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FCM Bank Currency Outlook

MONTH OF FEBRUARY

OVERVIEW

Currency markets have been struggling for clear direction throughout January as markets attempt to price in growing downside risks to the global economy. A volatile month in the UK finally saw the GBP strengthen as markets priced out some of the risks of a "No Deal" Brexit. On the mainland further political uncertainty in France and a slowing German economy left the Euro unable to make significant gains despite a dovish turn in the US Federal Reserve.

The narrative in both the US and Europe continues to revolve around fears of a slowdown, with both Central Banks becoming more cautious in recent statements. Without any clear divergence between the two narratives, the EUR/USD remained constrained to the range it has been trading in since November. The GBP, largely ignoring underlying economic fundamentals, suffered continued volatility as the Brexit deadlock left markets uncertain.

In February, the main themes are likely to be trade and Brexit. The US-China trade talks have far-reaching implications for global growth, particularly in manufacturing, as protectionism threatens primary industries. This will be a key theme both in the US and Europe as markets look to a trade war ceasefire to assist faltering global manufacturing. GBP volatility is expected to continue providing both risks and opportunities for those with exposure to the Sterling.

WHAT TO WATCH OUT FOR IN FEBRUARY

- → Volatility in the GBP around the February 14 House of Commons Vote
- → Q4 European GDP also released February 14
- → US-China Trade Talk announcements

USD – FEDERAL RESERVE PAUSES ON RATE HIKES

Global growth concerns, the US-China trade war and the longest government shutdown in history weighed on the Greenback in January. The risks to the US economy along with financial market instability caused the Federal Reserve to turn decidedly dovish compared to its stance in December. The Fed moved away from the prediction of "further gradual increases" in rates, emphasising the need to be patient. A tight labour market and relatively robust economic data outside of manufacturing limited dollar losses. In February, US-China trade talks will take the spotlight as the March deadline for an agreement looms.

GBP – BREXIT VOLATILITY CONTINUES

The ongoing Brexit crisis in the UK dominated GBP trading in January. It's hard to remember a time in financial markets where moves in a major currency has been so dictated by political uncertainty. Fears over a "No Deal" Brexit, almost unanimously considered by economists to be a catastrophic outcome for jobs and businesses, and a range of alternatives with no clear frontrunner, left markets as uncertain as the frustrated British public. High volatility will continue to be a theme in February, particularly around parliamentary votes, the first coming on the 14th.

EUR – SLOWDOWN WORSENS | ECB HINTS AT REACTION

A slowdown in the top three European economies set the tone for the Euro in January. German Industrial Output, a key driver of the wider European economy continued to slide, with French and Italian data following suit. The European Central Bank downgraded its outlook for Eurozone growth with ECB President Mario Draghi commenting that risks to the growth outlook had "moved to the downside". Uncertainty around Brexit and continued political turmoil in France weighed on the common currency. February is likely to bring more of the same. Markets will watch economic data closely to see if the worsening downturn is likely to require ECB intervention.

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BREXIT | VOTES AND VOLATILITY

Brexit developments continued to dominate UK Financial Markets in January. The GBP rallied early in the month as reports emerged of a growing consensus towards an extension of Article 50, effectively a request to the EU to postpone the March 29 Brexit date. This could lead to the negotiation of a “softer” Brexit, potentially including a comprehensive Customs Union and access to the Single Market, or even a second referendum. All of these outcomes are positive for the Sterling. Expect further gains in the GBP if they gain traction.

On the 15th of January Theresa May’s Withdrawal Agreement was defeated in parliament by the largest margin of a sitting government in over 100 years. This led to huge volatility as markets tried to price in the probabilities of alternative outcomes. The EUR/GBP traded in a 110-point range the day of the vote, the GBP eventually settling 40 points higher on decreased expectations of the UK “crashing out” of the EU with no deal. Volatility like this is expected to continue around key parliamentary votes.

There was a clear reversal in fortunes late in the month when parliament voted against a proposal to force Theresa May into requesting an extension, sending the GBP lower. It is not certain that the EU would grant an extension without a clear indication from parliament as to how the extra time would be used to break the current stalemate.

The parliamentary vote on the 29th of January resulted in a consensus around two issues. The first, as markets expected, that there is a majority in parliament that do not want to see a “No Deal” Brexit. The other, that if Theresa May is able to negotiate an alternative to the controversial Northern Irish Backstop, that parliament would support such a deal.

In February, we expect Pound volatility to be driven by political announcements and the shifting balance of power in parliament. Theresa May is scheduled to report back to parliament on her attempt to renegotiate the Irish Backstop on February 13. Expect further volatility the following day as attention shifts to the parliamentary vote on Brexit next steps. Responses to economic data are currently having muted reactions in financial markets as Brexit overshadows economic fundamentals. This likely to continue throughout February.

HERE’S A LIST OF THE MOST LIKELY BREXIT SCENARIOS WITH THEIR EXPECTED EFFECT ON THE POUND:

- 2nd Referendum – GBP to strengthen significantly
- Theresa May’s deal wins support – GBP to strengthen modestly
- Article 50 extension – GBP to strengthen slightly
- No Deal Brexit – GBP to sell off aggressively

KEY DATES FOR THE GBP IN FEBRUARY

THURSDAY 7TH
Bank of England Interest Rate Decision

WEDNESDAY 13TH
Theresa May reports on negotiations

THURSDAY 14TH
UK House of Commons Vote

TUESDAY 19TH
Retails Sales and Unemployment

THURSDAY 28ND
Consumer Confidence

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GLOBAL RISKS PUT THE FED ON HOLD

The US Dollar has been struggling for direction in January, caught between a dovish turn in the Federal Reserve and global risks weighing on other currencies. The USD Index, a measure of the value of the USD relative to a basket of major currencies finished the month lower. As recently as January 24th, however, it was trading at 3 week highs.

Investor concerns around a slowdown in manufacturing, China-US trade talks, and the longest government shutdown in history, all weighed on the dollar in January. Weaker economic data in Europe and political instability in the UK limited dollar losses. The EUR/USD largely continues sideways in a 1.13 to 1.15 range that, with few exceptions, it has clung to since November.

The Federal Reserve created the biggest USD story in January. Having forecast two rate hikes in 2019 at their December meeting, Jerome Powell's Fed completely backtracked in January. Beginning with a series of cautious speeches by top officials in the first two weeks of January the Fed began to loosen its stance. The new catch cry coming from the Fed became "we can afford to be patient"; with one Fed member going so far as to say the next rate move could be "in either direction". The January meeting solidified the dovish outlook. The Fed removed all mention to "gradual future increases" in rates from its statement. For the time being at least, the Fed is on hold.

It is a testament to the size of the perceived risks to both the US economy and the wider global economy that the Fed are pausing the tightening cycle when labour market conditions are tight and there has yet to be a material slowdown in growth. The sharp turn in Fed expectations would normally have caused a significant dollar selloff; markets however had largely priced out any rate hikes in 2019 creating a less severe reaction.

Overall US economic data remains strong. While inflation eased in the month of December this was largely due to a slump in gasoline prices. Inflation excluding food and energy remained stable at 2.2%. The closely watched Non-Farm Payrolls Report, which tracks the US labour market, beat expectations adding 312K new jobs. Wages in December grew 0.4% equalling the highest monthly gain in over a year. To top it off the Federal Reserve's Beige Book, a publication about economic conditions in the 12 Federal Reserve Districts, reported that labour were tight and firms were "struggling to find workers at any skill level". Labour market conditions, particularly wage growth have a delayed effect on inflation of approximately 3 quarters.

Attention will move away from the Fed to developments in the China-US trade talks as we approach the March 1 deadline. China has made concessions towards balancing the trade deficit by buying more US agricultural products but the bigger hurdle is Intellectual Property reforms. Trump is pushing hard to protect American technology IP. Progress on this issue would require structural reform of the Chinese economy, something President Xi has so far refused. If no agreement is reached this month there will likely be a resumption of the tit-for-tat tariffs. Though a resumption in tariffs will hurt the US economy and thus the Dollar, we could see some risk off dollar buying in the short term.

KEY DATES FOR THE USD IN FEBRUARY

FRIDAY 1ST
Nonfarm Payrolls

TUESDAY 5TH
Market Purchasing Managers Index

WEDNESDAY 13TH
CPI Inflation

FRIDAY 15TH
Retail Sales and Industrial Production

THURSDAY 28TH
GDP

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ECB CAUTIOUS AS EUROPE'S LARGEST ECONOMIES FALTER

European economic fundamentals continue to deteriorate. Slowdowns in the three largest European economies, Germany, France and Italy have been weighing heavily on the outlook for monetary policy tightening in the Eurozone. Mario Draghi has been striking a more cautious tone in recent months, suggesting in the most recent ECB meeting that the Central Bank's next move may be to provide more support not less. Risks to the growth outlook have "moved to the downside" he said in the press conference following the ECB announcement, fuelling expectations of a more accommodative ECB. Markets had been expecting a rate hike in by the second half of this year but after Draghi's recent comments a first hike isn't priced in until mid-2020.

"A significant amount of monetary policy stimulus is still needed to support the further build-up of domestic price pressures and headline inflation developments over the medium term"
– Draghi, the European Parliament in Strasbourg.

Inflation eased to 1.6% in the month of December with preliminary figures for January showing further easing to 1.4%, a long way from the 5-year highs reached as recently as October. The slowdown in inflation is significant as the ECB's mandate of keeping inflation below but close to 2% means that tightening will not be possible if the current trend continues.

A slowdown in industrial production has been weighing on confidence in the Eurozone. Germany in particular has been weakening, with figures released early January showing a 1.9% Month on Month decline in industrial output in November. Surveys of confidence in the manufacturing sector continue to decline, with the overall European Manufacturing PMI reaching its lowest level since 2014. The ECB attributes this to weaker global demand and geopolitical factors weighing on sentiment. The resilience of European carmakers has also been brought into question as they struggle with meeting emissions standards and trade tariffs. Markets will be watching primary markets to see if the slowdown continues in February.

Political uncertainties continue to weigh on the single currency. Brexit has no clear outcome and the risk of "No deal" is stalling investment in the industries that would be affected. On the continent, political unrest in France, with the ongoing yellow vest protests, is fuelling a drop in confidence. European elections in May are likely to see a move towards a more Euro-sceptic parliament, creating further uncertainty for businesses. Uncertainty like this stalls business investment, a key factor currently weighing on the common currency.

KEY DATES FOR THE EUR IN FEBRUARY

FRIDAY 1ST — Preliminary CPI Inflation

WEDNESDAY 13TH — Industrial Production

THURSDAY 14TH — European GDP

THURSDAY 21ST — Market Purchasing Managers Index

FRIDAY 22ND — Final CPI Inflation

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A COMMODITY REBOUND AND A DOVISH FED HELP RISKIER CURRENCIES HIGHER

January was a good month for the Commonwealth dollars. The Canadian dollar, particularly sensitive to the price of crude oil, rallied strongly at the start of the month as crude recovered from 18 month lows. Iron ore, key to the profitability of the big Australian mining industry, skyrocketed to the highest levels in over a year, helping the AUD to break out of the downtrend that had dominated trading through December. The New Zealand dollar, profiting from the risk on sentiment, followed suit. A more accommodative Fed is supportive to risk assets; this assisted the three dollars throughout the month.

The Swiss Franc and Japanese Yen generally trade in the inverse to the riskier commodity currencies due to their status safe haven assets. This proved to be true in January where the CHF in particular sold off as the Fed eased policy. A more accommodative Fed has been weighing on the JPY and CHF in the short term, however, the downside risks to the global economy that made the Fed change its stance, would likely see a rebound in risk-off sentiment should this deterioration continue.

In Japan, a dovish Bank of Japan is continuing what it calls Quantitative Qualitative Easing, a fancy way of saying they print trillions of Yen to buy government bonds. This puts more money in to the financial system, encouraging inflation and growth. While most of the world's central banks are slowly unwinding the mammoth balance sheets that resulted from Quantitative Easing in the Global Financial Crisis, the BOJ is continuing asset purchases, limiting Yen appreciation.

US-China trade talks are likely to be the main driver in risk sentiment in February. Expect any concrete progress to help the CAD AUD and NZD while weakening the CHF and JPY. A breakdown in talks and a resumption in tariff escalations would see a flight to safety and cause the opposite effect.

For further information on any of the topics discussed above, please reach out to our Currency Specialists directly at dealing@fcmbank.com.mt

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KEY DATES FOR OTHER CURRENCIES IN JANUARY

TUESDAY 5TH
(AUD) Reserve Bank of Australia Interest Rate Decision

FRIDAY 8TH
(CHF) Swiss Unemployment and Wages

WEDNESDAY 13TH
(NZD) Reserve Bank of New Zealand Interest Rate Decision

WEDNESDAY 27TH
(CAD) Bank of Canada Core CPI Inflation

THURSDAY 28TH
(JPY) CPI Inflation, Unemployment and Industrial Production