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Aerial View

Morning Briefing

November 24, 2020

2020 in Review

- **Our strongest conviction for 2020 was a trade war bottleneck**
- **Fiscal expansion could trigger term steepening and higher volatility**
- **Convoluted USD weakness**

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Trade War on Steroids

Next Tuesday we will be releasing our second year-ahead macro publication. A year ago, in our debut, we highlighted inflation risks in 2020. Our main concern back then was a supply shock resulting from the trade war, which should cause bottlenecks even if activity was not to pick-up in a meaningful way.

We stressed, “GDP-weighted MFN tariffs were 10.5% in 2018 in EM, compared to 4.2% in DM” and that “food prices are particularly susceptible to an inflation outburst because this sector is extraordinarily protected across the globe."

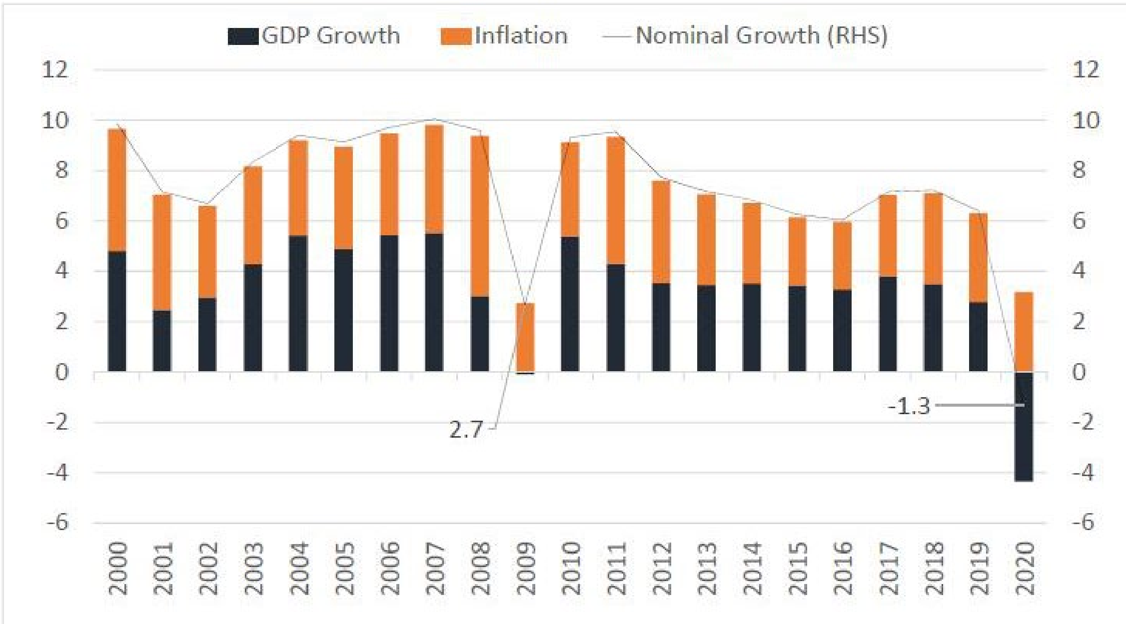
Fast forward to February 2020 and COVID-19 spreading out of a street market in central China, triggering one of the sharpest collapses in global activity, ever. We discussed bottlenecks out of COVID-19 in our mid-year update. See the mid-year note here where we explain how COVID-19 CPI baskets reflect heightened inflationary pressures.

In fact, as shown in the chart below, nominal growth in 2020 will likely decline to -1.3% from 6.4% in 2019. Between 2008 and 2009, nominal growth also declined approximately 7pp from 9.6% to 2.7%. The main surprise this time has been that real GDP growth registered -0.1% in 2009 against -4.4% in 2020. Meanwhile, inflation in

2009 was 2.8% against 3.2% in 2020.

For such a sharp collapse in activity through the Great Lockdown, one would have also expected that inflation would decline by more than observed back in the Great Recession, but quite the opposite materialized. Higher than expected inflation emanated from heightened regulation and supervision while growth collapsed.

World: Growth, Inflation and Nominal GDP Changes



Source: BNY Mellon Calculations and Bloomberg Consensus

> ***Higher than expected inflation emanated from heightened regulation and supervision, while growth collapsed***

Rotation from Treasuries to Corporates

We also emphasized an expected increase in focus on ESG strategies, primarily driven by the ECB. In “Green is the New Red" we discussed a
scenario where governments deliberately increase public sector imbalances aiming at environmental, social and governance causes.

We will delve into more detail on NextGen EU in our 2021 themes next week. The expected €750bn issuance will support ESG and spearhead fiscal coordination across the union.

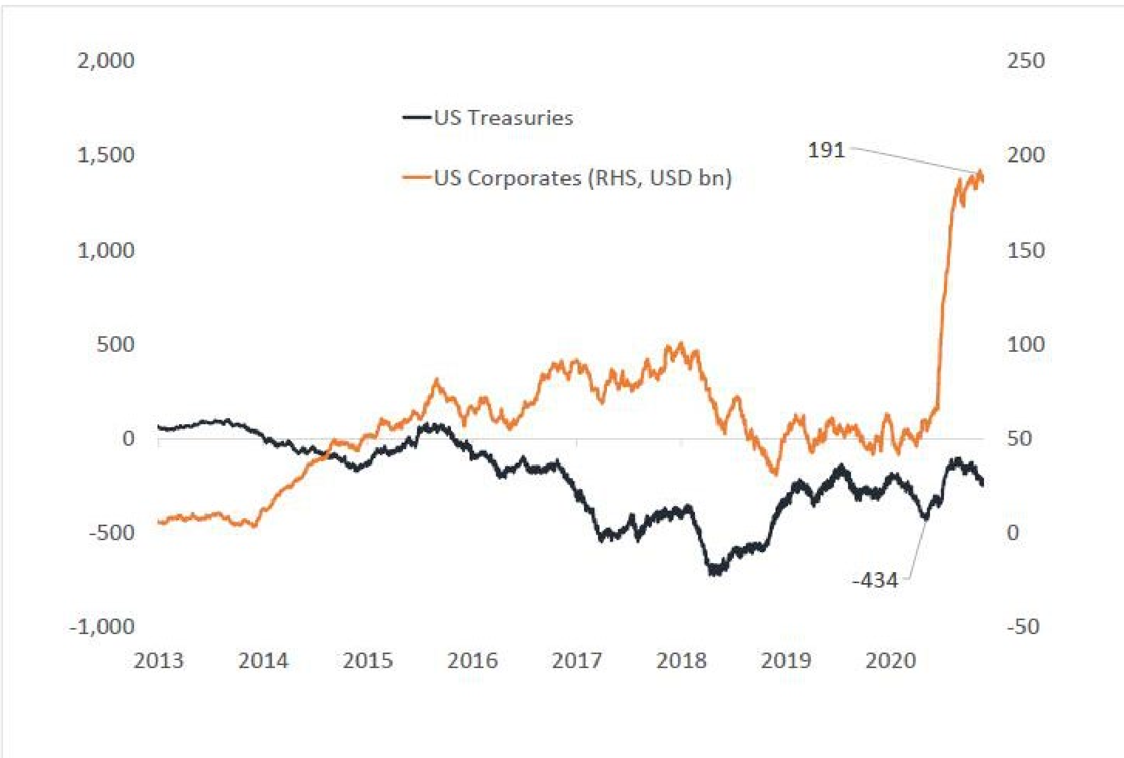
Meanwhile, in the US, significant fiscal expansion is already in place. As we show in the chart, heightened treasury issuance concerns raised unprecedented demand for US corporates. Most of these corporate issuers’ default risk is safeguarded by Federal Reserve policy, which is committed to buy all issuers, as long as these firms were investment great before the Great Lockdown.

Such a policy mix surprised us because it caused divergence between implied volatility across asset classes and maturities. UST 5s30s term steepened as expected from 58bp last year to 117bp now, reflecting duration supply. It has not been a straight line with this spread ranging between 51bp and 109bp during the Great Lockdown.

Aggressive central bank buying took implied volatility in swaption markets from 66bp last year down to 46bp now, near all-time lows. Liquidity stresses in March also pushed interest rate volatility as high 126bp.

All of this means that FX volatility may continue to absorb liquidity risk. Implied FX volatility was as low as 5.6% last year and still is higher at 6.8%. Steep yield curves have pushed FX volatility higher, but persisting inflation divergences will be the key to eventual fractures next year.

iFlow: Government and Corporate Bonds (12m rolling sum, bn $)



Source: BNY Mellon iFlow database

> ***Dollar overvaluation should not be a key driver next year. At least not as much as inflation divergences***

Ready to Sell USD, Nothing to Buy

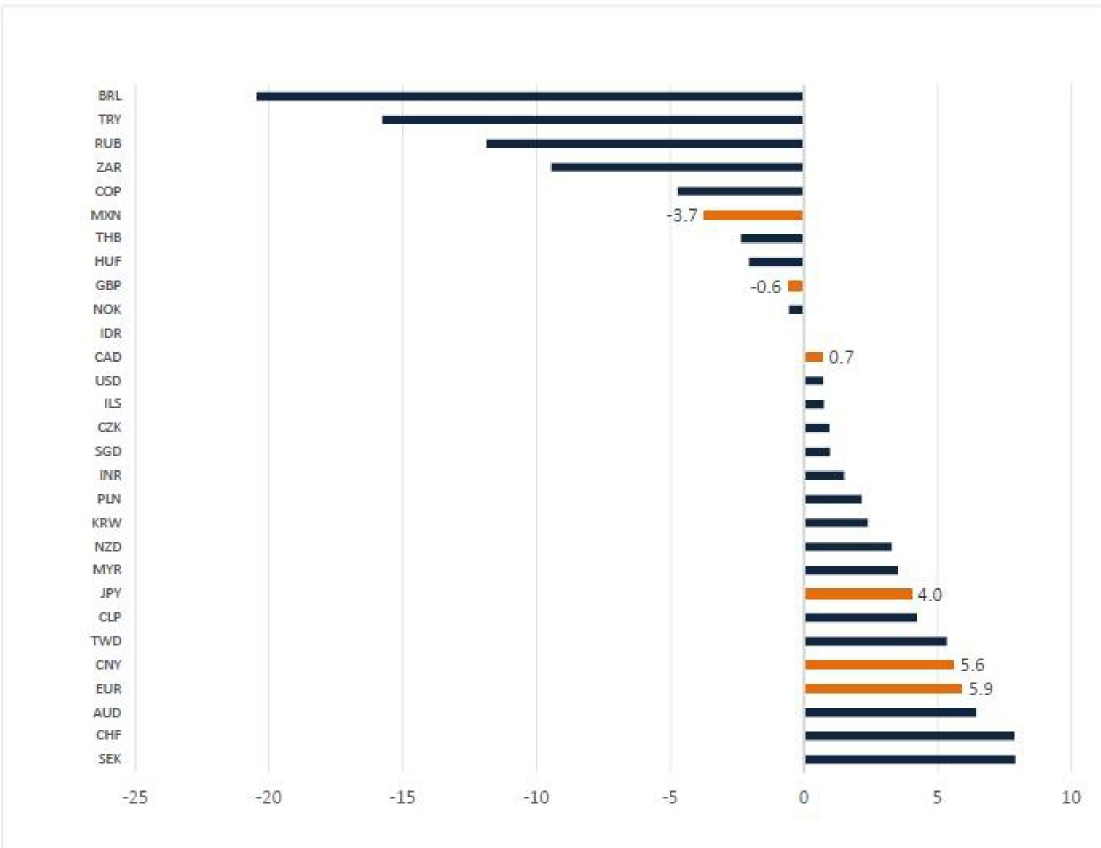
One of the last points made a year ago was a desire to sell USD. Our main concern was against what cross, and we were unsure about EM performance.

In the chart below, we show total return of all main USD crosses. Staying outright long USD since last December would have yielded 72bp return. The highlighted bars represent the US' main trade partners, adding up to 73% of the Federal Reserve USD trade weighted basket. MXN, GBP and CAD total returns were below USD returns. The three add up to 32% of the USD basket.

The remaining three, EUR, CNY and JPY add up to 41% of the USD basket yielding higher total returns primarily led by China and the Euro area. We believe these two currencies will remain the main contenders to compete with the USD as the leading reserve currencies (see more here).

The trade weighted USD appreciated 8% between December 2019 and March 2020, only to subsequently drop -9.4% since the peak. It will likely reach December about 2.5% weaker vs. December 2019. From a valuation perspective, this means that the USD is still overvalued. Dollar overvaluation should not be a key driver next year. At least not as much as inflation divergences.

Total Returns vs. USD



Source: Bloomberg L.P.

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