FOREIGN EXCHANGE

OUTLOOK FOR FIRST QUARTER 2020

FOREIGN**EXCHANGE**

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IS-05777-2019-12-20

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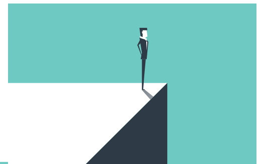

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Major Market Global Overview:

Markets Step Back from the Brink

By Dr. Win Thin

With the two biggest tail risks – the trade war and Brexit – seemingly addressed, markets are embracing the improved global outlook. There is still uncertainty regarding both, but we have stepped back from the brink. This should be enough to support further gains in risk assets such as equities, credit, and emerging market currencies in 2020. The dollar is a tougher call. It tends to weaken as safe haven flows abate, but firm as US rates go up.

We still hold on to our stronger dollar call against the major currencies in Q1 2020 due to growth differentials. Despite some green shoots in Europe, the US is doing better than the rest of the world and we expect this to continue in early 2020. Reduced odds of a hard Brexit and the "Phase One" trade deal remove tail risk for the entire world economy, not just for the signatories. As a result, many major central banks are sounding more upbeat (ECB, RBA, RBNZ) and this is feeding into the notion that the global easing cycle has reached an end. Perhaps that is true, but that still leaves the US with an advantage in yield and relative growth rates. We note that December Markit PMI readings across the globe have so far come in weaker than expected, while the US remains firmly in expansionary territory. Surprise fiscal stimulus out of Europe is a risk in our view, but even if it happens, it's unlikely to come in Q1.

US

The Fed is likely to maintain its wait-and-see approach throughout 2020 and well into 2021. As the Fed remained on hold at the December 11 FOMC meeting, and following recent positive domestic and global economic developments, the tail

risks have clearly fallen. As a result, US curve inversion (3-month to 10-year) ended October 10 and the market hasn't looked back. Did we dodge a bullet? Markets are likely to remain on US recession watch, but our understanding of the signals from past curve inversions is that we will likely avoid recession in 2020.

The December dot plot suggests steady rates in 2020 but take it with a pinch of salt. The June dot plot suggested no cuts in H2 2019 and then the Fed went ahead and cut on both July 31 and September 18. The September dot plot suggested no more cuts in Q4 2019 and yet the Fed cut on October 30. The December dot plot also shows one hike in 2021 followed by another in 2022, while Fed Funds futures are pricing in one more cut in 2020 followed by steady rates in 2021 and 2022. While our call for steady US rates differs from both the dot plot and the Fed Funds futures strip, we suspect the latter is closer to the truth than the former. That is, one more cut seems more likely than two hikes.

There will be the regular annual rotation of regional Fed presidents in the FOMC starting with the January 29 meeting. In 2019, St. Louis Fed President James Bullard had the greatest dovish leanings, dissenting from the September 25 bp rate cut in favor of a larger 50 bp reduction. Although Bullard will not be voting in the coming year, like-minded dove Minneapolis Fed President Neel Kashkari will take on a voting role in 2020. Kashkari supported all 2019 rate cuts. While he has expressed satisfaction with current monetary policy given present economic indicators, he has been vocal about his willingness to back additional rate cuts should conditions weaken in the short term. The biggest hawks in the 2019 FOMC, Boston Fed President Eric Rosengren and Kansas City President Esther George, both dissented on all three 25 bp cuts in July, September, and October in favor of holding rates steady. While this pair will not be voting in 2020, hawkish leaning members Loretta Mester of Cleveland and Patrick Harker or Philadelphia will assume voting positions. Mester also opposed all three rate cuts in 2019 in favor of leaving rates unchanged, and Harker opposed the most recent two cuts for the same reasons. The fourth non-returning voting member Charles Evans of Chicago has remained mostly centrist with some dovish inclinations throughout 2019. The final new voter Robert Kaplan of Dallas is similarly centrist. However, he seems to be prone to somewhat hawkish preferences.

The US economy is doing better than anticipated in Q4. The Atlanta Fed's GDPNow model currently estimates Q4 GDP growth at 2.0% SAAR, steady from the previous reading. Elsewhere, the NY Fed's Nowcast model now has Q4 growth at 0.69% SAAR, up from 0.58% previously. It also raised its estimate for Q1 growth to 0.82% SAAR from 0.66% previously. The Atlanta Fed is likely overstating growth a bit and the NY Fed understating it, and we suspect the truth is somewhere in between. Either way, we are far from recession and the Fed is right to pause for now to assess the landscape. Because we are upbeat on the US outlook, we do not see further easing in 2020.

Eurozone

Christine Lagarde chaired her first ECB meeting December 12 after taking over as ECB President on November 1. Lagarde faces growing skepticism within the European Central Bank (ECB) regarding the need for further monetary stimulus as well as the efficacy of negative rates. That said, she gave a relatively upbeat outlook for the eurozone at the December meeting, noting there were signs of economic stabilization. Lagarde cited geopolitics and protectionism as downside risks, though somewhat less pronounced. While there

have been signs of stabilization, these forecasts seem too optimistic and we see modest downside risks. December PMI readings suggest that 2019 is ending on a soft note.

At the press conference following her first meeting, Madame Lagarde said "I'm neither a dove nor a hawk, my ambition is trying to be this owl that is associated with a little bit of wisdom." She is clearly bringing her pragmatic, straightforward approach that she honed at the IMF to the ECB. We think she will keep all options open and will not behave dogmatically in any way. We liked this approach when she was at the IMF and we see no reason to expect anything different going forward.

ECB's "strategy review" to include climate change. The ECB's strategy review is akin to the Fed's so-called "framework review." Call them what you will, but it's clear that both central banks are undergoing an existential crisis in the current global environment of slowing growth despite low or negative interest rates. This will be the ECB's first strategy review since 2003. Lagarde said she hopes to start the review in January and complete it by year-end. She said the framework has not yet completely agreed but acknowledged that it will include the "immense challenge" of climate change.

Markets have pushed out any notions of ECB easing. Surveys and market pricing no longer see another rate cut in this current cycle. Yet growth remains subpar and inflation is running well below target. While that argues for further easing, the bar to further easing is likely quite high. For the next quarter or two, we are on board with steady ECB policy. However, we cannot rule out further easing if the eurozone outlook has not improved by mid-year but Lagarde will need time to build a consensus for further easing. It won't be easy, but it won't be impossible either.

With monetary policy nearing its limits, the calls for fiscal stimulus have grown. Even if it happens, it could be more "qualitative" than "quantitative." By this we mean that actions on the fiscal side could be more towards shifting the agenda on to environmental spending rather than supporting the economy as the chief priority. Still, the winds are even changing in Germany, especially after the Social Democrats (SPD) elected more left-leaning leaders. New SPD head Norbert Walter-Borjans said his party wants to improve the coalition rather than break it up but demanded that German Chancellor Angela Merkel's Christian Democratic Union (CDU) review its balanced budget policy in order to boost the economy via fiscal stimulus. CDU officials said they still expect the SPD to honor the coalition agreement from last year, but the political calculus has clearly changed.

UK

There were three big takeaways from the UK elections. (1) The Conservatives won a decisive majority, so Brexit is happening by the January 31 deadline. A majority of 78 seats in Parliament means that Prime Minister Boris Johnson is no longer hostage to the Brexit-hardliners and free to calibrate a deal with the EU to his liking. The UK will have an 11-month transition period to wrap up the deal, but many are skeptic Johnson can do so by the December 2020 deadline. We are less pessimistic. Johnson has proven to be a pragmatic politician and may be willing to make the necessary concessions to the EU that would "get Brexit done." Either way, failure to do so would mean falling back on WTO rules. (2) The collapse of the far-left incarnation of Labour and the implosion of the Liberal Democrats suggests that the power vacuum at the center will eventually be filled by Labour. Our best guess is that Labour will emerge from a period of

Markets are likely to remain on US recession watch, but our understanding of the signals from past curve inversions is that we will likely avoid recession in 2020."

soul searching more risk-averse and nostalgic for the 10-year period when former Prime Minister Tony Blair (centrist) kept them in power. (3) The Scottish National Party will interpret their victory in Scotland as a mandate for a second referendum on independence. While not a market-moving theme, this will remain an important feature of UK politics.

Attention should now turn back to economic fundamentals. Here the story is not very compelling and it's unclear how much room for improvement there is in 2020 given ongoing uncertainty about the UK's future trading relationship with the EU. UK preliminary PMI readings for December were uniformly weak, and this weakness is likely to carry over into 2020. Ongoing uncertainty will still hang over UK businesses in 2020 and so the PMI readings are likely to remain subdued.

BOE Governor Mark Carney's extended term ends on January 31. He was recently appointed as UN Special Envoy for Climate Action and Finance, which would seem to minimize the odds that he would extend his term for a third time. Here is a list of potential candidates (by no means complete and in no particular order) to replace Carney: Andrew Bailey (Chief Executive of the Financial Conduct Authority), Ben Broadbent (BOE Deputy Governor for Monetary Policy), Jon Cunliffe (BOE Deputy Governor for Financial Stability), and Minouche Shafik (Director of the London School of Economics and former BOE Deputy Governor).

The next Governor will inherit a weak economy. We see no justification for the BOE to hike rates anytime soon. Headline inflation is running at 1.5% year over year, well below the 2% target. Growth remains sluggish, with the IMF forecasting 1.4% in 2020 and 1.5% in 2021 vs. an estimated 1.2% in 2019. The IMF does not see inflation hitting the 2% target until 2021. If nothing else, rates should be kept steady in 2020. If anything, a case can be made for cutting rates in 2020.

Japan

Bank of Japan (BOJ) kept rates steady in September, as expected. There were two dissents, with one in favor of lower rates and one in favor of changing forward guidance that currently sees current policy through at least spring 2020. The consumption tax hike goes into effect October 1. As such, the BOJ will likely wait to gauge the potential impact on the economy before moving again. WIRP suggests 54 percent odds of a cut October 31 and 83 percent December 19.

Press reports suggest that a US-Japan trade deal is stalling out. Talks ended this month and negotiations are reportedly at an impasse over the US threat to slap tariffs on Japanese autos. Japan is asking for a sunset clause that ends any deal if the US imposes such tariffs. The two countries had been working toward signing a limited trade deal, but more work is needed.

Japan has also been impacted by US-China trade tensions. However, it is also experiencing a homegrown crisis with its intensifying spat with Korea over the issue of colonial-era reparations. Both countries have put some trade restrictions into place on sensitive and strategically important material inputs.

Emerging Market Country Profiles

By Ilan Solot

Emerging markets (EM) should enjoy a period of relative calm from external factors until the electoral cycle picks up in the US. We expect an initial period of broad gains and carry-focused trade strategies at the start of the year in which high-beta plays will outperform. A few Latin American currencies are well-positioned to capture these initial gains, recovering some lost ground during the protests that swept through the region. Eventually, however, markets should settle into differentiation mode, when fundamental weaknesses and idiosyncratic factors will become a drag on performance of the weaker countries such as South Africa, Turkey, and India.

Our call for a gentle uptrend in US yields and the dollar (vs. domestic markets) should not represent a threat to EM because it's happening for the "right reasons" (i.e. relatively better global growth outlook). Politics will remain a major source of downside risk, but we expect less of it from US President Donald Trump. The proximity to the elections means he will occupy a stabilizing role to avoid rocking the boat, even if that means fending off Congressional initiatives such as the recent ones against Turkey and China. Trump could, however, decide to pick other countries as targets to keep up his hawkish credentials. Either way, sensitivity to political events will remain high, as it was in 2019. Countries that experienced social unrest in 2019 will remain "on watch" and might command a protest risk premium for some time.

Latin America

After underperforming for most of the year, major Latin American currencies have turned a corner in December, and we think they can outperform in early 2020. Investors will remain sensitive to political developments, as the impact of the protests on the regional's fiscal outlook and prospects for reforms remains to be seen. But this doesn't look like a major risk going forward. Moreover, FX intervention in Chile and Brazil will help to take the sting off new bouts of currency weakness, and many idiosyncratic factors weighing on the region have already played out.

Concerns about social unrest in Chile and Colombia have abated, and the Chilean peso in particular has a lot of room to recover. In Colombia, we are worried about fiscal slippage in reaction to the protests which could trigger a ratings downgrade. Mexico's central bank will continue easing, but rates should remain high relatively to other EM currencies into 2020. External conditions permitting, we think markets should look past Mexico's weak economic outlook and focus on the currency's ample carry opportunity while it

lasts. In Brazil, we expect a greater interest by foreign investors in the country's equity markets after substantial outflows in 2019 amidst some signs of economic improvement. While carry will no longer be a source of support for the real, outflows from companies switching from dollar-denominated to local currency debt should diminish and the political landscape seems stable for now. Argentina will remain a wildcard. The ministerial cabinet under the new Fernandez government is shaping up as expected (leaning towards the heterodox ideological camp). The country has a tough year ahead between renegotiating debt payments amidst a very challenging economic backdrop.

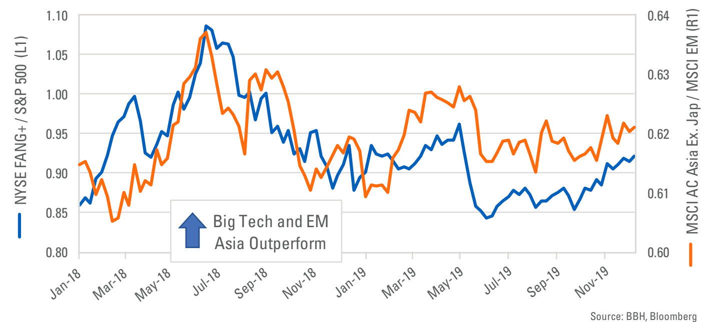
EMEA

We don't see a lot to get excited about when looking at the major countries in the EMEA region. For South Africa, we believe that investors are aware and have priced in the myriad of risk factors for next year: the Moody's downgrade, a dire economic backdrop, and energy blackouts. We prefer to stay on the sidelines regarding the rand given better investment prospects elsewhere. Similarly, we prefer not to get involved in Turkey, but for different reasons. We still think Trump has moved into a buffer role and will strive to protect Turkey against US Congressional hostility. The problem is that he may not be able to do much given the remarkable bipartisan agreements in matters of foreign policy. Trump still has some cards to play such as waivers and selecting innocuous Countering America's Adversaries Through Sanctions ACT (CAATSA) sanctions, but the setup allows for a lot of downside risk potential. Eastern Europe has some upside risk from trade with the EU, which depends on a rebound of the industrial (and specifically automobile) sector in German. There have been some green shoots in Q4, but no definitive signs that they are blossoming into a robust recovery.

Asia

US-China trade war and new tech cycle emerge as foremost themes. We see two emerging themes for the region in 2020: (1) changes in the distribution of gainers and losers in the next phase of the US-China trade war, and (2) the tech cycle. Our short answer to the first is that there will probably not be a huge change. Some beneficiaries of export dislocation, such as Vietnam and Taiwan, are at risk of losing the gains accrued last year. On the positive side, the prospect of a rebound in trade between the US and China could trickle down the Greater China supply chain. But this is not our base case. We don't expect the region to get a meaningful boost from an agreement between the US and China – at best it could translate into less of a drag and an improvement in sentiment towards assets in the more sensitive countries such as South Korea. Regarding the impact of the broader tech cycle on the region, it's entirely up to who will be the democratic nominee. We would expect local equity markets to take a big hit should Elizabeth Warren emerge as the victor.

EM Asia Exposed to Big Tech



Source: BBH, Bloomberg

The longer-term damage to China's trade has been done. The rise in anti-China sentiment across both parties in the US suggest that the conflict is here to stay, regardless of who is in the White House for the next term. Not even the most optimistic trade agreement between the US and China we can envision will change that. International businesses are now forced to consider a permanent level of uncertainty about future disputes between the US and China, forcing many to re-think how they want to involve China in their production chains and FDI going forward.

Economic activity in China should remain subdued despite monetary and fiscal country-cyclical policies. Most expect GDP growth to come in somewhere around the 6.0% level, but there seems to be more downside than upside risks at this point. From a growth point of view, India is set to be a bright spot in the region. The economy should get a boost from many fronts including the impact of lower interest rates and tax cuts for the corporate and consumer sectors, capital injections into the banking sector, income support, and good rainfall for farmers. But the risks are shifting to the local bond market as the curve steepens with expected fiscal slippage and the possibility of a rating downgrade. The outlook for South Korea will depend heavily on the balance between the downside risks from trade (US-China, as well as the dispute with Japan) against the impact of an expansionary fiscal policy next year.

2019-2020 FOMC VOTING MEMBERS: THEIR VOICES

By Maeve O'Brien

The Fed is expected to hold rates steady in 2020 and voting member turnover should not bring a large overall shift to policy direction. 2019 alternates Harker, Kaplan, Kashkari, and Mester will replace outgoing Bullard, Evans, George, and Rosengren as 2020 voters. The Board of Governors and NY Fed President Williams are always voting members of the FOMC. These returning members are mostly centrist with some dovish leanings by Governor Brainard. Note that there remain two vacancies on the Board. Judy Shelton and Christopher Waller were named by President Trump but have not been formally nominated. Both are considered to be very dovish.

DOVE

JAMES BULLARD:

Non-returning voting member 2019
(dissented on Sept 2019 rate cut in favor of a larger rate cut)

"The bottom line is that U.S. monetary policy is considerably more accommodative today than it was as of late last year."[1]

"The FOMC's adjustment toward lower rates in the face of trade policy uncertainty may help facilitate somewhat faster growth in 2020 than what might otherwise occur."[1]

NEEL KASHKARI:

Incoming voting member 2020

"My message is clear, we should be supporting the economy, not tapping the brakes (on monetary policy)… how much more do we have to cut, I don't know yet."[2]

"We've been undershooting inflation for basically six or eight years so why don't we commit not to raise rates until we actually achieve that (higher inflation)."[3]

"My own outlook for the economy is one of continued growth but somewhat cautious growth going forward, because there are some risks on the horizon."[4]

LAEL BRAINARD:

Returning voting member 2019

"It may be helpful to specify that policy aims to achieve inflation outcomes that average 2 percent over time or over the cycle. Given the persistent shortfall of inflation from its target over recent years, this would imply supporting inflation a bit above 2 percent for some time to compensate for the period of underperformance."[5]

"I will be watching the data carefully for signs of a material change to the outlook that could prompt me to reassess the appropriate path of policy."[5]

JOHN WILLIAMS:

Returning voting member 2019

"The economy is in a good place, and monetary policy is as well… Of course, things can change. Data dependency remains our motto, and if there were a material change to this outlook, we would adjust monetary policy."[6]

"With the adjustments we've already made, lowering interest rates, we've got the economy on a very strong footing, sustainable footing, for good growth next year… I expect inflation to move up, with that strong economy."[7]

RICHARD CLARIDA:

Returning voting member 2019

"We have the strongest labor market in 50 years… We have low and stable inflation. We have solid growth, and our baseline outlook for the economy is more of the same in 2020."[8]

"The consumer has never been in better shape in my professional career in aggregate."[8]

"We were just doing textbook monetary policy to provide some support for the economy in the face of this global slowdown and muted inflation pressures."[8]

CHARLES EVANS:

Non-returning voting member 2019

"So the economy is in a good place, and I think we've made good adjustments to the stance monetary policy. So cutting the funds rate target by 75 basis points – three cuts, as you mentioned. I think that puts us in a good place."[9]

"Policy is not that far off neutral, I would say it's accommodative."[10]

RANDAL QUARLES:

Returning voting member 2019

"By lowering the federal funds rate this year, we are supporting the continued expansion of the economy. Overall, with these policy adjustments, I believe that the economy will remain in a good place."[11]

Looking at a big picture view of voting turnover in the 2020 FOMC, it seems as though there are two hawks replacing two hawks, one dove replacing one dove, and one centrist replacing one centrist. However, while there appears to be a one-to-one replacement for each non-returning voting member based on policy leanings, the new dynamic of the FOMC voting members will depend on marginal differences in opinions amongst the new voters. Will Mester be as hawkish as Rosengren? Will Kaplan remain centrist or will he begin to lean slightly hawkish? Only time will tell but we should get our first clues at the next FOMC meeting January 29.

ROBERT KAPLAN:

Incoming voting member 2020

"Do we act now or do we let this situation breathe a little bit more – understand that we could take action in December or some future day. So that's the reason it was a close call (to support the October rate cut)."[12]

"It (US economic growth) gets worse if we don't make some policy changes. We think over the next five or 10 years it's going to slowly decline… I think policy is in the right place right now."[13]

JEROME POWELL:

Returning voting member 2019

"Monetary policy is now well positioned… If the outlook changes materially, policy will change as well. At this point in the long expansion, I see the glass as much more than half full."[14]

"Our existing framework has served us well. Nonetheless, the current low interest rate environment may limit the ability of monetary policy to support the economy… In a downturn, it would also be important for fiscal policy to support the economy. However.. the federal budget is on an unsustainable path."[15]

"A significant move up in inflation that's also persistent before raising rates to address inflation concerns: That's my view."[16]

PATRICK HARKER:

Incoming voting member 2020

(opposed past 2 rate cuts in favor of holding rates steady)

"My own view is that we should hold steady for a while and watch how things unfold before taking any more action… I held this same view regarding the last two cuts. And while it wasn't my preference, it does act as a good reminder that monetary policy in the United States is a deliberative process."[17]

LORETTA MESTER:

Incoming voting member 2020

(opposed past 3 rate cuts in favor of holding rates steady)

"I wasn't a supporter (of rate cuts) but it was a close call. I certainly understood the arguments for why it made sense to move the rate down. But now I think we're in a really good spot... I don't view the current readings on inflation expectations as being problematic, I view them as being relatively stable."[18]

"We're in a good spot right now to wait and see where inflation's going and where the labor market and growth are going before we make another change in policy."[19]

ESTHER GEORGE:

Non-returning voting member 2019

(dissented on past 3 rate cuts in favor of holding rates steady)

"Supporting an unchanged policy rate in recent meetings does not ignore the downside risks facing our economy. The emergence of those key risks to the outlook as early as the fourth quarter of 2018 caused me to moderate my expectation that further rate increases were needed… I shifted downward my view of the appropriate path for policy over the next one to two years... I view this as an appropriate adjustment."[20]

ERIC ROSENGREN:

Non-returning voting member 2019

(dissented on past 3 rate cuts in favor of holding rates steady)

"I view the U.S. economy as in pretty good shape right now… The U.S. economy is in good enough shape that I dissented at the last meeting… I did not think the last cut was necessary, and I certainly think that there is nothing that has come in since that meeting that would change my view."[21]

"I don't think there's a big cost to being a little below 2% (inflation)… I'd rather be higher, but I wouldn't want to distort financial markets to get that outcome."[22]

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CURRENCY FORECASTS*

Major Markets

In US Dollar Terms	Current	Q1 2020	Q2 2020	Q3 2020	Q4 2020
Euro	1.11	1.10	1.09	1.08	1.08
Yen	109	111	113	114	114
Sterling	1.30	1.28	1.25	1.30	1.35
Canadian $	1.31	1.32	1.31	1.30	1.29
Australian $	0.69	0.68	0.67	0.68	0.70
New Zealand $	0.66	0.65	0.64	0.66	0.67
Swedish Krona	9.44	9.77	9.63	9.72	9.49
Norwegian Krone	8.98	9.32	9.17	9.26	9.03
Swiss	0.98	0.99	1.00	1.01	1.02
In Euro Terms	**Current**	**Q1 2020**	**Q2 2020**	**Q3 2020**	**Q4 2020**
Yen	121	122	123	123	123
Sterling	0.85	0.86	0.87	0.83	0.80
Swiss Franc	1.09	1.09	1.09	1.09	1.10
Swedish Krona	10.48	10.75	10.50	10.50	10.25
Norwegian Krone	9.98	10.25	10.00	10.00	9.75

Emerging Markets

In US Dollar Terms	Current	Q1 2020	Q2 2020	Q3 2020	Q4 2020
Chinese Yuan	7.01	7.10	7.15	7.20	7.20
Hong Kong $	7.80	7.82	7.83	7.80	7.80
Indian Rupee	71.04	70.00	71.00	72.00	72.00
Korean Won	1166	1150	1110	1110	1110
Indonesian Rupiah	13985	13700	13500	13500	13500
Malaysian Ringgit	4.14	4.10	4.05	4.05	4.05
Philippine Peso	50.64	50.10	49.50	49.50	49.50
Singapore Dollar	1.36	1.37	1.37	1.37	1.37
New Taiwan $	30.18	30.00	29.75	29.50	29.50
Thai Baht	30.21	30.00	29.75	29.50	29.50
Brazilian Real	4.07	3.95	3.70	3.90	3.90
Mexican Peso	18.98	18.40	17.90	18.00	18.10
Czech Koruna	22.89	22.95	22.94	23.15	23.15
Hungarian Forint	297	300	307	306	301
Polish Zloty	3.83	3.82	3.81	3.89	3.89
Russian Ruble	62.36	62.00	61.00	60.00	60.00
South African Rand	14.26	14.50	14.25	14.25	14.25
Turkish Lira	5.94	5.80	5.90	6.00	6.10
Israeli Shekel	3.48	3.47	3.46	3.45	3.45
In Euro Terms	**Current**	**Q1 2020**	**Q2 2020**	**Q3 2020**	**Q4 2020**
Czech Koruna	25.44	25.25	25.00	25.00	25.00
Hungarian Forint	330	330	335	330	325
Polish Zloty	4.25	4.20	4.15	4.20	4.20

**There is no assurance that future forecasts will be attained.*

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