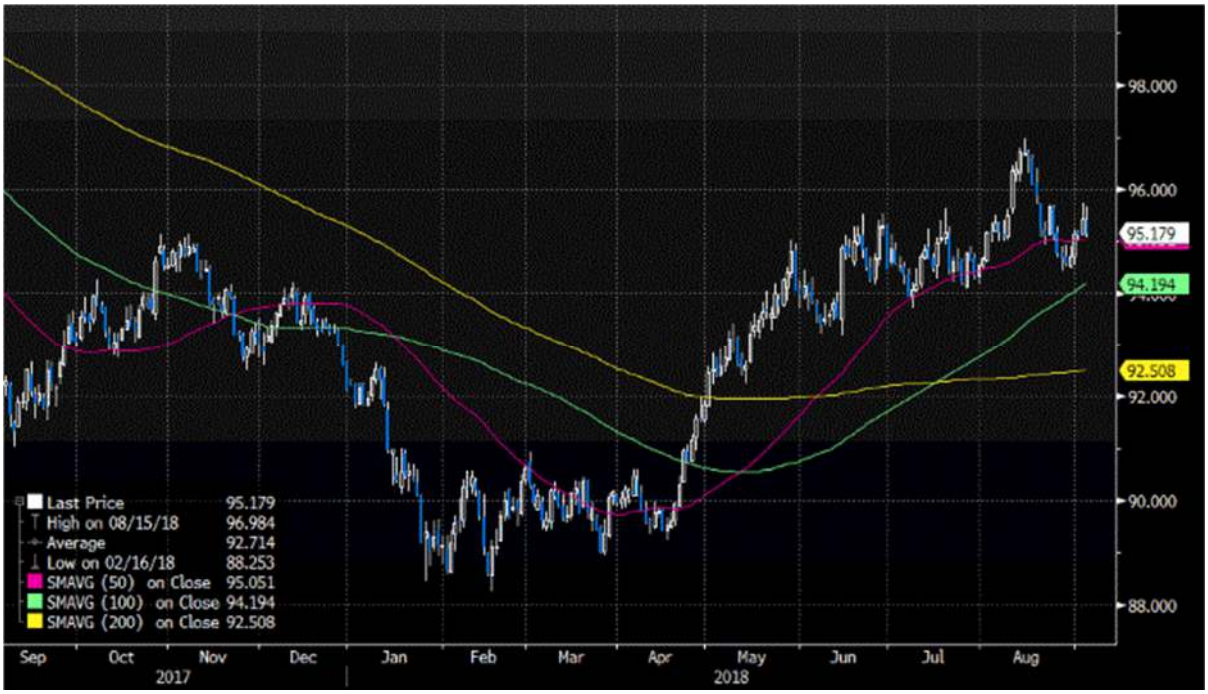
September 5th, 2018

September 2018 FX Outlook

The USD enjoyed a period of strength in mid-August helped by a generally risk negative tone rooted in uncertain global trade relations and unrest in the emerging markets and triggered by events in Turkey. Concerns about the impact of Turkish problems on global markets had largely dissipated by month end, and the USD finished the month only marginally higher. While the issues around Turkey have not gone away and there are still some dangers of contagion, even the biggest European bank exposures seem unlikely to be a major threat to stability. But the Trump reaction to the Turkish crisis and the threat of further tit-for-tat tariff increases with China continue to cast something of a shadow over global markets, with most forecasters reducing global growth expectations in response. August also saw continued anxiety over Brexit negotiations, and this seems likely to increase in September coming into key events in October. In the absence of major news, the markets are well supported by generally positive current economic news, despite some recent evidence of mild slowdown, but worries about trade, Brexit, and emerging market fragility seem likely to prevent any major breakout of optimism for the moment.

One-Year DXY:



Outlook for September

1) Trade wars and other geopolitics

Turkey was the biggest news in August, with Trump's doubling of steel and aluminum tariffs adding to Turkey's already significant problems with their current account deficit and foreign debt. But by the end of the month the focus on Turkey had faded a little as analysts assessed that the dangers of contagion were quite modest, even though the weakness in the currency had increased the default risk on foreign currency denominated corporate debt. The trade deal reached between the US and Mexico also helped to lift the mood a little. But reports of a Trump plan to raise tariffs on another $200bn of Chinese goods hit markets at the end of the month and looks likely to be high on the agenda early in September, with Trump threatening formal action as early as September 6. More retaliation would be likely from China if these come into effect. For now, the USD still seems to be benefitting from trade concerns – at least against European and EM currencies, but if the trade war threatens to lead to a growth slowdown and a downgrading of US rate expectations USD strength may not persist for long.

2) UK politics and Brexit

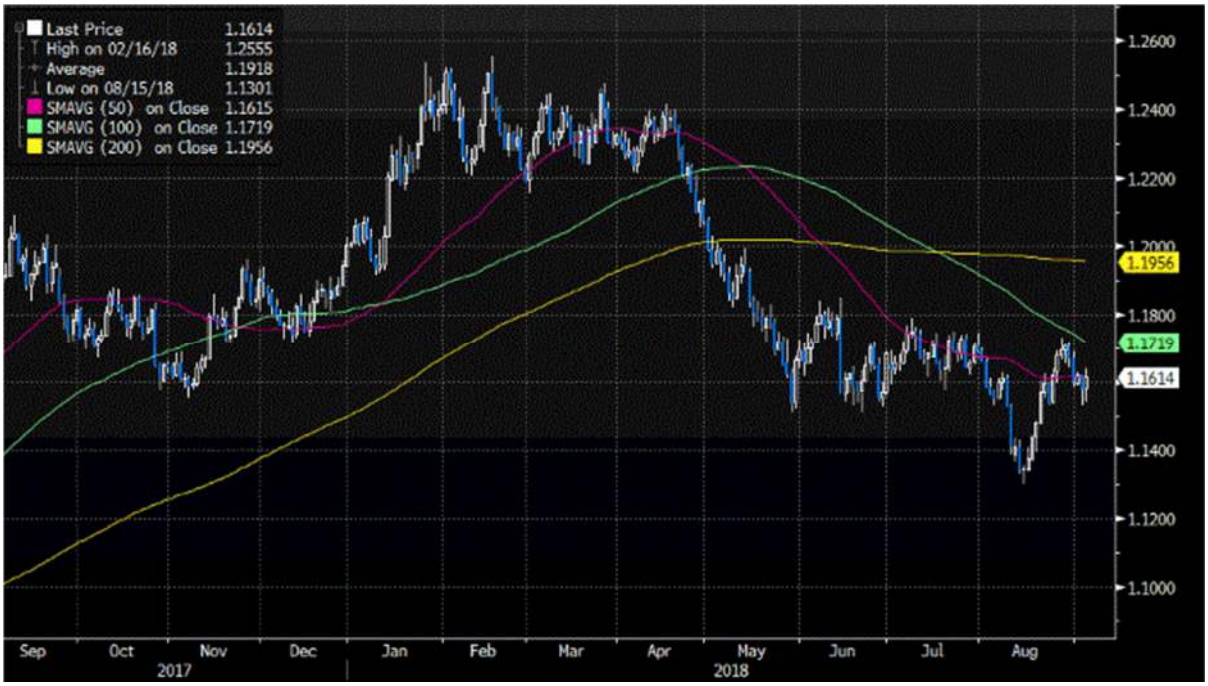
Uncertainty about Brexit continues, but the lack of real progress means that hopes of settling an exit deal by the October EU Summit have now fallen away with reports that the deadline has now been unofficially extended to November. There is an EU summit in Salzburg in September and unless there is clear progress there, hopes for a deal by October will dissipate further. The Conservative Party conference in early October may prove problematic for PM May if it the September summit breeds expectations of a "soft" Brexit deal. There are already major divisions in the party with May's "Chequers plan" seemingly having insufficient support from the party, parliament, public opinion or the EU, but it is unlikely at this stage that the Conservative Party is ready for a leadership challenge. Nevertheless, the second half of the month looks like it has potential for Brexit related volatility in the run-up to the October EU Summit, helped also by growing support for a second Brexit referendum.

Currency Outlooks

EUR/USD

EUR/USD broke lower in mid-August to its lowest level since June 2017 in response to the Turkish crisis. Concern centered on European banks exposed to Turkish corporate debt, but the consensus that emerged was that the risks were not sufficiently large to cause a major banking crisis. So although the concerns about Turkey were enough to trigger a break of the 1.15 support in EUR/USD, the break was not sustained and EUR/USD returned to the 1.15-1.18 range by the end of the month as markets took a more sanguine view. Nevertheless, there remains major resistance to EUR/USD gains in the 1.175-1.1850 area, and some clearly positive news from Europe is likely to be necessary to break above this level. With the market seeing negative news on global trade – including US spats with China – as positive for the USD, current concerns about more US tariffs look likely to mean the risks are still to the USD upside in September. A retest of the lows in the 1.13 area would therefore not be a surprise, but there is very strong support for EUR/USD in the 1.10-1.12 area, and it would likely require some clear negative news from Europe – either on Brexit or possibly on Turkey related issues – for this area to be broken.

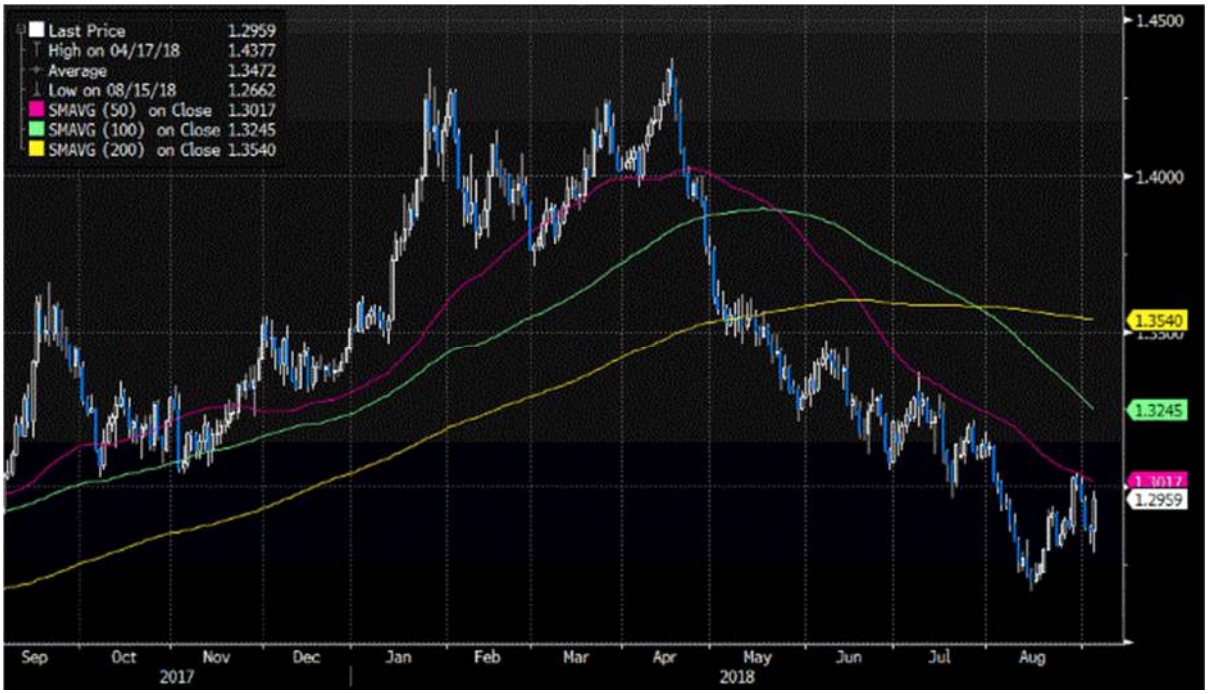
One-Year EUR/USD:



GBP/USD

Brexit uncertainty weighed on GBP through most of August, with both the UK government and the EU emphasizing the need to prepare for a “no deal” Brexit. While this should be understood to be a negotiating position from both sides, to emphasize that they are ready to take a “no deal” rather than accede to an unfavorable deal, the concerns about the potential breakdown of talks did push EUR/GBP to its highest level since September 2017 and GBP/USD to its lowest level since June 2017, though GBP/USD weakness was partially due to USD strength. GBP/USD recovered at the end of the month helped by a statement from chief EU negotiator Barnier saying he was prepared to offer the UK a partnership “like there has never been with a third country”. But he also made it clear he would not weaken the single market and the following day he warned that a “no deal” Brexit was still possible. The GBP recovery at the end of the month may therefore not extend into September unless there is some clear progress on achieving an exit deal – or alternatively some more momentum behind the campaign for a second referendum. There is good resistance for GBP/USD in the 1.31-1.32 area, and the risks look to be on the downside from here, both because of Brexit concerns and because USD risks still look to be on the upside because of global trade concerns. A clear agreement on an exit deal could be expected to trigger sharp GBP gains, but this looks unlikely before or even at the October Summit.

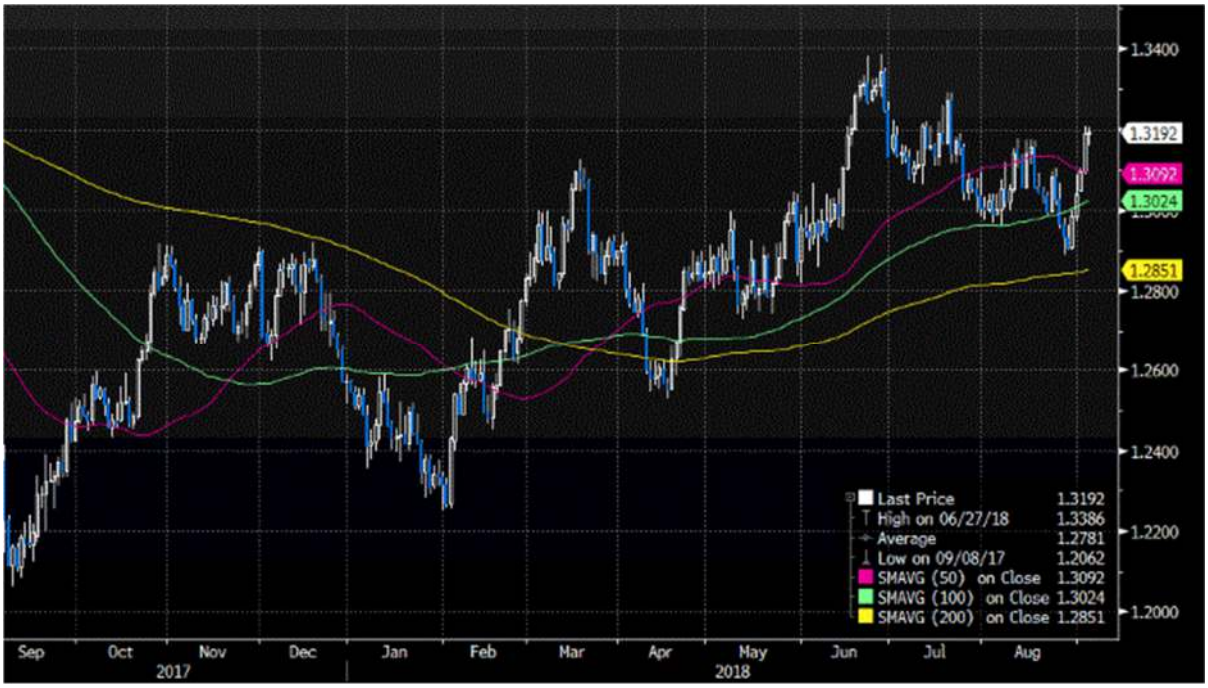
One-Year GBP/USD:



USD/CAD

Despite the lack of a US trade deal with Canada (in contrast with the US deal with Mexico), the CAD has held up relatively well through August, holding a 1.28-1.32 range and closing little changed on the month against a generally strong USD. US/Canada talks continue, and there still seems to be reasonable optimism that a deal can be reached despite some aggressive language from Trump. Some in Congress don't believe that the Mexican deal can be ratified by Congress without a Canada deal attached, so the lack of a deal with Canada may prove bad news for Mexico as well. There is an outside chance of a Bank of Canada rate hike on September 5, but it seems unlikely while trade negotiations are continuing, and most favor a move being delayed until at least October. As long as these issues remain undecided, the bias is slightly to the upside in USD/CAD, but a break through 1.32 should prove difficult without clear news. An announcement of a trade deal would put the 1.28 support under pressure.

One-Year USD/CAD:



USD/MXN

The announcement of a US/Mexico trade agreement ought to prove a positive for the MXN, but after initial MXN gains on the news, USD/MXN moved back above 19 as the USD made general gains, especially against emerging market currencies. Although the deal is good news for Mexico, two main factors are limiting the upside for the MXN. First, without a trade deal with Canada there is a risk that the agreement with the US is not ratified by the US Congress, which would kill any benefit to Mexico. Second, and probably more currency relevant in the short run, concerns about US/China trade are on the rise again with Trump proposing tariffs on a further $200bn of Chinese goods. Although this need not have any direct influence on Mexico, the negative sentiment it would engender about global trade and global growth and the consequent negative impact on emerging markets in general would likely weigh on the MXN as it did towards the end of August. The problems in Argentina also add to the impression of emerging market weakness. For the moment there should be good resistance for USD/MXN in the 19.40 area, but negative news on the prospect of a Canada deal or significant equity and emerging market weakness on the back of US/China concerns could trigger a break above here. Nevertheless, the MXN remains good long term value and anything close to 20 should be a selling area in all but the worst of scenarios.

One-Year USD/MXN:

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