

January FX Market Blues

Global FX markets look to be suffering from a bout of January blues - sluggish, tired and lacking any clear direction. Here are our latest thoughts after the first full week in 2018



Viraj Patel talks about the FX blues on Bloomberg TV

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USD: Predictability of Fed and unpredictability of Trump is a bad combo

The unpredictability of an 'America First' Trump is a key pillar of our bearish USD view

- One of the reasons we have cited for our strategically bearish USD view in 2018 is the markets' relative under-appreciation of the fragile US political backdrop in a mid-term election year.
- These political risks lie deeper than the noise around Michael Wolff's 'Fire and Fury' book; a change in America's status in the world political order may have long-run economic consequences for a country reliant on 'the kindness of strangers' to fund its twin current account and fiscal deficits.
- For a US economy in the latter stages of its economic cycle, such structural risks – coupled with the ambiguous economic and repatriation effects of the GOP Tax Bill, relative US asset valuations and the better goldilocks investment opportunities outside of the US – are why we retain a bearish view on the broad US dollar index over 2018.
- **The latter two factors, in particular, explain why we think the USD will lose its role as an investment currency** – and trade under new rules where an environment of rising US rates no longer guarantees dollar strength. Greater synchronicity across bond markets amid a broadening global economic recovery is one factor we've touted before.
- **But equally a fragile US political environment ahead of the November midterms also reduces the USD's investment appeal.** President Trump's State of the Union speech later this month could be a defining moment for markets in 2018. We would view a more anti-trade, 'America First' policy focus as negative for the USD – especially against the current account surplus currencies like the EUR (year-end target of 1.30) and JPY (outside risks of moving below 110).
- **While unconfirmed reports that China is looking to reduce its US Treasury holdings added fuel to the start of the year sell-off in global bond markets yesterday,** we remain somewhat reluctant to add this to the current list of reasons for upside risks to global bond yields (ie, rising inflation expectations due to higher oil prices and global QE taper talk).
- **Chinese government officials have since played down these reports – noting that they are merely looking to diversify their FX reserve holdings.** But the reasons for doing this are an equally telling sign of the USD's medium-term attractiveness – and not too dissimilar to the broader reasons (noted above) for why global investors are slowly looking to rotate out of US assets.

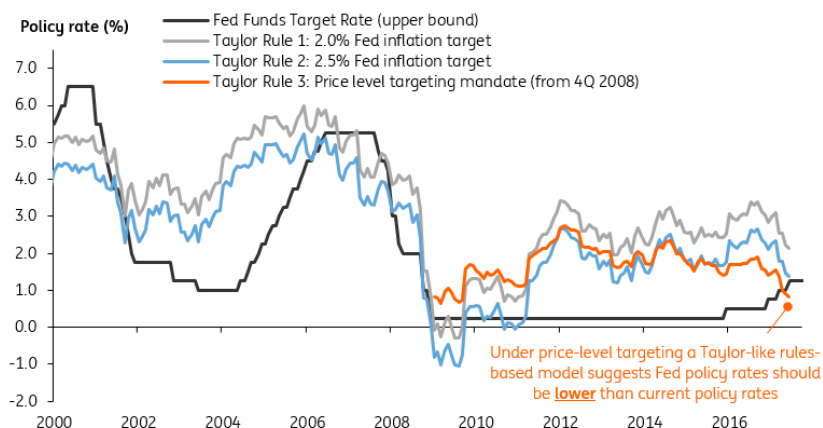
Predictable Fed policy will be a bore for the USD in 2018...

- **The logic of Fed tightening = a stronger USD is so 2014.** Exchange rates thrive on unpredictability and mispricings– and therefore monetary policy as a driver for currencies packs more punch in economies where the gap between actual policy rates and neutral interest rates is the biggest. For the US, if one were to view terminal rates to be around 2.0-2.5% – markets are largely pricing this in. Debating over a few hikes here or there won't set a new trend for the dollar.
- **Plus, for some time now, the skew within markets has been to bet against a hawkish Fed** given (a) the central bank is inherently risk-averse; (b) there is no consensus ideology within the FOMC on the US economy; (c) the Fed hasn't consistently met its inflation goal since 2012.
- **The latter has meant that the Fed is now actively discussing possible future changes to its policy framework** – with concepts like price-level targeting being considered. So long as the debate remains on this (dovish) side of the spectrum, we expect the downside skew around US rates to stay in place – and the Fed to be a redundant factor for the USD in 2018.

... only a Fed policy regime shift can cause a fundamental change in the USD outlook

- **US monetary policy can only be a factor for the USD in 2018 if we see a major regime shift** – or something that causes a split Fed moving cohesively towards either the dovish or hawkish spectrum. Neither tail risk seems likely under a Powell-led Fed – where continuity seems to be the most likely path forward.
 - **On the hawkish side, the tail risk is that we see the appointment of strong hawks to the four open Fed Governor positions.** Even though hypothetically this may create a bit of short-term noise in markets, we think the hard economic data will ultimately prevail the economic ideologies of new policymakers.
 - **On the dovish side, the tail risk is if the Fed were to take its symmetric inflation mandate more strictly** and embrace the idea that constant missing of its 2% target requires a more gradual policy approach than currently signalled. This was indeed flagged in the FOMC minutes – with some members stating that the Fed should consider studying alternative frameworks such as price-level targeting.
- **Based on Taylor-like policy rules, we estimate that a switch to a de facto price-level targeting mandate would be a dovish move – and would imply even lower for longer US policy rates.** While one may see any shift towards price-level targeting anytime soon as unrealistic, speculation about this move is likely to keep the Fed inherently dovish – while global markets can afford to remain bearish on US rates and the US dollar.

Are the Fed doves right to be worried about hiking rates despite constant inflation misses?
Taylor-like rule looking based on a price-level targeting mandate suggests... Hell Yeah!



Source: ING FX Strategy | @VPatelFX

Source: Bloomberg, ING FX Strategy estimates

EUR: ECB's path of least resistance will be a 'gradual' EUR/USD rally to 1.30

- **We're expecting stability in EUR/USD around the 1.20 level over the coming months – given the lack of obvious directional catalysts.** Muted Eurozone inflation data and the run-up to the Italian elections may act as limiting factors for the EUR. But this should not mask the broader fundamental reasons for a stronger EUR in 2018: (1) above-potential Eurozone growth, (2) greater European integration, (3) structural and financial reforms and – most importantly – (4) the markets' general underestimation of the pace and extent of ECB policy normalisation.
- **All of this means that we're looking for EUR/USD to gravitate towards 1.30 by end-2018 –**

and for us, it's more a question of how, not if, we get there.

- **The ECB's path of least resistance will be a gradual appreciation in the EUR.** Our estimates show that the central bank's 'pain threshold' – that is the point at which currency appreciation starts to weigh on the real economy – is a sharp move above 1.25 this side of summer. Any negative effects would be exacerbated if we also saw an overall tightening of financial conditions (ie, higher bond yields and lower equity prices). With policymakers likely to be wary of this – we expect to see fairly neutral ECB rhetoric.
- **Easing of short-term political risks and a resilient Eurozone economy should give way to a higher EUR.** We expect forward-looking FX markets to price in the ECB's next policy steps this summer (call it Sintra Part II)– and that will see EUR/USD trading at 1.25.
- **While the USD's role as a global currency may start to come into question, one story we could see making a comeback in 2018 is greater sentiment for the EUR as a reserve currency.** Since 2010 – we've seen the share of EUR reserves held by global central banks fall from 28% to below 20%. This is a pretty big move for something that is usually quite static over time. Eurozone political risks and the slower post-crisis economic recovery were two factors behind this decline; but with both of these set to reverse course in 2018 – there's a strong chance you'll start to see real money investors once again favouring the EUR as a safe, investment currency.

GBP: Looking for GBP/USD at 1.40 as UK economy regains some of its swagger

Pound to shake off Brexit blues and hit \$1.50 this year

- **It's a striking headline – but one that requires some context:**
 - First, the breakdown of this move is a 3% appreciation in the pound, and a 7% depreciation in the US dollar against European currencies. In fact, when looking at the pound in trade-weighted terms, 2018 will be largely a bottoming-out story – with a gently recovering bias (as long-run Brexit risks partly unwind).
 - Second, given the unique uncertainties that come with long and complex Brexit negotiations – and not in possession of a Brexit crystal ball (who is?) – any directional calls on the pound are being reassessed on a rolling basis. Our conviction call is for GBP/USD to move up to 1.40 by the end of 1Q18. That's based on a positive reassessment of the UK economy – and a one-off hawkish re-pricing of Bank of England policy expectations.
- **“Less Noise, More Poise” is our motto for GBP in 2018 and its resilience in recent weeks somewhat encapsulates this sentiment.** While progress during Phase II of Brexit negotiations – and subsequent clarity over the UK's new macroeconomic and trading paradigm – will be the overarching theme dominating GBP's direction of travel in 2018, we see two factors dictating the pound's narrative in the short-term: (1) UK politics and (2) the Bank of England's policy path.
- **On the former, we believe noise around a fragile Tory government may act as a limiting factor for the currency – but note that the bar to actively sell the pound on UK politics remains high.** This has been evident in GBP positioning data; while speculative investors have turned net long in recent months, this adjustment in positioning has been mainly

driven by GBP shorts bailing – which suggests to us that the attractiveness of selling GBP has been fading in the absence of any factor that could seriously delay Brexit talks and push the UK closer towards the March 2019 cliff-edge. In terms of UK politics, only a 2018 General Election may feasibly see such risks being priced into GBP. This is not our base case scenario.

- **We prefer to focus on potential catalysts for a positive reassessment of the UK economic cycle and a hawkish re-pricing of BoE policy expectations.** We cite two non-mutually exclusive factors – an agreed Brexit transition deal by 1Q18 and positive surprises in UK economic data.
- A combination of these factors could bring into play a 1H18 BoE rate hike (most likely May). Our conviction call is for GBP/USD to rally up to 1.40 on this story, with EUR/GBP moving to 0.85-0.86.

JPY: Case fading for USD/JPY moving higher... outside risks of 100-105 this year

- **Way too premature to be calling for a BoJ policy shift.** We are potentially seeing an over-reaction and misunderstanding of the central bank's bond-buying programme. In a Yield Curve Control (YCC) world, the focus is on price (yield target) – not quantity. So one should refrain from extrapolating policy signals from any changes to the amount of monthly bond purchases.
 - For example, these can easily be increased if JGB yields for whatever reason deviate from the desired target level.
 - Plus lower monthly purchases are not new news. This idea of 'stealth tapering' has been going on for some time now – the BoJ only bought 60 trillion yen worth of JGBs from October 2016 to October 2017 (versus the conventional 80trn yen annual purchases). We expect this to continue – especially against the backdrop of an orderly global bond bear market.
- **Raising the yield curve target – and allowing for the JGB yield curve to steepen a bit more – is not an unrealistic scenario in 2H18.** It would require the domestic Japanese economy remaining resilient, but also seeing (a) other major central banks normalising policy and (b) the global risk environment staying positive. The latter two factors would help to avoid a sharp appreciation in the yen – which is something the BoJ would be wary of engineering themselves.
- **But equally there has been a positive Japanese economic story unfolding over the past year – and the lack of observed JPY weakness may in part be down to this.** Certainly, in the context of positive GDP surprises and stubbornly low inflation, Japan is looking like less of an economic outlier these days – and the local macro story doesn't make the JPY an obvious sell anymore.
- **For us, the case for USD/JPY moving above 115 is fading.** Not least, you have the USD trading under new rules – such that higher US yields don't guarantee dollar strength. But also the domestic macro story, potential BoJ tightening story and potential turn in the risk environment mean that the catalysts for USD/JPY downside are beginning to stack up.
- **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 estimate) later this year.

CNY: Fade the noise, PBoC want FX stability but have some tolerance for upside

- **China has arguably, and unexpectedly, stolen the market spotlight for two days in a row now.** On Tuesday, it was news of the PBoC removing its countercyclical factor from its daily USD/CNY fixing mechanism. Despite the initial negative reaction, we actually believe that the move should be interpreted as a positive one for the medium-term CNY outlook – not least given that it signals a level of comfort over the PBoC's efforts to liberalise its FX regime.
- **But as with the China Treasuries story, we doubt noise around the removal of the counter-cyclical factor has altered the general trend.** Sure, with a more open capital account - and slightly more liberal FX policy - we may see greater two-way flows. But with FX and broader market volatility likely to stay structurally low, the risks of large swings in USD/CNY are trivial.
- **At best, the PBoC is willing to tolerate just a bit of appreciation pressure in the Renminbi this year** – and in a weakening USD environment, we expect USD/CNY to gently nudge lower to 6.30 by year-end.

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