THINK economic and financial analysis

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Loving lowflation: Our latest FX views

The failure of price pressures to emerge, even in mid-to-late cycle economies, is being welcomed by investors. Risk-free benchmark rates remain near ultra-low levels and may not be seriously challenged until later in the year. For FX markets, a mostly neutral dollar outlook means investors can chase growth or re-rating stories.

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By Chris Turner

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Source: Shutterstock

EUR/USD: Trading the taper

EUR/USD is starting to trade consistently above levels typically associated with short term interest rate spreads. We attribute that to speculation of ECB tapering this summer. We think the ECB will have to provide updates on the PSPP scheme either at its 20 July meeting or more likely its 7 September meeting. We have a baseline view that Bund yields break higher in 3Q17, carrying EUR/$ to 1.15.

In the US, rates and ineffective Trump policy are holding the dollar back. On rates, there is a huge gulf between market pricing of Fed Funds at end 2018 (+40bp) versus Fed Dot Plots (+100bp). The balance of risks to US activity/inflation points to the Fed moving to the market – and not vice versa. This is neutral/negative for USD.

European political risk has ebbed, but Italian elections in 1Q18 may restrain EUR/USD strength – delaying the 1.20 story until 2Q18.

1.20 12-month EUR/USD forecast

USD/JPY: Shackled to the US long bond

USD/JPY continues to trade tightly with US ten year Treasury yields. We tend to think the latter could be finding a base in the 2.10/15% area and particularly by the end of 3Q17 look for yields to have picked up to the 2.50% area. This may owe largely to passage of some modest reflationary fiscal policy ahead of the new US fiscal year (starting in October) and some modestly better US activity data. A break-out in US price pressure looks uncertain.

Thus if there is any further cyclical dollar strength to be seen, we believe it will be seen largely in USD/JPY.

In Japan, activity is quietly picking-up and the BoJ is of the view that a 'virtuous circle' is in place. Yet a large output gap and inflation at 0% versus a target of 2%+ will keep the BoJ at the back of the pack when it comes to normalising policy.

118 12-month USD/JPY forecast

GBP/USD: Cheap, but cheap for a reason

GBP is softer on the back of a disastrous UK election performance by the ruling Conservatives. Having lost their majority, the Tories now rely on 10 Northern Irish DUP members to pass key votes – the first of which will be the vote on the Queen's Speech (the government's planned legislation) on Wednesday, 21 June. While Theresa May's Hard Brexit has been rejected by the electorate, securing a soft Brexit, or securing any legislation whatsoever looks very challenging with this very weak government.

The fact that GBP has not fallen further largely owes to GBP undervaluation (around 25% versus USD) and one of the key reasons we think Cable will bounce back later this year.

Yet the UK economy looks weak (full year growth 1.5%) and we think the 3 external MPC members voting for a hike should be ignored.

1.41 12-month GBP/USD forecast

EUR/JPY: 130 here we come!

EUR/JPY is staying quite bid despite a variety of geo-political challenges. We retain a high conviction view that EUR/JPY is about to embark on a major bull trend – largely on the back of a view that the world economy is recovering and that the normalisation of central bank monetary policy will be a key theme. For 2H17, we think that ECB policy normalisation will trigger a break-out in Bund yields – probably lifting US yields in the process. At the back of the pack will be the BoJ, who should keep JGB yields stable near 0% into year-end.

There is also the prospect that France and Germany could push for stronger Eurozone integration after German elections in Sep.

We compare the current environment to 2005-2007 – where synchronised global growth & ECB hikes helped EUR/JPY higher

142 12-month EUR/JPY forecast

EUR/GBP: 0.8800/0.9000 looks the top of range - but many risks

EUR/GBP has once again met resistance over 0.88, despite a collection of GBP negatives building – particularly a weakened government that may not be able to deliver anything. Indeed, well-intentioned calls for a cross-party approach to Brexit look naïve – with both Labour and the Conservatives unlikely to reach compromise. Labour looks more focused on bringing down the Tory government – and early elections, or at the very least a new Conservative leader, look likely this summer.

The GBP bull case relies on a) GBP being undervalued (we agree), b) a government being able to deliver a softer Brexit (very uncertain at this stage).

A strong EUR in 3Q17 should see EUR/GBP test 0.88/0.90 – and an uncertain political outlook favours high GBP hedge ratios.

0.85 12-month EUR/GBP forecast

EUR/CHF: Sluggish reaction to reduced EZ political risk

The removal of French Presidential risk has been greeted by EUR/CHF with a move back to levels seen last October. We would expect some of this year's safe haven purchases of CHF to soon reverse. SNB data show that foreigners acquired an extra CHF20bn in CHF sight deposits in the first 3 months of this year. It would be no surprise to see it unwind.

Domestically the SNB are still focusing on spare capacity and inflation not sustainably moving above 1% until 2019. We suspect the SNB will eagerly await the ECB tapering debate – and having chosen to abandon the floor in the face of forthcoming ECB QE in early 2015, will be expecting a EUR/CHF rally on ECB tapering.

Italian elections will prove a risk in 1Q18, but for the rest of 2017 we see momentum behind EUR/CHF and are raising our forecasts.

1.12 12-month EUR/CHF forecast

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Source: iStockphoto

USD/BRL: Political woes partly offset by stronger fundamentals

Political risk intensified again in Brazil, with President Temer perilously hanging onto power amid new corruption allegations. Considering the uncertainties associated with another change in power in Brazil, the selloff in local assets has been relatively mild.

The BRL remains vulnerable but it is supported by the stronger fundamentals seen in external accounts and inflation. The CB also has enough firepower for FX intervention to stabilize the BRL, should demand for FX hedge surges in the coming weeks/months.

Still, the political crisis has clearly harmed prospects for fiscal-enhancing reforms and, as a result, for a robust economic recovery. The monetary easing cycle should continue, albeit more tentatively, assuming the USD/BRL does not overshoot towards 3.5, staying around its medium-term equilibrium, close to 3.2-3.3.

3.30 12-month USD/BRL forecasts

USD/MXN: Making a full recovery from Trump

The MXN outperformed its LATAM peers in recent weeks, becoming the chief beneficiary of the supportive risk appetite for EM FX in the region. For now, the carry seems high enough to compensate for the peso's chief medium-term risks: the NAFTA update and the final outcome of the 2018 presidential race.

Further appreciation is likely if appetite for EM FX remains robust, especially as more cautious investors should continue to shun exposure to Brazilian assets, amid that country's fragile stability.

The higher hedging cost could make the MXN more vulnerable to bouts of risk aversion later in the year, however. NAFTA negotiations will intensify later in 2H while political risk (moderate for now) could intensify after the turn of the year, if polls suggest leftist firebrand Lopez Obrador could win in the July 2018 ballot.

19.00 12-month USD/MXN forecast

USD/CLP: Easing cycle concluded as economy seen stabilizing

The CLP traded within a relatively narrow range in recent weeks, broadly following the outlook for copper prices, which returned to levels seen earlier in the year after plunging early May.

Disappointing domestic drivers had also been weighing on the currency's performance this year but, despite the weak GDP data seen for 1Q, the stabilization of mining output, with the end of the labour strike, along with the lower inflation suggest that domestic drivers could turn more construction from now on.

The CB cut the policy rate again in May, for a total drop of 100bp this year, to 2.5%, and announced that the cycle has been concluded. The bank should maintain a neutral forward guidance, indicating that rate hikes should take a long time to materialize given the benign inflation and lukewarm economic growth.

680 12-month USD/CLP forecast

USD/COP: COP tracks oil as BanRep extends easing cycle

High volatility continues to mark the COP market, with the currency closely tracking oil price trends and, as a result, underperforming its regional peers in recent weeks, as oil prices dropped to levels close to the lows seen in the past year.

Underlying COP fundamentals remain solid, thanks to the ongoing correction of the current account deficit, but the outlook for fiscal accounts turned less constructive on the back of the weaker-than-expected economic activity and the proposed increase in government spending, which largely reverses the fiscal improvement envisaged by the VAT tax increase.

With inflation expectations gradually falling towards the target, BanRep should be able to extend the rate-cutting cycle, with the policy rate returning to the 5.5-5.0% range, from 6.25% now.

2900 12-month USD/COP forecast

USD/PEN: Sideways with mixed drivers

The PEN traded within a narrow range in recent weeks, in line with the mixed performance seen across the metals that compose its export basket (e.g. gold and copper). The currency preserves the bulk of the substantive gains seen since mid-January.

Peru's central bank surprised a majority of analysts by cutting the policy rate in May, while maintaining a cautiously dovish forward guidance. With the inflation outlook improving following the recent food-supply shock, the easing cycle should resume, after the pause in June, with the policy rate dropping towards 3.0-3.5% from 4% now.

Despite the more lukewarm prospects for GDP growth, Peru's fundamentals stand out, thanks to the ongoing rebalance in the current account and superior fiscal sustainability metrics.

3.22 12-month USD/PEN forecast

USD/ARS: Welcoming Brazil's FX market contagion

BCRA authorities should have welcomed the contagion in the ARS market triggered by Brazil's political crisis and the BRL selloff. The bank had recently announced a new FX accumulation policy, aiming to boost reserves to about 15% of GDP and, also, to help prevent the ARS from strengthening too much.

The ARS has since stabilized and shown less sensitivity to BRL moves, but the risk of sudden shifts in the BRL, triggered by new developments, has increased to risk to ARS positions, reducing the appeal of the carry trade, as the CB apparently intended. Still, FX inflows (e.g. external debt issuance) should remain supportive.

Inflation pressures finally eased somewhat, reducing the pressure on BCRA to raise rates and helping consolidate expectations of a faster GDP growth this year, of close to 3%.

16.65 12-month USD/ARS forecast