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BANNOCKBURN GLOBAL FOREX, LLC

2017 FX Outlook – Trumponomics and European Politics

The key questions for the FX markets in 2017 are: 1) what impact the Trump presidency will have on the US and world economy, and 2) whether the populist movements that had such an impact on the politics of the developed world in 2016 will continue to have an influence via the French, German, Dutch and possibly Italian elections in 2017. The issue of Brexit and the triggering of Article 50 will also come into sharper relief in Q1, and is likely to continue have an influence on GBP and related markets throughout the year, while the oil price will continue to be a key factor for the world economy and the FX markets, particularly the CAD and MXN.
Below is detail on 3 drivers of the 2017 outlook:

- **The Trump Presidency**
- **European Elections**
- **Brexit**

as well as additional color on USD against key currencies (**EUR, GBP, CAD, and MXN**).

Outlook for 2017

1) The Trump presidency and the outlook for US rates

Trump won the election promising a big rise in infrastructure spending and big tax cuts. The details remain unclear, and he will not have a free hand in implementing his ideas, with Congress likely to put major obstacles in the way of any plans that significantly increase the deficit. For 2017, the key question will probably be the extent to which he is able to quickly enact a plan to increase infrastructure spending which he has made a priority for his first 100 days in office. Tax cuts are also likely to come, but may have to wait and the impact may not be felt for a year or more. For infrastructure spending, Trump is likely to get support from House Democrats and this may make it easier to pass than tax cuts, although the method of financing and the detail of projects remain unclear. For the FX markets, financing will be key because of the implied interest rate impact of expansionary fiscal policy, but also because one of the possible plans involves tax changes to encourage US firms abroad to repatriate profits. In sum, the more successful Trump appears to be in pushing his economic agenda through, the more positive the likely impact on the USD via the expectation of higher US interest rates.

The other aspect of Trump policies involving restricting immigration and increasing protectionism is also likely to have a direct positive impact on the USD against some currencies, notably in EM, but the impact on the USD versus developed market currencies will be less clear if protectionist policies are perceived as damaging to the US economy. In practice, the initial wilder versions of these policies now seem to have been moderated, and may prove less significant than initially thought, especially if policies for economic expansion prove effective. The market is starting the year looking for two 25bp rises in the Fed funds in 2017, slightly below the path implied by the Fed "dot plot" which at this stage doesn't include any consideration of the likely impact of changing fiscal policy. The composition of the Fed also may become more conducive to a rising rate profile if Trump's appointments are on the hawkish side as most anticipate. However, whether the market starts to price in higher US rates is still likely to be data dependent, and the recent tendency of the US data to be weak in Q1 suggests risks may be the other way early in the year.

2) European elections – a risk or an opportunity?

There has been a lot of talk about European political risk in 2017, with general elections in the Netherlands, France, Germany and possibly Italy. The experience of the UK Brexit vote and the US presidential election in 2016 has alerted the market to the possibility of surprises, and there is perennial concern that the Eurozone is fragile and vulnerable to shocks. But on closer examination the elections may not be as dangerous as some believe. While more right wing and populist governments seem likely in the Netherlands and France, the US election has shown that this is not necessarily going to be received badly by the markets. While new governments may seek some adjustments to the relationship with the EU, there is little chance that the Dutch (and no chance that the French) look to leave the EU. While the Italian situation is more complex, and an election in 2017 could create some nerves, it is also unlikely that there is any Italian move to leave the EU. Concerns about the banking system remain, but in aggregate the system is more stable than it has been for some years, despite some individual concerns. The key for Europe will be whether the economy continues its slow improvement. If it does, concerns may recede and new governments may be seen as potentially adding dynamism rather than representing a risk. However, Greece remains a worrying wild card.

3) UK Brexit process still in focus – Article 50 likely to be triggered by March

Parliament voted in favor of Brexit on December 7th, and although this was not a formal approval of Article 50, it underlines the likelihood that parliament will vote to trigger Article 50 (assuming the Supreme Court agrees with the High Court that is up to parliament rather than the government). While there is some conditionality to the support of parliament, with the government pledging to reveal some of its negotiating position, in practice it looks like the government will be able to trigger Article 50 by March with very few concessions to parliament. While the UK economy is still performing reasonably well, and may continue to do so for some time, the Brexit outlook is likely to remain key for GBP and will also influence the EUR against the USD.

Currency outlooks

EUR/USD

EUR/USD managed to break to new 13 year lows at 1.0350 after the US election and the Fed rate hike in December. The EUR also suffered to some extent from the association with GBP, as it never regained its pre-Brexit vote level above 1.14. All eyes will be on a possible test of parity with the USD this year, with both the possibility of further yield spread widening as the Fed tightens further and concerns about European politics potentially weighing on the EUR. The 10 year T-note/bund yield spread at 228bps is already at a level that is consistent with a test of parity based on recent correlations. The USD is often seasonally strong in January so an early test may be seen, but further out the fate of the EUR may hinge more on European developments. If recent evidence of an improving economy is maintained there may be more scope for rises in Eurozone yields, and provided European elections to not prove too disruptive, this may help secure a bottom for EUR/USD not too far below 1.00. While there is little prospect of an early tightening of ECB policy, the market is pricing a very long period of zero rates which could be shortened on solid European and more positive global data, and below 1.00 the EUR should offer very good long term value if political and economic catastrophes are avoided.

GBP/USD

GBP/USD fell substantially in 2016 primarily because of the June 24 Brexit vote, but despite the big decline it is hard to argue that GBP is significantly undervalued, even if Brexit doesn't substantially impact the economy. While GBP/USD in the low 1.20s is well below the "normal" levels it has traded in recent years, relatively high UK inflation since the financial crisis means that in real terms today's 1.20 is equivalent to around 1.50 in 2008. GBP/USD is trading close to Purchasing Power Parity against the USD, as it did for longer periods before 2000, and with the uncertainties of Brexit still looming, the UK still running a very large current account deficit, the Bank of England unlikely to move rates and inflation likely to rise, further reducing real interest rates, it is hard to see anything other than further GBP weakness this year unless the US economy disappoints dramatically. The initial focus will be on the likely invocation of Article 50 to leave the EU which the government has pledged will come by March. Ahead of that, a Supreme Court ruling on whether parliament needs to vote Brexit through will garner some initial interest, but even with a parliamentary vote, there will be no guarantee of the government negotiating the softer Brexit that would be seen as more supportive for the pound. A test towards 1.10 looks likely in a strong USD environment.

USD/CAD

The CAD was one of the few currencies to gain against the USD in 2016, and was supported mainly by the recovery in the oil price, with WTI doubling by the end of the year from the lows seen in January. The oil price will obviously be key for the CAD through 2017 as well, as it has been for many years, and the OPEC deal late in 2016 may help secure some more gains, but as the price approaches $60 p/b the declining US and Canadian supply seen through 2016 which has helped to bring the price down may well pick up again, reducing the upside scope for the oil price and the CAD.

In the long run, the oil price does tend to be the main driver for the CAD, as there is rarely much long term divergence between the US and Canadian economies. But in the shorter run rising interest rates in the US and the lack of any such trend in Canada, with declining Canadian inflation discouraging the Bank of Canada from any tightening path, suggests there are some downside risks for the CAD even with a reasonably firm oil price, especially if US yields rise further on anticipation of aggressive fiscal easing from the Trump administration. So with a stable oil price the risks are for USD/CAD to move towards 1.40, but unless the oil price weakens significantly we doubt that there will be any significant progress beyond there. Equally, the WTI oil price would need to rise to $70 or more to threaten $1.30, unless the US economy and the Fed seriously disappoint.

USD/MXN

While the MXN has typically been similarly oil dependent to the CAD, the MXN was one of the weakest currencies in 2016 because of concerns about protectionist policies that might be implemented by the Trump administration. As the market barometer of election sentiment, USD/MXN surged higher after the Trump victory, but has been little changed since as the market awaits any details of policy towards Mexico. Indications from House Republicans suggest the idea of the southern wall is unlikely to achieve reality. While a fiscal boost seems very likely, and infrastructure spending looks to be an early priority for a Trump administration, protectionist and anti-immigration measures that would hurt Mexico currently seem less certain to be enacted, in part because infrastructure projects may require a heavy dose of immigrant labor. If that is the case, Mexico may actually be a significant beneficiary of Trump's economic policies, and looks good value at these levels, though will be vulnerable to any careless Trump utterances on immigration and protectionism.

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