



## **December FX Outlook – Fed hikes on the horizon, Europe remains in flux**

The USD rose strongly in November after the unexpected Trump victory, despite most commentators and pre-election price action suggesting a Trump victory would be negative for the USD. In practice, expectations of looser fiscal policy have “trumped” concerns about the potential negative impact of protectionist policies or other more general worries about Trump’s suitability. The Fed is now fully expected to raise rates in December, and the focus has shifted towards European political risk and the Italian referendum on December 4<sup>th</sup>. Recent OPEC developments will keep oil related currencies in focus, while GBP will continue to monitor Brexit news, though the Supreme Court hearing on December 5-8 won’t produce a verdict until the New Year.

### **Outlook for December**

#### **1. US monetary policy. Key events: FOMC meeting December 13/14, Employment Report December 2**

The market is now fully priced for a 25bp Fed rate hike on December 14. The main question is now what is priced in subsequently. The Fed does provide an indication with its “dot plot” of individual FOMC member expectations, but this has consistently shown rates higher than market expectations. Nevertheless, an increase in the dot plot in December would probably be seen as a sign that the Fed had become more hawkish in response to recent data. However, the Fed won’t make any assumptions about fiscal or trade policy under Trump at this stage, so a significant change in the Fed outlook is unlikely. Even so, going forward the market expectation may continue to edge towards tighter Fed policy both because of the expectation of easier fiscal policy and the probability that Trump appointees to the Fed will be on the hawkish side.

#### **2. UK still in focus. Key events: Supreme Court hearing December 5-8, MPC meeting December 15**

The High Court ruled that parliament rather than the government had to take the decision to trigger Article 50 and start the process of leaving the EU, and this was seen as positive for GBP because it increased the chance that parliament could moderate the terms of Brexit. The government is appealing this decision at the Supreme Court. Most expect the court to uphold the High Court decision, which would again be seen as GBP positive. However, although the hearing is scheduled to end on December 8<sup>th</sup>, the Supreme Court has said it won’t rule until the New Year, so while the hearing may generate some volatility, it is unlikely to trigger a decisive GBP move.

#### **3. Seasonality**

December is typically a weak month for the USD against most currencies, with the exception of the JPY, probably related to year end (Japanese year end is in March). Typically, USD weakness in December is reversed in January. However, although this is a clear seasonal tendency in the last 20 years or so, it is not true of every year by any means.

#### **4. ECB policy meeting, December 8**

This ECB meeting will have increased focus as Draghi has promised to give an update on the proposed path of policy going forward, in particular whether the QE program will be extended beyond the current earliest possible end date of March 2017. It is generally expected that an extension will be announced. If it is not, expect the EUR to rally significantly.

#### **5. The Italian referendum and the Austrian presidential election, December 4**

These events have become the major market focus for the first week of December, though it isn't obvious that they should have a major impact, whatever the results. Polls suggests that the referendum will reject the changes, and this is seen as dangerous because it will likely lead to the resignation of PM Renzi and some fear this could lead to elections which might produce a victory for the populist 5-Star party.

The Austrian presidential election polls suggest the return of far right president in the shape of the Freedom Party's Norbert Hofer. The position of president is largely ceremonial, so would not have immediate significance, but may lead to speculation of early elections and a challenge to the centrist pro-EU consensus.

### **Currency Outlooks**

#### **EUR/USD**

EUR/USD broke to new lows for the year in the wake of the Trump victory, trading down to a low of 1.0518, also breaking the low seen in December 2015, but still short of the 14 year low of 1.0462 seen in early 2015. The driving force was widening yields spreads in favor of the US as US yields rose sharply in anticipation of easier fiscal policy and protectionist policies from Trump that are expected to push up inflation, and potentially from a more hawkish Fed composition. Pre-election concerns about longer term negative US growth consequences due to protectionism and tax policy have been ignored for the moment.

On the EUR side, the Trump victory also triggered more speculation of the populist wave spreading to Europe in the Italian referendum and Austrian election on December 4<sup>th</sup>, and the elections in France and Germany next year. This initially added to pressure on the EUR, but perceptions of the likely impact of the Italian referendum and Austrian referendum have been scaled down a little in the run up to the votes, and some corrective pressure has been seen against the USD rise. However, the underlying USD uptrend remains intact, and there is potential for renewed EUR weakness if the ECB announces an extension to QE at the December 8 meeting as most expect. Even if seasonals help to prevent a retest of the lows and a break to new 15 year lows this month, there is a strong chance that the start of the Trump presidency in January will trigger renewed USD strength, potentially leading to a test of 1.00 in early 2017. View a 90 day EUR/USD chart [here](#).

#### **GBP/USD**

GBP recovered strongly through November, helped partly by the High Court decision that parliament was

responsible for triggering Article 50 to formally start the process of Brexit. GBP also gained from the Trump victory, which triggered some position squaring in EUR/GBP, and GBP actually rose slightly against a strong USD in November. GBP/USD finished the month little changed from its level on November 9 when the election result was announced.

Going forward, the Supreme Court hearing this month will be of interest, but won't produce a verdict until the New Year, so GBP may be more side-lined until then. While positioning is still short GBP, and seasonals also tend to be favorable in December, the recovery in November against the USD trend has removed any obvious risk premium in GBP/USD relative to yield spreads, so rallies through recent highs at 1.2674 should probably be seen as a medium term selling opportunity. View a 90 day GBP/USD chart [here](#).

### **USD/CAD**

USD/CAD was little changed in November despite initial sharp gains after the surprise Trump election victory, helped by a late month rally in the oil price in reaction to the OPEC deal. The CAD also benefitted against other currencies from the general risk positive tone and a more positive outlook for US growth, which will typically benefit Canada more than other countries, as long as Trump protectionism doesn't extend to the northern US border.

Nevertheless, despite the recent uptick the oil price is still below the October highs and yield spreads have moved strongly in favor of the USD versus the CAD, so unless the oil price continues to press higher and/or the market starts to price in more hawkish Bank of Canada policy, risks still look to be towards CAD weakness against the USD going forward. View a 90 day USD/CAD chart [here](#).

### **USD/MXN**

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. Some 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. If that is the case, Mexico may actually be a significant beneficiary of Trump's economic policies, and will also be helped by any oil price support provided by the latest OPEC deal. So in the absence of more concrete proposals on immigration/repatriation and protectionist measures, the MXN may prove attractive at these levels, especially on the crosses with European currencies and the JPY, as a risk and yield positive play. View a 90 day USD/MXN chart [here](#).

### **USD/JPY**

The JPY was the biggest loser from the Trump victory, falling more than 8% in November on the combination of higher US yields and strong equities and risk appetite which are traditionally negatively correlated with the JPY. These are likely to remain the main drivers for the JPY, with the rise in US bond yields tending to have full impact on the spread with Japan because of the BoJ policy of fixing the 10 year yield near zero. View a 90 day USD/JPY chart [here](#).

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