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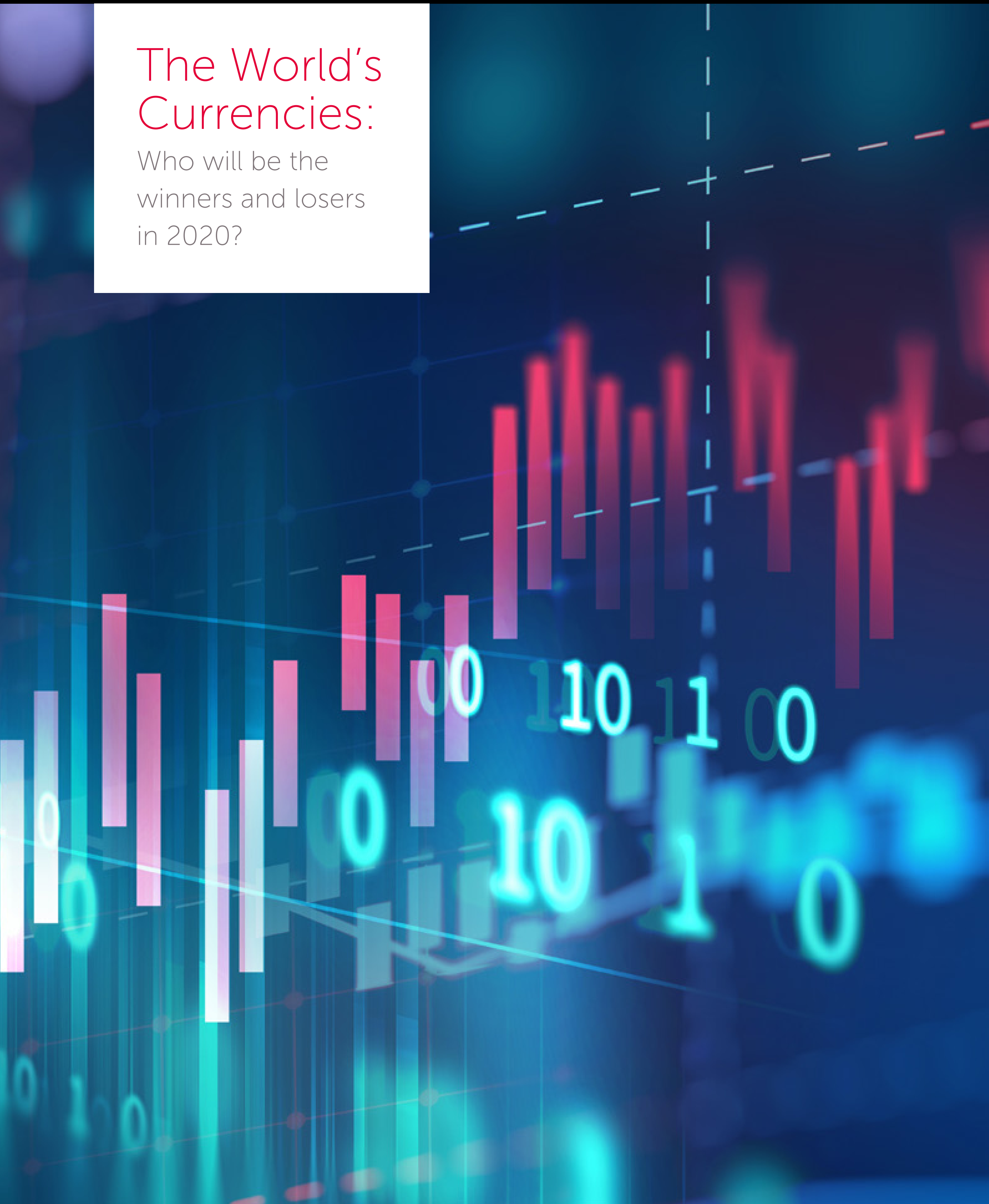
The World's Currencies:

Who will be the winners and losers in 2020?



Introduction

After such a volatile 2019, one could argue it is an almost futile exercise to predict any of the world's major currencies. Brexit has taken much longer than anyone (including the Brits) expected. The US trade war with China worsened as the year progressed. Russia came in from the geopolitical cold with its enhanced visibility in Syria. The Eurozone was distracted by the political impasse in the United Kingdom, and India's economy slowed to a five-year low of 4.5 per cent GDP growth.

However, it is incumbent upon us to peer into 2020 and at least attempt to predict how the world's major currencies will perform over the next twelve months. In this review, we take several approaches to forecasting exchange rates. We consider primary economic data differences, such as inflation and interest rates, across the most important currency markets (US, Eurozone, Japan, UK, China and Russia). We review the relative economic strength of these markets and use analytical models, combined with educated predictions about the 2020 geopolitical environment, to arrive at a coherent forecast of the relative performance of each of the six currencies.

Our 2019 Forecasts: How Did We Do?

This annual review is the third to predict currency movements during the following twelve months. Before considering 2020, we review our forecasting performance from last year. At the beginning of 2019, we forecasted the relative performance of each currency.

Rank	Currency	Prediction Accuracy (consistent within 2% of starting FX exchange rate)	Correct Predictions wrt currency	Incorrect Predictions wrt currency
Top forecasted performer (best appreciation against other currencies)	**Sterling**	**80%**	euro; yen; renminbi; dollar	rouble
2	**Yen**	**80%**	sterling; euro; renminbi; dollar	rouble
3	**Euro**	**80%**	sterling; yen; renminbi; dollar	rouble
4	**Rouble**	**40%**	renminbi; dollar	sterling; yen; euro
5	**Renminbi**	**100%**	sterling; yen; euro; rouble; dollar	nil
Worst performer (greatest depreciation against other currencies)	**Dollar**	**100%**	sterling; yen; euro; rouble; renminbi	nil

Table 1 – Forecasting Performance from 'The World's Currencies: Who will be the winners and losers in 2019?', Moneycorp Review, December 2018

In Table 1, we present the relative prediction accuracy of our forecasts from last year's review. We declare a forecast to be accurate if it predicted the performance of the currency to within two per cent of the beginning year's exchange rate. For example, as presented in Table 1, the pound sterling was predicted to be the strongest performer among all six major currencies. This prediction was accurate except for the Russian rouble, which was the only currency that appreciated against the UK currency. All other currencies presented in Table 1 depreciated against sterling in 2019.

On the whole, with the exception of the Russian rouble, we are pleased with our forecasting performance. We correctly predicted that sterling and yen would be strong performers, and both the dollar and renminbi would depreciate against the other major currencies. We were blindsided by the Russian rouble's appreciation and did not expect the currency to strengthen by so much.

Figure 1 presents the performance of the rouble against sterling during 2019. The rouble reached its highest point in July 2019 and has since depreciated steadily as US sanctions started to bite, an outcome predicted in last year's review.

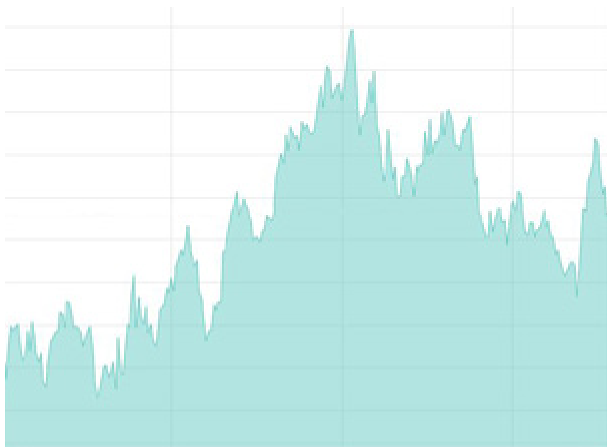


Figure 1: Rouble/Pound exchange rate throughout 2019

General Overview of the Global Economic Environment in 2020

In this section, we present the results of several quantitative forecasting methods on the 2020 performance of the UK pound sterling, US dollar, euro, Japanese yen, Chinese renminbi and Russian rouble.

We begin by using international parity conditions and relative inflation and interest rates to predict whether a currency will appreciate or depreciate in relation to other currencies. We then consider the relative economic strength of each country's economy, under the view that strong economic growth will increase demand for a country's currency. International parity conditions convey the long-term trend in exchange rates, whereas relative economic growth is more a signal of short-term changes. Taken together, they can provide an insight into possible foreign exchange dynamics over the coming twelve months.

Both approaches provide a data-driven prediction of exchange rate performance. However, their combined weakness is that they use historical data to predict the future. We compensate by using our knowledge of the global economic environment and anticipated events within each country to arrive at a compounded forecast (quantitative and qualitative) for a foreign exchange rate.

Our approach in this third annual review is substantially more complex than in previous years, and we hope this will lead to improved performance in our forecasts.

International Parity Conditions

We draw on two international parity conditions to predict future FX performance: relative purchasing power parity and interest rate parity. Relative purchasing power parity predicts that foreign exchange rates evolve according to the inflation rate differentials between two countries. Interest rate parity makes a similar prediction based on interest rate differentials.

In our analysis, we are not predicting actual exchange rates but instead the relative performance of each of the main currencies. Removing the need to predict actual exchange rates makes the task of forecasting somewhat simpler because we are only looking at the relative values of inflation rates and interest rates in each country. Table 3 presents the predicted performance ranks for the six selected currencies.

Country	Inflation Rate	Relative Purchasing Power Parity Currency Performance Ranking	1-year bond yield	Interest Rate Parity Currency Performance Ranking
United Kingdom	**1.50%**	**3**	0.70%	3
Eurozone	**1.30%**	**2**	-0.52%	1
United States	**2.10%**	**4**	1.50%	4
Japan	**0.50%**	**1**	0.00%	2
China	**4.50%**	**6**	2.40%	5
Russia	**3.00%**	**5**	5.50%	6

Table 3: Relative Purchasing Power Parity and Interest Rate Parity Analysis

Table 3 predicts the Japanese yen and the Euro to be 2020's strongest currency performers over the longer-term, with the Chinese renminbi and Russian Rouble most likely to depreciate against other currencies.

Relative Economic Strength

Both relative purchasing power parity and interest rate parity are long-term conditions and useful in predicting foreign exchange movements over several years. A forecasting method thought to be stronger over the short-term is the Relative Economic Strength approach.

Relative Economic Strength considers the relative growth rates in two countries' economies to predict relative demand for each currency. The higher the demand arising from economic growth, the stronger the currency performance. For our analysis, we compare the relative GDP growth rates among countries as a proxy for relative economic strength. Other metrics could be used, such as short-term interest rates, but given we have used interest rates in the previous section, a different measure tied to economic productivity is appropriate.

Table 4 presents predicted 2020 currency performance based on relative economic strength.

Country	GDP Growth Rate	Relative Economic Strength Ranking
United Kingdom	**1.10%**	**6**
Eurozone	**1.40%**	**5**
United States	**2.10%**	**2**
Japan	**1.70%**	**3**
China	**6.00%**	**1**
Russia	**1.70%**	**3**

Table 4: Relative Economic Strength Rankings by GDP Growth Rate

As can be seen, Relative Economic Strength predicts an entirely different order of currency performance over the short-term, with China and the United States forecasted to have the strongest currencies in 2020. The Relative Economic Strength approach predicts the Eurozone and UK will depreciate against other currencies over the same period.

The contradictory forecasts in Tables 3 and 4 may appear confusing, but they provide a window into the short- and long-term dynamics of exchange rates. Clearly, with the different trends over twelve months and longer, there will likely be competing forces (both appreciation and depreciation) on the performance of each currency.

Country by Country Analysis

United Kingdom

The parliamentary elections at the end of 2019 will hopefully provide some stability for the UK in 2020.

The British populace has given Boris Johnson's government an unequivocal mandate to deliver Brexit. With such a large majority, the UK can afford to compromise on some of the more contentious issues likely to arise in the coming trade negotiations. Although it is almost impossible to predict, there appears no real obstacle for a trade agreement to be agreed that will satisfy both parties. A much-heralded US trade deal will also be on the table, and if there is good progress in these talks, then the UK could set the foundation for strong future economic growth.

The UK-EU trade talks may or may not be resolved in 2020. However, as long as progress is made, then the UK will start to become attractive to foreign investment again, which will lead to upward pressure in sterling's value.

Downside risks to the UK include a possible constitutional crisis, but this is not likely to become significant until after the Scottish Parliament elections in May 2021, when a new Scottish government (likely the SNP) will use the elections to push for another independence referendum.

Sterling Outlook: Positive

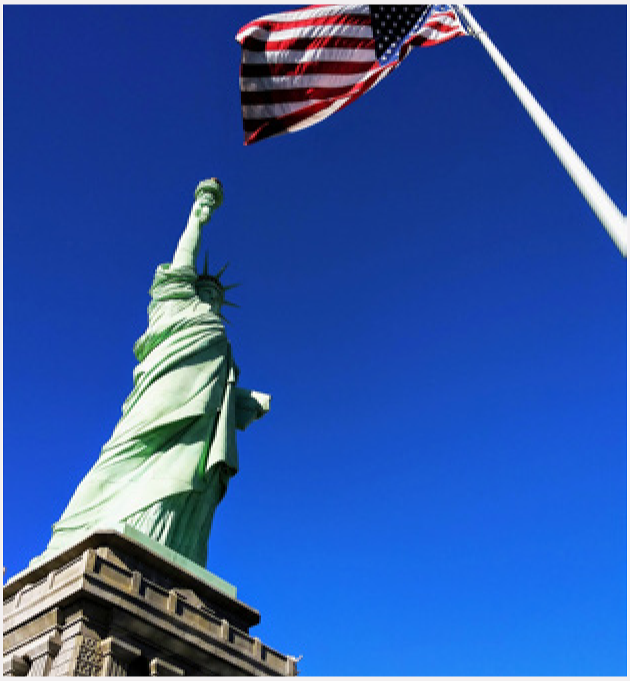
United States

Competing pressures will affect the dollar in 2020. Since September 2019, the currency has weakened against other major currencies, and the trend is likely to continue.

However, on the horizon is a potential US-China trade deal, as well as progress on a US-UK trade deal. If both talks are successful, there will be downward pressure on the dollar. On the flip side, should there be a conflict between Iran and US in the coming months, there will be an increase in demand for the dollar (as usually happens when global political uncertainty is high) because of its status as a safe currency.

Other risks to look out for are US business inventories that continue to grow (and signal a possible slowdown in the economy) and a potential interest rate hike.

Dollar Outlook: Negative



Eurozone

Like the UK, the Eurozone has been distracted by the endless Brexit discussions over the past few years.

Now that the road is clear for trade negotiations to progress, the economic bloc's focus will be on other members. Politically, the Eurozone is facing many challenges, most notably from Eastern Europe and Italy. These all have the potential to drag the Eurozone economy down. However, Brexit does provide some opportunities to countries within the block. As the UK pulls back, other countries within the EU will have the chance to capture new business, particularly in financial services. German firms are most likely to take advantage and, if successful, their improved performance will benefit the whole of the Eurozone.

The biggest weakness facing the Eurozone is that interest rates are negative, and there is very little the ECB can do to fire up its economy, short of continuing to buy up bonds in the financial markets. However, this strategy has a limit and is merely shoring up possible problems for the future.

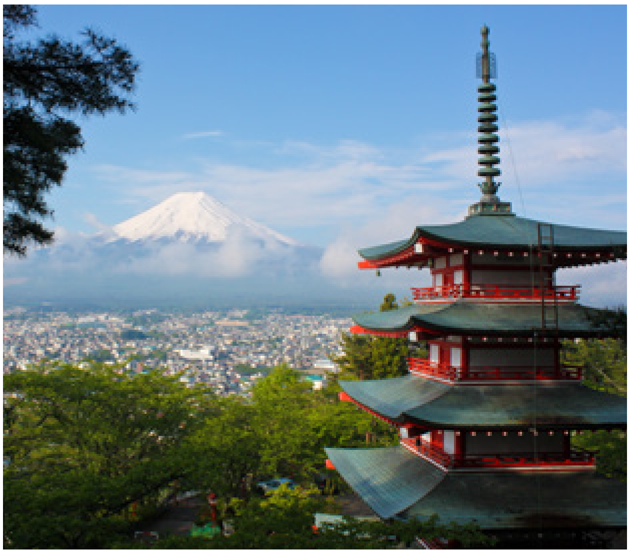
Euro Outlook: Positive and negative pressures

Japan

The Japanese economy showed some faint hints of recovery at the beginning of 2019, but recent economic figures have firmly dampened any expectations of a healthy economy in 2020.

Personal spending collapsed in Q4 of 2019, and this is likely to continue into 2020. The economy grew more slowly than expected, and private consumption was also disappointing. On top of this, the Japanese sales tax was increased by 2 per cent in October, and this will exert further downward pressure on the economy and the yen.

Yen Outlook: Negative



China

Unlike other major currencies, the People's Bank of China (the central bank) strictly controls the renminbi and exchange rates are only allowed to vary within 2 per cent of the previous day's set rate.

Active central bank intervention means the currency is easier to predict because its changes will be tied to political and economic decisions.

During 2019, the US-China trade war led the government to weaken the renminbi to offset additional trade barriers imposed between the two countries. Assuming trade negotiations are close to resolution, the downward pressure on the Chinese economy and currency will be lifted.

There are internal pressures in China, most notably worsening credit conditions, a substantial debt burden and fear of large capital outflows from the country. With all of these factors, it is unlikely the renminbi will appreciate significantly across other major currencies in 2020.

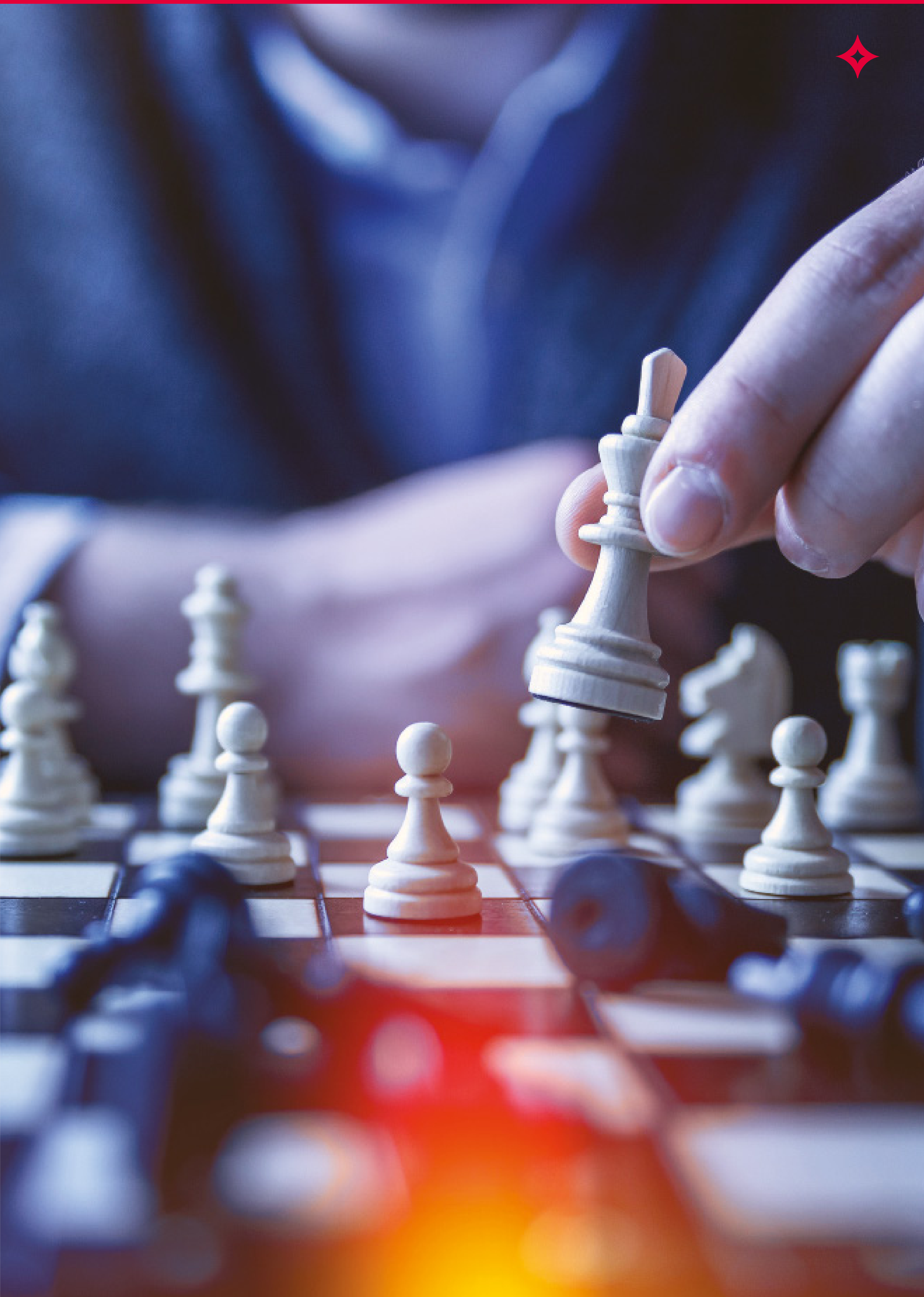
Renminbi Outlook: Marginally Negative

Russia

Many analysts believe the rouble will perform weakly in 2020 because of continuing US trade sanctions.

However, there are several indicators that suggest the rouble will, in fact, perform much stronger than expected over the next twelve months. Foreign investment in the stock market has been growing, as has domestic involvement in the capital markets. Russia's new influence in the Middle East and its improving relations with Turkey suggest improved foreign trade and stronger demand for the currency. Political risk is also much lower than in other developing countries, and this will have a compounding effect on the currency's strength.

Rouble Outlook: Positive



The winners and the losers revealed

With long-standing global economic trends steadily eroding, it has become much more difficult to predict how currencies will perform in the coming twelve months.

There are outstanding issues to be resolved in 2020 (examples include the US-China trade dispute and Brexit negotiations), and the success or failure of these will have a considerable impact on foreign exchange rates.

With this in mind, and combining our quantitative analysis with our forward-looking assessment of individual country strengths, we have decided on the currency ranking presented in Table 5.

Predictions: Best Performers in 2020

1.	Russian rouble
2.	UK pound sterling
3.	Euro
4.	Japanese yen
5.	Chinese renminbi
6.	US dollar

Table 5: Forecasted comparative currency performance in 2020

This ranking may seem surprising, given the quantitative analysis presented earlier. We make our forecast on the basis that Russia and the UK will both experience increased demand for their currencies given improving economic and political stability. We forecast the US dollar to depreciate against other major currencies because of a resolution of the US-China trade dispute and the high likelihood of a weakening economy in 2020.

We present a more detailed breakdown of performance forecast in Table 6. The Table shows along the horizontal rows how a currency will perform against a foreign currency. For example, the first row predicts how sterling will perform against other currencies in 2020.

Country	United Kingdom	Eurozone	United States	Japan	China	Russia
United Kingdom	-	Strengthen	Strengthen	Strengthen	Strengthen	Weaken
Eurozone	Weaken	-	Strengthen	No Change/ Strengthen	Strengthen	Weaken
United States	Weaken	Weaken	-	Weaken	Weaken	Weaken
Japan	Weaken	No Change/ Weaken	Strengthen	-	No Change	Weaken
China	Weaken	Weaken	Strengthen	No Change	-	Weaken
Russia	Strengthen	Strengthen	Strengthen	Strengthen	Strengthen	-

Table 6: Forecasted detailed currency performance in 2020

In such an uncertain geopolitical landscape, it's difficult to say how accurate these predictions will prove to be. If there are no surprises on the horizon, there is an opportunity for sterling to make gains but as ever in the currency market, there are no guarantees. Regardless of the outcome of the many expected developments in 2020, moneycorp provides specialist guidance and support to all our clients throughout the currency transfer process. As an award-winning foreign exchange specialist, moneycorp has been helping clients with their currency requirements for over 40 years and we're well prepared for whatever 2020 will bring.

About the author

David Hillier is Executive Dean and Professor of Finance at the University of Strathclyde Business School. He is the author of the largest franchise of Finance textbooks outside of the US and has visiting appointments at universities in Italy and Thailand. David is recognised as being in the top 3% of the most prolific finance researchers in the world over the past fifty years (Heck and Cooley, 2009) and appears regularly in the media as a business commentator. His YouTube channel of Finance lectures (professordavidhillier) has attracted more than 60,000 views worldwide.

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