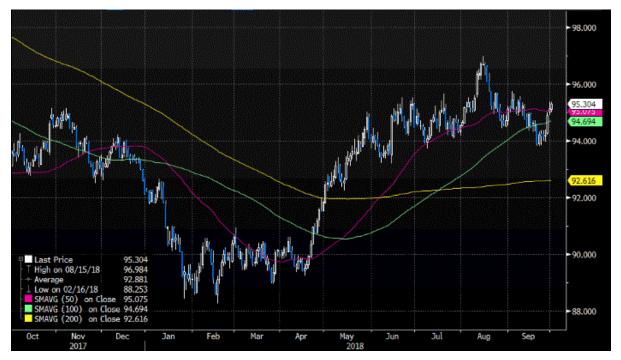


#### October 2018 FX Outlook

After a brief break higher in August in response to the situation in Turkey and global trade uncertainty, September saw the USD trade essentially the same range as July. The fading of trade concerns removed the bid from the USD in late August and early September, and the more positive equity market tone generally worked against the USD versus both emerging markets and the EUR and GBP, in part because of the correlation of European equity markets with emerging market equities. However, concerns about the Italian budget at the end of the month knocked the EUR back from the high end of its range and it finished little changed on the month. GBP held up relatively well against the USD helped by some strong UK inflation data and hawkish Bank of England rhetoric, despite a failure of Brexit talks in Salzburg to move the negotiations any closer to resolution. The USD performed best against the JPY, helped by the strength of equity markets. Coming into October, the Italian situation and Brexit are likely to be the primary focuses, while the last minute NAFTA deal and a rising oil price suggests a positive outlook for the CAD and MXN.

## One-Year DXY:



## **Outlook for October**

### 1) Italian Politics and Fiscal Policy

The EUR dropped at the end of September as the Italian government announced a deficit target of 2.4% of GDP for 2019 - above the market expectation for a more modest expansion of the deficit to less than 2% of GDP. The announcement appears to have been against the wishes of finance minister Tria - a technocrat brought in to provide some credibility to the populist government's economic policies - but for the moment, he seems likely to stay in government despite talk of resignation. Italian and European markets all reacted negatively to the news, with Italian equities falling more than 3% and Italian bond yields rising around 25bps, while other European equities also fell along with the EUR. Concerns about the impact of the populist government are likely to persist and are intensified by memories of the Greek crisis and the current Brexit process. While the 2.4% deficit target is within the 3% EU limit, the Italian debt level is well above the limit and the EU could use this to start the excessive deficit procedure if they think the deficit plans are not consistent with attempting to reduce this debt level. However, even if the procedure is started, it is a long process, and in the end is much less important than the market verdict on the sustainability of Italian debt. On this front it is hard to argue that the Italian situation is significantly serious, as yield levels and debt interest payments remain much lower than in the past, and even the deficit target itself is hard to get excited about, as the deficit has only been less than 2.4% of GDP in 3 years since 2000. Markets can get overexcited, but in this case it is hard to see this escalating any time soon.

## 2) UK Politics and Brexit

Brexit looms ever larger for the UK (and the Eurozone). The October EU summit this month was originally seen as the target for finalizing the UK withdrawal agreement, but after the failure to make progress at the smaller Salzburg summit last month, few now see an agreement at this month's summit, and even talk of a November agreement is starting to sound hopeful rather than realistic, as there seems to be little progress on the key issues – primarily how to deal with the backstop arrangement for the Irish border. The withdrawal agreement is not a trade agreement – it will only contain a very broad outline of the likely trade arrangements after Brexit – but it is necessary for trade negotiations to begin and the Brexit transition period until the end of 2020 to be agreed. Without it, the UK leaves the EU at the end of March 2019 without any continuation of the status quo of free trade and freedom of movement. Before the October EU Summit, Prime Minister May has to face the Conservative Party conference at the beginning of the month, in which there will no doubt be plenty of Brexit discussions. Currently, she is trying to stick to the "Chequers plan" but this seems effectively dead after the Salzburg summit and is in any case unpopular with the more committed supporters of Brexit. Without some shift in May's position, the possibility of a "no deal" Brexit with major negative implications for GBP becomes more real.

The oil price rose steadily in September and many are talking about a return to \$100 p/b for the first time since 2014. The primary cause is the renewed imposition of sanctions on Iran, with the second round of energy sector sanctions set to be imposed on November 4. While most expect some response of increased supply from Saudi Arabia, it is not clear how large this will be or whether it will be sufficient to compensate for the loss of Iranian supply. The oil price is consequently seen to be heading higher, at least in the short run, which should favor oil producing countries' currencies (e.g. CAD, MXN) as long as it doesn't have a serious impact on market expectations for global growth.

## **Currency Outlooks**

#### **EUR/USD**

EUR/USD has fallen back in the last few days due to concerns about the larger than expected Italian deficit target announced by the new populist Italian government. However, there seems little reason to expect EUR weakness to extend on the back of this story. Although there will be interest in the verdict of the EU Commission on the proposals when they are presented on October 15, any EU processes to sanction Italy will be slow and essentially secondary to the market's verdict. The Fed's rate hike at the end of September and the continued expectation of further Fed tightening underpins US yields and the USD against the EUR. However, the ECB is cutting its bond purchases from this month and if it confirms that it will end them in December at the October 25 ECB meeting the EUR is likely to get some support. Until then, the risks are for a break to the downside of the 1.15-1.18 range, but major declines are not anticipated.

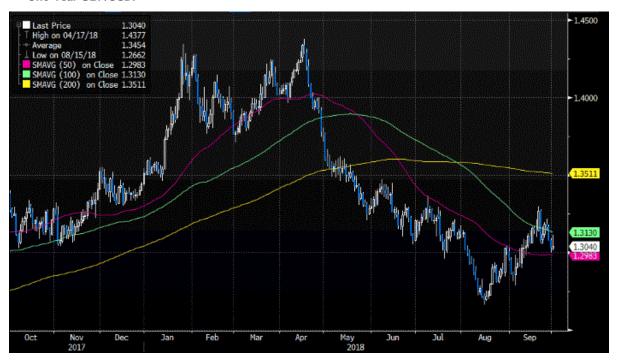
#### One-Year EUR/USD:



#### GBP/USD

GBP/USD has held up well in the face of continued and increased Brexit uncertainty, helped by stronger than expected UK August inflation data, but the Conservative party conference followed by the EU Summit this month makes it difficult to see much strength in GBP unless some progress is made on Brexit. At this stage, the main stumbling block of the backstop solution to the Irish border problem looks unlikely to be resolved this month, suggesting the upside for GBP/USD is capped in the short term, especially if EUR/USD continues to be biased lower. However, as long as the market continues to believe that a deal will be done, GBP/USD is unlikely to fall sharply on Brexit concerns, even though none of the potential deals look particularly positive for GBP longer term. 1.32 still looks like a near term ceiling for GBP/USD, and if fears of a "no deal" Brexit increase there are dangers of a dip to 1.25 or below, but as long as we remain in limbo 1.28-1.32 range should hold.

### One-Year GBP/USD:

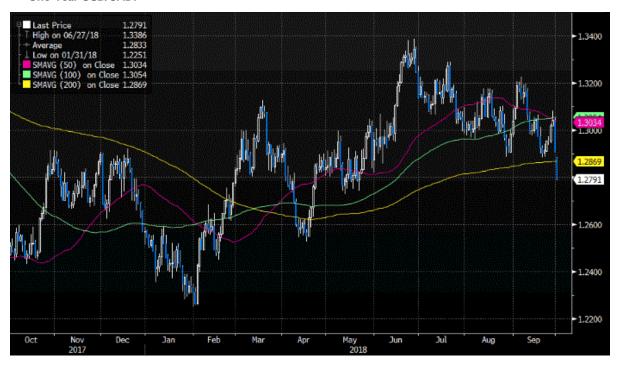


#### USD/CAD

The last minute NAFTA deal has given the CAD a boost, and combined with the likelihood of a Bank of Canada rate hike this month and an oil price that looks to be headed higher on the back of Iran sanctions, should maintain CAD strength through October. Although Canadian rate hikes are not quite keeping pace with the US, the 10 year spread is fairly stable near 60bps, and support from the oil price should ensure that the CAD continues to hold its own against the USD. 1.30 should now be a short term ceiling for USD/CAD as long as the oil price doesn't go into reverse, and there is potential to push down to 1.25 if the

oil price continues to rise.

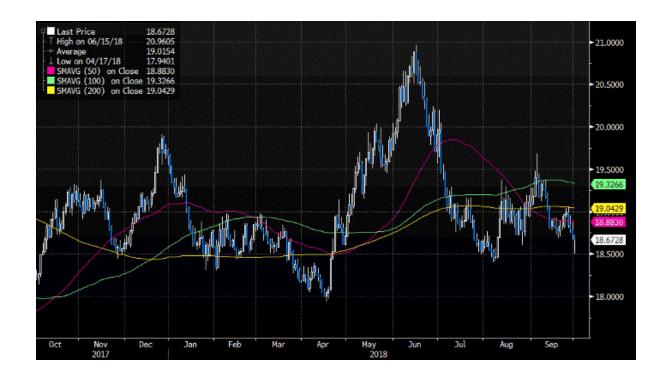
#### One-Year USD/CAD:



## USD/MXN

The NAFTA agreement benefits the MXN as well as the CAD even though the US/Mexico trade deal had already been agreed, in part because it removes uncertainty about the US/Mexico deal being ratified by Congress, in part because the deal will in general improve market sentiment on trade, risk, and consequently emerging markets. The strong oil price is also favorable. As we have noted before, there is still considerable value in the MXN at these levels after the sharp losses in 2015/16, but there is strong technical support in the 17.95-18.40 region which is unlikely to break quickly. Nevertheless, a break of this area would open up scope for a drop to 17 or even 16, so any rallies towards 19 should be seen as good selling

# One-Year USD/MXN:



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