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FCM Bank Currency Outlook

MONTH OF JANUARY

OVERVIEW

December saw a continuation of recent financial market volatility as investors assess a growing number of risks to the global economy. In the UK uncertainty around Brexit has been keeping the GBP unstable while in the US we saw extreme volatility around the Federal Reserve interest rate decision as markets became fearful of a Federal Reserve induced recession. In Europe ECB Governor Mario Draghi pointed out that the balance of risks to the ECB's growth and inflation outlooks was tipping to the downside.

Politics continued to be the other key theme affecting markets in December. The Euro strengthened on an end to the Italian debt faceoff with Brussels but new fears of instability in Europe were sparked by the Yellow Vest protests in France. The GBP continues to see volatility around any Brexit news as markets assess the possible outcomes of the turbulent debate in the United Kingdom. In the United States a government shutdown weighed on the dollar late in the month.

Riskier commodity currencies the AUD NZD and CAD continued to react to news around the China US trade talks and were pulled lower as commodity prices continued to fall. Safe haven currencies the CHF and JPY have been strengthening as risk aversion became a dominant theme in December.

WHAT TO WATCH OUT FOR IN JANUARY

→ UK House of Commons vote on the Brexit deal the week of January 14

→ Volatility in the USD following the January 30 Fed Interest rate decision and associated dialogue

→ ECB Rate decision January 24, particularly optimism or pessimism in the press conference

USD – FEARS OF A RECESSION

The US Dollar had a change of fortunes in December as the established trend that had seen it strengthening against the EUR for much of the year reversed. Volatility in the dollar centred around the Federal Reserve meeting on December 19. The Fed hiked rates in December and signalled a further two hikes next year, significantly more than the market had priced in. This would usually have been bullish for the USD but fears that over-tightening by the Fed could lead the economy in to a recession reversed the early rally in the dollar following the announcement.

GBP – BREXIT TURMOIL CONTINUES

The trajectory of the GBP continues to be almost entirely dependent on Brexit news as markets evaluate possible outcomes ahead of the House of Commons vote in the week starting January 14. The possibilities of a second referendum increased as political opposition to Theresa May's proposed deal continued. It is unlikely there would be a political majority in parliament for a "Hard Brexit". Other alternatives such as postponing the leave date currently set for March 29, or holding a second referendum gained some traction. Politics and news will be the main drivers of the GBP in January.

EUR – ECB CAUTIOUS

Mario Draghi struck a dovish tone at the ECB meeting in December. He backed away from earlier dialogue calling for a rate hike late in 2019 and highlighted lower global growth, financial market volatility and trade protectionism as key risks to the single market. Italian Debt concerns offered some respite for the Euro with Italy and the European Commission coming to a final agreement on a reduction in the Italian deficit. Riots in France tempered any further move higher.

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GBP SENTIMENT RULED BY BREXIT

The outlook for the Pound continues to be dominated by Brexit uncertainty. In December Theresa May's proposed EU divorce deal faced ongoing criticism from politicians in the UK, culminating in the postponement the House of Commons vote until the third week of January. Having faced off a vote of no confidence brought about by members of her own divided party May continues to campaign hard for the deal. Any news indicating increased chances of a second referendum supports the Sterling while the possibility of an economically disastrous "No deal Brexit" weigh on the UK currency.

The current deal is politically unpopular as it could leave the UK indefinitely tied to the EU customs union. With the European commission having ruled out the possibility of renegotiating the treaty, more extreme alternatives are becoming increasingly likely. In the New Year we anticipate further volatility around Brexit events as markets attempt to price in the ever changing likelihoods of a second referendum or a No Deal Brexit.

From a data perspective December brought weakening industrial output and business confidence as companies hold back on investing due to the current uncertainty. Inflation edged lower to 2.3% but remained stubbornly above the Bank of England's 2% target. Inflation is being supported by wage growth which hit the highest level in a decade topping 3.3%. This is particularly strong compared to wage growth in the rest of Europe, currently 2.4%. Output is holding up well with GDP growth remaining steady at 1.5% and retail sales numbers significantly beating expectations. This at a time when overall business investment is down -1.8% year on year.

One factor that might be skewing this data is that many UK businesses are currently stockpiling goods in fear of border problems that would affect supply chains if there were a no deal Brexit. According to a survey by EEF, the manufacturer's trade body in the UK, "evidence suggests current output maybe more a reflection of precautionary stockpiling rather than production driven by demand". This adds downside risk to the UK economy when stockpiling halts.

While current wage and inflation statistics show price pressure still alive and well in the UK, the Bank of England has pointed to the drop in crude oil prices as counteracting domestic inflationary pressure. The BoE forecasted in December that inflation would drop to 1.75% in 2019 comfortably below the bank's 2% target. The majority of economists polled by Reuters believe the BoE will keep rates on hold until there is a clear Brexit outcome. So much of the UK's economic outlook is dependent on Brexit that we expect most pound volatility to be driven by news flow rather than economic data in January.

KEY DATES FOR THE GBP IN JANUARY

FRIDAY 4TH
Market Services PMI

WEDNESDAY 9TH
NIESR GDP Estimate

WEEK OF JANUARY 14TH
UK House of Commons Brexit Vote

WEDNESDAY 16TH
CPI and PPI Inflation

FRIDAY 19TH
Retail Sales

TUESDAY 22ND
Unemployment Rate and Wage Growth

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ECONOMIC AND POLITICAL UNCERTAINTY WEIGH ON THE USD

An important factor this month was the yield curve on US treasuries which has begun to invert. An inverted yield curve, one where shorter dated treasuries have higher yields than longer dated treasuries, is a leading indicator of recession. Inverted yield curves have preceded every US recession since 1970. While currently the key 2 year and 10 year yield spread has not fully inverted, fears about this have been a key reason we have seen the USD weaken.

Economic data has not been as terrible as the yield curve might suggest. While 3rd quarter GDP dropped from 3.5% to 3.4% on an annual basis, the slight easing is in line with lower global growth and does not represent a huge decrease. The underlying job market remains strong with wage growth hovering at 3.1% the highest levels since 2009. Unemployment is even stronger holding steady at the lowest level in 49 years, a mere 3.7%. With the Fed forecasting two rate hikes next year further robust growth and wage data could see USD strength in the New Year as markets reassess their assumption that the fed will back track on rate hikes in 2019.

The black spot on the US economy, much like the rest of the world, has been consistently poor manufacturing numbers. Manufacturing is particularly sensitive to the US China trade uncertainty so if a deal is reached these numbers could improve, or at least stop deteriorating. While recent Tweets from Trump have spoken of progress on a deal, the world waits to see if the two superpowers can overcome some very large hurdles. The Chinese have shown willingness to assist with the trade deficit by purchasing agricultural products, but the biggest challenges will be intellectual property rights and Chinese subsidies of State Owned Enterprises. Solving these two issues would require extensive economic reforms domestically in China, not something Xi Jinping has previously been open to. All eyes will be on negotiations as the March 1 deadline to the ceasefire looms. The immediate downside risks to the USD are tempered somewhat by the currencies safe haven status. As the consequences of the trade war have negative consequences for global growth the USD sees some short term strength on bad news as investors look for less risky assets.

Political uncertainty has also been hurting the Greenback. The Democrat led House of Representatives have denied funding for President Trump's proposed wall along the US Mexico border. On December 22nd Trump responded with a partial government shutdown. The shutdown affects 9 of the 15 federal departments and hundreds of thousands of government employees either working without pay or taking forced leaves of absence. With both sides refusing to back down the risks of a prolonged shutdown are increasing. This heavily weighed on the dollar over the Christmas break and further weakness is expected if the shutdown is prolonged. Be aware that some US data releases will be postponed if the government is not operational.

KEY DATES FOR THE USD IN JANUARY

THURSDAY 3RD
ADP Employment and Manufacturing PMI

FRIDAY 4TH
Nonfarm Payrolls

FRIDAY 11TH
CPI

WEDNESDAY 16TH
Retail Sales

FRIDAY 25TH
Durable Goods Orders

WEDNESDAY 30TH
Federal Reserve Interest Rate Decision

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ITALIAN DEBT CONCERNS ALLEVIATED BUT OTHER RISKS EMERGE

An end to the lingering Italian Debt issue was the main highlight for the Euro in the month of December. Concerns over sanctions by the European Commission over Italy's proposed 2.4% budget deficit had been weighing heavily on the single currency. Following the agreement between Italy and Brussels for a revised deficit of 2.04% the important Italian 10 year bond yield, a benchmark for the health of Italian debt, reduced to close the month at 2.74% down over a percent from the recent highs. While the Italian Debt battle between Brussels and Rome may be over for now any meaningful improvement in the 131% government debt to GDP ratio still looks a long way off.

The civil unrest in France over President Emmanuelle Macron's proposed fuel taxes limited gains for the EUR in December. While the damage to the retail sector in France caused by the riots has a negligible impact on overall European economic output, it was another reminder of the current instability in European politics. Political uncertainty makes it harder for businesses to have confidence in investment spending which negatively impacts overall growth. Expect any further political unrest to weigh on the common currency as markets look ahead to the European Parliamentary elections in May.

Data in December was mixed with producer prices and manufacturing for November showing resilience early in the month before waning in the preliminary forecasts for December. Gross Domestic Product also disappointed by a small margin mirroring its US counterpart with a 0.1% drop to 1.6% growth on an annual basis.

The big news though was Mario Draghi striking a more dovish than expected tone at the ECB announcement citing a number of downside risks to their inflation and growth expectations. They downgraded both their growth and inflation forecasts for 2019 by 0.1% to 1.7% and 1.6% respectively. Lower inflation is a key risk to EUR strength as the ECB hopes to get interest rates off 0% where they have been stuck since March 2016. Increasing the benchmark rate is important as it provides a buffer in case of recession. With inflation forecasted to be below target it does not give the ECB much room to move.

Currently the market does not have a rate hike priced in until Q4 of 2019. Markets will be closely watching the preliminary Consumer Price Index inflation data January 4th and the final figures to be released on the 17th to see if the number disappoints as it did in December. Expect particular EUR volatility around these inflation readings and further moves in the single currency on the 24th when the ECB holds its next press conference.

KEY DATES FOR THE EUR IN JANUARY

WEDNESDAY 2ND
Manufacturing PMIs

FRIDAY 4TH
Producer Price Index and CPI Inflation

THURSDAY 17TH
CPI Inflation

THURSDAY 24TH
ECB Rate Decision

THURSDAY 31ST
European GDP

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TRADE WAR CONCERNS AND COMMODITY PRICES KEY DRIVERS IN OTHER MARKETS

The trade war continues to hamper the Australian, Canadian and New Zealand dollars. All of these countries are heavily export dependant and fear over the escalation of the tit-for-tat tariffs between the world's two largest economies continues to weigh on the commonwealth dollars. These currencies are also perceived as more risky by investors. With lowering outlooks for global growth and financial market instability dominating the news there has been a distinct move away from risky assets in December. Commodity prices have also continued to fall adding to a perfect storm in which these "Commodity currencies" have come under increasing pressure. Markets will be watching trade talk progress and commodity prices to set the tone for these currencies in January.

On the contrary, the risk-off move in December buoyed the Japanese Yen and Swiss Franc. Both are seen as less risky currencies as they have positive trade balances and net foreign assets i.e. the Swiss and Japanese own more foreign assets than foreigners own Swiss and Japanese assets. This means that in times of political and economic uncertainty investors flock to these currencies as they are seen as more resilient to economic turmoil. Fears over yield curve inversion in the US and a subsequent recession, along with the trade war concerns and the US government shutdown have all contributed to the prevailing risk-off sentiment. Expect further gains in the JPY and CHF if the US yield curve continues to invert. Any bad news on China US trade talks would send these currencies decidedly higher.

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 8TH
(CHF) Switzerland Unemployment Rate

WEDNESDAY 9TH
(CAD) Bank of Canada Interest Rate Decision

TUESDAY 22ND
(NZD) New Zealand CPI Inflation

WEDNESDAY 23RD
(JPY) Bank of Japan Interest Rate Decision

THURSDAY 31ST
AUD Reserve Bank of Australia Rate Statement