.3 billion (17%), Ores, slag, ash $13.1 billion (14.5%) and Vehicles $11.4 billion (12.7%)
- Top importers of South Africa's goods: China (10.7%), Germany (8.3%), United States (7%), United Kingdom (5.2%)
- Manufacturing (22% of GDP) and mining (21%) used to be the key drivers of growth for the South Africa's economy but has declined over the years.
- Today, the finance sector (20%), government (17%) and trade (15%) are the key drivers of the economy.

Summary/Recap of events in the past 6 months

- GDP expanded an annualized 66.1% in Q3 2020, the first positive number after four periods of contraction. The main drivers were: manufacturing and mining which expanded more than 200%.
- The economy contracted 51% in Q2 2020, the steepest decline since 1990 and extended recession in its 4th quarter.
- In the nine months to September, GDP contracted 7.9% in year-on-year terms.
- Record year of power cut as the state utility, Eskom Holdings conducted power rationing known as load shedding.
- In July, South Africa went against its long standing resistance and took out a $4.3 billion loan from the IMF.
- Debt ballooned as finance minister Mboweni warns of a potential sovereign debt crisis as debt levels may exceed 100% of GDP.
- South Africa fell deeper into junk territory after Moody's Investors Service and Fitch Ratings lowered the country's credit ratings in November

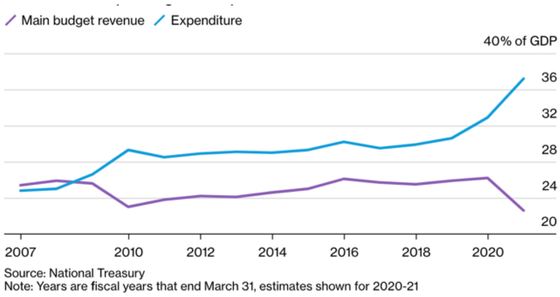
- Medium Term Budget Policy Statement (MTBPS) highlighted the stance of fiscal consolidation and debt stabilisation through the public wage bill cut
- Going Green: Energy transition from electricity generated from coal to renewable energy
- South Africa has declared a second wave of Covid-19 which has taken the country to more than 1 million confirmed cases – this is among the key downside risks to growth and recovery in 2021

Figure 3: South African Debt Projections



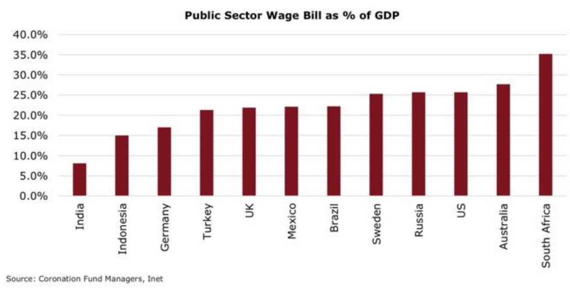
Source: National Treasury, Bloomberg

Figure 4: Budget Revenue and Expenditure Levels in South Africa



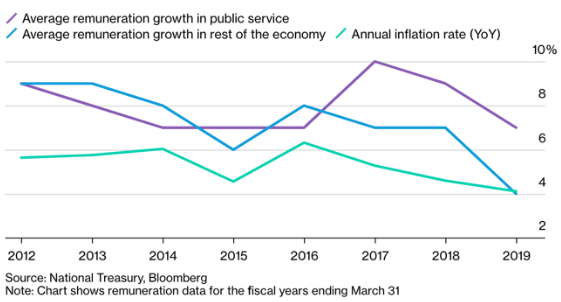
Source: National Treasury, Bloomberg

Figure 5: Public Sector Wage Bill as % of GDP



Source: Coronation Fund Managers, Inet

Figure 6: Average Remuneration Growth in Public Service and in Rest of the Economy and the Annual Inflation Rate



Source: National Treasury, Bloomberg

Tickling Debt Bomb

Based on the latest Medium Term Budget Statement, the nation will end the year with gross debt level more than 81% of GDP. Based on October's projection, the debt will stabilise later and at a much higher level (95.3% of GDP in 2025/2026) as compared to June active-scenario projections (87.4% of GDP in 2023/2024). (Fig. 3)

Expenditure has outpaced collections since the financial crisis as the gap widens. (Fig. 4) The budget deficit is a result of years of slow growth, bailouts of loss-making state-owned companies and high levels of public wage bill.

Public Wage Bill

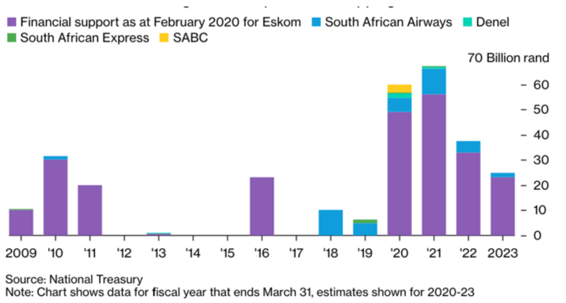
Due to an above-inflation wage increase agreement, civil servants' wages have surged by 51% since 2008 and is now equal to 11% of GDP, placing a major burden on the already weak fiscal health. The finance minister has admitted that such compensation spending is unsustainable as over the last 15 years, it has grown at almost 1.5 percentage points faster than the growth in GDP. As a percentage of GDP, the wage bill stands at about 35% which is much higher than the international standards. (Fig 5)

Funds should be redirected to employees from the private sector who had a lower average remuneration growth over the year and are experiencing severe pay cuts or job losses due to the Covid-19 relative to their public-sector counterparts. (Fig. 6)

State-Owned Enterprises

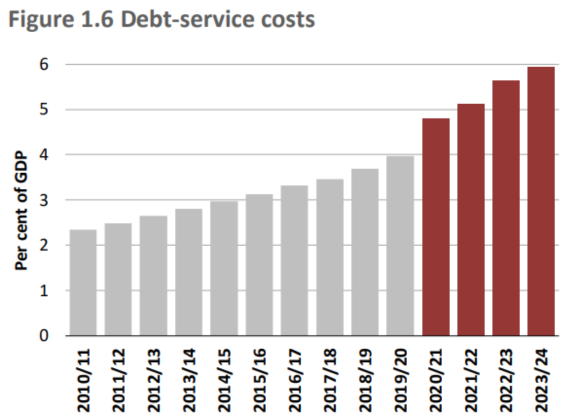
The longstanding problem of providing lifeline and multiple bailout of loss-making state owned enterprises has also placed a massive strain on government finances. (Fig. 7) The government has spent nearly R200 billion on bailouts in the past 20 years. More state companies are coming under financial pressure due to the lockdown and this has led to many more bailout requests in the recent months which amounts to almost R10 billion.

Figure 7: Level of Financial Support for State-Owned Companies in South Africa



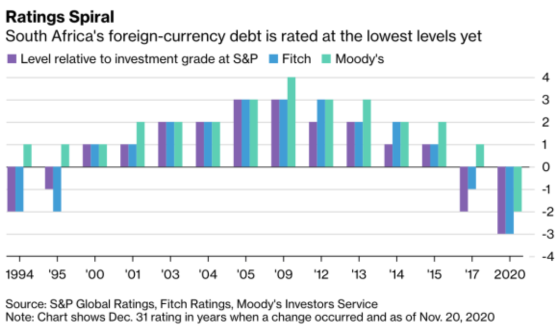
Source: National Treasury, Bloomberg

Figure 8: Debt Service Costs as a Percentage of GDP



Source: National Treasury

Figure 9: South Africa's Foreign-Currency Debt Ratings



Source: Bloomberg, S&P Global Ratings, Fitch Ratings, Moody's Investors Service

Tax Collections

The weaker import outlook, virus lockdown and tax reliefs heavily weighted down the tax collection in areas such as personal income tax and import taxes. In the recent Medium Term budget, the gross tax revenue has been revised down by R8.7 billion from June projections. For the year 2020/21, the tax revenue shortfall is expected to be R312.8 billion. To help with consolidation, the government announced in the Medium Term budget that it will attempt to raise tax collection and expand revenue streams by R5 billion in 2021/22 and a total of R40 billion over the next three years. However, the treasury has acknowledged that the scope may be limited given that recent tax increases generated less revenue than expected and that tax increases can be detrimental to GDP. Furthermore, the tax revenue to GDP ratio in South Africa is standing at 26% compared to a global average of 15%.

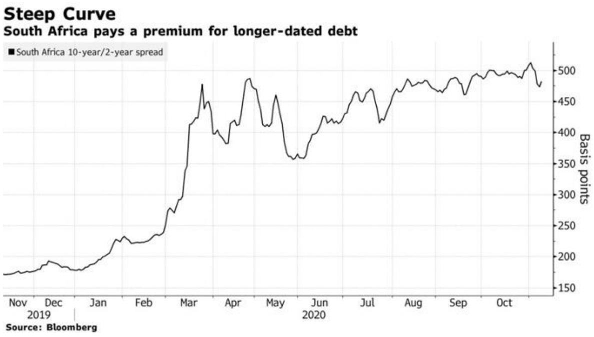
Debt Servicing Costs

Debt servicing cost has become the fastest growing category of expenditure and it is crowding out spending in most functions. Debt-service costs are now 4.8 per cent of GDP, up from 3.3 per cent in 2016/17. (Fig. 8) Debt servicing costs are among the government's top four expenditure items in the 2020/21 budget allocations as it receives about 25% of the total expenditure. In December, South Africa fell deeper into the junk territory after Fitch Ratings and Moody's Investors Service lowered its credit rating while S&P kept its assessment three levels below investment grade, with a stable outlook. Fitch cut its ratings to BB-, three levels below investment grade while Moody's cut its rating to Ba2, two levels below investment grade – both with a negative outlook which signals the possibility of further cuts. (Fig. 9) With the sovereign credit ratings downgraded by all major agencies to its record low ratings, this has driven up credit risk premium and cost of borrowing. (Fig. 10)

The silver lining in this is that South Africa plans to introduce a new short-dated bond to reduce reliance on more expensive longer-term debt and reduce the cost of borrowing.

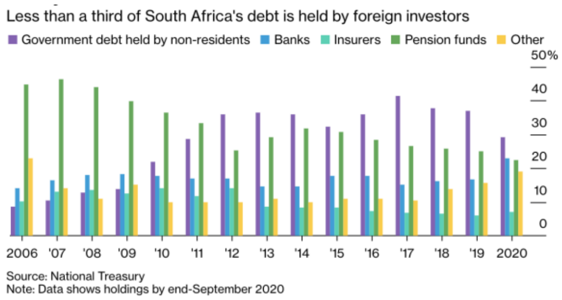
Furthermore, this year marks the first time since the Apartheid that South Africa has turned to external multilateral lenders, a feat considering the longstanding political resistance within the ruling party. They secured a $4.3 billion emergency loan from the International Monetary Fund (IMF) used to support the $500 billion-rand Covid-19 stimulus package. However, loan talks with the World Bank have stalled due to disagreements over the conditions set. As a standard lending facility, a World Bank loan will carry more conditions such as a wage bill cut and ring-fenced spending, away from bailouts of state-owned enterprises.

Figure 10: South Africa 10Y/2Y Spread



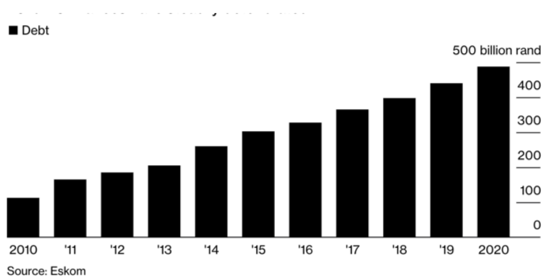
Source: Bloomberg

Figure 11: Debt Holdings by Foreign Investors



Source: Bloomberg, National Treasury

Figure 12: Eskom Holdings' Level of Debt



Source: Eskom, Bloomberg

However, since less than a third of South Africa's debt is held by foreign investors, it makes rolling over mature debt much easier and they are less vulnerable to rand weakness. (Fig. 11)

Fiscal Consolidation Plans: Focus on Wage Bill

The latest Medium Term Budget Policy Statement (MTBPS) seeks to rein in spending by R300 billion in the next 3 years and bulk of the reduction will rely on the state wage bill. The success of the fiscal consolidation hinges heavily on the proposed wage bill reduction to be done through a pay freeze in the next 3 years. The process is likely to be met with strong resistance from the 1.3 million-strong public sector workforce and under the presence of strong politically influential labour unions. As the state reneged on the previous 2018 wage deal, the union is already at the labour court for the matter.

The state has a poor track record in succeeding in wage negotiations and many prior attempts to cut compensation such as offering early retirement were also unsuccessful. The debt stabilisation goals set out in the budget are subjected to major risks and are dependent on the highly uncertain savings on public sector compensation. If state salaries can't be cut, there is limited room for offsetting measures in other expenditure areas. The debt stabilisation target (95.3% of GDP in 2025/2026) depend crucially on the difficult negotiations with the unions on cutting public wage. Furthermore, the main driver behind the most recent ratings downgrade by the agencies is the risk and struggle of the proposed wage freeze. Even if the government overcomes the union opposition to cut wage expenditure, the budget deficit is projected to hit a record 15.7% of GDP this year, the highest since post-apartheid era.

On the bright side, most recently, unions have lost their bid to force the government to implement the third round of the 2018 wage agreement, which the government said it could not afford to do. This is a victory for the government as the wage increase would lump the country with R37.8 billion of additional debt and this serves as a signal of the credibility of South African debt curbs for the rating agencies. It also highlights to unions the government's commitment and seriousness towards the wage bill cut.

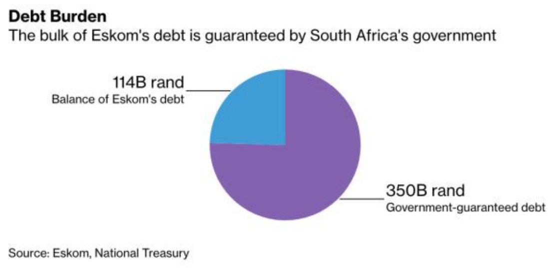
Risks from State-Owned Enterprises

During the Medium Term budget, the government remains scant on details about the future of state-owned enterprises and has yet to introduce significant, proper structural reforms such as privatisation.

Eskom Holdings

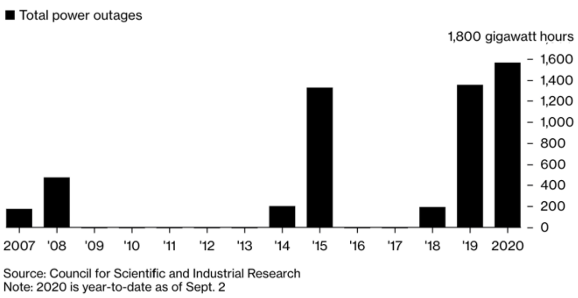
At the forefront of a group of state-owned companies who needs funding is the state power utility monopoly, Eskom Holdings which provides 95% of the nation's power. Eskom just posted a net loss of R22 billion for the financial year 2020, compared to R20.5 billion last year. This marks the fourth consecutive annual loss as it struggles to deal with continuing financial and operational problems. As electricity sales fell by 10% due to virus restriction, this exacerbated their financial problems. Eskom's debt had ballooned to R464 billion rand, almost 11% more than it owed a year earlier. (Fig. 12) The utility's

Figure 13: Breakdown of Eskom's Debt



Source: Eskom, National Treasury, Bloomberg

Figure 14: Total Power Outages (in Gigawatt Hours)



Source: Council for Scientific and Industrial Research, Bloomberg

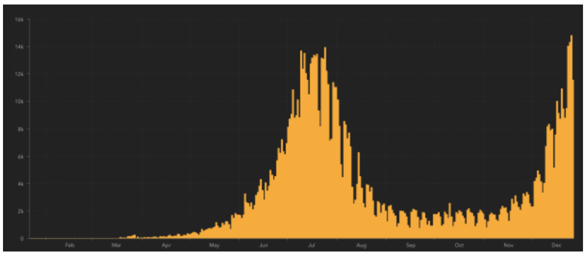
finances have deteriorated despite the government having given it R188 billion in grants and loans over the past decade. With about 66% of its borrowings guaranteed by the government (Fig. 13), Eskom's level of debt poses a systemic risk to the fiscus and the country as a whole.

In terms of operational difficulties, Eskom Holdings have set a record this year for power outages as its aging fleet of power plants struggle to keep up with demand. (Fig. 14) However, power supply is needed to enable economic growth and this will remain a binding structural constraint. As a result, South Africa's growth potential will be stuck at 1%, even if progress is made in other areas. Goldman Sachs describes Eskom's inability to supply sufficient energy as "the greatest threat to the economy". In addition, one of the focus areas for the economic recovery plan is the revival of the mining industry which has declined with deposits harder to access and as they dealt with issues such as power shortages and regulatory uncertainty. In order to boost mining investments, investment impediments need to be removed. Liberalisation of the energy market to ensure reliable and cost-competitive energy is essential.

In December, South African labour unions, business groups and the government endorsed a pact – Eskom Social Compact - to turn the debt-stricken Eskom Holdings around. The proposed solution involves conversion of R95 billion of Eskom debt into equity, made possible through the 1.91 trillion rand of civil-servant pensions and unemployment funds managed by the Public Investment Corp.

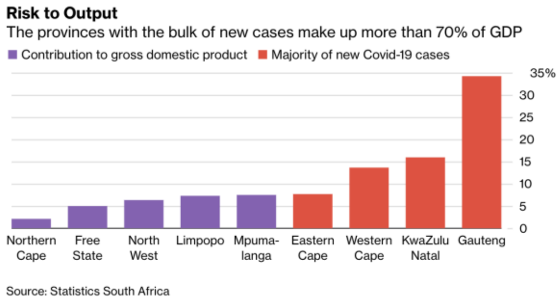
To manage the issue of power outages, there have been some attempts to open up the electricity market in South Africa and increase electricity output to address the issue of rolling blackouts. They allow municipalities to source for their own energy instead of relying solely on Eskom and has launched a program to seek energy supply from a range of independent power producers to address shortage of as much as 3000 megawatts. More than two dozens of developers have submitted their bids. The agreements are estimated to be finalised by June 2021 which will help alleviate the issue of energy shortage in South Africa.

Figure 15: Number of Daily Cases in South Africa



Source: John Hopkins Coronavirus Research Center

Figure 16: Contribution to GDP and Proportion of New Covid-19 Cases By Provinces



Source: Statistics South Africa, Bloomberg

Virus Resurgence

A new variant of the Covid-19 is driving a second wave of infections in South Africa as the number of daily cases doubled in December, bringing the total to more than a million - more than any other African countries. (Fig. 15)

The new strain appears to be more infectious than the original virus and the Health Minister has warned of faster spread and a higher peak for the 2nd wave. To curb the spread, the government has introduced relatively limited and localised control measures at the moment. This include: cutting down on the alcohol sales hours, closure of a number of popular beaches and imposing restrictions on mass gatherings. The Health Minister has called for reviews of current restrictions and stricter measures considering the alarming rate of spread. With hospitals reaching capacity and no sign of the new surge reaching a peak, we can expect more restrictive measures. Furthermore, it is unclear if the vaccine offers protection against the new strain.

But a re-imposition of a full hard lockdown will be economically untenable and there should be a good balance between containing the spread while protecting livelihoods. The imposed measures are likely to hamper the economic recovery especially in the alcoholic-beverage and tourism/hospitality sectors. Furthermore, the provinces with bulk of the new cases make up more than 70% of GDP. (Fig. 16)

However, President Ramaphosa has indicated that the country's health system is now better equipped to handle the virus and a full lockdown will not be necessary. The danger is that, should they fail to contain the virus, this may necessitate stricter measures down the road.

The recovery remains at risk, with power shortages, virus resurgence and slow structural reforms likely to weigh on sentiment. Moving forward, balance between stimulating the economy while boosting its fiscal sustainability and achieving debt stabilisation can prove to be a major challenge. Focusing on spending cuts and debt stabilisation may risk throwing the country into a deeper crisis given that South Africa may need a bigger stimulus now than ever. However, the reserve bank has highlighted low and possibly negative fiscal multipliers which means that as fiscal consolidation to narrow budget deficit and stabilise debt is more likely to drive growth than continued spending funded by taxation and borrowings. The lack of clarity and credibility in policy implementation in structural areas is likely to keep the level of business confidence in South Africa low and stall the economic rebound. It is important for accelerated reform to complement a credible commitment to stabilise debt to work together.

Figure 16: USDZAR Daily Chart

Source: TradingView

Trade Idea: Short USDZAR

Being a high beta emerging-market currency, the Rand is highly dependent on the global drivers and is sensitive to broader economic cycle and market returns. Despite domestic headwinds, the Rand has rallied for months given a favourable global recovery and optimistic international backdrop.

The ongoing economic recovery, rollout of vaccine programmes, rising commodities prices continues to enhance risk appetites and provide support for high-yielding currencies like Rand. Especially since an unprecedented U.S. peacetime fiscal deficit, combined with low rates strategy is putting pressure on the dollar.

Using a Double Bollinger Band trend trading strategy, prices are now in the DBB sell zone – the area between the single standard deviation and the double standard deviation that is found below the 20 SMA which presents a sell signal. This is further supported by the graph crossing below the moving averages, signalling a downtrend. The 20 SMA acts as a dynamic support. As long as price remains between the buy zone and the 20 SMA (brown line), traders can maintain the short bias. A conservative stop loss is placed at 14.87710, after a candle closes above the 20 SMA. We can also wait till there is a breach of the neutral zone into the DBB sell zone. The take profit is set at the psychological level of 14.100.

However, weak domestic fundamentals such as high debt and resurgence of the virus may limit the upside potential for Rand and cause a correction within the market.

Entry: 14.56790

Take Profit: 14.10000

Stop Loss: 14.87710

Risk Reward Ratio: 1.51

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