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BANNOCKBURN GLOBAL FOREX, LLC

November 2018 FX Outlook

The US dollar has been resilient in recent weeks despite the increased volatility in equities and the decline in yields. Two considerations remain dominant. The widening interest rate differentials and the policy mix can continue to underpin the dollar. With fiscal stimulus still in the pipeline, and talk of a further reduction in middle class income taxes, the US economy is still the best positioned to weather the headwinds of trade tensions and equity weakness. Europe is challenged on many fronts, including Merkel becoming a lame duck, ongoing Brexit negotiations, and a budding confrontation between Italy and the European Commission. The Japanese economy may have contracted in Q3, which would be the second such quarter in 2018. Presidents Trump and Xi are slated to meet in late-November, but a deal on trade is unlikely and that sets the stage for an escalation of the conflict that will carry over into the New Year. Given the Fed's trajectory, efforts by China to offset weakening domestic and foreign demand will likely see the dollar rise above CNY7.0 in the coming weeks. Meanwhile, a combination of technical factors is creating a shortage of dollar funding for the year-end roll.

Currency Outlooks

US Dollar

The November FOMC will not amount to much. Since the normalization process began in late 2015, rates hikes have only been delivered in meetings that were followed by a press conference. A 25 bp rate hike in December remains the most likely scenario despite the heightened volatility in the stock market. With the effective Fed funds rate hitting the level of interest on reserves, there is scope for a new technical adjustment. It is possible, but seems unlikely, that the Fed would end the unwinding of its balance sheet.

Interest-rate sensitive sectors, and especially housing, have softened. Households have drawn down savings and increased credit to maintain strong consumption. Non-residential investment also has weakened.

The most likely results of the mid-term election, according to tracking polls is for the Republicans to retain control of the Senate and the Democrats to secure a majority in the House of Representatives. It may not be an important near-term market factor.

US President Trump may meet China's President Xi on the side of the G20 meeting, but barring an improbable breakthrough, the US will likely initiate its own procedures that levy 10% tariff on the remainder of Chinese goods that have not been impacted thus far. They can be implemented around the middle of February. Remember on January 1, the 10% tariff on $200 bln of Chinese goods increases to 25%.

The US dollar rose against all the major currencies in October but the Japanese yen, against which it fell about 0.7%. The Dollar Index gained nearly 2% on the month, its best showing since May. It has gained every month since the end of Q1 except for September when it slipped less than 0.1%. The dollar appreciated against most emerging market currencies. Argentina (~12.4%) and Turkey (~10.3%) staged recoveries, and investors were encouraged by the political developments in Brazil (~9.5%). Other Latam currencies fell, led the declines with Chile (~-5.3%), Mexico (~-6.8%), and Colombia (-7.4%).

Euro

Growth slowed to 0.2% in Q3 after 0.4% expansions in Q1 and Q2. In 2017, the eurozone economy grew consistently at 0.7%.

Inflation ticked up in October, with the headline rate edging up to 2.2% from 2.1%. Half of EMU's inflation is coming from food and energy. The core rate rose 1.1% from a year ago after a 0.9% pace in September. Core goods prices rose 0.14%, and core service prices rose 0.19%.

Merkel's decision not to continue as CDU head and pre-announce no intention to seek re-election as Chancellor, nor an EU post, is significant even if the market impact is minimal. The next key development will be the CDU convention in December to choose a successor as party leader.

Italy has until November 13 to respond to the EU’s unprecedented demand that the initial budget proposal is revised. There are many face-saving ways to strike a compromise, but the Italian government, emboldened by its electoral success, and feeling even more entitled following news that the economy stagnated in Q3, is unlikely to do much to soften its proposals, as it looks toward next springs European Parliamentary elections. Italy has largely covered this year’s borrowing needs, and the debt management office is very skillful. With some kind of accommodation, the risk is of escalating tensions into year-end, which creates conditions that repel rather than attract investors.

The euro fell roughly 2.5% in October. It is the second largest monthly decline this year after May's 3.2% fall. It is near the year's low set in mid-August near $1.13. We look for lower levels, and our near-term target is a little below $1.12, and we expect a push below $1.10 in Q1 19. The recent decline has left technical indicators stretched, but we anticipate corrections to be capped now in front of $1.15.

Yen

The Bank of Japan left policy on hold as widely expected, though it did downgrade its inflation outlook, which simply underscores the ongoing extraordinary monetary measures. The BOJ is trying to minimize the disruption of its bond purchases. The recent rout in stocks saw the BOJ step of its ETF purchases.

Japan reports Q3 in the middle of November (13th). The risk is on the downside, and indeed the economy may have contracted after weakness in September related to the natural disasters. Recall the economy expanded by 0.7% in Q2 after a 0.2% decline in Q1.

If US bond yields continue to trend higher, the BOJ could allow its bond yields to rise more. The central bank wants a steeper yield curve.

In January and February, when global equities lurched lower, the yen strengthened. The dollar fell from around JPY112 to around JPY106. This month the greenback proved more resilient despite a drop in equities of similar magnitudes. The dollar did fall from the year's high near JPY114.60 to low by JPY111.40 and quickly rebounded, recouping almost 62%. The dollar is likely to remain in a JPY110-JPY115 into next year.

Sterling

The UK and EC may strike a deal on Brexit in November. The problem remains to sell it at home. A contingent of Tories may defect, perhaps 30-40 and it may turn on May being able to secure enough opposition support.

S&P warned that the failure to reach an agreement would send the UK into a four-five quarter recession that would see unemployment rise to as much as 7% (currently 4%). Hammond's budget contained GBP500 mln for preparation for no agreement.

The Bank of England is widely understood to be on hold until after Q1 2019 when the UK leaves the EU. Governor Carney also has warned of the risk of a recession on a no-deal Brexit.

Sterling has fallen around 4.5% on a trade-weighted basis since April. If sustained and extended, it will underpin prices. The ostensible boost from competitiveness may be offset by slowing foreign demand.

After reaching almost $1.3250 in the middle of October, sterling tested the $1.27 area at the end of the month. Near-term potential extends toward $1.2850. It seems more likely to see $1.2900-$1.3000 before $1.26. This is also consistent with a firmer tone against the euro. Specifically, the euro's momentum stalled near GBP0.8940 and a modest retracement of this month's gains brings it toward GBP0.8830.

Canadian Dollar

The Bank of Canada hiked rates in October, bringing the overnight rate to 1.75%. The statement seemed more hawkish than the Governor’s subsequent comments. Investors are confident (80%+) of a follow-up hike in Q1 19.

After hitting a soft patch into Q3, the Canadian economy may be re-accelerating. Despite ongoing trade tensions with the US (steel and aluminum tariffs on national security grounds remain in place), Canada reported a merchandise trade surplus in August and September, the first in a couple of years.

Over the past 60 sessions, the correlation of the percent change in the Canadian dollar and the percent change in the price of WTI and the S&P 500 was nearly identical near -0.33.

A move above CAD1.3160 likely signals a run at the CAD1.3200-CAD1.3225 area and maybe back to the year's high near CAD1.3380. Only a break of CAD1.3115 would undermine this constructive view.

Mexican Peso

The market's apparent honeymoon with President-elect AMLO abruptly ended when he chose to respect the decision of an overwhelming majority (70%) opposed to the construction of a new airport outside Mexico City. Mexican assets sold and the peso fell sharply.

Citing policy uncertainty and "deterioration.", Fitch cut the outlook for Mexico's sovereign rating to negative while affirming its BBB+ assessment.

Some of AMLO policies to scare investors, especially in energy, but investors will recall that former President Fox from the center-right PAN also had to reject a new airport due to popular disapproval. Based on his contribution to the NAFTA negotiations and other comments, we suspect AMLO is more in the Lula tradition and Chavez.

Mexico's central bank meets on November 15. If the currency remains under pressure ahead of AMLO taking office on December 1, a rate hike cannot be ruled out. With speculators in the futures market close to the largest net long peso position since May, positioning may have been more important than the actual airport decision itself. Even if the short-term technical indicators are stretched, the weekly readings give scope for the peso to weaken further in November toward the year's high set in June near MXN21.00.
