December 2019 FX Outlook

November was really about consolidation in the foreign exchange market. Recall that the US dollar has fallen against nearly all the major currencies in October. It recovered in November. No new themes emerged. The drivers remained the vagaries of the US-China trade talks, the build-up to the UK election in the middle of December, which is being heralded as a referendum of sorts on Brexit, and the broad economic outlook.

Equity markets trended higher globally in November. The MSCI index of developed countries' equity market rose more than 2% for the second consecutive month, and its benchmark for emerging market stocks edged slightly higher after the 4% jump in October. While this seemed like investors were willing to take on risk, the strains deepened in the leveraged loan space. The trailing 12-month trailing default rate rose to 1.8%, and some economists expect it to rise to 3% next year. Energy and retail sectors were particularly hit.

Among the major central banks, monetary policy is expected to be on hold. The Federal Reserve has signaled as much. Lagarde holds her first ECB meeting, and the overwhelming sense of continuity means she will not do to Draghi what he did to Trichet, and that is to overturn his last moves. The BOJ has quietly reduced its equity purchases and systemically tapered its bond purchases. There is nothing for it to do it now. Two dissenters on the Bank of England's Monetary Policy Committee in October and the risk of a cut at the MPC meeting a week after the election is possible, but it still seems unlikely.

It had been hoped that the US and China could sign "phase one" of a trade agreement in November after the Trump Administration claimed a deal was struck in principle in the middle of October. However, this proved more elusive, and an agreement is unlikely to be reached until Q1 20 at the earliest. President Trump has threatened to raise tariffs if there is no deal. However, as November wound down, there was talk that 15% levies on roughly $160 bln of Chinese imports scheduled for December 15 would likely be suspended like the October tariffs.

The polls are showing the UK Conservatives enjoy around a 10-percentage point lead over Labour. The Liberal Democrats, the only party that is unambiguously for remaining in the EU, has slipped, and the Brexit Party has also faded. Ideas that Prime Minister Johnson can secure a majority and lead the UK out of the EU by the end of January have supported sterling. If so, there will be a standstill agreement for a year, during which time a new trade relationship between the UK and Europe will be negotiated. If these talks go the same way as the divorce, it will again come down to the wire and leaves open the possibility that the UK still leaves with only the World Trade Organization rules governing the new trade relationship. In effect, the risk of a no-deal Brexit remains untarnished by the election outcome. Many look for sterling to rise toward $1.35 confirmation of a Tory victory.

We had seen a window of opportunity for the US Congress to pass the new trade agreement with Canada and Mexico (USMCA). However, negotiations to enhance enforcement of the labor provisions continued until the end of November. The holiday recess is scheduled to begin December 13, making the window of approval small. There is another window in the first part of next year, and we would subjectively give it about a 50/50 chance of passing before electoral considerations stymie it. We note that in late November, Mexico approved the 2020 budget, which allocated more to implementing the labor reforms required by the USMCA than initially anticipated.

Currency Outlooks

Dollar

The Federal Reserve assures business and investors that the "economy is in a good place" and that the midcourse correction is complete. We are less sanguine. The US economy appears to have slowed further in Q4. The record-long expansion is getting old, and many cyclical indicators, like the 12-month moving average of employment and auto sales, peaked a few years ago. The index of Leading Economic Indicators declined for three consecutive months through October, which used to be a sign of a looming recession. The re-steepening of the yield curve rather than its inversion seems to be associated with economic downturns, according to some recent studies. The economic risks are biased to the downside. Many investors are looking past the impeachment proceedings, the trade drama, and the near-term economic noise and are attracted to the positive returns in the US, and continues to underpin the dollar and US assets.

Euro

Germany narrowly avoided contracting for the second quarter in a row, and the eurozone economy appears to be stabilizing. It is not clear where the new stimulus will come from as the surplus countries in Northern Europe are still reluctant to take on more debt, regardless of the cost, and the global economic slowdown curbs foreign demand (i.e., exports). The ECB meets on December 12, and it will the first meeting with Lagarde at the helm. There is nothing for it to do, but Largarde's press conference will be widely watched. While the US auto tariffs have been avoided, the tensions in the alliance are building. At the same time, European politics is another source of vulnerability. German-French relations are strained, and German politics itself seems in transition. Merkel was forced at her party convention to block Huawei from 5G contracts, and the Social Democrats contest for party leadership may still result in a decision to leave the grand coalition.

(previous in parenthesis, end of October indicative levels)

Spot: $1.1018 ($1.1150)

Median Bloomberg one-month forecast: $1.1065 ($1.1065)

One-month forward: $1.1046 ($1.1165)

One-month implied vol: 4.1% (4.5%)

Yen

Anticipation of the sales tax increase on October 1 brought forward economic activity and especially consumption. This, coupled with the disruption of the typhoon, has meant a weak start to Q4. The Bank of Japan has been tapering its bond purchases at least partly to help the yield curve steepen, and with the stock market trending higher, it has also seen less need to buy ETFs. Prime Minister Abe has called for a JPY5 trillion supplemental budget, but a weaker than expected start of Q4 may boost the size. The yen, however, seems to be more sensitive to global developments, especially the risk appetite. Japanese banks, including the Postal Savings Bank, have significant exposure to Collateralized Loan Obligations (CLOs), which have been facing stronger pressure, especially the retail and energy space. An index of Japanese banks stocks has underperformed the TOPIX. In fact, the banks have hardly participated in this year's rally. It is up about 2.5% compared with 13.75% for the overall market.

Spot: JPY109.49 (JPY108.05)

Median Bloomberg one-month forecast: JPY108.85 (JPY106.95)

One-month forward: JPY109.18 (JPY107.85)

One-month implied vol: 4.5% (5.4%)

Sterling

The UK election will be held on December 12. The polls have consistently shown the Conservatives clearly ahead. The Brexit party has faded, and the Liberal-Democrats, the only national party that unequivocally advocates remaining, appears to be backed by less than one-in-five voters. There are a couple of caveats. First, the polls in 2017 also suggested the Tories would secure a majority, which they didn't. Second, the youth vote, if it comes out, and predicting it may be difficult, appears to be more pro-Europe than their elders. If the Tories do secure a majority, many look for sterling to rally toward around $1.35. If it appears, it could govern as a minority party, sterling might not fall particularly far, but if it looks like a coalition government is necessary or that reaching an agreement on Brexit before the January 31, 2020 deadline, sterling could sell-off toward $1.24. Moreover, if the UK does leave at the end of January, it enters a standstill transition period until 2020. During the transition period, the UK and the EU will negotiate a new trade agreement. If the negotiations fail, the UK will leave the EU with only the WTO to govern trade. The BOE meets a week later (December 19). Although two members of the policy committee dissented from the steady policy in November in favor of immediate cuts, a rate seems more like a Q1 2020 story.

Spot: $1.2925 ($1.2940)

Median Bloomberg one-month forecast: $1.2970 ($1.2655)

One-month forward: $1.2945 ($1.2960)

One-month implied vol: 11.2% (7.7%)

Canadian Dollar

In the face of soft domestic data, and global growth risks, the Bank of Canada softened its neutral stance. However, central bank officials were clear that it does this was more a recognition of downside risks than a signal for a rate cut. The December 4 meeting will most likely pass without incident. Parliament will return the same day. Trudeau, who will lead a minority government, after losing his majority in the late-October election, is pushing for a middle-class tax cut. Despite the rise in equities (a proxy for risk) and firm oil prices, which often support the Canadian dollar, the underlying strength of the US dollar has been overwhelming. Also, the small interest rate premium that Canada offered over the US on two-year borrowing in October disappeared in November.

Spot: CAD1.3282 (CAD 1.3165)

Median Bloomberg one-month forecast: CAD1.3261 (CAD1.3210)

One-month forward: CAD1.3277 (CAD1.3165)

One-month implied vol: 3.8% (4.5%)

Australian Dollar

The Australian economy is weakening, and the central bank will have to reduce interest rates. The market is pricing it in for Q1 2020 rather than December 3. Recall that RBA cut rates by 75 bp (50 bp in May and 25 bp in October). However, as the cash rate, now 75 bp, approaches zero, there is speculation that an asset purchase program can be adopted. The labor market held up well until lately. The next report employment report is due December 18. On top of no longer offering a premium over the US, Australia has seen its terms of trade deteriorate, as the price of its largest exports, like coal, iron ore, and gold has fallen. The Australian dollar has fallen almost 4% against the US dollar this year, and nearly half (1.9%) took place in November. The OECD's model of purchasing power parity sees the Australian dollar (~$0.6770), as about 3% undervalued, but given the economic conditions, it is likely to become more undervalued.

Spot: $0.6763 ($0.6895)

Median Bloomberg Forecast: $0.6773 ($0.6790)

One-month forward: $0.6770 ($0.6905)

One-month implied vol: 5.1% (6.3%)

Mexican Peso

In the September-October period, the peso appreciated roughly 4.3% against the US dollar. It was under pressure throughout November, losing about 1.7%. There were both domestic and international drivers. The Mexican economy contracted for three quarters before eking out the smallest of gains in Q3 (0.01%). The central bank has cut the official cash rate in November to 7.50%. It is the third cut in H2. Banxico meets on December 19 but is likely to wait until Q1 to cut again. The recent pressure on the currency, the government's policies have sparked a bit of a capital strike, but also acts as a lightning rod for other emerging markets. From Argentina and Chile, through Peru and Bolivia, on to Colombia, Brazil, and Venezuela, the region is in convulsions, and the peso is the liquid and accessible proxy.

Spot: MXN19.5300 (MXN19.2330)

Median Bloomberg one-month forecast: MXN19.5225 (MXN 19.4215)

One-month forward: MXN19.6110 (MXN19.3085)

One-month implied vol: 8.1% (8.4%)

Chinese Yuan

There is nearly universal agreement that the world's second-largest economy is slowing. Many expect it to report less than 6% annualized growth in Q4. The impact of the US tariffs is palpable in the exporting sectors, while the more domestic industries, like infrastructure, continue to perform well. The financial system is under strain as well. Opinion seems broadly divided between a camp that thinks China is destined to replace the US as global hegemon and another that believes China is on the precipice of a serious financial crisis. We suspect the truth lies somewhere in the middle. Its system is fragile, but Beijing as the will and resources to avert a severe crisis. China is projecting its power and influence, but like all great powers, it struggles to convert its economic presence and financial power into actual political influence beyond the non-recognition of Taiwan. After allowing the dollar to move above CNY7.0 in August, China has not sought a significant devaluation. The yuan has strengthened for three consecutive months through November. The dollar has appreciated by about 2.2% against the yuan this year

Spot: CNY7.0325 (CNY7.0395)

Median Bloomberg one-month forecast: CNY7.0499 (CNY7.0985)

One-month forward: CNY7.0338 (CNY7.0455)

One-month implied vol: 4.2% (4.2%)