The 2018 FX Market Soundtrack

Getting bored of the same Christmas songs on repeat? Fear not, we've got you covered with our 2018 FX Market Soundtrack. Think of it as Desert Island Discs for FX markets - with our hand-picked anthems telling you everything you need to know about our currency views for next year

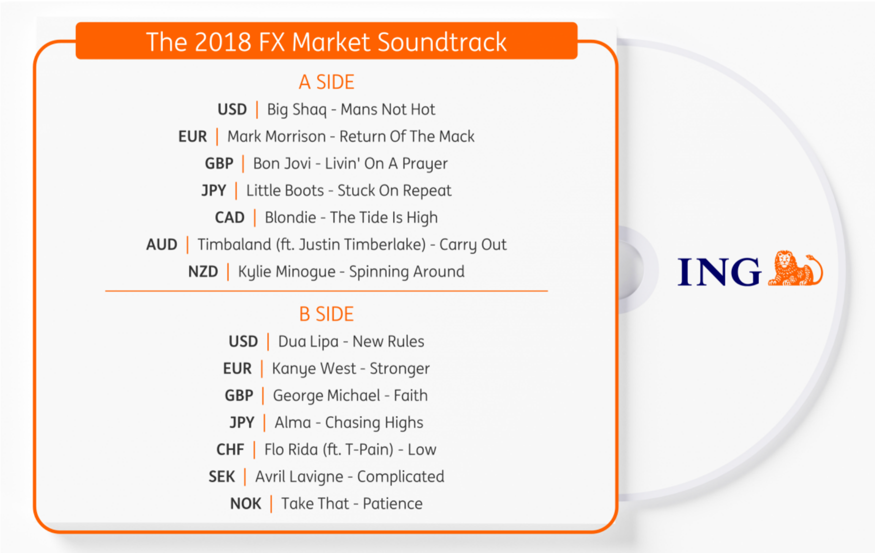
Dua Lipa, the English singer, songwriter and model

Source: Wikimedia Commons

USD: Mans Not Hot (Big Shaq)

- Back in October – and likely over the top of most people's heads – we used the title 'The Dollar's Not Hot' for our FX Week Ahead publication. Yes, unashamedly, that was a play on the song **Mans Not Hot (Big Shaq)** – which has since gone viral and become a pop-culture phenomenon (the fact that we referred to the song is a case of correlation, not causation here). Fast-forward to today and we're sticking by our claim that the USD is 'not hot' – despite the currency arguably getting some heat from the passing of a GOP Tax Bill this week. There are a multitude of factors for our bearish dollar view - the ambiguous economic effects stemming from the Tax Bill (as we note here), an unsettled US political backdrop ahead of the November midterm elections (as we note here) and the better goldilocks investment opportunities outside of the US (as we note in our 2018 FX Outlook).
- Crucially – and unlike this time last year – markets have not fallen into the Trumpflation

trap. One could playfully say that while **Last Christmas (Wham!)** investors gave their hearts to the dollar in anticipation of a reinvigorated US economy, gains were quickly given away the next day (or so). And it appears that this year, guarded investors will be looking to save themselves from tears by putting money to work somewhere more special.
- The bottom line is that the USD is trading under **New Rules (Dua Lipa)**. An environment of rising US yields no longer guarantees USD outperformance – not least because of the greater synchronicity across bond markets amid a broadening global recovery. Fatigue with the US economic story suggests that, at best, we expect to see a pretty quick rise and fall in the USD as a result of the GOP Tax Bill.



EUR: Return of the Mack (Mark Morrison)

- We've gone a bit more retro with our song choice for the EUR - not least because our constructive outlook for the single currency is reminiscent of the good old pre-crisis days of greater European integration. 2017 has seen the return of a strong EUR - with its comeback driven by both the start of ECB policy normalisation and positive sentiment over what the Merkel-Macron axis could mean for the future of the Eurozone.
- These two forces have worked together to make the EUR fundamentally 'Harder, Better, Faster, **Stronger' (Kanye West)**. And our message to investors in 2018 is to embrace the strong euro; the next major catalyst for a move higher will be when markets position for higher ECB deposit rates - and this story could see EUR/USD rallying to 1.25 by summer 2018.
- But equally, with "mo' money" comes "mo' problems" - and a stronger euro doesn't come without any economic consequences for European policymakers. Our estimates suggest that only a sharp rise in EUR/USD above 1.25 over a short period of time (say 1Q18) would test the ECB's 'pain threshold'. This scenario, however, would be unlikely in the absence of any disorderly Eurozone bond market moves or an externally driven downturn in the global risk environment.

GBP: Livin' on a Prayer (Bon Jovi)

- Much like Tommy in the song **Livin' on a Prayer (Bon Jovi)**, the pound has been down on its luck amid a tough post-Brexit referendum backdrop. But the year ahead should see GBP bulls holding onto what they've got - especially now that we're technically 'halfway there' when it comes to resolving Brexit.

- While the next stage of Brexit negotiations will be much more testing for our positive GBP call - and may require living on a prayer at times - we do have **Faith (George Michael)** that politicians are on a path to delivering an economically rational Brexit. A transition deal until at least the end of 2020 - and the partial reduction in uncertainty that this brings - would help alleviate the cliff-edge fears of UK businesses. This could see some of the cyclical pessimism over the UK economy priced out of GBP - although the semantics of a transition period matter for how forceful any positive GBP re-rating story will be. We have a conviction call for GBP/USD to move up to 1.40 in 1Q18 - and we outline the logic underpinning this in our recent note GBP: Brexit Breakthrough.
- Despite our constructive view, it would be remiss to claim that **The Only Way Is Up (Yazz)** for the pound - especially when taking stock of the fragile UK political backdrop. While it doesn't appear that Theresa May will be **Walking Away (Craig David)** from all the Brexit and domestic political troubles in her life, any factor that meaningfully pushes us closer towards a WTO trading relationship with the EU - especially in the absence of an agreed transition deal - could mean that it **All Falls Down (Kanye West)** for GBP next year. However, a UK general election in 2018 is not ING's central scenario - meaning that for now, GBP's tail risks remain just that - *tail* risks.

JPY: Stuck on Repeat (Little Boots)

- The factors driving the Japanese yen have been **Stuck on Repeat (Little Boots)** for some time now. If there's one currency set to come under short-term pressure from rising US yields it's the JPY; while this has been evident this week, we do expect the window for USD/JPY upside - beyond the 115 level - to slowly close in early 2018.
- Despite a pick-up in the global economy, we suspect long-run Japanese inflation expectations may struggle to move higher ahead of the 2019 sales tax hike. This could see Japan fall into the familiar cycle of declining inflation expectations, real JPY rates increasing and Japanese policymakers having to accept unwanted yen appreciation. Moreover, with JPY retaining its status as the safe-haven currency of choice, any lingering risk-off concerns could also fuel a stronger currency. We look for USD/JPY to remain in the 110-115 range for 2018, with outside risks of a correction towards 100-105 area (our fair value estimates) later in the year.

And the rest...

- **CAD - The Tide Is High (Blondie... or Atomic Kitten if you're a 90s baby).** The Canadian dollar has been one of the outperformers this year, although its sharp 10% rally since bottoming in May was partly an unwind of political and financial stability concerns. NAFTA risks mean that the tide will remain high for the CAD early next year - although we do expect the currency to hold on given that we believe such risks have already been adequately priced in. This suggests that USD/CAD will bounce side-to-side around the 1.27 anchor point in 1Q18. Beyond this, we do see CAD as the darling of the dollar bloc amid an outperforming Canadian economy, the resumption of the BoC's hiking cycle and reduced sensitivity to supply-driven oil price moves. USD/CAD medium-term bias is towards 1.20.

- **AUD - Carry Out (Timbaland ft. Justin Timberlake).** One of the big themes for the Aussie dollar of late has been its depleting yield advantage - and we expect this to continue with the Reserve Bank of Austraila happy to sit tight on policy normalisation. With the domestic economy stuck in 'lowflation' mode, the necessary inflation signals to trigger an RBA re-pricing may not arise until 2H18. Australian politics are unlikely to actively weigh on the currency, although the latter half of 2018 may also see a narrowing focus on the 2019 Federal Elections - which could act as a limiting factor for any upside. We've got AUD/USD stuck in the broad 0.75-0.80 range for most of 2018.

- **NZD - Spinning Around (Kylie Minogue).** It's a bit cheeky using a song of Australia's 'Princess of Pop' to describe our New Zealand dollar outlook. But like the AUD, the combination of political risks and financial stability concerns have reduced the speculative carry attractiveness of the NZD. However, on both of these fronts, the worst may be behind us - and we believe the resilient economic outlook will at some point trigger a hawkish RBNZ re-pricing. Timing this next year is key - and it may not be until 2Q18 before NZD/USD moves meaningfully back above 0.70. Before this, expect the NZD to be spinning around against a backdrop of gently rising G3 yields and mixed domestic signals.
- **CHF - Low (Flo Rida ft. T-Pain).** The Swiss franc is going 'low, low, low, low, low...' in 2018. That's definitely the Swiss National Bank's desire - with the central bank probably welcoming the latest breakout higher in EUR/CHF above 1.17. Given our positive EUR story as well next year, we expect EUR/CHF to head back to 1.25 - albeit acknowledging that this isn't as big a move as the headlines suggest given that it would take the real CHF trade-weighted index back towards levels that existed prior to the start of the Eurozone crisis in 2009/10.
- **SEK - Complicated (Avril Lavigne).** 'Why do you have to be so complicated' is certainly what currency analysts like ourselves have been screaming when it comes to the Swedish krona in 2017. When you look at the core macro fundamentals of the Swedish economy, there's very little to suggest that the SEK should be trading at post-crisis lows against the EUR. But as Jonas Goltermann and Petr Krpata have been noting, a mix of technical factors in the local rates market - as well as housing-related financial stability concerns - have kept the SEK weaker than economic logic would dictate (see here and here). We are looking for a one-off adjustment higher in an oversold SEK early next year - which should take EUR/SEK back to 9.50-9.60 (see here for more details).
- **NOK - Patience (Take That).** Despite a hawkish Norges Bank surprise last week - which saw the central bank significantly bring forward its expectations for the first rate hike - the Norwegian krone also remains under year-end pressure (see here). Petr Krpata thinks that the trough in the NOK decline will come soon, although the cheap krone lacks any major catalysts for a big rally. Patience is required, but we're looking for a very gentle and gradual decline in EUR/NOK throughout 2018 - and target a move back to the 9.40 area by the end of next year.

This will be our last FX note for 2017. We wish you a very Merry Christmas and a Happy New Year. Normal service resumes Wednesday 3rd Jan 2018.

Author

Viraj Patel
Foreign Exchange Strategist
+44 20 7767 6405
viraj.patel@ing.com

Chris Turner
Global Head of Markets and Regional Head of Research for UK & CEE
chris.turner@ing.com

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