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G3 FX Forecast Revision August 2021

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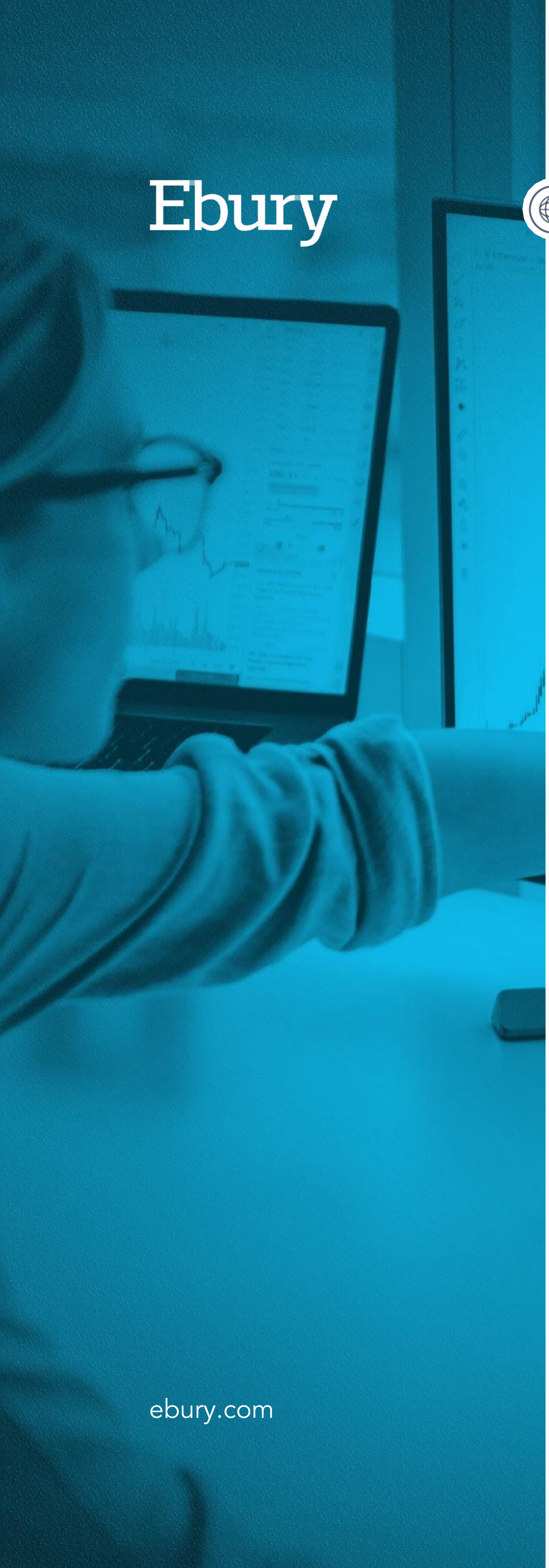

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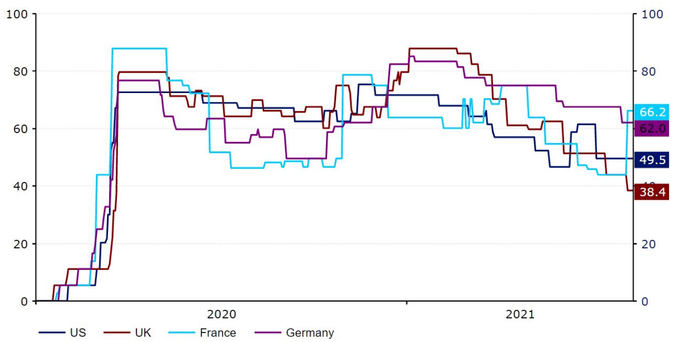
Introduction

Attention among FX traders has, for the most part, shifted away from the COVID-19 pandemic and back towards central bank monetary policy, particularly when it comes to the major G3 currencies.

Now that the majority of the populations among the developed nations are either partially or fully vaccinated, most virus restrictions have been removed and economies have begun to bounce back strongly. This removal of lockdown measures is evident in the COVID-19 Government Response Stringency index, courtesy of Oxford University, which has fallen to, or around, its lowest level since the start of the pandemic in the US, UK and most EU nations (with a handful of exceptions, notably Germany).

Figure 1: G3 COVID-19 Government Response Stringency Index (Jan '20 - August '21)

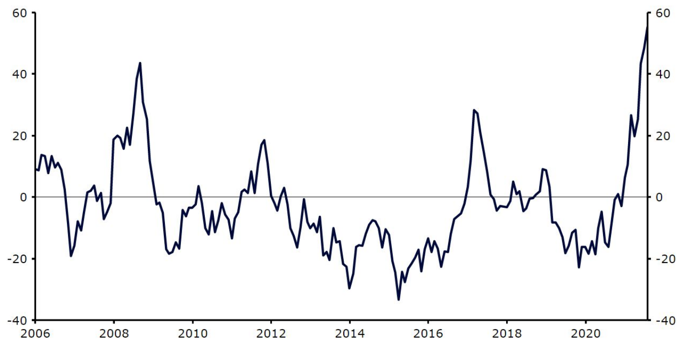


Source: Refinitiv Datastream Date: 16/08/2021

The US economy has performed particularly well thus far in 2021, with the rapid vaccination rollout there allowing it to post a fourth consecutive quarter of solidly positive growth in Q2. President Biden's massive $1.9 trillion relief package has further supported the recovery and led to a boom in consumer spending activity, albeit we think that it has partly held back the pace of hiring.

The unleashing of pent up demand, coupled with supply shortages, have sent US inflation sharply higher in the past few months - the core rate of consumer price growth, for instance, rose to its highest level since 1992 in June. This is a trend that we're currently witnessing among much of the developed world, as is evident in Citibank's G10 Inflation Surprise Index, which spiked to an all-time high 55.3 in July (Figure 2).

Figure 2: Citibank G10 Inflation Surprise Index (2006 - 2021)



Source: Refinitiv Datastream Date: 16/08/2021

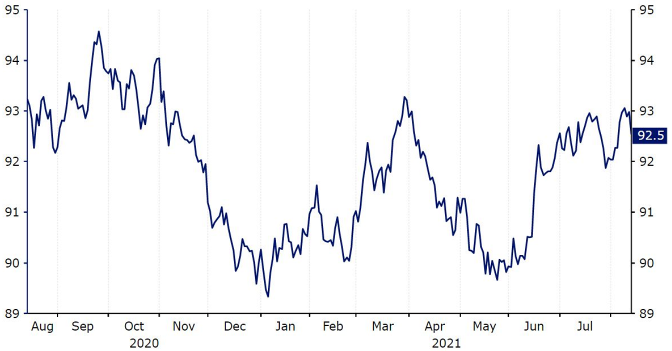
With concerns surrounding the virus abating, aside from localised flare ups in infection caused by the delta variant, we think that the main driver of the major currencies in the second half of the year will be how central banks respond to rising inflationary pressures. So far, the Federal Reserve has insisted that the spike in prices is transitory, although we think that a hint at a tapering in its QE programme is still more likely than not at the September FOMC meeting. The Bank of England has struck a similar tone on inflation, although we think that it remains on course to raise interest rates in 2022, and sooner than its G3 peers. As for the European Central Bank, policymakers there have struck a more dovish tone, causing the market to push back expectations for policy normalisation and send EUR/USD to its lowest level in four months.

US Dollar USD

It is fair to say that the US dollar has experienced mixed fortunes so far in 2021.

The US currency was among the better performers in the G10 in the first quarter of the year, with the US dollar index touching its strongest position in almost five months at the end of March (Figure 3). This outperformance was, in our view, in large part due to the approval of President Biden's stimulus package and the impressive rollout of vaccines in the US, which drove yields higher and allowed the economy to open up at a faster rate than much of the developed world. These gains were almost entirely reversed in April and May, although the dollar has rallied sharply since the Federal Reserve's June meeting on rising expectations for US interest rate hikes.

Figure 3: US Dollar Index (August '20 - August '21)



Source: Refinitiv Datastream Date: 16/08/2021

With the majority of virus restrictions now removed in most US states, attention among currency traders has turned to Federal Reserve monetary policy and the bank's views on the likely path of US inflation. We've witnessed a sharp increase in inflationary pressures in the US in recent months amid a combination of pent up demand, rising commodity prices and supply disruptions. The headline rate of consumer price growth has beat expectations during most of the year thus far, surging to 5.4% in June and July (Figure 4), its highest level since August 2008. Even more striking has been the rapid increase in the typically less volatile core rate of inflation, which jumped to a near 30-year high of 4.5% in June. The three-month annualised rate of core inflation, which serves as a good indication of price momentum as it isn't distorted by the base effect, rose to an alarming 10.6% in June, and remained at a lofty 8.1% last month.

Figure 4: US Inflation Rate (2012 - 2021)

Source: Refinitiv Datastream Date: 16/08/2021

So far, policymakers have continued to stress that this spike in inflation is likely to prove short-lived. Communications from FOMC Chair Jerome Powell were mixed at the July meeting. Powell didn't appear particularly concerned with the recent spread of the delta variant both domestically and abroad.

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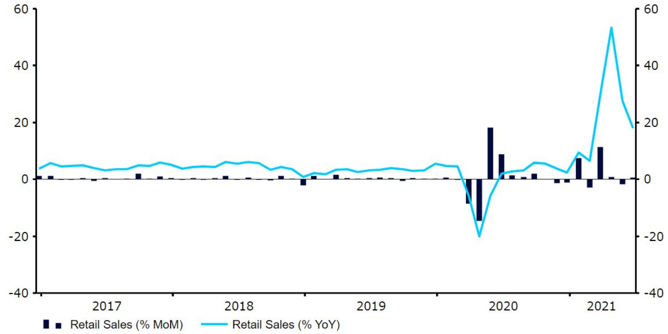
He noted that the economic implications had tended to be less with each successive wave and that it was reasonable to assume that would be the case this time around. Powell also downplayed the impact of rising US inflation. He admitted that prices had risen faster than expected in recent months, although he once again stressed that the inflation spike would likely fade and that patience was required in response. It is worth noting that the Fed now targets 2% inflation on average over time, so won't be rushed into raising rates should the bank's preferred measure of price growth, the PCE index, rise above this level for a brief period of time.

The market was, however, left underwhelmed by the lack of clarity regarding the timetable for QE tapering at the July meeting. Powell stated that the bank had taken the first 'deep-dive' into how to scale back purchases, although no decision had been made regarding its timing. Perhaps more importantly for markets, he also emphasised that the bank was still 'a ways away' from considering raising interest rates. According to the Fed's June 'dot plot', seven committee members now see higher rates in 2022 (up from four in March), and thirteen now see at least one hike by the end of 2023 (up from seven). This lifted the median dot higher, and suggested that the Fed now sees two hikes before the end of the forecast horizon. In light of the recent inflation surprises, we think that another upward revision may be on the cards at the September meeting, which could bring hikes into view during 2022.

While inflation has continued to come in very high, the US economy has evolved broadly as anticipated in the past few months. The early and meaningful unwinding in virus restrictions, combined with the country's generally more relaxed approach to enforcing said measures, has allowed the US economy to outperform most of its peers so far this year. It expanded by a solid 6.5% annualised in Q2, following on from similarly impressive growth of 6.3% in the first quarter. Particularly encouraging is the robust recovery witnessed in consumer spending since the peak of the shutdowns. An unleashing of pent-up demand and highly accommodative fiscal policy have supported the recovery in domestic demand. Retail sales increased sharply at the start of the year and were 18.2% higher in June than pre-pandemic levels (February 2020). Indicators of business activity have also remained very strong, with the services PMI from ISM remaining above the level of 60 for the fifth consecutive month in July.

Figure 6: US Retail Sales (2017 - 2021)

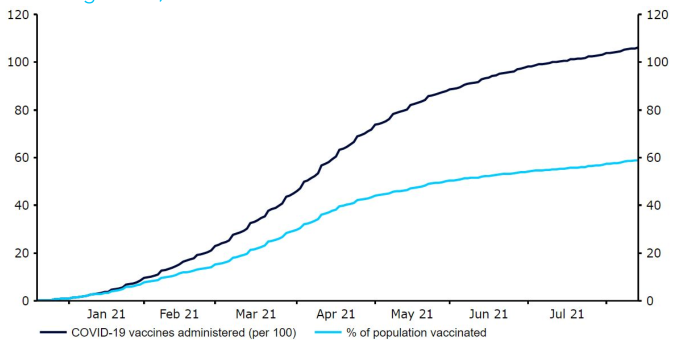


Source: Refinitiv Datastream Date: 16/08/2021

The US labour market has also continued to rebound relatively well, despite Biden's generous stimulus package undoubtedly holding back the pace of hiring in recent months. Another 943k net jobs were added in July, the most since August 2020, while the June number was also revised higher to 938k. Approximately 75% of the jobs lost during the entire pandemic period have now been recovered, with the unemployment rate also dropping sharply to 5.4% from 5.9%. Average hourly earnings are also now growing at a very steady clip (4% YoY), which bodes well for growth during the remainder of the year.

Concerns surrounding the spread of the delta variant of the COVID-19 virus around the world have provided support for the dollar, given its status as one the world's chief safe-haven currencies. The domestic virus situation in the US has also significantly improved now that approximately 59% of the country's population has received at least one vaccine dose (Figure 6). We do, however, remain concerned with the relatively high levels of vaccine hesitancy in the US compared to many of the country's major peers. While this is not too much of an issue at present, we think that rising infection levels over the winter months may disrupt both the supply side and alter consumer spending behaviour.

Figure 6: US Share of Population Vaccinated Against COVID-19 (Dec '20 - August '21)



Source: Refinitiv Datastream Date: 16/08/2021

We think that the impact of vaccines on the US economy is already reflected in the value of the dollar. We do, therefore, remain bearish on the USD and continue to forecast a deprecation in the currency versus most of its peers over our forecast horizon. The return to more normal levels of global economic activity brought about by the vaccines should, in our view, support risk sentiment and weigh on the safe-haven currencies, including the dollar. We also expect the gap in economic performance between the US and most of the rest of the developed world to narrow, once the recovery picks up speed elsewhere.

The Federal Reserve's insistence that it will look through temporary increases in US inflation, and the political pressure against policy tightening in the US, also suggests that the gap between FOMC rhetoric and actual interest rate moves may be quite large. We believe that the Fed will wish to leave a reasonable amount of time in between tapering its QE programme and hiking rates. We now don't expect any word on the former until September, with rate hikes unlikely to follow until at least late-2022 or early-2023.

	EUR/USD	GBP/USD
Q3-2021	1.18	1.41
E-2021	1.19	1.42
Q1-2022	1.21	1.43
Q2-2022	1.22	1.44
E-2022	1.24	1.45

Euro EUR

EUR/USD has traded largely within the 1.17-1.19 range since the FOMC's June meeting, which triggered a sharp move lower in the currency to its weakest position since early-April.

The euro has hovered around the midpoint of the G10 performance tracker most of the year. It underperformed slightly in the first quarter of the year following the disappointingly slow rollout of vaccines in the EU. The bloc's vaccination programme has picked up sharply since then, allowing for most countries to unwind lockdown measures. While this has helped improve sentiment towards the euro, the absence of inflationary pressures in the bloc and the ECB's subsequent dovish stance at recent meetings has capped the currency's gains.

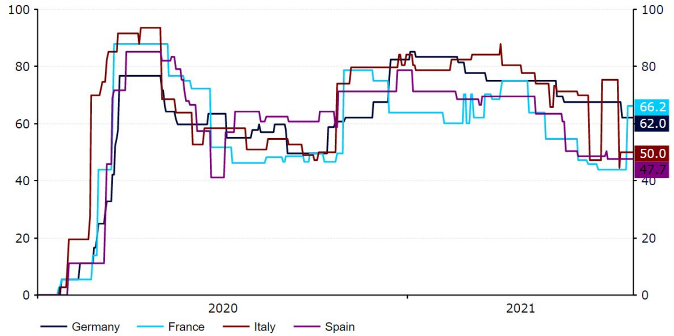
Figure 7: EUR/USD (August '20 - August '21)

Source: Refinitiv Datastream Date: 16/08/2021

The European Union struggled to roll out the various COVID-19 vaccines at anywhere near the pace of either the US or UK at the start of the year. The programme faced a number of significant challenges, notably supply issues of both the Pfizer and AstraZeneca vaccine.

An increase in supply since the start of the second quarter has, however, allowed vaccinations to pick up pace. At the time of writing, approximately 62% of the EU's population have received at least one dose of vaccine, with 53.5% now fully vaccinated. Virus restrictions have subsequently been unwound across the continent in recent weeks. A good indicator of the severity of these restrictions is the COVID-19 Government Response Stringency index from Oxford University. This indicator has either dropped below or hovered around the level of 50 in Italy (50) and Spain (47.7), albeit authorities in Germany (62.0) have taken a more cautious approach, while France (66.6) has recently tightened restrictions once again.

Figure 8: COVID-19 Government Response Stringency Index [Europe] (Jan '20 - August '21)

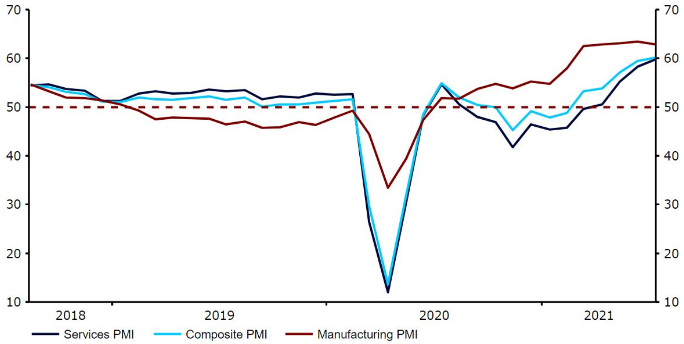


Source: Refinitiv Datastream Date: 16/08/2021

The Euro Area economy entered into a 'double-dip' recession in Q1 following the extension of many of the strict lockdown measures in place over the winter months. Since then, we've seen a marked improvement in economic activity, as the successful vaccination rollouts allow for a material unwinding in restrictions in most European nations.

Growth returned in the second quarter, with expansion coming in at a faster-than-expected 2.0% quarter-on-quarter. Portugal (4.9%), Spain (2.8%) and Italy (2.7%) were among the outperformers, with Germany (1.5%) and France (0.9%) both lagging behind due to the slightly more gradual removal of restrictions there. We expect growth to pick up further in Q3 on the back of the continued return to near-normal levels of economic activity. We've already seen evidence of this in the latest business activity PMIs that, unlike in the US, have continued trending higher in the Euro Area in recent months. The composite index increased to 60.2 in July, comfortably in expansionary territory and its highest level since June 2006.

Figure 9: Euro Area PMIs (2018 - 2021)

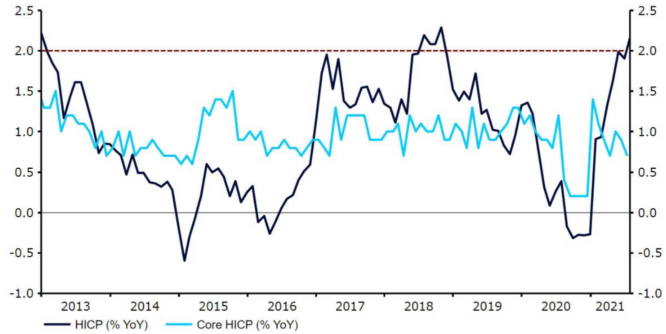


Source: Refinitiv Datastream Date: 16/08/2021

Despite the broad recovery in indicators of economic activity, the European Central Bank has continued to strike a dovish tone during recent meetings and looks highly unlikely to raise interest rates any time soon. At its June meeting, the balance of risks was upgraded from 'tilted to the downside' to 'broadly balanced' in light of the recent improvements in the health crisis. President Lagarde stated that the bank expects growth to rebound strongly in the second half of 2021, with the economy now expected to expand by 4.6% in 2021 and 4.7% in 2022 versus the previous 4% and 4.1% projections.

Perhaps of greater significance was the upward revision to the staff's inflation forecasts, which were shifted fairly markedly higher to 1.9% in 2021 and 1.5% in 2022 from the 1.5% and 1.2% respectively estimated in March. The headline inflation rate has risen gradually as lockdown measures are removed (2.2% YoY in July), although we've not quite seen the same buildup of price pressures as that witnessed in the US. The core rate of inflation remained stuck at 0.7% in July - nowhere near the levels witnessed across the Atlantic.

Figure 10: Euro Area Inflation Rate (2013 - 2021)



Source: Refinitiv Datastream Date: 16/08/2021

The outcome of the ECB's Strategic Review in July has further lessened the need to react to rising inflation. The ECB will now no longer target inflation of 'close to, but below 2%' and has instead adopted a symmetric inflation target over the medium-term, whereby it will target price growth of 2% by the midpoint of its forecast horizon (currently the end of 2023). While not desirable, this allows for an over or undershooting of the target and reduces pressure on ratesetters to normalise policy should inflation move above this level. So far, the bank has failed to provide any indication as to the timing of a tapering in its Pandemic Emergency Purchase Programme (PEPP), nor word on whether it will end as planned in March 2022. We think that the absence of inflationary pressures in the bloc means that this is now unlikely to be announced when the next set of projections are released in September.

We think that the recent move lower in EUR/USD has perhaps been excessive, and think that the likely convergence in economic performance between the US and Euro Area in Q3 should support the euro in the near-term. We also continue to pencil in gains for the pair over our forecast horizon in view of the return to near-normal economic capacity brought about by the unwinding of virus restrictions globally. That being said, inflationary pressures in the Euro Area are lagging and the ECB appears in no rush whatsoever to normalise monetary policy. For that reason, we are revising our near-term EUR/USD forecasts lower.

	EUR/USD	EUR/GBP
Q3-2021	1.18	0.84
E-2021	1.19	0.84
Q1-2022	1.21	0.85
Q2-2022	1.22	0.85
E-2022	1.24	0.86

UK Pound GBP

The pound fell to a near six-month low versus the US dollar in July, although it has since rebounded strongly and is currently one of the best performers in the G10 year-to-date.

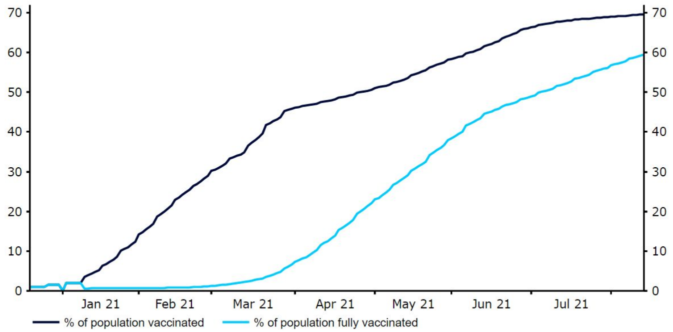
Somewhat counterintuitively, the market initially reacted negatively to the prospect of 'Freedom Day' and the removal of almost all virus restrictions in England in July. Investors feared that the end of lockdown would trigger a fresh surge in virus caseloads and hospitalisations and the reintroduction of measures in the not too distant future. While it is still relatively early days, this has not yet materialised, and traders are instead back favouring sterling on optimism that the UK economy is on course to outperform most of its major peers in 2021. At the time of writing, the pound is back trading around the 1.39 level, up approximately 2% from July's lows.

Figure 12: GBP/USD (August '20 - August '21)

Source: Refinitiv Datastream Date: 16/08/2021

The UK's successful vaccination programme, which has been the envy of most nations in the world, has allowed for a near-total removal of lockdown measures at a time when most other European countries are imposing at least modest restrictions on daily life. As of the release of this report, the UK has administered at least one vaccine dose to 70% of the population, with 59.5% now fully vaccinated. The latter number is higher than any other G10 country or economic area, with the exception of Canada. We now see the UK as a leading indicator for the rest of the world, as it is one of the few countries to remove all restrictions based solely on its vaccination programme alone. New virus caseloads soared in the first half of July, although daily cases have dropped by more than a half since 'Freedom Day'. The effectiveness of the vaccination rollout means that there is now a large and growing gap between caseloads and new hospitalisation and deaths.

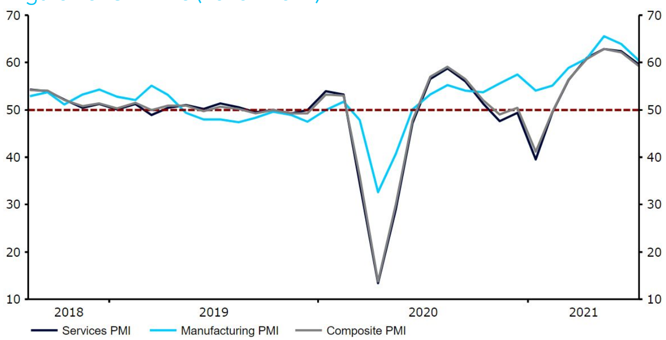
Figure 13: UK Percentage of Population Vaccinated Against COVID-19



Source: Refinitiv Datastream Date: 16/08/2021

As one would expect, indicators of economic activity have taken a turn for the better following the removal of lockdown measures. GDP contracted by a revised 1.6% in the first quarter of the year, although growth returned in the second quarter (+4.8%). The business activity PMIs have increased markedly since the beginning of the year and are now firmly back above the level of 50 that denotes expansion. Most encouraging has been the boom in activity witnessed in the UK's dominant services sector. The services index rose to a record high 62.9 in May and, despite easing in the past couple of months, remained at a lofty 59.6 in July. According to the monthly GDP data, the economy lost a bit of momentum in May (+0.8% MoM), although expansion for Q2 as a whole is expected to come in around 5%. We expect growth to moderate in Q3s. The ongoing 'pingdemic' presents a downside risk to the economy, although we think that fears are perhaps overblown and that the impact from the mass isolation orders will be small.

Figure 15: UK PMIs (2018 - 2021)



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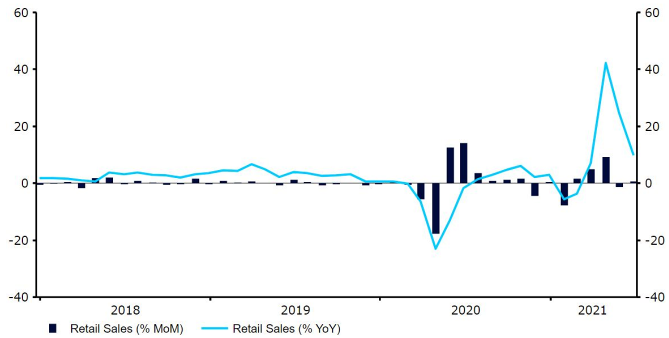
Meanwhile, the rebound in UK consumer spending has slowed since the boom in domestic demand we saw earlier in the year. Retail sales jumped by 9.3% month-on-month following the reopening of all high street shops in April, although sales volumes have actually fallen since then. A concern for both the UK government and the Bank of England will be how well consumer demand holds up once the furlough scheme ends at the end of September. 1.9 million people were still enrolled on the scheme at the end of June and there is some uncertainty as to how many will actually return to the workplace when the government's financial assistance stops. The programme has so far been highly successful in limiting layoffs during the crisis period. The UK's jobless rate peaked at just 5.1% in December 2020 and has been on a general downward path since then, coming in at 4.8% in the three months to May.

Figure 14: UK Retail Sales (2018 - 2021)



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An unleashing of pent-up demand, among other factors, has pushed UK inflation above the Bank of England's target in recent months. The headline rate of consumer price growth rose to 2.5% year-on-year in June, its highest level since August 2018, while the less volatile core measure has also shot up to 2.3%. The MPC does, however, appear split over the nature of the recent inflation overshoot, with most members still of the opinion that the recent spike in prices will be temporary.

The BoE's August meeting delivered a moderately hawkish message. Inflation is now expected to rise to 4% by the end of the year, up from the 3% previously pencilled in, before moderating in 2022. The MPC also noted that the bank now plans on reducing its stock of purchased assets when the base rate is at 0.5%, rather than the 1.5% it had earmarked back in 2018.

We continue to remain bullish on the pound. The successful removal of almost all virus restrictions in England in July looks likely to allow an outperformance in the UK economy relative to most of its major peers in 2021, in our view. We also think that the Bank of England is on course to normalise policy sooner than both the Federal Reserve and European Central Bank. We expect the first 15 basis point hike to come in mid-2021, likely at either the May or August meetings. This, we believe, should provide decent support for sterling and allow the currency to post reasonable gains versus the dollar over our forecast horizon.

	GBP/USD	GBP/EUR
Q3-2021	1.41	1.19
E-2021	1.42	1.19
Q1-2022	1.43	1.18
Q2-2022	1.44	1.18
E-2022	1.45	1.17

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