March 4th, 2019

March 2019 FX Outlook

The dollar rose against most of the major and volatile emerging markets currencies, like the South African rand, Turkish lira, and the Brazilian real in February. The gains were mostly by default as concerns about the strength of the US economy continued to linger. The weakness abroad, especially in Europe, seemed more profound. Trade tensions ebbed as investors correctly anticipated an extension of the US-Chinese trade freeze, while the beginning of the EU-Japan trade agreement coupled with the prospects of Brexit suggest scope for a re-division of labor. China's economic sluggishness is likely more responsible for the decline in global trade the "globalization in reverse" meme, and its myriad of efforts to support the economy coupled with a record expansion of lending in January boosts the chances of the better economic traction in the coming months. The Federal Reserve is widely understood to be on hold, while its balance sheet operations continue. The European Central Bank will announce a new long-term loan facility that may be launched near mid-year. The Bank of Japan continues to slowly reduce the amount of bonds it is buying, but the soft economy limits its degrees of freedom ahead of the sales tax hike at the start of October.

USD

US growth reached a cyclical peak in Q2 and Q3 18 when quarterly growth was annualized to 4.2% and 3.4% respectively. It slowed to 2.6% in Q4 and is expected to have slowed further in Q1 19 under the weight of the government shutdown, the unusually cold weather, softer growth abroad, fading fiscal stimulus, and the maturing business cycle. The US dollar's resilience may be a function of worse economic impulses coming from abroad. After a difficult Q4 18, equities have rebounded smartly and the S&P 500 is the best performing major index. It appears that the erosion of financial conditions at the end of last year scared the Federal Reserve, which has since adopted a new mantra to re-assure investors of patience and flexibility. Operationally it means that the Fed will not raise interest rates in the coming months. We think a new opportunity may exist toward the middle of the year when the cross-currents will subside, and the underlying strength of the US economic will be more evident again. The recent minutes suggest an agreement in principle to end the balance sheet unwind by the end of the year has been reached, and details will likely begin emerging in the coming months. We maintain a constructive outlook for the dollar based on continued divergence.

EUR

The euro averaged $1.1420 in January and about $1.1340 in February. It spent several sessions below the lower end of the $1.13-$1.15 range that has mostly confined the price action within a larger range of around $1.12 to $1.16 since the end of Q3 18. Poor economic data and somber assessment by the ECB weighed on the euro. At its meeting on March 7, with new staff forecasts in hand, which will likely shave growth forecasts again, the ECB may commit itself to a new round of targeted long-term refinancing operations. The new four-year loans will replace the outstanding loans made previously, thereby maintaining the ECB's balance sheet and preventing distortions to the banks' short-term funding ratios Some new net borrowing is possible, as well. The details of the operation may not be announced until later in Q2. The eurozone expanded by 0.7% a quarter throughout 2017 and slowed dramatically last year. We suspect the worst is past and anticipate improvement beginning in March.

Spot: $1.1340

Median Bloomberg Forecast: $1.1410

One-Month Forward: $1.1370

One-Month Implied Vol: 5.75%

JPY

The dollar rose against the yen steadily even if not spectacularly through February. It rose to the highs of the year so far near JPY111.25 at the end of the month. Economic activity at the start for the year has mostly been disappointing, but the downside bias of the yen is likely more a function of the use of it as a funding currency to buy more volatile assets, like equities. The end of the Japanese fiscal year (end of March) is often associated with repatriation, but the impact on the yen is no longer clear. The past three years the yen has strengthened in March but fell during the previous seven. The dollar is often range-bound against the yen, and we understand the uptrend in February as fishing for the upper end of the range. We suspect it to be close around JPY112.00.

Spot: JPY111.85

Median Bloomberg Forecast: JPY111.40

One-Month Forward: JPY111.60

One-Month Implied Vol: 5.7%

GBP

Even if one is sympathetic to the Brexit cause, this is not the UK's finest hour. Former Prime Minister Cameron's idea that a referendum would unite the Conservative Party was a blunder of historic proportions. The party and the country are sorely divided. Prime Minister May's brinkmanship strategy was to force a Hobbesian choice on the House of Commons. Either accept the hated Withdrawal Bill or be held responsible for a leap into chaos that could very well result from leaving without an agreement. The most likely scenario still appears to be a delay of the March 29 exit date. A couple month delay at the least. A longer delay is complicated by the EU Parliament election at the end of May. A couple year delay, which has been suggested, extends the period of uncertainty, which has seen business investment in the UK slow for four consecutive quarters. Sterling has appreciated as the market perceives the downside risks have lessened. The likelihood of a softer and later Brexit has helped lift sterling 3.5% in January and February. It has advanced for three consecutive months, which is its longest rally since early 2012. We see potential toward $1.35-$1.36 but recognize a great deal of good news has discounted.

Spot: $1.3200

Median Bloomberg Forecast: $1.3200

One-Month Forward: $1.3210

One-Month Implied Vol: 10.5%

CAD

The Bank of Canada has not adopted the “patient and flexible” language of the Federal Reserve, but it effectively has reached the same conclusion. The accumulation of past rate hikes, including three last year, and the global slowdown has pushed central bank to the sidelines, though it recognizes that the normalization process is not complete. The dismal Q4 GDP of 0.4% (at annualized pace), with the monthly GDP readings falling three of the past four months, the economy has virtually no momentum coming into the New Year. The two-year rate differential has widened in the US favor by the most since before the Great Financial Crisis (~80 bp). The Canadian dollar's other drivers, oil and risk appetites seem are more supportive. The political climate has worsened as Trudeau stumbles and the Huawei extradition process, which has begun, is a no-win situation. February's narrow range (~CAD1.3070-CAD1.3340) is unlikely to contain March's price action, and that means volatility is likely to rise. The deterioration of the economic and political factors leave the Canadian dollar vulnerable. In a weak US dollar environment, it means that the Canadian dollar will likely lag.

Spot: CAD1.3315

Median Bloomberg Forecast: CAD1.32601.1473

One-Month Forward: CAD1.3310

One-Month Implied Vol: 6.5%

AUD

Housing market weakness and household indebtedness may be expected to slow an economy through the wealth effect and diminished aggregate demand. Australia's labor market is continuing to hold up well. Nevertheless, domestic banks continue to press for lower rates. The market has discounted a little more than a 50% chance of a cut this year. Early last year, for the first time since 2000, Australia's two-year yield fell through the US two-year yield and widened to a little more than 90 bp in early Q4 18 and averaged almost 80 bp in February. It has stabilized in February, after Australia has antagonized China over the role of Huawei in building out 5G. Some have linked a reduction of China imports of coal from one Australian port as a shot across Australia's bow. The Australian dollar has been in a sawtooth pattern since last April, rising one month and falling the next. We see the risk to the downside, but the Australian dollar fell 2.5% in February and appears to have carved a shelf near $0.7050.

Spot: $0.7085

Median Bloomberg Forecast: $0.7115

One-Month Forward: $0.7070

One-Month Implied Vol: 8.5%

MXN

Mexican growth faded in the second half of last year. High real rates are choking the economy, while high nominal rates support the currency. President AMLO has not won over many skeptical investors, and the goodwill over delivering an uncontroversial budget has been spent on Pemex, whose rating was cut two notches by Fitch at the end of January. On March 1, S&P cut the outlook of its rating from stable to negative citing the weaker growth and government policies. The central bank has earned investors' goodwill, but it needs softer inflation or a stronger peso to provide the cover of a rate cut, which business needs. This leaves the currency vulnerable. We suspect there is potential toward MXN19.75 in the coming weeks.

Spot: MXN19.365

Median Bloomberg Forecast: MXN19.393

One-Month Forward: MXN19.454

One-Month Implied Vol: 10.4%

CNY

This year marks the 70th anniversary of China's revolution. The economic slowdown, which seems likely more pronounced than official data may reveal, may have undermined authority in China as it has done nearly throughout the world. This may be the logic of President Xi's more rigid political rhetoric. At the same time, the government has announced numerous reforms, including a bank recapitalization scheme. Data in the coming weeks will be scrutinized to see it the economy is getting better traction. The low point may be past. The US reportedly is demanding that China maintain a stable yuan, but China does not want to need a Hong Kong dollar like peg. While CNY 70 can continue to cap the dollar, the lower end of the "stable range" we had thought was around CNY6.70, but officials may tolerate a slightly stronger yuan.

Spot: CNY6.70

Median Bloomberg Forecast: CNY6.72

One-Month Forward: CNY6.698

One-Month Implied Vol: 4.6%

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