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Staying Fluid Amid Headwinds —2020 International Financial Market Outlook

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In 2019, global financial markets diverged from a slowdown in the real economy, and carried bull markets in both stocks and bonds. Looking forward to 2020, macroeconomic policies of major global economies will become more proactive. Fiscal and monetary policies will become the main driving force behind the stability of economic growth, and will provide more abundant liquidity for financial markets. Liquidity will continue to chase high-quality financial assets, pushing global financial markets against a deceleration of the global economy.

I. Global economic growth still faces multiple uncertainties in 2020

In 2019, IMF lowered global economic growth forecasts five times to 3.0%, a record low since 2009, indicating that Sino-US trade dispute is becoming a systemic risk affecting global economic growth. Fluctuations in geopolitical events as exemplified by Brexit also brought many uncertainties, leading to a further slowdown in global economic growth.

In 2020, the main factors affecting global economic growth may change.

The first is that China and the United States have reached a phase one trade agreement. China has agreed to increase the amount of American manufacturing and agricultural products purchased every year. The United States has also agreed to suspend a new round of tariffs and reduce the tariff rate from the previous round. Even though the two sides have not resolved issues such as intellectual property rights, protection of foreign investment rights, state-owned enterprise subsidies, technology transfer, and the Huawei incident, it is unlikely that the Sino-US trade war will escalate in full, where the United States would impose tariffs on all imports from China and trade disputes become technology and financial disputes. At the same time, reduction of tariff rate by the United States is expected to reduce concerns from enterprises and investors and to help alleviate the downward pressure on foreign trade, investment, and the overall economy.

The second is populism as exemplified by Brexit. On December 12, 2019, the Conservative Party won more than half of parliament seats in UK's general election. Prime Minister Johnson's proposal to leave the European Union (EU) is expected to be passed by parliament. The UK will leave the EU under an agreement by the end of January 2020. After a formal Brexit, the UK still needs to renegotiate with the EU on economic and trade relations between the two parties, but it will not leave the EU without an agreement. This will greatly reduce the possibility of a hard Brexit, alleviating uncertainties faced by the global economy.

Third, in 2020, the macroeconomic policy of major global economies will become more proactive, and fiscal and monetary policies will be the main driving force behind the stability of economic growth. In 2019, the Federal Reserve and the European Central Bank both adjusted their monetary policy orientation, with the Federal Reserve cutting interest rates three consecutive times. The European Central Bank announced in September 2019 a new round of easing measures, cutting the deposit rate 10 bps to negative 0.5%, restarting a debt purchase plan of EUR 20 billion per month. It also introduced a two-tier bank reserve requirement system, and did not set a time limit for negative interest rate and bond purchases. On December 12, the

European Central Bank announced that its three key policy rates will remain unchanged, in line with market expectations. It is expected that in 2020, the Federal Reserve's monetary policy will turn to the sidelines with high probability, and the chance of reducing interest rates further is less than 30% in the first half of 2020. The major global economies have gradually shifted from normalizing their monetary policies in the past to finding space to promote easing, which can hedge the downward pressure on the global economy to a certain extent.

Fourth, other factors affecting 2020 global economic growth also include US bipartisan political disputes, US presidential election, rise of populism and geopolitical risks, increasing debt burdens worldwide, and the potential reversal of global monetary easing, etc.

Taking the above factors into consideration, it is expected that global economic growth in 2020 may recover slightly from the low in 2019.

The IMF's latest forecast shows that the global economy will grow by 3.4% in 2020, up from 3% in 2019, with main contributions from emerging markets. With simultaneous deceleration in the United States and China, the two major economies in the world, it remains to be seen whether emerging economies can independently become the main source of global economic growth.

Since the end of the global financial crisis in 2009, the US economy recorded 126 months of continuous expansion, setting the longest expansion cycle since World War II. The US Treasury yield curve inverted in the first half of 2019, stoking concerns that the US economy may enter a recession. In the real economy, the US growth slowed from a year-on-year growth of 3.2% in the second quarter of 2018 to 2.1% in the third quarter of 2019, mainly due to diminishing effects of US tax reform, nine rate hikes and balance sheet reduction by the Federal Reserve, and Sino-US trade disputes. However, the economic growth rate is still higher than the Federal Reserve's projection of long-term US economic growth rate at 1.9%. At the same time, the US job market has performed strongly, with the unemployment rate remaining at a low level of 3.5% since 1969, and the number of new non-farm payrolls maintaining rapid growth after years of economic expansion, reflecting relatively robust growth drivers that substantially supports a consumption-based US economy. The Fed cut interest rates three times in 2019, turning the inverted yield curve back to normal, indicating that the risk of a recession in the US economy in the short term is not high.

II. Liquidity expansion accelerates as global investors pursue better returns from safe assets

The liquidity status of international financial markets mainly depends on the adjustment of balance sheets at major global central banks. At the beginning of 2018, total assets of the three major central banks in the United States, Europe, and Japan fell from a peak, reducing for the first time since the 2008 financial crisis. In August 2019, the Fed ended its balance sheet reduction earlier than planned. In mid-October 2019, to ensure that the banking system has sufficient liquidity, the Fed started to buy about USD 60 billion of short-term bonds each month, to be continued till at least the second quarter of 2020.

In September 2019, the European Central Bank announced a new round of bond purchases, totaling EUR 20 billion each month. In third quarter of 2019, the German economy, due to a slump in the automotive industry, poor weather, and other factors, recorded an annual growth rate of only 0.5%. Growth in eurozone economy also underperformed, as GDP growth slowed from 3.0% in the fourth quarter of 2017 to 1.2% in the third quarter of 2019. The eurozone manufacturing purchasing managers index has been in contraction range for 11 consecutive months, with inflation and core inflation rates of only 1.0% and 1.3%, respectively, failing to meet the European Central Bank's target. The European Central Bank introduced a two-tier bank reserve ratio, and did not propose time limits for negative interest rates and bond purchases. In 2020, the two major uncertainties of Sino-US trade dispute and Brexit are expected to ease, and the eurozone economy, which is more export-dependent and more sensitive to the global economy, will have more positive impetus. In addition, with inflation and core inflation rates continuing to fall below target, the European Central Bank is expected to ease monetary policy further by cutting interest rates and increasing debt purchases in 2020.

Since the global financial crisis, the Bank of Japan has never stopped loose monetary policy. In 2020, the Bank of Japan will adopt a wait-and-see attitude and maintain an ultra-loose monetary policy. If downward pressure on the economic and inflation outlook increases, then it may achieve monetary easing through a lower 10-year government interest rate target (0%). The focus of Abenomics rests on both monetary and fiscal easing. After the real economy grew by 1.1% year-on-year in the first three quarters of 2019, the Japanese economy will fall into negative growth in the fourth quarter. The Japanese government has formulated an economic stimulus package with a scale of more than USD 100 billion, which includes repairing the damage caused by typhoons, upgrading infrastructure, and investing in new technologies to ease the downward pressure on the economy. Supported by both fiscal and monetary policies, the Japanese economy is expected to recover from negative growth in the fourth quarter of 2020, but the overall growth rate is still difficult to break through.

Although the Fed emphasized that the recent purchase of short-term bonds will not have a significant impact on household and corporate spending decisions and overall economic activity, and is not quantitative easing in the strict sense, it will directly lead to the expansion of the Fed's balance sheet. The expanding balance sheet of major global central banks will make its total size exceed USD 20 trillion, more than three times that of 2008, and provide sufficient support for global financial market liquidity in 2020.

In its last meeting of the year in December 2019, the Fed decided to keep interest rates unchanged. Of the 17 participants in the Fed's dot plot, 13 expected to leave interest rates unchanged at least until 2021. Only four expected to raise interest rates once in 2020.

The US unemployment rate in November fell by 0.1 percentage point from the previous month to 3.5%, which is the lowest point in 50 years. It is expected that the unemployment rate will remain at the current level of 3.5% until 2020, and will only rise to 3.6% in 2021. The stability of the labor market means a continuous net increase in employment and a decline in the probability of economic slowdown. Inflation is below the Fed's target. The US core CPI growth in November was 2.3%, the same as in October. November PCE and core PCE growth of 1.5% and 1.6% are both below the 2% policy target. Inflation is expected to climb to only 1.9% in 2020, indicating that inflation levels are still out of touch with low unemployment. Fed Chairman Powell argued that only if inflation continues to rise significantly will it support an increase in interest rates. Considering that the US economy is generally stable, inflation continues to be moderate, and the presidential election is imminent, it is estimated that the Fed will still have a slight room for interest rate cuts in 2020, but may not do so until the second half of 2020.

Major central banks, led by the US Federal Reserve, will likely maintain accommodative monetary policies. But the effect on the real economy may not be enough, so the global economy is still more likely to continue the 2019 trend of slow growth.

However, with the further easing of the major central banks, the global monetary environment will continue to improve.

Global interest rates have continued to fall, failing to boost demand for credit. Some banks are reluctant to lend for risk management purposes, causing part of the liquidity flowing back to central banks. As a result, some central banks launched "negative interest rate policy" to reduce the interest rate on reserve and guide capital flow back to the real economy. In July 2009, the Riksbank took the lead to introduce "negative interest rate policy", cutting the deposit rate to negative 0.25%. In July 2012, with increasing rate cut expectations from the European Central Bank, pressure for the Danish Krone to appreciate began. In order to alleviate this pressure, the Danish central bank also implemented "negative interest rate policy". In June 2014, the European Central Bank decided to implement the "negative interest rate policy". In December of the same year, the Swiss National Bank introduced "negative interest rate policy" to curb the appreciation of its currency. Since implementing QQE in April 2013, Japan has fell short of expectations, with long-term inflation expectations still in the doldrums. On January 29, 2016, Japan introduced "negative interest rate policy" in parallel with QQE in order to achieve a 2% inflation target.

In the second half of 2019, the scale of negative interest rate bonds reached a new high of USD 17 trillion, much higher than USD 12 trillion in 2016. The large number of negative interest rate bonds in the global financial market reflects ultra-loose monetary policies after the global financial crisis, which has greatly distorted the pricing function of the financial market. It is a direct result of market failures and liquidity traps, which means that the amount of safe assets that can bring ideal returns in the global financial market are seriously insufficient.

III. US dollar index changes lead global exchange rate outlook

The foreign exchange market is the world's most liquid market. As the world's major reserve and trading currency, the direction and adjustment of interest rate and exchange rate movements of US dollar are important variables in global financial market fluctuations.

The global foreign exchange market transaction volume continues to increase. According to the triennial central bank survey from the Bank for International Settlements, the global foreign exchange market's transaction volume in April 2019 reached USD 6.6 trillion per day, an increase of 29% compared to 2016.

Based on the basic patterns of the foreign exchange market, the euro, which accounts for 58% of the US dollar index, is highly negatively correlated with the US dollar index (about -0.9 in the past 10 years). The US dollar is highly correlated with the two-year government bond yield differential between United States and Germany, as both are considered safe-haven assets. The US dollar is also highly correlated with the difference in inflation between the United States and Europe. The Yen is highly correlated with its central bank policy and the 10-year government bond yield differential between the United States and Japan. Since Japanese short-term and long-term interest rates became fixed at near zero after 2017 while quantitative easing approached a terminal limit, the Yen and global stock market volatility became highly correlated (correlation with the VIX is about 0.4). The Pound has been highly correlated with the 2-year government bond yield differential between United States and UK until June 2016, when the Pound fell from about 1.5 to about 1.2 against the US dollar due to Brexit.

The US dollar index (DXY) has increased by an average of 2.3% per year over the past 10 years. Other major currencies all depreciated, with the smallest depreciation coming from the RMB. The RMB also carried the lowest volatility and the lowest correlation to the US dollar index.

The trend of the US dollar exchange rate is highly correlated with the US economic cycle. In 2019, the US dollar exchange rate maintained its relative strength. Even with the Federal Reserve cutting interest rates three times, the US dollar index still recorded a 0.2% increase in 2019. In 2020, with expectations of slower US economic growth, relatively low inflation, and slight cuts to the Fed Funds Rate, the US dollar may be subdued. With United States and China reaching a phase one trade agreement to avoid a further escalation of their trade dispute, lower safe haven demand may suppress the strong US dollar trend from the past year. However, monetary policies of central banks such as the euro area and Japan have continued to be loose, and their momentum of economic growth is weaker than that of the United States, making it difficult to support the strengthening of their currencies. Therefore, the US dollar index is expected to fluctuate around 95 in 2020.

The Euro's rebound will be limited. In 2020, the economic growth momentum of the eurozone will weaken, and inflation will continue to fall below policy target. The European Central Bank has room to further promote loose monetary policy, which will limit the performance of the Euro. At the same time, even if the risk of a hard Brexit is reduced, the EU and the UK still need to negotiate on future economic and trade relations, and uncertainties remain. It is expected that the rebound of the Euro will be limited, with little room for volatility.

The Yen looks stable with downside risk. For many years, Japan's accommodative monetary policy has become the norm, but its economic growth continues to be weak. In October 2019, the Japanese sales tax rate was raised from 8% to 10%, and the economy is expected to record negative growth in the fourth quarter. However, the Japanese government is formulating an economic stimulus plan, which may reduce the urgency of the Bank of Japan to further relax monetary policy, unless its economy and inflation outlook deteriorates significantly. In addition, with less uncertainties around the Sino-US trade dispute and Brexit, safe-haven demand may wane and lead to a lower Yen.

A lower chance for hard Brexit is positive for the Pound. Ever since the referendum to leave the EU, the sterling has been highly subject to Brexit negotiation progress. After the Conservatives won the recent general election, a Brexit agreement can be passed by Parliament. In the future, the pound will depend more on the state of its economic and monetary policies and the process of discussing new economic and trade relations with the EU. It is expected that the rebound of the pound will still be limited.

Adverse global economic growth weighs on commodity currencies. The global economic growth remains slow, causing a difficult growth environment for major commodities. Therefore, commodity currency performance will also be limited. At the same time, after the US Federal Reserve cut interest rates three times, the Australian and New Zealand central banks also cut interest rates by 75 bps each to historical lows of 0.75% and 1.00%, while the Bank of Canada kept interest rates unchanged, but left the door open for future interest rate cuts. In 2020, monetary policy in Australia, New Zealand and Canada will have the opportunity to follow the Fed and ease further, but with lower expectations for interest rate and economic growth relative to the United States, Australian dollar, New Zealand dollar, and the Canadian dollar are expected to experience moderate devaluation pressure.

The ASEAN currencies are generally stable against the US dollar. ASEAN economic performance is mixed, partly affected by the global economic slowdown and Sino-US Trade disputes, and partly due to the restructuring of global supply chain and trade routes. However, the overall stability of ASEAN currencies against the US dollar is related to the three interest rate cuts by the Federal Reserve. Looking into the future, ASEAN economies will recover moderately, and there is still room for the Fed to loosen monetary policy slightly. The exchange rate of ASEAN countries against the US dollar is expected to remain stable.

IV. RMB: Wide fluctuations

In 2019, the CNY against the US dollar has depreciated by about 1.2%. The CFETS RMB exchange rate index has fallen by about 1.7% to 91.65. RMB movement in 2019 can be divided into three stages: Upward between January and April; falling significantly between May and September; rebound to stability between September and December.

According to our quantitative analysis, the RMB exchange rate is highly correlated with the two-year government bond yield differential between the United States and China. During 2017-2018, the Federal Reserve raised interest rates seven times, making US Treasury yields approaching Chinese bond yields. After the RMB became tied to a currency basket in November 2015, the correlation between the US dollar index and the RMB doubled from 0.2 to 0.39.

Looking at 2020, an exchange rate pact in the phase one trade agreement between United States and China can provide short-term support for the RMB exchange rate. From a longer-term perspective, Sino-US trade relations may still be volatile from time to time. The RMB exchange rate will depend more on the Mainland's economic performance, US-China interest rate differential, and the US dollar exchange rate, and may still experience a slight depreciation. In addition, the Mainland's financial market opening will encourage foreign financial institutions to participate in China's financial market, while the reduction of market access threshold will also encourage more foreign investors to hold RMB assets, thus supporting the RMB exchange rate performance to a certain extent.

Since 2019, the fluctuation of the RMB exchange rate has shown three characteristics: First, the Sino-US trade war has dominated the trend of the RMB exchange rate. The trade war heats up and the RMB exchange rate drops; the trade war eases and the RMB exchange rate rebounds. Second, RMB exchange rate becomes more flexible, with CNY fluctuating between a wide 6.65-7.18 range. Third, the correlation between the RMB exchange rate and the US dollar index fell, with independent market dynamics shown by sometimes divergent behaviors.

Looking forward to 2020, if we observe the main factors affecting RMB exchange rate dynamics, we can find the following changes:

The first is the prospect of a Sino-US trade war. Currently, China and the United States are close to signing phase one of the trade agreement, and the short-term RMB exchange rate will rise to 7 or less, but a sharp rebound is unlikely given that the news has already been priced-in. Tough issues have been postponed to the second phase, and the next round of negotiations will be more difficult. The persistence of Sino-US economic and trade frictions has taken shape. Even if there is a truce in the trade war, the United States will still provoke incidents against China in other economic and non-economic fields. 2020 is a US election year, and a strong consensus in the United States government to take a hardline against China. Therefore, the possibility of the Sino-US trade war heating up again cannot be ruled out. At that time, the RMB will face greater depreciation pressure.

The second is the difference in fundamentals between China and the United States. China's GDP growth may slow to 6.1% in 2019. Investment, consumption and exports are all facing downward pressure, and it will take time for old growth drivers to evolve into new ones. It is expected that the trade surplus will narrow in 2020, and GDP growth has a chance to break 6%. The IMF cut its forecast for China's economic growth in 2020 to 5.8%. US consumption and employment are solid. GDP growth in the third quarter was raised to 2.1%. The Fed judges that the modest expansion of the US economy can continue. The US government plans to launch a second tax cut to boost economic growth. The IMF predicts that the US economy will grow by 2.1% in 2020. Given the varying pressures causing economic slowdown in China and the United States, fundamentals for the RMB exchange rate is neutral or neutral to somewhat weaker.

The third is the difference between China and US monetary policy. The Fed cut interest rates three times in 2019 for a total of 75 bps. China's interest rate cuts are small. The difference between the yields of 10-year government bonds in China and the United States has generally widened. Theoretically, it should push up the RMB exchange rate, but its effects are not apparent. Both China and the United States are likely to cut interest rates in 2020, and interest rate futures indicate that the United States will cut 1 time. Since China-US 10-year government bond yield difference is likely to narrow, the impact on the RMB exchange rate is neutral or slightly downwards.

Fourth is the trend of the US dollar index. The US dollar index has fluctuated between 95 and 99.4 in 2019. In 2020, the US economic performance will still be the best among developed economies. Of the six currencies in the ICE US dollar index basket, the weight of the euro and the sterling is close to 70%. There is great chance that the US dollar will consolidate at the current range. It is difficult for the US dollar to fall, and coupled with the decline in correlation with the RMB, the role of the RMB exchange rate will be limited.

Fifth is measures taken by the central bank to deal with external shocks recently. They include adjusting the RMB central parity and market price through counter-cyclical adjustment factor mechanism, maintaining a 20% reserve ratio on FX forwards, and issuing central bank bills in Hong Kong to help the RMB exchange rate reach stability at a reasonable and balanced level.

Trade war developments will continue to dominate the RMB against the US dollar during the current short-term consolidation. In 2020, the RMB exchange rate is likely to show a two-way fluctuation, with a stable to weak trend.

To conclude, the global economy and financial markets have continued to be affected by elevated uncertainties over the past few years. In order to sustain the economic expansion, major central banks around the world have implemented the highly accommodative policy. The total global debt reached US$ 188 trillion at the end of 2018, equivalent to 226% of global GDP. The global elevated debt burden could be a grey rhino for 2020, i.e. a highly probable, high impact yet neglected threat, implying that the global economy and financial markets are facing increasing vulnerability. Geopolitical events and the development of trade war may also trigger broad-based financial market adjustments. In 2020, the volatility of global financial markets is likely to rise significantly, with the market structure diverges further. The market participants should remain vigilant in responding to the market corrections and challenges ahead. Controlling risks should be a constant theme for the financial industry.