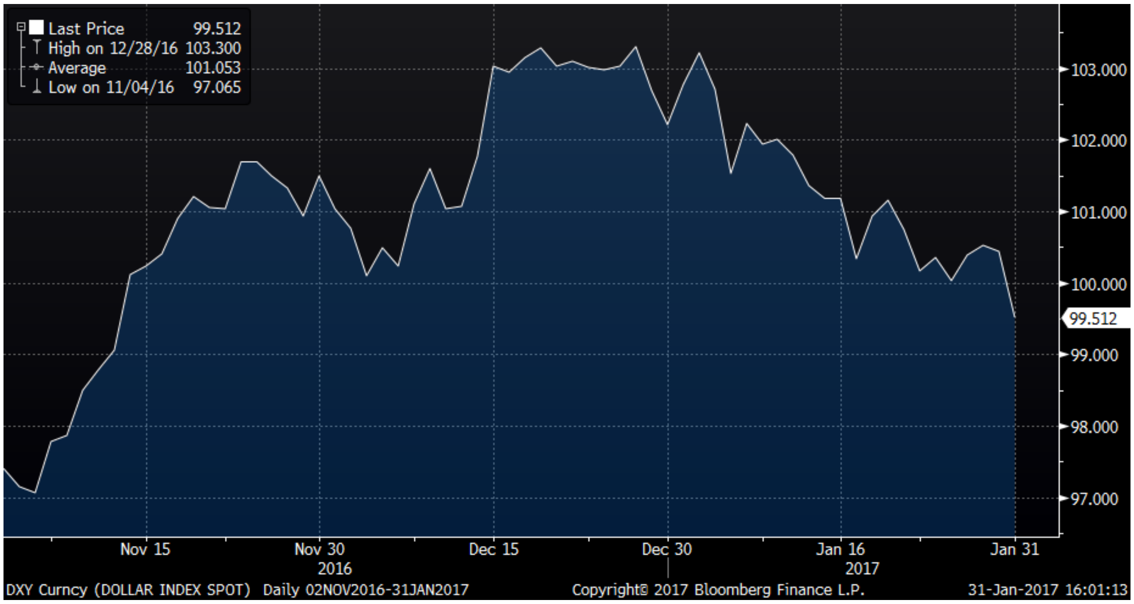
February 1st, 2017

February FX Outlook – Trumponomics the Focus

The FX market continues to wait for more information on the Trump presidency before settling on a direction for the USD. The USD weakened though much of January as the market squared up some long USD positions established on the basis of an expectation of expansionary economic policies from Trump, as political concerns and lack of clarity on the economic agenda clouded the outlook. However, the Fed still seems intent on tightening again by the middle of the year provided evidence of strong economic momentum continues. This suggests the USD bias is still higher in the absence of concrete evidence that the economy will suffer from Trump's protectionist agenda or fail to benefit from promised infrastructure spending.

US Dollar Index:



Following is additional detail on 3 key drivers of the near term outlook:

- The Trump presidency
- FOMC guidance

- Brexit

As well as the outlook for USD against:

- EUR
- GBP
- CAD
- MXN

Outlook for February

1) The Trump Presidency

Trump won the election promising a big rise in infrastructure spending and big tax cuts, but also with a protectionist and isolationist agenda, looking to reduce import competition in order to create US jobs, and increase control of immigration. In January there has been little new information on his economic proposals, but since his inauguration he has taken some measures on immigration and made some proposals on import restrictions which have created some nerves around the USD. The question surrounding his administration since the election has been whether the likely stimulative impact (at least in the short run) of his macroeconomic policies would dominate or be dominated by any negative impact from trade policy. This is still unclear, but the market had been pricing in a positive outcome since the election, and the latest news on his policies has been less encouraging. It looks likely that the Trump presidency will continue to be seen as a negative factor until or unless the focus switches towards infrastructure spending and potential tax cuts and away from trade and immigration.

Even if the economic impact of his trade policies is not negative for the US economy, the value of the USD could be affected by decisions taken by managers of foreign exchange reserves. Trade policies towards China and/or immigration policies towards the Middle East could lead to some diversification away from the USD by these central banks and sovereign wealth funds, and it is possible this is already happening. However, Trump could also act on his promise to encourage the repatriation of assets held by US companies abroad, and any general flight to quality triggered by concerns about the implications of the Trump presidency could also prove USD supportive. So there is a lot of uncertainty about the likely USD impact. For now, we still favor a stronger USD driven by higher US yields, but the statement to Congress that Trump is due to make on February 28 may prove a key event.

2) FOMC – guiding towards higher rates?

The FOMC meeting this week is unlikely to see any change in policy, but there is scope for the market to start to price in a more aggressive tightening cycle if we get some more hawkish rhetoric from the Fed. At the moment the market is pricing in 2 hikes this year – with the central expectation being for June and December, and if the Fed are to move before June the March meeting is most likely given that it includes a scheduled press conference. If the Fed wants to open up that possibility it would make sense to prepare the market with some hawkish content to this week's statement. While there is little justification for a more hawkish stance based on Trump's policies, given the lack of concrete steps so far, the data has been on the firm side and suggests the Fed may want to open up the option of a March move. The risks consequently look likely to be to the USD's upside on the FOMC.

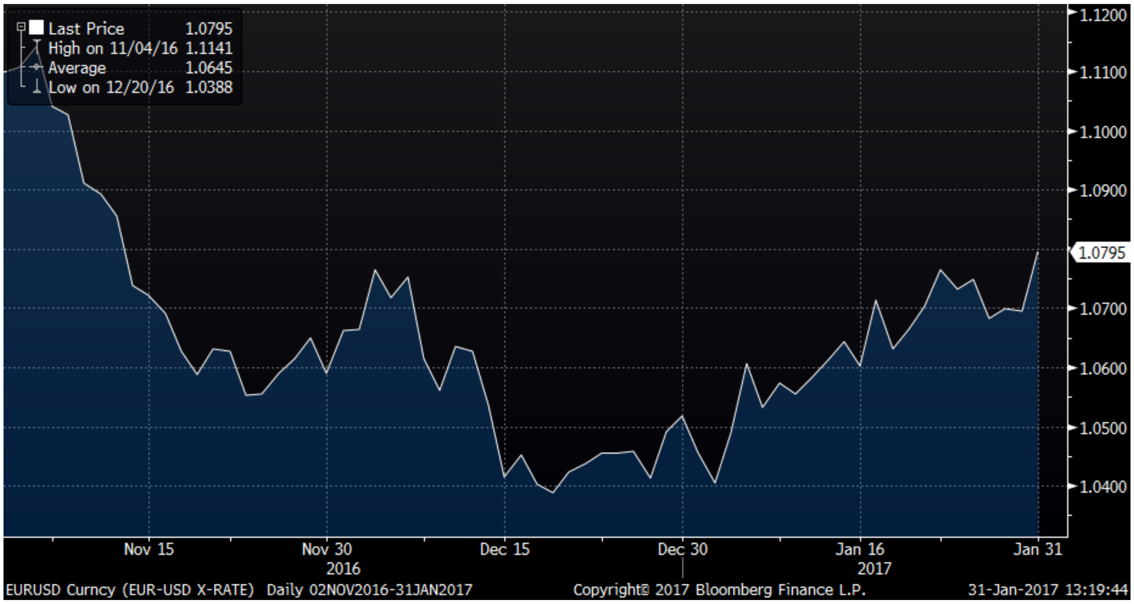
3) UK Brexit bill to go through parliament

The Supreme Court ruled that parliament has to grant the government the right to trigger Article 50, so the government is putting a bill through the Commons this week. It's a short bill and it will pass, but the opposition have tabled some amendments and the market reaction is likely to depend on whether any of these are accepted. After the vote in the House of Commons, the bill goes through a committee stage next week before going to the House of Lords, which may also make amendments. However, the consensus is that the parliamentary process is unlikely to prevent the triggering of Article 50 by March.

Currency Outlooks

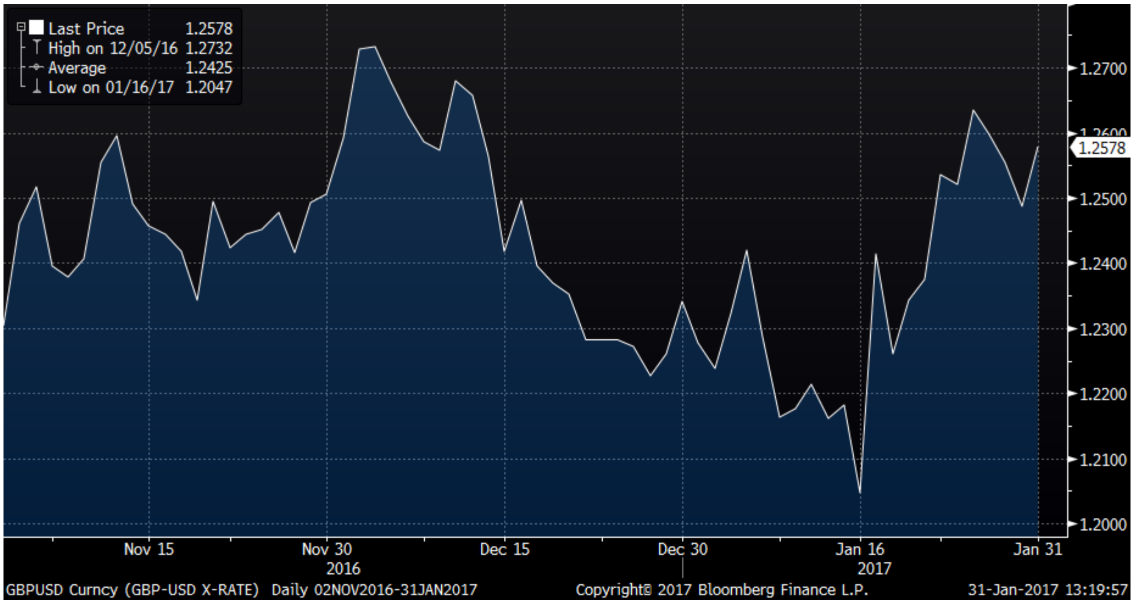
EUR/USD

EUR/USD rose in January after initially weakening to a new 14 year low, helped both by the uncertainty surrounding the Trump presidency and relatively positive news on the Eurozone economy, which continues to show evidence of a slow acceleration in growth. 10 year yield spreads with the US narrowed slightly back to close to 200 bps, and this continues to be well correlated with the EUR/USD rate. Although Eurozone inflation has picked up modestly, the ECB has made it clear this is mainly oil price related and will not lead to them tightening monetary policy. So while the Eurozone economic outlook is better than for some time, there is little reason to expect any rise in European short rates or any trend narrowing of spreads with the US from the European side. But unless the USD reacts positively to news from the Fed or Trump EUR/USD is likely to hold well above January's lows and may press above 1.08.



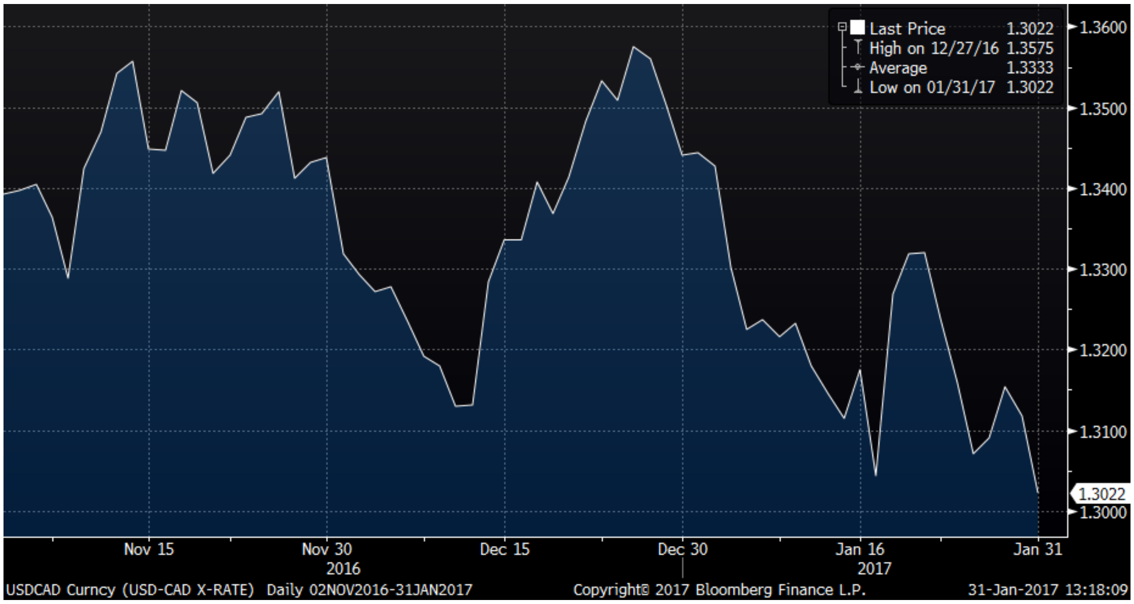
GBP/USD

After a brief dip below 1.20 as Theresa May made it clear that Brexit was unlikely to involve UK membership of the European single market, GBP/USD rallied strongly as she indicated that parliament would be involved in the ratification of the process, and finished the month well above opening levels. However, much of this move was USD related, with GBP finishing the month little changed against the EUR. The market remains sensitive to Brexit news, but that sensitivity may be reduced once Article 50 is triggered and negotiations starts, as it is unlikely there will be much clarity on the outcome for some time. The details of the cost of the UK “divorce” from the EU and any further news on trade deals with the US or elsewhere can have an impact but the current focus may now shift to UK economic data. Last year’s GBP weakness is expected to translate into higher inflation and weaker growth, and the Bank of England’s response to this will be keenly watched. GBP/USD may still manage a recovery to the 1.28 or even the 1.30 area on USD weakness, but it is likely to require much stronger than expected economic data to extend gains beyond there. Renewed USD strength on the Fed or increased confidence in Trump, as well as the usual Brexit concerns, could yet trigger renewed losses below 1.20.



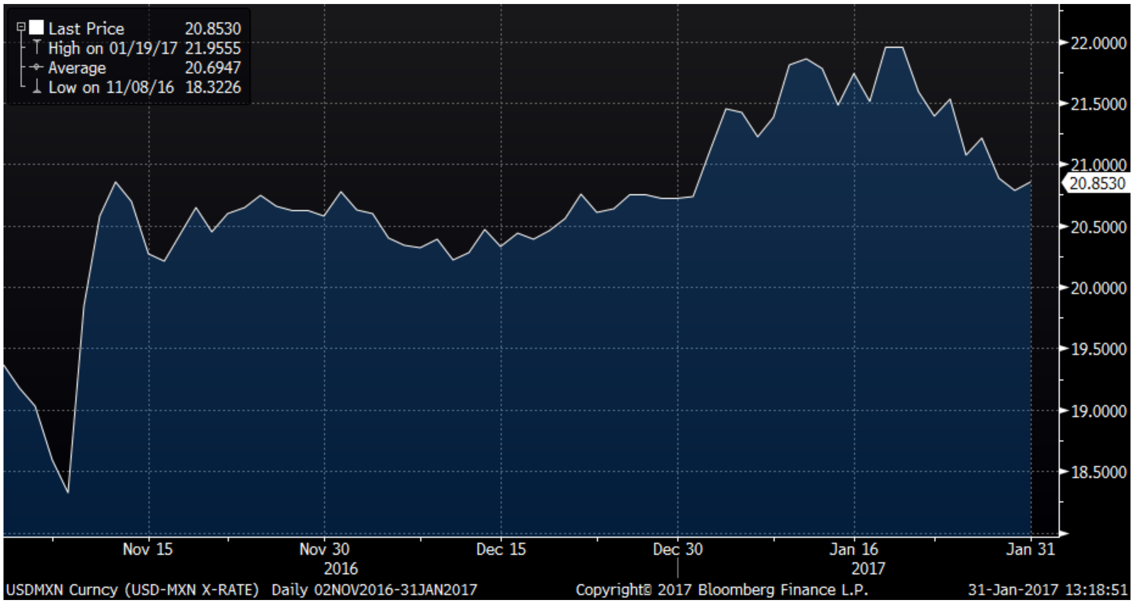
USD/CAD

A higher oil price, uncertainty about the Trump presidency and better Canadian employment data all helped the CAD recover in January after a weak December, but USD/CAD has so far held above the key 1.30 level. Comments from BoC governor Poloz playing down the idea of a rate hike have also helped prevent further CAD gains. As it stands, yield spreads still suggest plenty of upside scope for USD/CAD, but in common with many other pairs it has suffered from general USD weakness through January. Trump's trade policies have so far not had any obvious direct impact on the CAD, unlike the MXN, and in spite of Trump's apparent concerns about NAFTA, few think US/Canadian trade will be affected. Nevertheless, this still looks like a potential negative rather than a positive for the CAD, and given the yield spread favoring the USD this suggests a significant upside bias from levels near 1.30 unless we see a big rise in the oil price to $60 and beyond.



USD/MXN

In common with most USD pairs, USD/MXN has fallen through January after early gains, in spite of Trump signing an executive order to begin the building of the wall on the US southern border with Mexico that he promised during his campaign. He also floated the idea of paying for the wall with a 20% import tax on Mexican goods, and this has received some positive responses from a Congress that would otherwise likely be reluctant to fund such a project. It is surprising that USD/MXN has fallen following this news, and we doubt the MXN will show continued strength if Trump follows through on these promises. Much of the USD/MXN decline relates to the generally weaker USD tone through January and the heavy short MXN positioning that was already in place. Nevertheless, the MXN is probably too weak if the impact of Trump's trade policies proves modest. USD/MXN would need some clearly positive news on this score to trigger a break through key supports in the 18.15-19.00 region. Increased certainty that import tariffs are being imposed on Mexican goods could still propel USD/MXN to new highs above 22.00.



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