2019 FX Outlook: Surviving the climb and hoping for a safe descent

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Second-guessing the US policy agenda

Correctly second-guessing the Trump policy agenda would have paid off handsomely over the past two years.

A relatively quiet first year in office for Trump (2017) saw global recovery stories come through and a benign decline in the dollar. This second year of Trump's presidency has seen Washington come out fighting on trade, insulated by January's US$1.5trn fiscal stimulus. This put paid to notions of a synchronised global recovery and a weaker dollar.

Hats off to the US Administration for the timing of their protectionist card. As (current) US Commerce Secretary, Wilbur Ross, says: 'It's a good time to get aggressive on trade'.

What of 2019? As always, there is a range of scenarios, but we doubt that 2019 will see fresh US fiscal stimulus sufficiently large enough to prevent the US economy slowing back to trend growth near 2%. Despite widespread acknowledgement on the need for infrastructure spending, we doubt the Democrats will want to back a stimulus from which the Republicans could reap the benefits in the 2020 presidential election. In other words, policy gridlock makes it more likely than not that the US growth slows to trend.

When it comes to trade, we know that the President's executive powers are wide-ranging. The Democratic control of the House may make it harder to pass Trump's NAFTA 2.0, but there is bi-partisan support for a more aggressive stance against China. The Democrats acknowledge that the Strategic Economic Dialogue established under the Obama White House failed to produce results. And if China did join the WTO on unfairly good terms, they did so under the watch of George W. Bush in 2001.

Our baseline assumes that existing US tariffs against China remain in place through 2019 and are broadened/strengthened, such that, by the end of 2019, China's entire exports to the US are subject to tariffs. Other scenarios are possible, too. Please see our trade team's assessment of the 2019 environment on page 50.

What does Washington policy mean for the US macro cycle?

Some comparisons are being drawn between the US and Australia, where the latter has not seen a technical recession since 1991. But we suspect the US business cycle is not dead. And while not calling a US recession in 2020, let alone in 2019, our US economics team do feel that we are at a late point in the US business cycle – or at least the point where calls for the death of the Philips curve are proved premature and inflation risks look skewed to the upside.

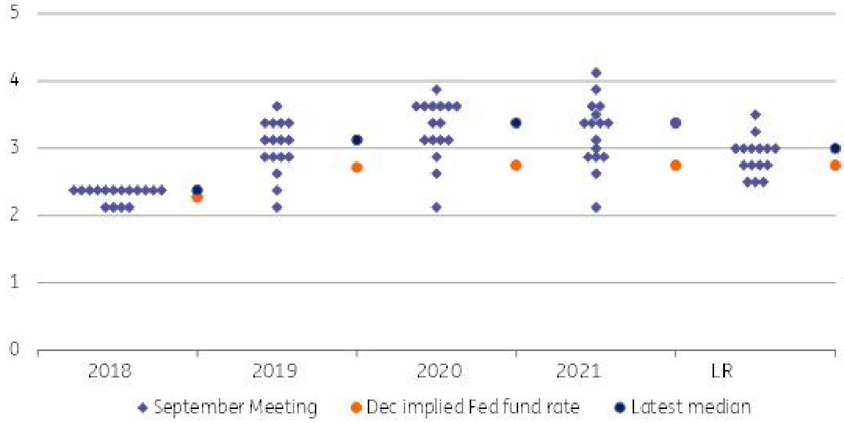
GDP to slow to trend in 2019

Our 2019 baseline view sees US growth slowing from the peak 4.2% (QoQ annualised) in 2Q18 to 2.0% by the end of 2019. Typically faulty seasonals see the first quarter as the worst of the year (we see 1Q19 at 1.5%), but the market should be prepared for this. The softening in US growth through 2019 should largely be led by the consumer and government sectors – as the effects of the January 2018 tax cuts wear off.

More focus, however, will come on the US inflation side. The Fed has so far sounded relaxed on inflation and our debt strategy team are amazed that break-even inflation rates – those derived from the difference between 10 year nominal and TIPS yield – are not much above 2%.

Despite this seemingly benign view on inflation, our US macro team see US wages breaking sustainably above 3% over the coming months and core inflation staying above 2% for the majority of 2019. In terms of a profile, we see core US inflation working its way towards the 2.5% area by the middle of 2019 and peaking around there. In our minds, this profile justifies another Fed hike this December and three more through the first three quarters of 2019 to take the Fed target range to the 3.00/3.25% band.

We look for the market to move to the Fed Dots – and not vice versa (%)



Source: ING

Despite recent discussion that Fed policy is close to neutral, we suspect this is not more seriously debated until 2Q19, when Fed Funds have been taken into the 2.75-3.00% range – close to the middle of the Fed's Long Run Dots.

Thus we are in the camp looking for the market to move towards the Fed Dots and not vice versa. If we're right, this will mean further bearish flattening of the yield curve, with the potential for inversion if there are any meaningful signs of a slowdown in activity.

Of course other Fed scenarios are possible. We explore these in Figure 22 on page 12. In assessing these alternatives, we do see inflation risks being skewed to the upside at this stage in the cycle and think it is too early to back ideas of a near term pause in Fed tightening.

What does Washington policy mean for the dollar?

Washington's policy of domestic stimulus and external economic aggression has delivered strong outperformance of both US equities and the dollar in 2018. Significant repatriation of overseas US corporate profits – far larger than in 2005 – has seen record US share buybacks and has helped to insulate US equities from slowing world trade volumes and from the downward revisions to world growth rates.

YTD benchmark equity returns (in US$ terms)

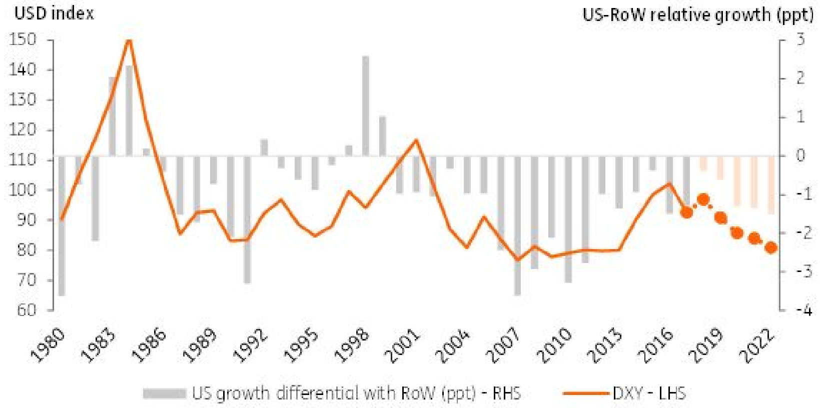
However in 2019, slowing US growth, rising input costs and a diminishing marginal impact from share buybacks stand to limit US equity outperformance.

And for the dollar itself, we think simple growth differentials remain very important indeed. From the desynchronized global growth story in 2018, we look for a resumption of resynchronization in 2019 – largely as fiscally-inflated US growth rates slow back to trend at around 2.0/1.75%.

That resynchronised growth story should prove negative for the dollar over the next two years

(Figure 6), as investors rotate into better activity stories overseas. Since we're not looking for a US hard landing, slowing US growth need not spell disaster for emerging markets – although China's ability to deliver a soft-landing will be key.

After US outperformance in 2018, slowing growth in 2019 should soften the USD



Source: ING

In addition, slowing US growth will start to expose the recent deterioration in the twin deficits (Figure 7). Unlike the dollar rally seen in the late-1990s, when a productivity boom helped deliver a budget surplus, this year's dollar rally has been built on unfunded tax cuts.

High interest rates and temporary US macro outperformance has allowed the US to finance these deficits in 2018 but, into 2019, we expect funding these deficits to become more difficult. This could be the payback for populist policies.

And we fully expect a weaker dollar to become a populist policy as the US business cycle matures – now that fiscal stimulus is off the table. Earlier this year we outlined five options open to the US administration should it want to weaken the dollar.

Dollar and the US balance sheet: On thin ice?

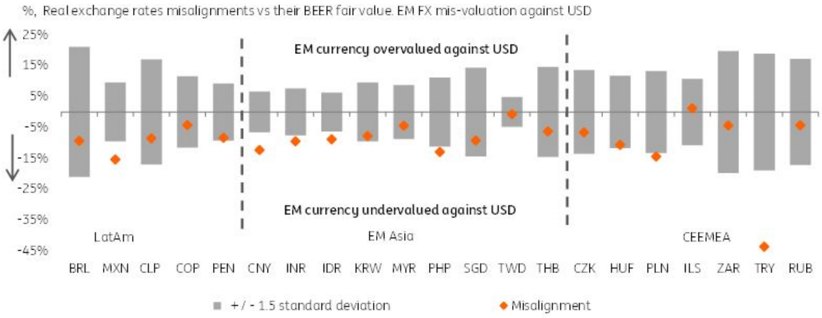
Understanding dollar valuation and key drivers

This year's rally in the dollar and collapse in emerging currencies has generated the view that the dollar is expensive. Indeed, fund managers feel the dollar is at its most overvalued since 2006, according to some buy-side surveys.

Our Behavioural Equilibrium Exchange Rate (BEER) model agrees that the dollar is expensive. It actually sees the dollar as overvalued against the entire FX spectrum, apart from the CHF and the ILS (Figure 8 for EM FX and Figure 9 for G10 FX).

While both G10 and EM FX segments are cheap against the dollar, according to our model, EMFX is cheaper in both absolute and relative terms. This is evident in Figure 10 , which not only shows a larger nominal EM FX undervaluation, but also shows a more extreme undervaluation, being outside of the 1.5 standard deviation band. This more appealing EM FX valuation versus G10 FX should not come as a surprise given that EM FX bore the brunt of the 2018 storm of high US rates, high oil prices and trade wars.

Only one currency (ILS) in the entire EM FX space is not undervalued against USD



Source: ING

We think this very cheap valuation should provide some cushion to EM FX during this final phase of the dollar strength over coming months (be that rise driven by Fed tightening or escalating trade wars).

Moreover, even though we don't look for a full risk-on environment over the coming months and risk appetite is likely to remain fragile, those high yielders where interest rates have risen over recent quarters may remain relatively resilient. Here the mix of undervaluation and high rates will demand very high conviction levels to sell EM FX. We frame this view in Figure 11 . The top left hand quadrant depicts those currencies where valuation is attractive and the risk adjusted carry is high (though in the case of CNY we expect further managed CNY decline versus the dollar

We acknowledge that higher US rates and escalating trade wars mean that EM FX will struggle to post nominal gains over coming months. But our key view is that undervaluation and high rates mean that they can outperform expensive forward prices.

We also note that those EM currencies exposed to EUR/USD are unlikely to do overly well given our cautious/downside risk view on this cross in 1H19. In such an environment, CEE FX is unlikely to do particularly well.

Indeed, our Principal Component Analysis (PCA) of the factors driving EM FX trends identified general risk sentiment and EUR/USD as the most important common drivers of EM FX (explaining 42% and 11% of the total EM FX variation, respectively). In terms of the relative importance on bilateral EM exchange rates, this is depicted in Figure 12 . Our PCA work also identified crude oil as another factor driving FX rates – but less important than the risk environment and EUR/USD.

As evident in Figure 12 , unsurprisingly EUR/USD has the highest relative importance for CEE FX when measured against USD (a higher number on the vertical axes). Interestingly, the EM risk factor (horizontal axis) also shows a higher relative importance for CEE FX and other EM lower yielders than for EM higher yielders.

The latter is largely because over past quarters/years, oftentimes negative idiosyncratic stories affected EM high yielders meaningfully (think Russia, Brazil, Turkey, Argentina) and made the general EM risk sentiment factor relatively more important in explaining the variation in returns for the better behaved low yielders.

Funky chart

The above conclusion is important to the extent it recognises that the higher yielders are not only a pure beta, but also a meaningful alpha generator – with the latter providing some cushion during what should be the last phase of the dollar ascent and should the domestic stories turn positive.

What will 2019 mean for those three factors: Risk, EUR/USD and oil?

Above we introduce the idea that a view on Risk, EUR/USD and oil will help frame a global view for FX rates in 2019. So where do we stand on these trends?

Factor One (Risk): Late cycle does not necessarily mean bear market

Earlier we discussed how the Fed should be pushing on with its tightening cycle into 2019, which will probably be associated with bearish flattening and perhaps even an inverted US yield curve.

Probably one of the views that most ING analysts agree upon is that the withdrawal of liquidity will trigger higher volatility – think quantitative tightening or rate hikes from the Fed and slowing asset purchases from the ECB and the BoJ. Figure 13 suggests rising US equity volatility (VIX) is just about overdue at these later stages in a US economic cycle.

It is one thing to believe US equity volatility is set to rise (which we do) but another to call a bear market. As Figure 14 shows, the last three sizable downturns in US equity markets only happened shortly before or during US recessions. Currently, our macro team is forecasting a US slowdown rather than recession in 2020. This tends to favour a flat to modestly higher US equity market in 2019 – although we will need to carefully monitor how trade tension and potential gridlock in Washington impacts US activity.

If one believes that US equities are essentially a flat story in 2019, then undervalued overseas equity markets become a far more compelling proposition. Emerging market equity indices are historically undervalued (Figure 15), their currencies are cheap and 2019 could be shaping up to see a more modest repeat of the rally EM equities enjoyed in 2H06/1H07, once it had become clear that Fed Funds had peaked at 5.25%, Figure 16 .

Of course the electoral cycle is always important for emerging markets as events in Turkey, Mexico and Brazil have shown this year. The electoral calendar in 2019 is also busy and investors will closely watch the build-up to elections in Argentina, India, Indonesia, Nigeria, South Africa, Thailand, Ukraine (all general) and Turkey (local) – see table on the right. Of those our sovereign credit team believe elections in Argentina, India and Ukraine pose risks of seeing the greatest turnaround in economic policy.

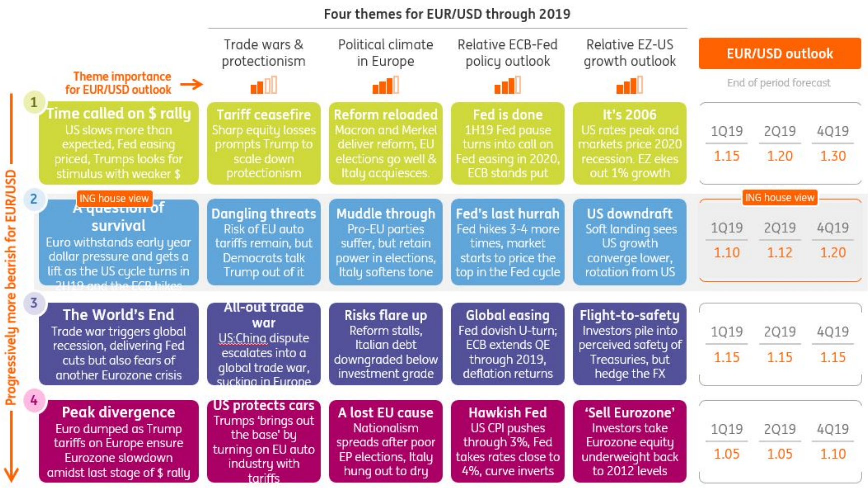
European Parliamentary elections in May 2019 (held every five years) will also be very important for the risk environment. Please see Carsten Brzeski's take on this issue on page 16.

In short then, we think the US rate environment will continue to create a headwind to risk assets in early 2019, but a turn in the US rate cycle in 2H19 will allow undervalued EM risk assets to make a comeback.

Factor Two (EUR/USD): A year of two halves

2018 proved a difficult year to forecast EUR/USD and for 2019 it is certainly worth looking at alternative scenarios. We now have a baseline view of EUR/USD staying soft through 1Q19 and then recovering, but there are several alternatives. See Figure 17 for our scenario analysis and Page 13 for a more detailed view on the EUR.

Landscape for global markets is pretty murky but here are four potential EUR/USD paths



Source: ING

Factor Three (Crude oil): The surplus returns

Based on our PCA analysis, the oil price is the third most import factor driving returns in the whole EM universe (after Risk and EUR/USD). As per Figure 18 , which shows the sensitivity of various EM regions to the oil price, Latam is the key beneficiary from higher oil prices (and vice-versa), while EM Asia benefits the most when oil prices decline. CEE FX is generally neutral, while the USD block CEMEA benefits from higher oil prices mainly via RUB (oil exports) and ZAR (commodity status). Hence a relative basket of Latam FX against EM Asia is a neat way to position for higher/lower oil prices, in our view.

In the G10 space, it should not come a surprise that commodity currencies (led by CAD) show positive sensitivity to the oil price (Figure 19). While NOK also benefits, it does less so when measured against USD crosses, since the EUR/USD impact is taming its upside.

EUR/USD shows negative sensitivity to the oil price partly because of the rising impact of oil on the US economy (following the start of shale exploration). In addition, what was previously a positive effect of higher oil prices on EUR/USD via the monetary policy transmission channel is no longer the case, given that the current dovish-leaning ECB is looking through the 'one off' impact of the oil price on the headline EZ CPI (which is currently above the 2% target) and is more concerned about still muted core price pressures (with core CPI being well below the 2% target).

So what of oil? Warren Patterson discusses key commodity drivers on page 33 and for 1H19 notes that the global oil market stands to see a sizeable surplus – buoyed by record production levels from the US and Russia. That puts pressure on OPEC+ to cut production at its meeting on 6 December in Vienna. ING feels that OPEC+ will need to deliver production cuts of 1.5 million barrels per day to see Brent returning to US$75 per barrel, our year-end target. And we favour crude stabilising near US$65 per barrel by the end of 2019. Yet Brent is now trading on an implied volatility near 50% and conviction calls on this market will be difficult to hold.

Bottom line

We suspect US rates and the dollar have a little further to climb, keeping their stranglehold over risk-sensitive currencies for the next few months. However, the dollar has risen a long way in 2018 and is now overvalued against a whole host of currencies – particularly those in emerging markets. We therefore doubt that the dollar in 2019 will repeat its gains of 2018.

In terms of timing, defensive positions against the dollar look advisable over the coming months as the dollar pushes to marginal new highs against the low yielders. Those currencies least sensitive to a lower EUR/USD and trading off their own risk characteristics could outperform. We are thinking here of IDR, BRL and RUB. At this time EUR/USD could be pressing 1.10.

Towards the summer, however, we think signals of a Fed pause will become stronger and investors will be encouraged to rotate out of defensive positions in the dollar. Emerging market currencies should be able to breathe again and selective stories in all of the CEEMEA, Latam and Asia (ex-China) regions should start to perform as EUR/USD slowly climbs to 1.20.

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