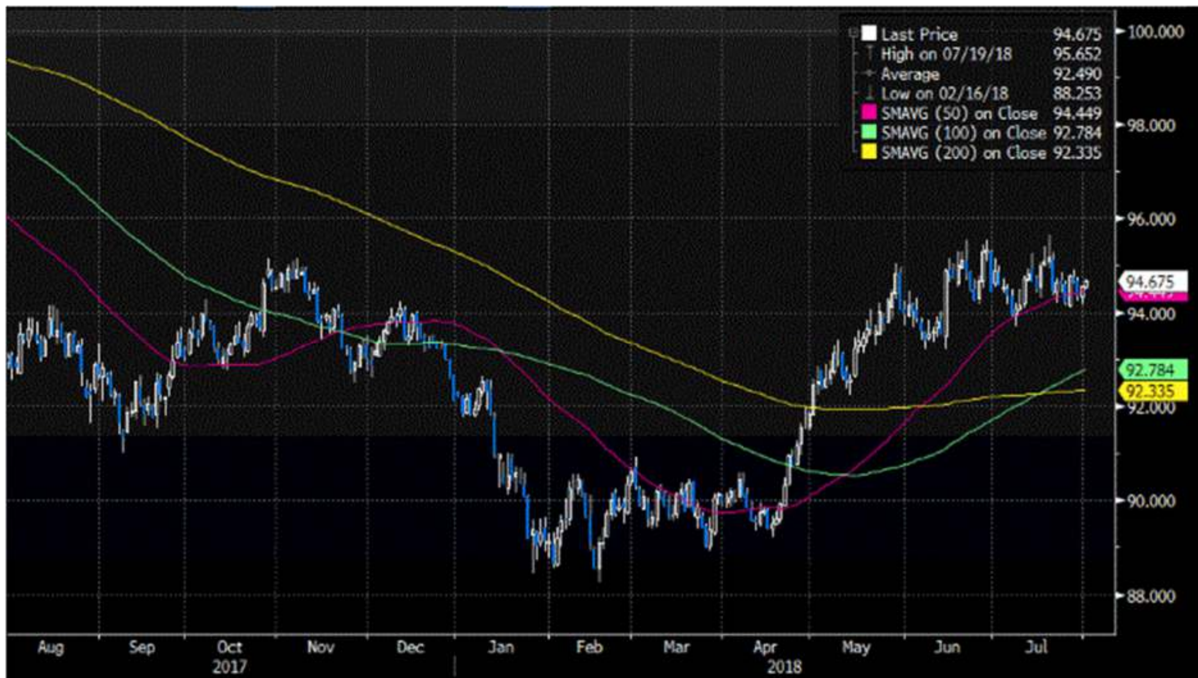
August 1st, 2018

August 2018 FX Outlook

The USD was mixed through July seeing little net change against most of the majors in generally quiet summer trading. However, the USD continued to make ground against the CNY while falling back against the MXN. The trade war between the US and China has continued and is the main factor behind the weakness of the CNY, but trade tensions elsewhere have calmed somewhat, with the latest meeting between Trump and EU Commission president Juncker apparently averting a further major tariff increase. Coming into August, the initial focus is on monetary policy, with FOMC and Bank of England meetings at the beginning of the month, but the background issue of trade remains. Nevertheless, economic news has been generally positive, with strong US Q2 GDP growth and continuing growth in Europe, despite some concerns about slightly weaker growth in China. Against this background risk appetite looks likely to remain reasonably well supported in the absence of escalation in trade concerns, and this should favor the higher yielding currencies, though for now the USD looks range-bound against most of the majors.

One-year DXY:



<u>Outlook for July</u>

1) Trade wars and other geopolitics

While the US raised tariffs on $34bn of Chinese goods on July 6 and China immediately retaliated with similar tariffs on US goods, trade concerns have ebbed since, with the meeting between Trump and Juncker seemingly ending the US threat to increase tariffs on US imports of European cars. While the global trade picture is still very uncertain, with the US relationship with China particularly volatile, the current feeling is that we have seen the majority of the action in the trade war. The consequences of what has been done so far will certainly be negative for the world economy, as all impositions of tariffs are, but is not substantial enough to change underlying trends.

2) UK politics and Brexit

July was notable for the resignation of two senior UK cabinet ministers – David Davis and Boris Johnson – over PM Theresa May's change in policy on Brexit announced after a meeting at Chequers. The new policy is perceived as allowing a much softer Brexit with greater willingness to accept EU rules and something close to continued membership of the customs union, so the markets generally saw the plan as relatively good news as it reduced the chance of a "hard" Brexit. However, the pro-Brexit wing of May's Conservative party clearly do not support the new policy, and there is no clarity on the likely outcome of talks with the EU on the new position, nor whether any deal agreed with the EU would pass the UK parliament. In practice the issues probably won't come to a head until at least the October EU summit, but the lack of consensus in the UK is making it clear that there may be no version of an EU exit deal which the UK can agree. This means the possibility of "no deal" is being considered more seriously, which could increase pressure on GBP as the year goes on if no progress is made.

3) Monetary policy meetings in focus, but impact likely to be modest

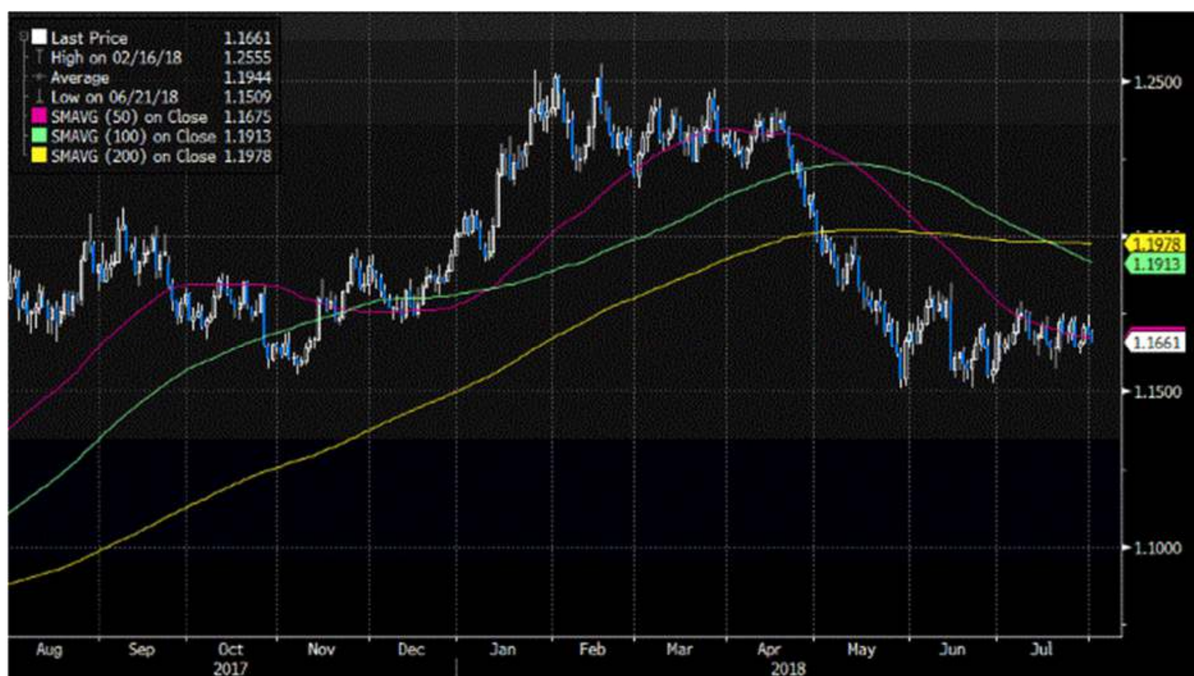
The beginning of August sees an FOMC meeting closely followed by a UK MPC meeting, and both follow hot on the heels of the late July ECB and BoJ meetings. Of these, the UK MPC meeting may be the most significant, as most expect it to produce a rate hike (market probability around 90%). The FOMC is expected to leave rates unchanged by almost everyone (probability 96%) following essentially unchanged policy announcements from the ECB and the BoJ. The ECB had already announced its path of no change to rates until H2 2019 at the earliest with bond purchases to be phased out by year end. There had been talk ahead of the BoJ meeting of some tightening plans, but in practice there was no significant change to ultra-easy policy, and this has weighed on the JPY. The Fed is still expected to raise rates twice more this year,and seems unlikely to deviate from this message at the FOMC, which should help underpin the USD. The UK MPC have signaled that a rate hike is likely, but the impact on the pound may not be great, both because it is well anticipated and because the looming shadow of Brexit makes a 0.25% move in rates less relevant given the major uncertainties ahead.

Currency Outlooks

EUR/USD

EUR/USD was very stable through July holding well within the June range. A break of the 1.15-1.18 range would now be significant, but there is no obvious trigger for a break at this stage. Monetary policies are well established, and surprises seem unlikely this month. While the USD is the higher yielding, it has not generally benefitted from strong risk appetite of late, so the slightly positive bias in the equity markets seems unlikely to be enough to break the recent ranges. So unless we see a return of the US/European trade war concerns or some clarity on the Brexit situation, both of which seem unlikely in August, the range seems likely to hold.

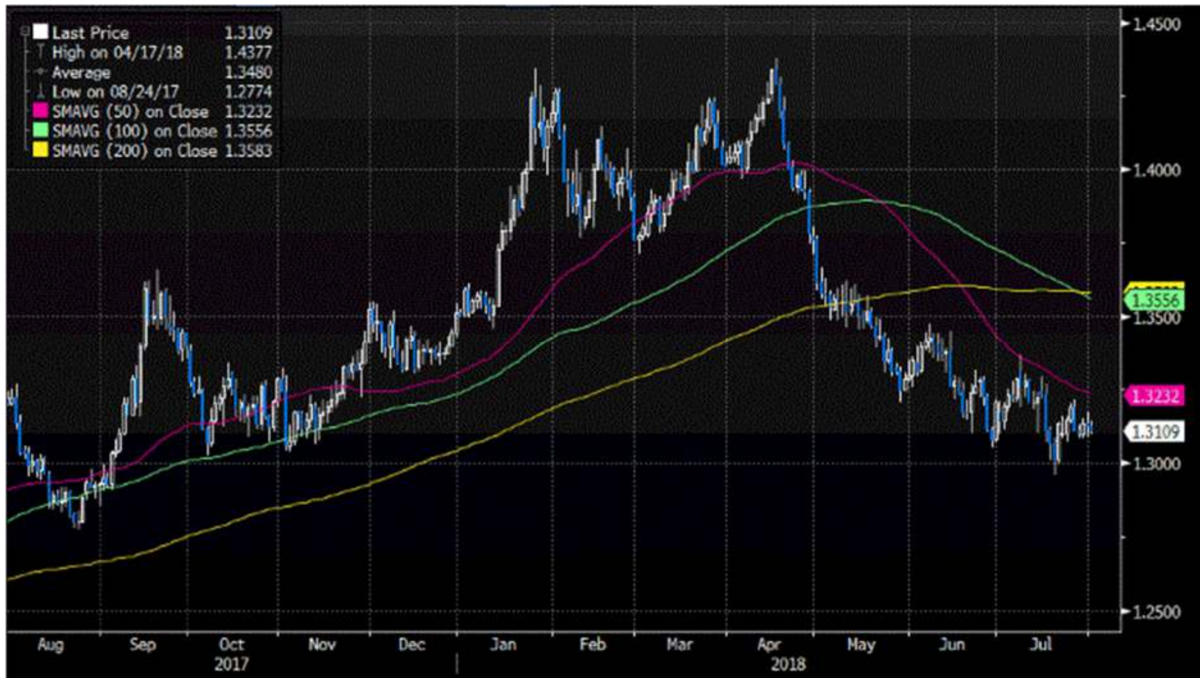
One-year EUR/USD:



GBP/USD

GBP/USD dipped briefly below 1.30 in the middle of the month on a weaker than expected retail sales number for June, having slipped early in the month on increasing Brexit and political uncertainty. But the break below 1.30 was short lived as markets realized that despite a weaker monthly reading, the June number actually indicated solid retail sales for Q2, and consequently maintained their expectation of a rate hike in August. This does now seem likely, though is perhaps not quite as certain as the market is pricing in given the degree of uncertainty surrounding Brexit negotiations and UK politics. Nevertheless, the UK MPC will likely make the decision based on solid UK data and worry about bad Brexit outcomes if and when they happen. Still, with the market well priced for a hike, the impact on GBP is likely to be modest, and GBP/USD seems likely to hold in the 1.30-135 range this month.

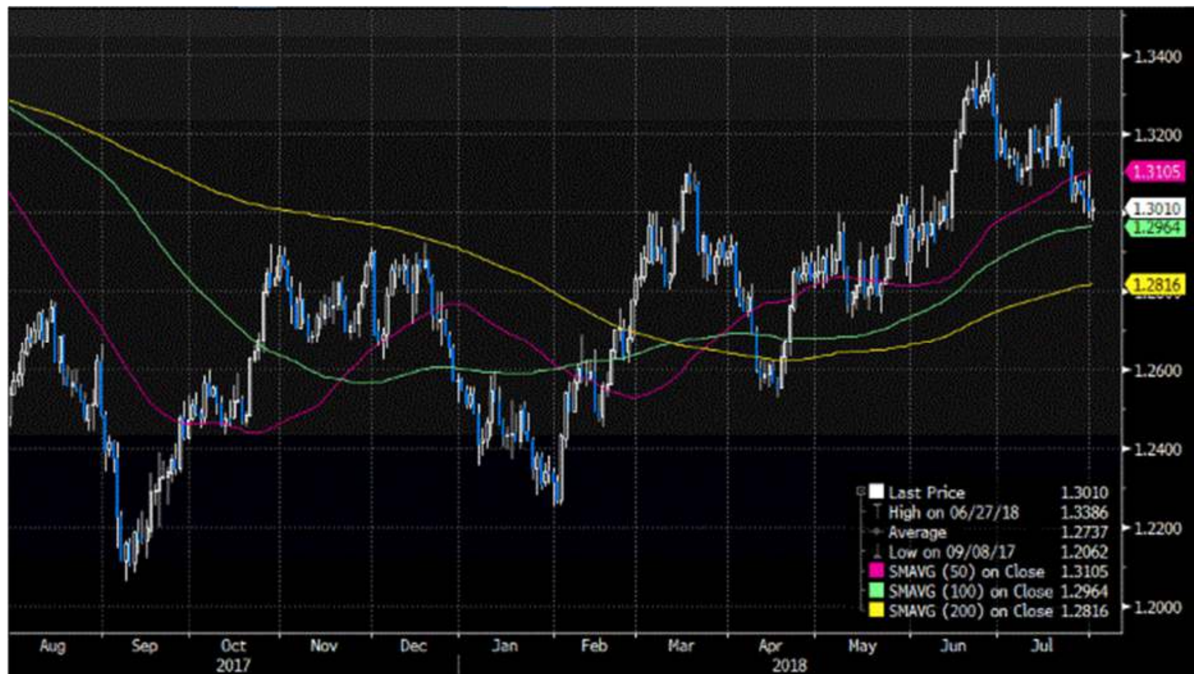
One-year GBP/USD:



USD/CAD

The CAD performed well in July helped by a rate hike at the beginning of the month and strong GDP data at the end of the month, combined with some growing hopes that a NAFTA deal will be done in the coming months. However, a sustained break below 1.30 is likely to prove hard to achieve without a new engine for CAD strength or more general USD weakness. As it stands, while the CAD looks modestly cheap at current levels from a long term perspective, the more aggressive tightening cycle and consequent yield advantage to the USD justifies the USD's mild overvaluation. Any new trade uncertainties are also likely to prove USD positive. CAD strength could be justified by some further reduction in trade tensions or a stronger oil price, while a more dovish Fed stance seems likely to be required to trigger a generally softer USD view. So for now the USD/CAD range may have edged a little lower, but 1.28-1.33 should contain it near term, though talk of a NAFTA deal as early as this month, if validated, could trigger a CAD break higher.

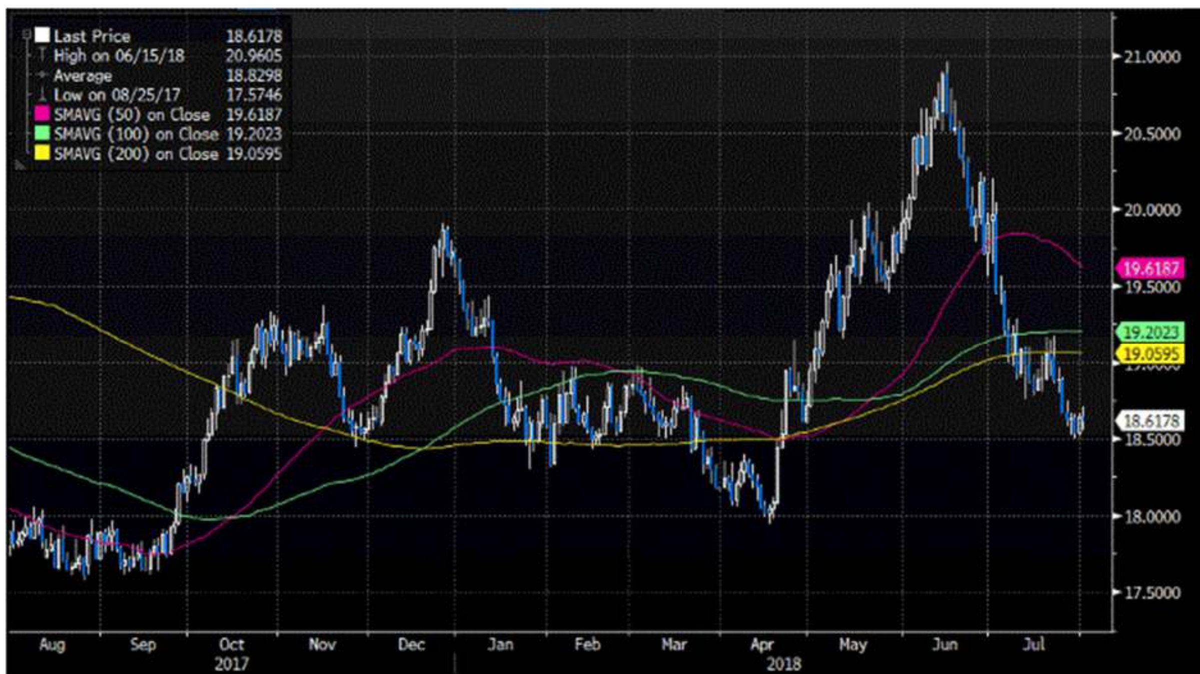
One-year USD/CAD:



USD/MXN

The MXN has strengthened steadily since the election as optimism has grown about the possibility of a NAFTA deal in the coming months. The new regime under Obrador (AMLO) has so far not generated any negative surprises, and given the still cheap level of the MXN from a long term perspective, and earlier concerns about the new leftist regime this has been enough to allow the MXN to rise to levels last seen in April. However, weak Q2 GDP data at the end of the month has cut short the MXN rally, and a break below the key support area around 18 now looks unlikely without better data and/or a NAFTA deal being concluded. The short term bias now looks to be to the upside, with the 19-19.20 area the first target. However, this should hold in the absence of further negative news.

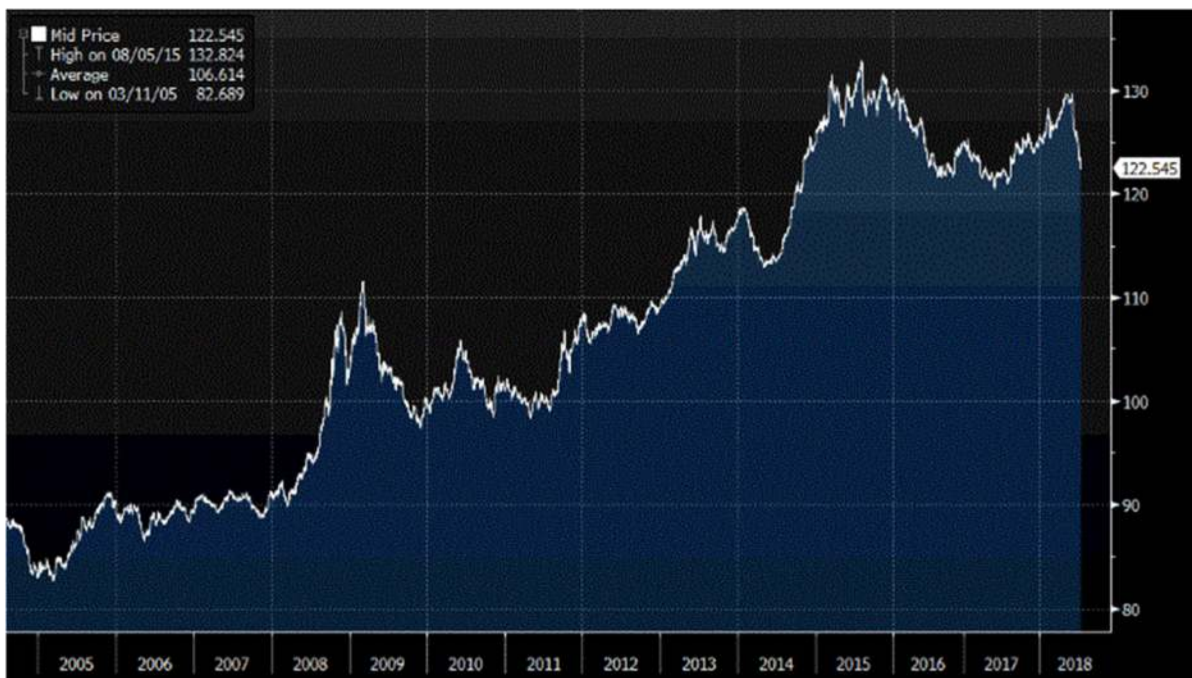
One-year USD/MXN:



USD/CNY

USD/CNY (or the offshore version USD/CNH) has been the center of attention in the FX market in the last couple of months, with a sharp rise from a low of 6.37 in June to a high of 6.85 in July. It should always be remembered that the CNY is a controlled currency. USD/CNY is where it is because that is where China wants it to be. While there may have been private capital flows involved in the rise of USD/CNY, the Chinese authorities would have opposed them and prevented the rise had they wanted USD/CNY to remain at lower levels. The trigger for the rise has been the deterioration in trade relations with the US, and it seems very likely that China is using the currency as both a bargaining tool and a way of minimizing the impact of US tariffs on the price of US imports of Chinese goods. Where USD/CNY goes from here is thus very much dependent on what happens to trade relations with the US. If we see no more tit-for-tat tariff increases, it is likely we will see USD/CNY stabilize close to current levels in the short run, and probably renew its trend decline in the fullness of time. China had managed a steady appreciation of the CNY trade-weighted index for many years, and while the recent sharp decline in the CNY has reversed this year's appreciation, it hasn't so far broken the main uptrend (see chart below). Given the targeting of the trade-weighted index USD/CNY will in part depend on the general USD performance. With a strong US economy and rising US rates a significant USD decline seems unlikely near term, so there is some potential for further modest USD/CNY gains on that basis. Nevertheless, in the absence of more tariffs a rise above 7.00 seems unlikely, and there should be scope for the downtrend to resume by next year.

Fourteen-year USD/CNY:



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