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2018 FX Outlook Happy Hour!

FX Strategy Team





Chris Turner Global Head of Strategy London +44 20 7767 1610 chris.turner@ing.com



Viraj Patel Foreign Exchange Strategist London +44 20 7767 6405 viraj.patel@ing.com

2018 FX Outlook: Happy Hour!

- Despite the threat of President Trump's policy-by-Twitter approach, global policy uncertainty has fallen in 2017. The world has seemingly learned to live with Trump
- Fears of central bank liquidity withdrawal look overplayed. A broadening business cycle will also favour those currencies benefiting from firmer investment trends
- In all we look for one more year of investors chasing growth stories in the FX space. 2019 looks tougher, however, so let's enjoy it while we can

This time last year, the dollar was rallying on the view on the view that Donald Trump was going to unleash the kind of fiscal stimulus not seen since the Reagan years. Whether he was going to deliver on his protectionist campaign rhetoric was anyone's guess. But the backlash against globalisation evidenced in the Trump and Brexit votes had certainly elevated levels of policy uncertainty ahead of key elections in Europe.

At the same time, markets were also starting to question whether the withdrawal of Fed stimulus was going to expose some unexpected dollar dependencies – such as the excessive credit growth in the likes of China or Turkey. Would Fed balance sheet normalisation also deflate the financial asset bubbles in the making since 2009?

Investors were also asking whether global growth would broaden or whether the rest of the global economy hoped to dine out on US consumption – potentially creating a headon collision with Trump's 'free and fair' policy for global trade?

A year ago we had described the above environment as the global economy entering a Brave New World, an environment of opportunity and uncertainty.

The good news, one year on, is that opportunities have been taken, while uncertainties have decreased. Global consumer and business confidence is on cycle highs and most asset classes have recorded stellar returns. And for the first time since the Global Financial Crisis, higher global growth forecasts now look credible.



Fig 1 2018 global growth outlook looks relatively cheerful



Fig 2 Global 'Animal Spirits' running at post-crisis highs Diffusion index



Note: Diffusion indices based on a sample of 25 DM & major EM economies Source: Macrobond, ING FX Strategy Where will 2018 mark in the global business cycle? 'Happy Hour' seems the most appropriate description. Broadening growth and low inflation should remain a wonderful cocktail for risk assets. But like all good 'Happy Hours', the window for enjoyment is limited. As the US cycle matures and G3 central bank balance sheets start contracting, 2019 will provide much stiffer headwinds.

It is in this context that we examine the key FX challenges for 2018, looking through the lens of: (1) **declining policy uncertainty**; (2) **the changing composition of global liquidity**; and (3) **the broadening and maturing of the global business cycle**.

Assumption 1: Policy uncertainty falls

Despite the occasional scares from Trump's twitter account, measures of policy uncertainty have actually fallen substantially over the last year. The Global Economic Policy Uncertainty index (GEPU), for example, scans newspapers in 18 countries for

" It should be no surprise that risky currencies are performing well, even as major central banks ease up on liquidity " terms relating to the Economy, Policy and Uncertainty. Having peaked in January 2017, this index is off sharply as the world has seemingly learned to live with Trump. Supporting these moves has been the greater

confidence in economic forecasting as represented by the narrower dispersion in GDP forecasts. Lower uncertainty lowers financing costs, raises asset prices and, as we shall discuss later, encourages investment.

On a relative basis, we note some particularly large falls in these uncertainty indices for the likes of Eurozone, the UK and Mexico. The Eurozone fall should be no surprise given the failure of Le Pen in the French Presidential elections and growing business confidence. And that improvement was embodied in President Draghi's June speech in Sintra – effectively signalling the all-clear on the Eurozone crisis raging since 2010.





Fig 4 Synchronised fall in uncertainty across the majors



*Peak was in June 2016 unless stated. Chart shows normalised scores. Source: ING calculations using Baker, Bloom and Davis (2014) data

Into 2018, Italian elections are probably the biggest source of Eurozone uncertainty through the early part of the year. Our team believe the elections will probably take place in March and notionally assign only a 30% probability to an outcome that could create greater uncertainty such as the need for new elections or anti EU coalition of 5SM and Lega Nord gaining power.

German politics will also be a major feature at the start of 2018. As we go to press our German team assigns these probabilities to the three main scenarios: (1) CDU/CSU form a grand coalition with the SPD, for the 'price' of greater European reform (40%);

(2) Merkel is left to form a minority government, which would likely fall within twelve months (30%); and (3) fresh elections (30%).

Brexit will, of course, continue to play a role in the broader uncertainty index. Our baseline view here is that UK authorities, belatedly understanding the economic realities of a Hard Brexit, make the necessary concessions to secure Phase II of the Brexit process this December. This should help keep the Brexit uncertainty risk contained in the early part of 2018, although another robust debate about the shape of a future trade deal may emerge towards the end of 2018.



Fig 5 2018 political calendar still looks fairly eventful... but the risks are more local

" Bar the Italian and US mid-term elections, the 2018 political calendar sees more local – rather than global – risks "

Source: ING

We will also see mid-term elections in the US and Presidential elections in Russia, Brazil and Mexico. Our team feel that some modest tax cuts and 3% US growth may be enough for the Republicans to maintain control of both houses of Congress.

Of the Presidential elections, our team feel that those in Latam could generate the greatest turbulence. At this stage, though, we doubt they will have global ramifications.

Lower policy uncertainty has also been helped by the well-telegraphed and seemingly synchronised policies of some of the world's largest central banks. This has been evidenced by the greater co-movement of bond yields – and has also sent G7 FX volatility down to its lowest levels in three years.

We continue to see policy uncertainty remaining at its more subdued levels into 2018. But will the synchronised slowdown in central bank balance sheet growth start to create problems for those currencies dependent on global liquidity?

Assumption 2: Liquidity fears look exaggerated

When it comes to the some of the biggest challenges to the investment environment in 2018, one of the most commonly cited is the withdrawal of central bank liquidity. After all, the Quantitative Easing policies employed by central banks were heavily skewed towards driving investors down the credit curve and into riskier assets.

ING's Chief Eurozone economist, Peter Vanden Houte, wrote an article on this subject entitled '<u>The next Minsky Moment</u>' on ING's new <u>THINK</u> website. While history is not always a good guide, we do agree with Peter's conclusions that the withdrawal of central bank liquidity is more likely to prove a threat to asset markets in 2019 than 2018.

We also believe two factors will be important in creating benign investment conditions through 2018:

- Aggregate central bank balance sheet will still grow in 2018
- Private sector liquidity will compensate for declining official liquidity provision



Fig 6 Central banks will begin to withdraw liquidity in 2018... but ever so gradually

" Aggregate balance sheet of the world's largest central banks will not start contracting until after summer 2019 "

As Figure 6 shows, the growth in official sector liquidity is certainly going to slow in 2018. The Fed have become experts in unwinding their legacy QE programmes and have a well-telegraphed balance sheet reduction plan. In theory that could see a maximum US\$50bn per month decline in the Fed balance sheet being enacted by 4Q18.

The ECB are also learning from the Fed's successful experience with tapering. At present we assume PSPP is cut to €15bn per month for the final quarter of 2018, before being stopped completely. For the BoJ, its Yield Curve Control scheme has seen JGB buying decline by JPY20tr over the last 12 months. We assume another small decline in JGB buying in 2018.

Other marginal contributors to our aggregate central bank balance sheet chart, eg, the likes of China, Brazil, Switzerland and Russia, are not expected to have a meaningful impact on broad trends. We acknowledge this relies on a benign international environment (meaning that USD/EM does not surge and prompt defensive FX intervention from local central banks) and that a EUR recovery can keep the SNB away from the market.

" Remember, for G3 central banks this is a voluntary withdrawal of liquidity

In sum, we do not look for the aggregate balance sheet of the world's largest central banks to start contracting until summer 2019 – suggesting that the headwinds to risk assets

may not stiffen before late-2018. It's also crucial to remember that for G3 central banks this is a voluntary withdrawal of liquidity. Were we to see a sharp equity correction or a geopolitical shock, the Powell-Fed would no doubt slow balance sheet reduction.

Fig 7 USD cross-border credit to start growing again?







Source: BIS

Fig 9

Even though the term 'liquidity' is much maligned, the BIS have written several articles over recent years on how to define private sector liquidity. The disintermediation and de-leveraging of the global banking system has seen one of the key measures of global liquidity, cross-border interbank claims, stagnate since the Global Financial Crisis.

But debt issuance has surged and one could argue that greater confidence in global growth, unleashing those animal spirits, could see cross-border USD lending continue its slow recovery. Notably the increase in USD lending to EM a decade ago help fund stronger EM growth rates, EM currency rallies and the broad dollar decline.

A much neglected side of private sector liquidity is the strong growth of client Assets Under Management (AUM). Surely this explains why the exceptional global rally in equities has been accompanied by generally high readings for investor cash ratios?

For reference, PWC estimates that global AuM are going to rise to US\$112tr by 2020 from US\$85tr today and US\$78tr in 2015. As a share, passive investment strategies are expect to rise to 21% in 2025 from 14% in 2015. The OECD notes in its latest outlook, ETF funds under management have surged 27% this year to US\$4.3tr.

These trends have been driven by a number of factors, including ageing of OECD populations and the shift towards funded/defined benefit contribution plans. This trend looks unlikely to change anytime soon – indeed regulatory changes in the UK and Australia are directing increasing amounts into funded pension schemes. These trends should help to soothe the withdrawal of official sector liquidity.



Signalling effect of QE policies & risk appetite...

Fig 10 High external deficit countries at risk to QE unwind

FX change over Oct-17 (y-axis) vs. 2017 Current Account/GDP ratio (x-axis)



Source: Bloomberg, Macrobond, ING

It's really hard to find a strong statistical relationship between central bank balance sheet adjustments and, for example, risk-sensitive EM currencies. In fact, the more convincing relationship seems to be via some sort of 'signalling channel' – that is G3

" It should be no surprise that risky currencies are performing well, even as major central banks ease up on liquidity central bank balance sheets tend to grow during sharp economic slowdowns, which is obviously associated with a bear market in risky assets. It should be no surprise that risksensitive currencies are performing quite well

now, even as major central banks ease up on liquidity. Global growth matters more.

A word of warning, however. The performance of some of the EM high yielders over the last couple of months – albeit driven by local stories – provides a preview of what a sudden stop of portfolio financing could mean for FX markets.

We would expect headwinds to portfolio flows to become stiffer as 2018 progresses and thus investors will need to be more nimble with carry strategies. Instead we would prefer those pro-cyclical currencies, backed by stronger external positions, that can flourish during the 2018 extension of generally benign liquidity conditions.

We don't see too many threats from the withdrawal of official sector liquidity – at least through 1Q18-3Q18. Rather than pursuing high yield FX (many undermined by local politics), we prefer pro-cyclical FX backed by external surpluses.

Assumption 3: Investment trends key for FX in 2018

The global expansion heading into 2018 looks to be broadening out – and after years of remaining depressed, the conditions for a pickup in investment are fairly ripe given the sweet spot of lower political uncertainty from the 2017 peak, easier financial conditions and greater global 'animal spirits'.

A goldilocks global economy – one where growth picks up but inflation remains fairly benign and orderly – underpins our assumptions for global markets in 2018. Sizable output gaps suggest very few economies are running hot – and the risk of a marked pickup in inflation remains low – bar a few economies such as the US. Even for the US, a marked upside break-out in inflation has to be marked as an 'extreme alternative'.



Fig 11 ING Economic Cycle Dashboard: World economy likely to remain in 'Goldilocks' mode given negative output gaps

Note: Left hand chart shows the revision to IMF country forecasts for inflation and growth between April 2016 and October 2017 Source: ING, IMF.

However, even in a synchronised global growth backdrop this won't be a free-ride for all countries. Investors still want to chase positive local growth stories and in 2018, in particular, will want to chase stories related to the pick-up in investment. This is because

both corporate profitability and capex intentions are on the rise. So too are IMF forecasts for investments as a share of growth in 2018.

For FX markets, the differing stages in the economic cycle will mean that not all will benefit from this investment story. Following up on well-received scorecards on themes such as the 2015 CNY devaluation, Brexit, Trump and Eurozone politics, we are now introducing an **Investment Scorecard** for FX.

Inputs into the scorecard are factors such as business confidence, the manufacturing intensity of an economy, corporate profitability and the expected change in investment in 2018. This scorecard is largely illustrative but, in our opinion, provides a great sense of the winners and losers during the 2018 investment cycle.







-1.0

KRW RUB CZK EUR CAD SEK TRY HUF CNY PLN CHF IDR GBP MXN JPY CLP USD NOK MYR SGD RON NZD THB COP BRL ZAR PHP AUD INR Note: Our ING Investment Scorecard looks at four characteristics for each country: (1) change in domestic business confidence indicator over the past 6M; (2) the contribution of the manufacturing sector to GDP; (3) the change in return on equity for domestic stocks; and (4) IMF revision to 2018 total investment forecast. Source: ING, IMF, Bloomberg, Macrobond

European currencies look good on this basis, as do parts of Asia. Despite synchronised global growth, the commodity producers do not score impressively. This should not be a surprise in that this is not a China-driven terms-of-trade story.

Indeed growing investment and the firing up of the manufacturing sector will expose economies like Australia, that have struggled to diversify away from reliance on commodity exports.

As the business cycle matures and investment trends improve, investors should favour the currencies of those economies set to benefit the most from this story. The outperformers on our scorecard are generally European and Asian currencies.

The 'Sweet Spot' for FX in 2018

Bringing together our three themes of: (1) reduced policy uncertainty; (2) supportive liquidity conditions supporting pro-cyclical currencies; and (3) a bullish turn in the investment cycle, we create a venn diagram to identify the sweet spot for FX.

Meeting all our criteria for this 2018 thematic are many European currencies. In general the EUR and the CE3 currencies look well-placed to benefit from the environment we describe for next year.

Another year of strong growth in the Eurozone should allow EUR/USD to work its way towards 1.30, even though the US economy may be growing quite nicely. A tightening cycle underway in the Czech Republic should allow CZK to outperform the EUR – delivering healthy gains against the USD.

In Asia, we particularly like the KRW story. The early stage recovery, the tightening cycle and Korea's exposure to the global manufacturing cycle should all help USD/KRW to drop to the 1000 area.

Holding back some currencies that should perform well on the lower uncertainty and reasonable liquidity story is the exposure to the investment cycle. Here India, Australia and the Philippines score poorly; consequently our 2018 FX forecasts see their currencies underperforming their peers. MXN and BRL will be held back by political uncertainty.

Combining our assumptions for: (1) subdued policy uncertainty; (2) ongoing support to the global recovery from liquidity conditions; and (3) a rotation into investment stories, we see **Europe and Asian FX currencies generally out-performing**. The **commodity bloc looks mixed** and typically favoured **high-yielders lag on politics**.



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