February 1st, 2019

BANNOCKBURN GLOBAL FOREX, LLC

Is the Dollar Range Bound or is it Trending?

The new month is beginning with the US dollar at the lower end of its recent ranges against several of the major currencies, and at a couple month lows against the dollar-bloc currencies. The key question is whether the dollar is truly breaking lower, perhaps encouraged by the Federal Reserve's pivot to a neutral stance. On balance, we expect the dollar to remain range-bound until later in the crosscurrents of trade, the federal government's fiscal issues of both spending authorization and the debt ceiling, and Brexit may be clearer.

US Dollar

The Dollar Index has been softer over the past two months, only rising one week in December and one week in January. It has been confined to about 100 points on either side of roughly 96.15 where it finished last year. Although the S&P 500 has recouped a little more than half of the loss seen since the record high was set last September near 2940, expectations for Fed policy have not returned to status quo ante. Indeed, after the late January FOMC meeting, the market has nearly priced out any chance of a rate hike this year. Trade issues with China will come to a head in February ahead of the early March self-imposed deadline. China's willingness to take steps to reduce the bilateral trade imbalance is helpful and plays into the transactional approach of the Trump Administration and its desire for immediate action, but it is not clear whether it will be sufficient without deeper structural reforms and a verification process. Expect it to go to the wire. Domestic US politics will intensify now that the government has re-opened, as the Democrat-led House of Representatives provides a check on the power of the executive. The 200-day moving average is near 95.30, which was frayed at the end of the month. Also, important chart support is seen near 95.00. A break could signal another 100-point loss to retest last September's lows.

Euro

The European Central Bank was more dovish than expected in January, and this lays the groundwork for fresh action at the next meeting in early March. The evolution of the ECB President Draghi's comments points to the likelihood of a new long-term loan (targeted long-term refinancing operation or TLTRO). Italian and Spanish banks are seen as the biggest beneficiaries of the new loans, and the sovereign bonds have outperformed as they did at the end of last year. The eurozone grew by 0.7% each quarter of 2017 and slowed to 0.4% in the first two quarters of 2018, before slowing to 0.2% in the last two quarters. Germany, the economic engine for Europe, may have escaped the second consecutive quarterly contraction, but it is still reeling from two shocks. The first is domestic and is specific to the auto sector. The second is slower world growth, and especially in China. The New Year has begun on weak footing as the manufacturing PMI fell below the 50 boom/bust level in January. The median forecast in the Bloomberg survey is for the euro to finish Q1 at $1.16, which is a cent higher than expected a month ago.

Yen

The Bank of Japan shaved its growth and inflation forecasts as the data showed that the recovery from the natural-disaster contraction in Q3 has been lackluster after the October bounce. Indeed, the Japanese economy may be smaller at the end of the year than it was in June. Japan will report Q4 GDP in the middle of the February and the 0.4% expansion expected will not offset the 0.6% contraction in Q3. Many short yen positions got squeezed out when during the flash crash that saw the dollar drop through JPY105 at the start of January. The dollar’s drop set off positioning dynamics that appear to have weakened the yen’s sensitivity to the vagaries of the general appetite for risk. The policy change that lies ahead is the tax breaks that be given to reduce the impact of the sales tax increase in October (from 8% to 10%). There is little to excite investors. Foreign investors have been net sellers of Japanese shares since the middle of November except for two weeks. The 10-year yield straddles zero. The median forecast in the Bloomberg survey is for the dollar to end Q1 at JPY110. In December the median was for JPY112.

Sterling

Expectations that the UK would delay its exit from the EU was the primary driver behind sterling’s six-week rally. It is the strongest of the major currencies last month, appreciating about 3.2% against the dollar and 3.5% against the euro. In important ways, however, a delay does not change anything. The Irish border is as vexing as ever. If the trade border cannot be drawn between Ireland and Northern Ireland, nor between Northern Ireland and the UK, then there is only one obvious solution: no trade border, which requires being in the same customs union. Prime Minister May will return to Parliament in the middle of February. The underlying strategy appears to be to allow the looming deadline to focus attention if a what is widely seen as a cliff edge is to be avoided. A second referendum is possible and may be gaining support. On the one hand, it is returning the question to people for more instruction of their intent. On the other hand, if Remains win, the Leaves will be inconsolable. Analysts’ views of sterling have not changed since the end of 2018 with the median forecast still at $1.30 for the end of Q1.

Canadian Dollar

After trending lower in Q4 18, depreciating by almost 7% against the US dollar the Canadian dollar jumped back in the first part of January, recouping a little more than half of its losses. The US dollar had been consolidating between CAD1.3180 and CAD1.34 before lurching lower (~CAD1.3120) in response to the Federal Reserve statement. The macro concern in Canada is that the weakening real estate market and levered households squeeze consumption and weaken the economy. Real final domestic sales fell in Q3. Retail sales excluding auto fell in October and November. The economy contracted in November. The two-year interest rate differential has widened ten basis points in the US favor (to ~74 bp). The exchange rate often responds with a lag. The median forecast in the Bloomberg survey for quarter-end is for the US dollar to be at CAD1.32, which is up from CAD1.3020 forecasts in December.

Australian Dollar

The Australian dollar performed better than the fundamentals would have implied. The flash crash saw it drop from around $0.7000 to about $0.6740. It snapped back quickly and was testing $0.7200 by the middle of January and approached $0.7300 after the dovish Fed statement. The weakening of the domestic economy and the headwind from the slowdown in China has prompted some speculation that the Reserve Bank of Australia may cut rates in Q3 19. Central bank officials continue to insist the next move is higher. The two-year interest rate differential moved about 25 bp more in the US favor from the end of last year to stand near 85 bp. Analysts' forecasts from the Bloomberg survey are unchanged from the end of last year with the median looking for the Aussie to finish the quarter at $0.7200.

Mexican Peso

The peso fell 4.75% in Q4 18 and recovered about 3.5% in January. It had already begun recovering by the middle of December, and the dramatic moves in the equity markets mattered little. From MXN20.50, the dollar fell to nearly MXN18.88 by the middle of January. It spent the second half the month consolidating between MXN18.90 and MXN19.25. A two-step downgrade of PEMEX credit by Fitch to BBB- (lowest investment grade) and the negative outlook seemed to reinforce the lower end of the dollar's range late in the month. In the bigger picture, Mexico saw a sharp depreciation of the peso over the past decade. The dollar rose from around MXN10 before Lehman's collapse to MXN22 after Trump's election in 2016. The depreciation of the peso is much more than can be explained by inflation. Over the past decade, Mexican CPI has averaged 4% while US CPI has averaged 1.8% a year. The sharp depreciation and high-interest rates have attracted funds into Mexico's debt market. The median forecast in the Bloomberg survey is for the dollar to finish Q1 at MXN19.47. At the end of last year, the median stood at MXN20.10.

Chinese Yuan

The focus on China has been four-fold. Trade talks with the US, the steady stream of stimulus measures, and the pressure on Huawei, and the impact of the slowing of China on US corporate earnings. Among these stimulus measures appears to be a form a bank recapitalization though issuing perpetual bank capital bonds that can be swapped with PBOC for bills. Some are comparing this to a version of quantitative easing. The yuan strengthened a little more than 2.6% in January. This reflected more than the recovery of emerging market currencies as an asset class, but also, many believe, a desire not to antagonize the US during the trade negotiations. Officials seemed to indicate they did not want the dollar to rise above CNY7.0. The market may have to fish for the floor, but officials may have hinted at CNY6.70. This area was being tested as the US dollar slid broadly after the FOMC meeting, and as the round of trade talks concluded. At the end of last year, analysts in the Bloomberg survey expected the dollar to be near CNY6.94 at the end of Q1 19. Now the median forecast is CNY6.86.

---

advisory, hedge analytics, and transaction processing for closely held enterprises. We create distinctive value by combining the personal attention and flexibility of a boutique, with scalable efficiencies and expert counsel.

www.BannockburnGlobal.com