FX Outlook 2019: Shifting sands ahead?

20 December 2018

Treasury Research & Strategy

Global Treasury

OCBC Bank

G10 FX Outlook

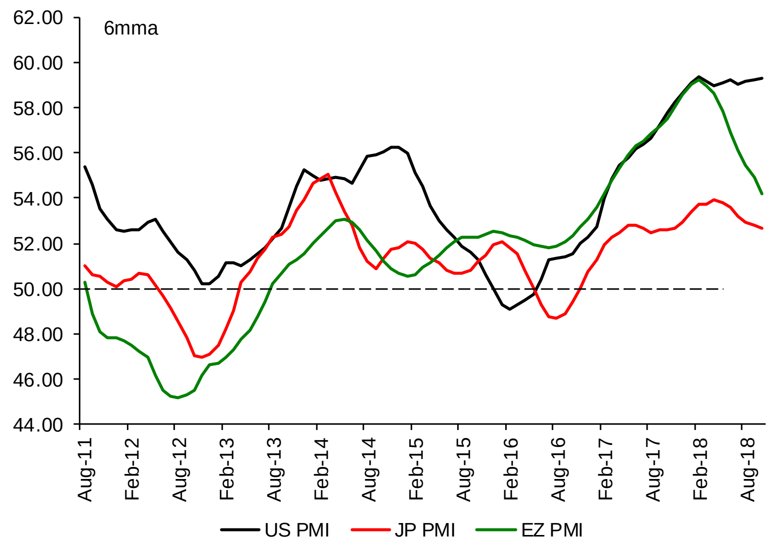
G10 FX: USD on a shakier footing

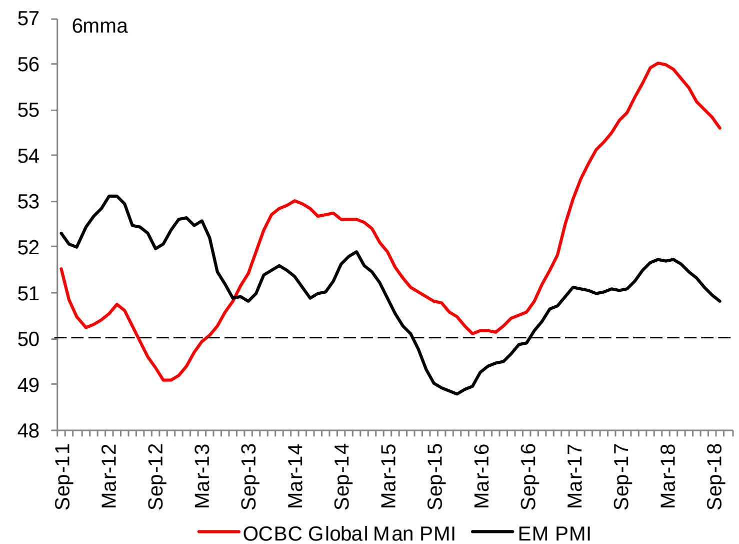
- On the macro front, US economic outperformance is standing on an increasingly narrow base. Nevertheless, it should continue to carry USD strength into the beginning of 2019, despite idiosyncratic drivers pulling the majors in different directions.

- Thereafter, weakening fundamentals should make broad USD prospects considerably murkier.
  - The Fed's hiking cycle should enter its last legs by mid-2019. This should give the other major central banks the opportunity to catch up to the Fed in terms of policy normalization – putting the USD on the back seat on a structural perspective.
  - However, the risk is for the dollar smile to kick in, especially if the expected pause by the Fed collides with a sharper, more protracted downturn in the economic momentum. In this context, expect the other major central banks to under-deliver on their potential rate hikes.

Global macro backdrop – US still ahead

- In terms of macro indicators, the US has been (and still is) a relative outperformer as China and the EU fall by the wayside. As it stands, the US PMI gauges continue to hold up well relative to other major economies.
- However, there is already an increasing awareness that the US economy is about to run into late-cycle dynamics in 2019 – narrowing the hitherto dichotomy with the rest of the world.

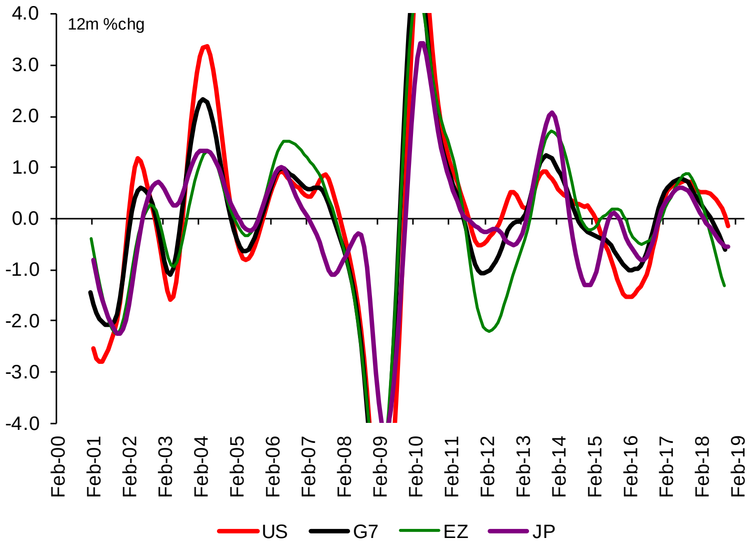


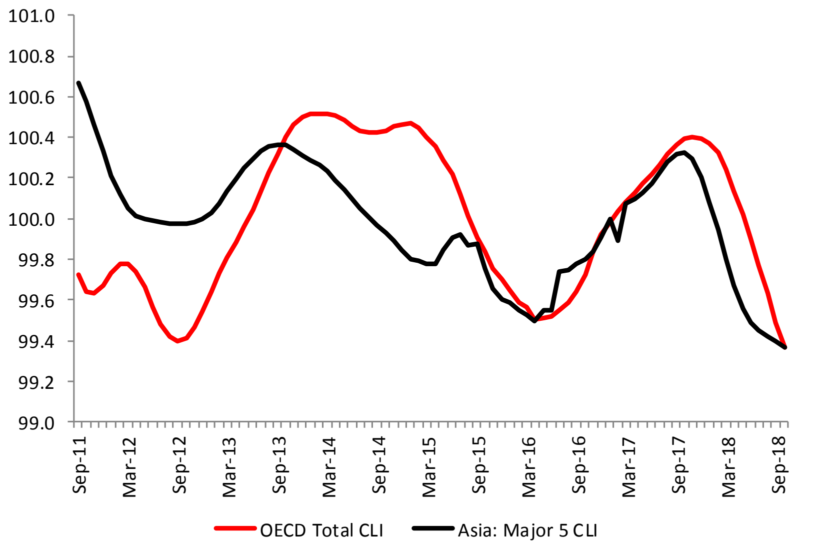


OCBC Bank Source: Bloomberg, OCBC

Global macro backdrop – US still ahead

- Note a consistent easing of global composite leading indicators (CLIs) throughout 2018. Looking ahead, the leading indicators continue to portend a softening of global economic momentum.
- A similar story, though, presents itself with the US relatively outperforming other key economies. However, looking forwards, the CLIs also portend a slowing of economic momentum in the US.





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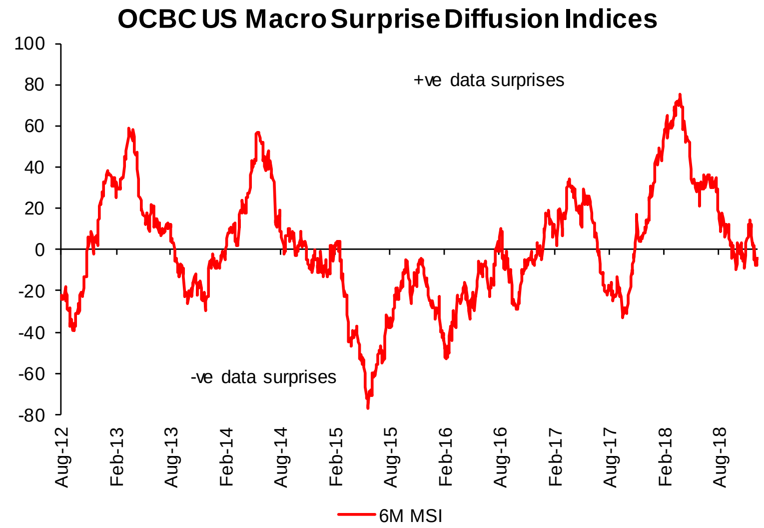
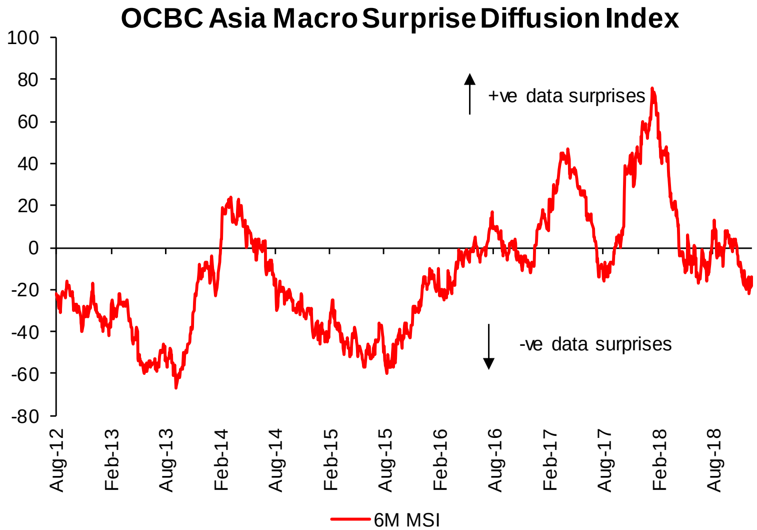
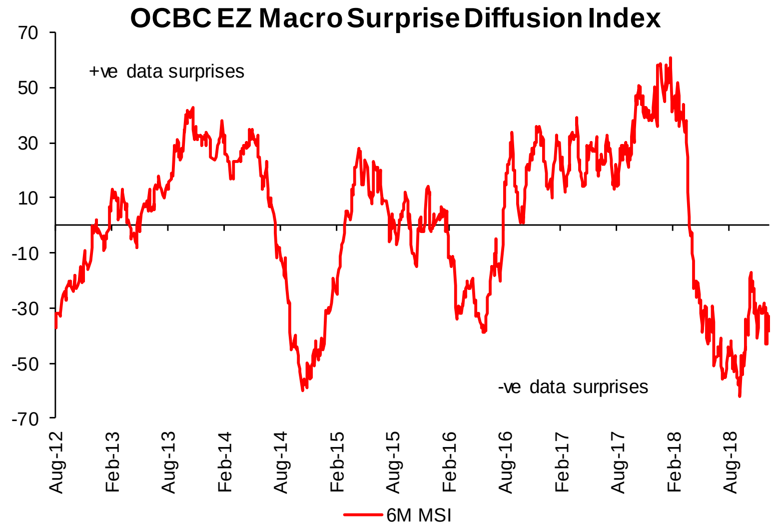
Source: OECD, Bloomberg, OCBC

Macro convergence to dilute the USD

- While headline indicators in the US appear strong, tracking a wider range of economic indicators through the Macro Surprises Index (now at neutral levels) reflect a slowing of momentum.
- Asia and Eurozone faring worse, but US macro convergence with the rest of the global economy has been under way.







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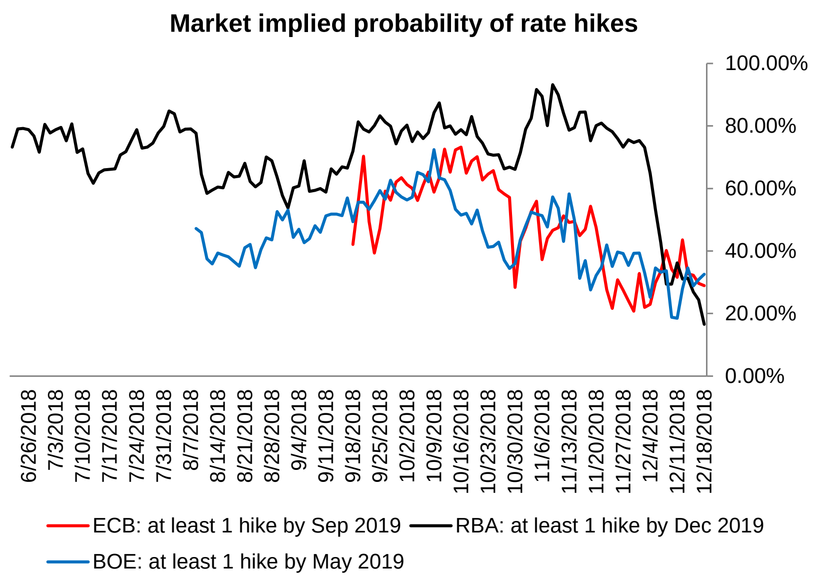
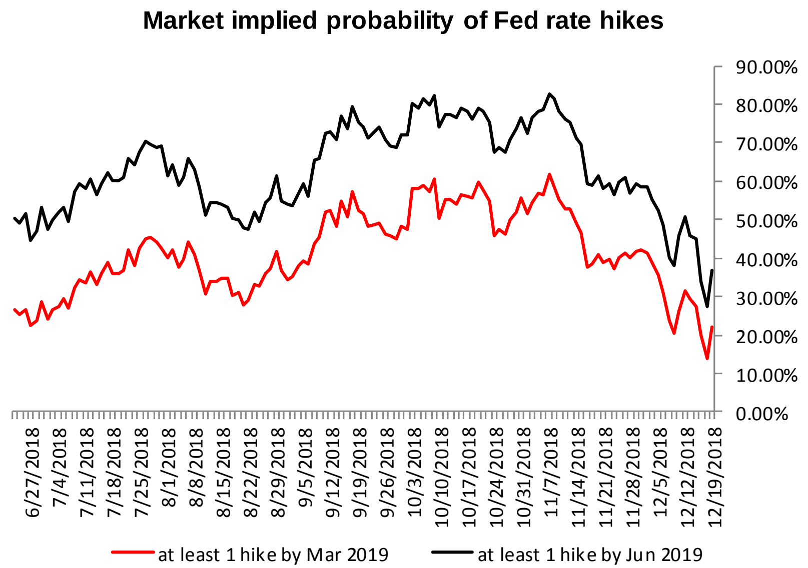
Source: Bloomberg, OCBC

Major central banks catching up with the Fed

- Fed in late-stage hiking cycle, with projections to getting sketchy and data-dependent after the first 1-2 hikes in 2019. How will the other central banks tread in this context? Expect largely ambivalent policy postures by the other majors central banks in 1H19.
- Nevertheless, the catch-up may start deeper into 2019, barring a protracted downturn. In that context, market expectations for rate hikes at the other major central banks may start to kick in from 2Q19. Expect, however, significant divergence. Watch the September 2019 meeting for the ECB, while the BOE may be in position to contemplate hikes by May (pending a Brexit resolution). RBA, meanwhile, may still lag the pack.

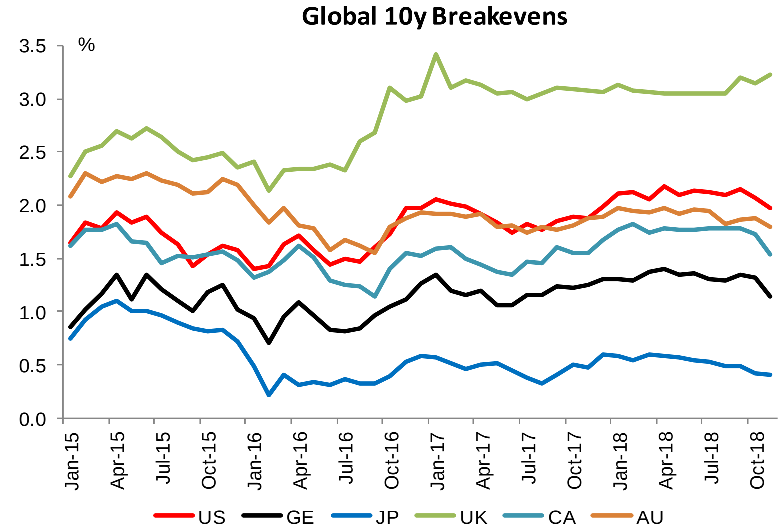


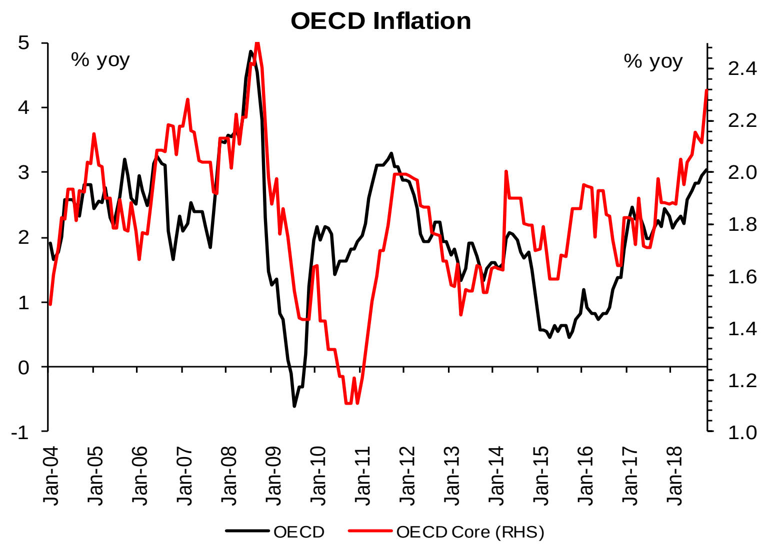


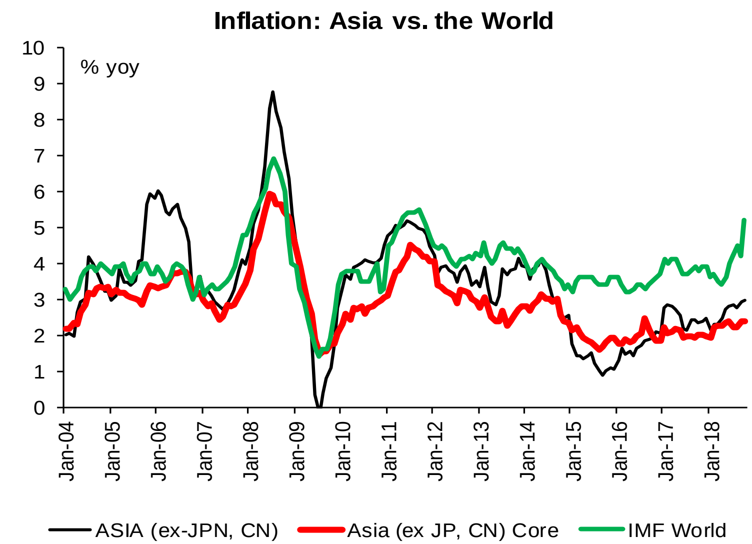
OCBC Bank Source: Bloomberg, OCBC

Little urgency in global inflation

- However, slowing global growth and less-than-acute inflation threats temper policy normalization impetus across the other global central banks. Lessened impetus for the Fed's eventual terminal rate to be significantly above neutral?
- Global breakevens also turning lower in the end 2018, highlighting less-than-enthusiastic inflation expectations into 2019.



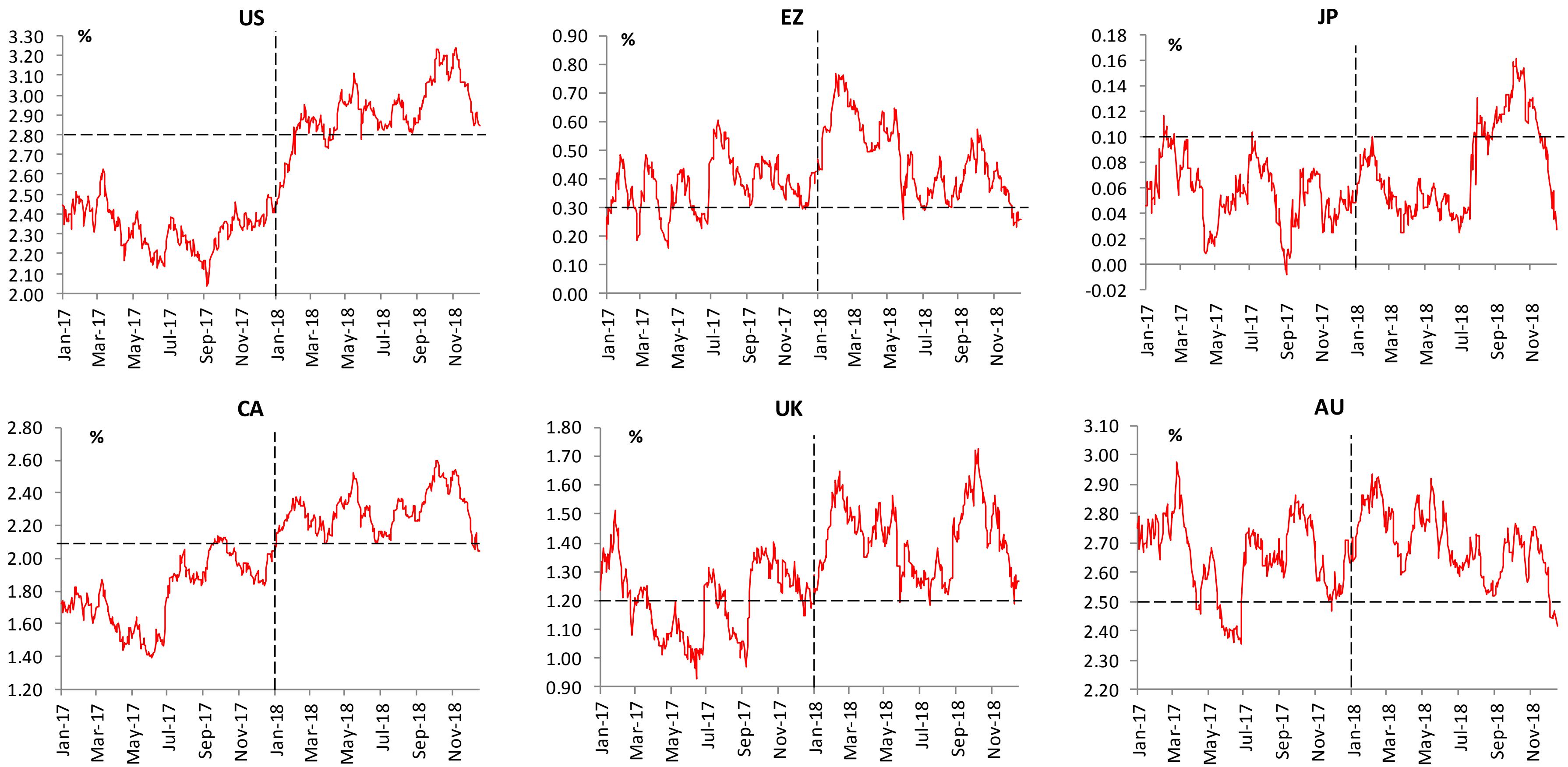




OCBC Bank Source: Bloomberg, OECD, OCBC

Long-end yields – Reality bites

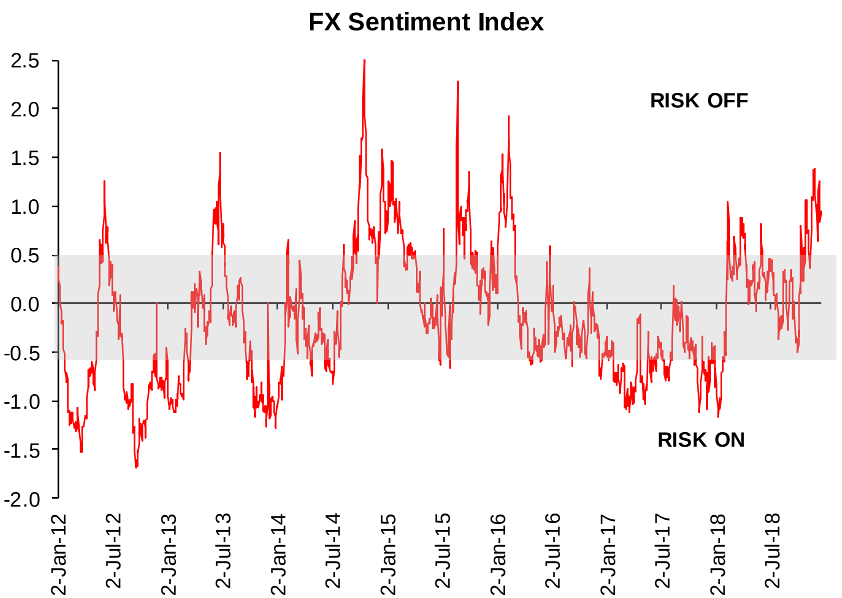
- Core 10y yields manifesting the true state of global macro environment. Ongoing re-pricing of Fed expectations should cause USTs to lead global yields lower. Nevertheless, expect volatility ahead as markets adjust to a new Fed rhetoric.

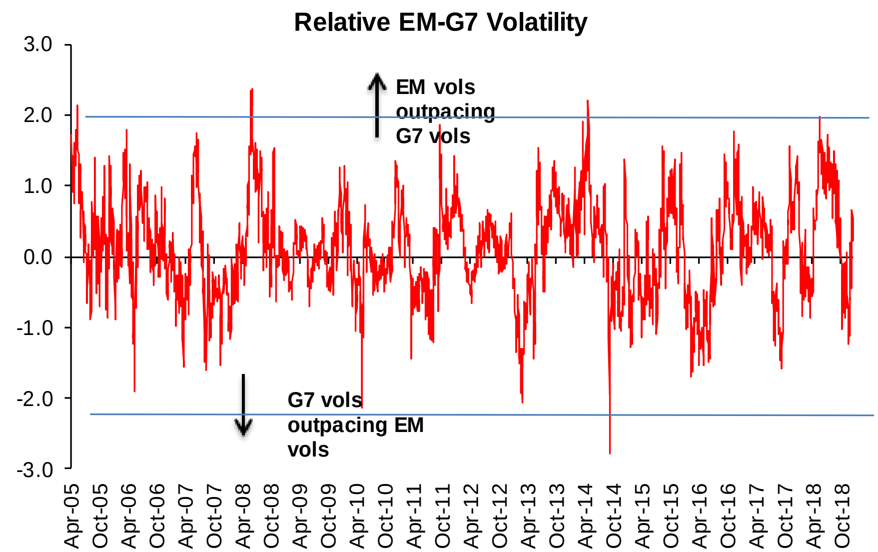


OCBC Bank Source: Bloomberg, OCBC

Risk appetite considerations

- The world is a much rougher place in 2018. Our FX Sentiment Index spent only 22 days (and mostly in Jan) in the Risk-On zone this year, 71 days in the Risk-Off zone, and most of the other days in the Risk-Neutral zone closer to the Risk-Off boundary. In contrast, the risk appetite is much more sanguine in 2017, with 173 days in Risk-On and no days in Risk-Off.
- Expect no shortage of potential trip-ups as we head into early 2019, keeping the haven currencies very much in demand.

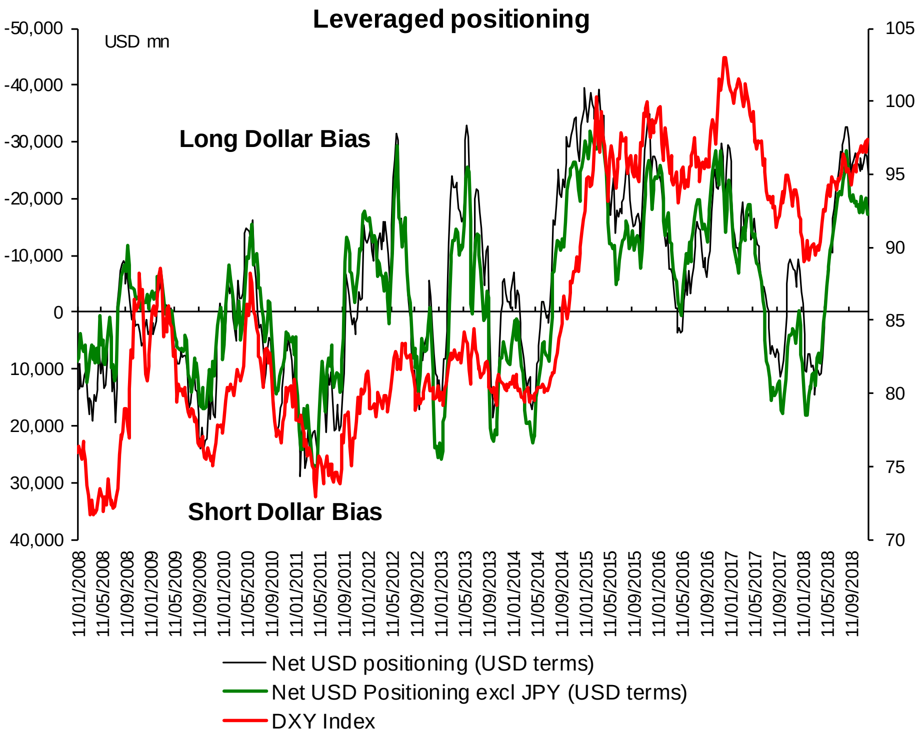


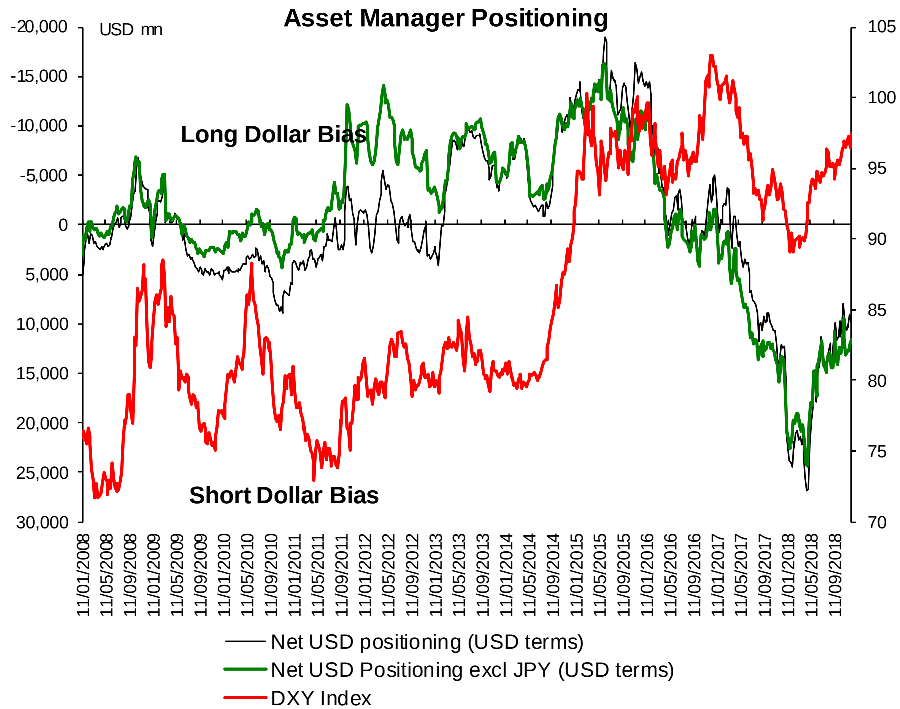


Source: Bloomberg, OCBC

USD positioning remains mixed

- Leveraged accounts stay considerably net long USD despite the shifting Fed rhetoric. Meanwhile, asset managers are consistently cutting their implied USD shorts. Overall investment community is still favoring the USD.
- Still heavy net implied long USD positioning opens up periodic risks of position paring, but no signs of sustained reversal (as yet).



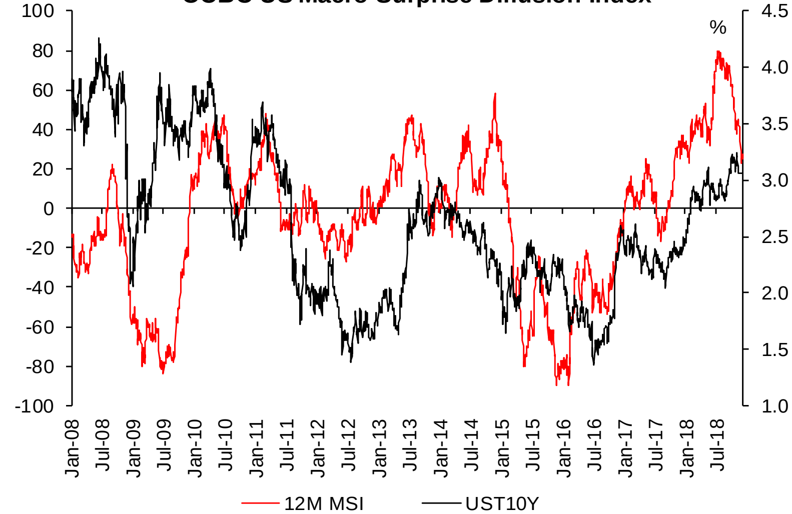


Source: Bloomberg, CFTC, OCBC

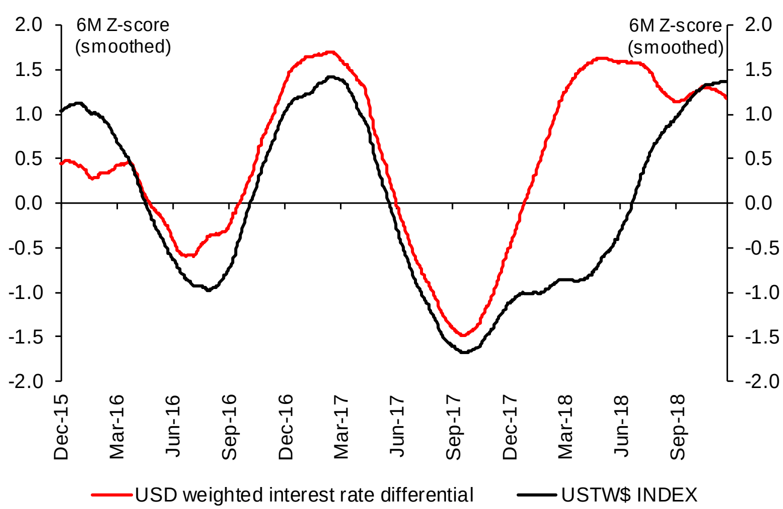
Inevitable that the USD will (eventually) waver?

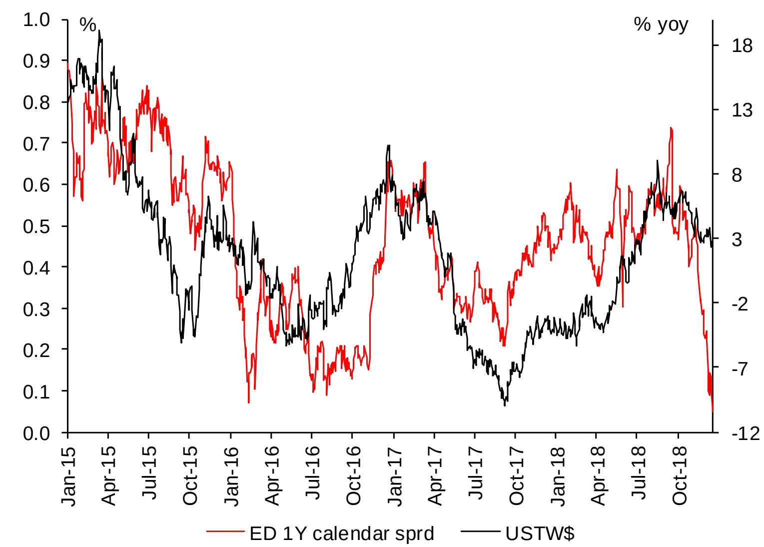
- The Fed is shifting towards more flexibility and data-dependency in its rate hike trajectory. The "further gradual increases" phrase is retained, but in a more nuanced form ("some" added). Latest "dot plots" were shifted lower.
- Into 2019, expect the USD's rate advantage to be chipped off gradually, as markets re-align to a shifting Fed paradigm in 2019.

OCBC US Macro Surprise Diffusion Index



10y rate differentials vs. USD

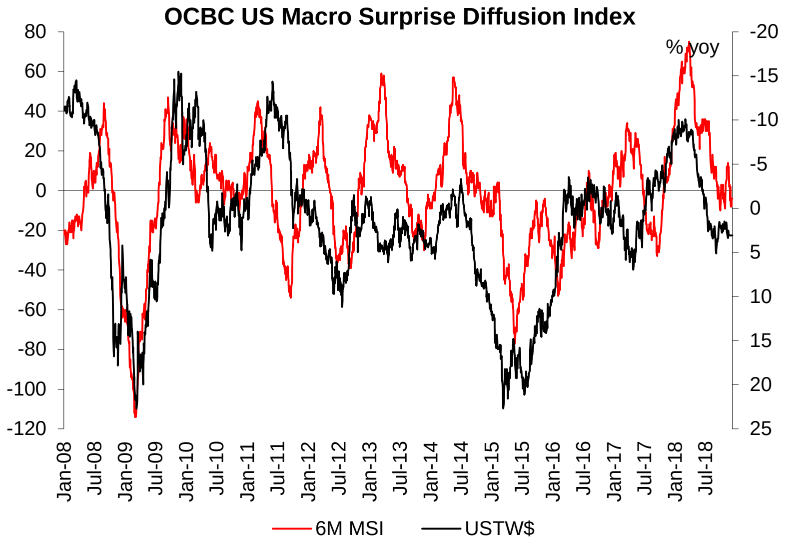


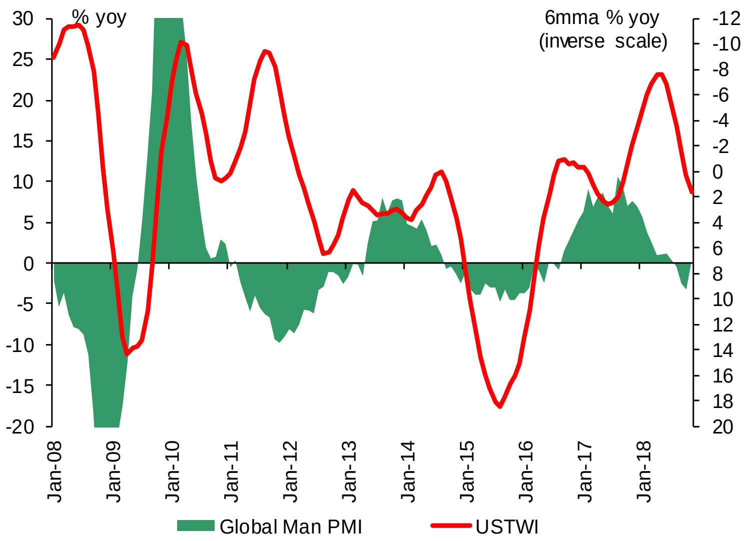


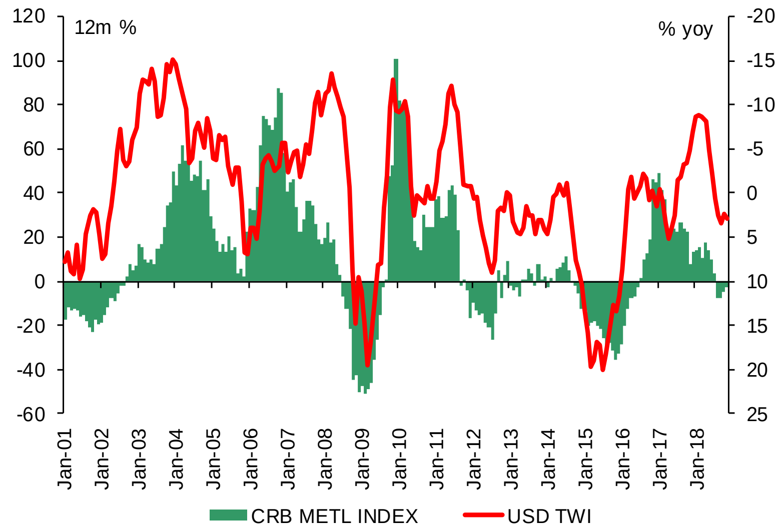
OCBC Bank Source: Bloomberg, OCBC

Dollar smile once again?

- Can major central banks deliver on policy normalization if economic prints continue to soften and inflation expectations muted?
- An accelerated worsening of global economic momentum may trigger the USD's countercyclical properties – ie. a global recession and increased risk aversion providing support for the USD.



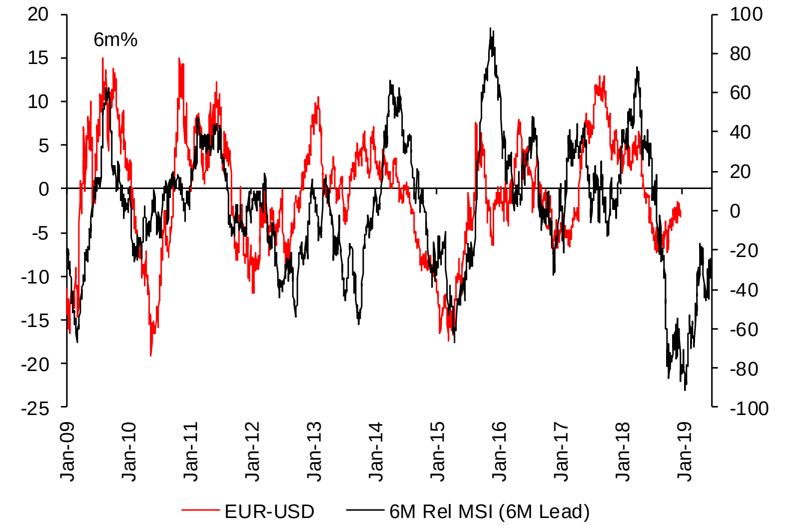


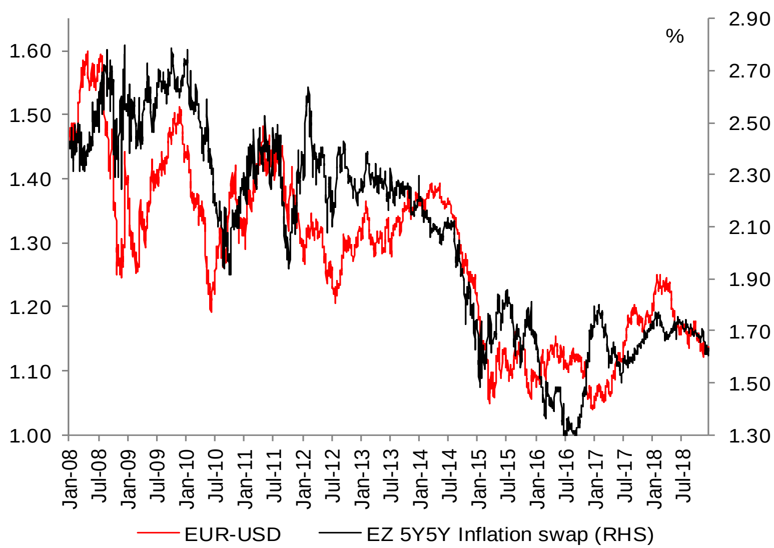


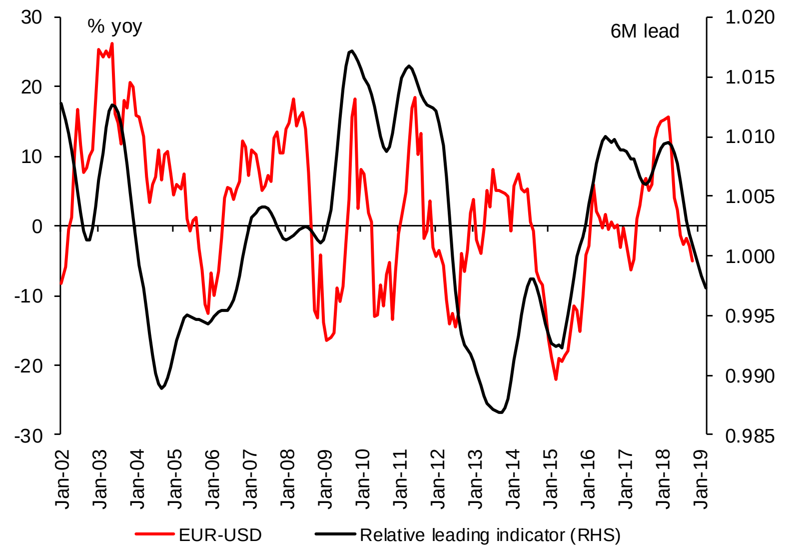
Source: Bloomberg, OCBC

EUR-USD

- The ECB remains concerned with slowing economic momentum in Europe, and may persist with a cautious guidance before summer 2019. Also expect ongoing political issues (Italy or otherwise) to plague the EUR.
- Overall, the EUR-USD may still be attempting to find a bottom in 1Q 2019. Further out, expect the EUR-USD to be driven by the relative stances between the ECB and Fed.



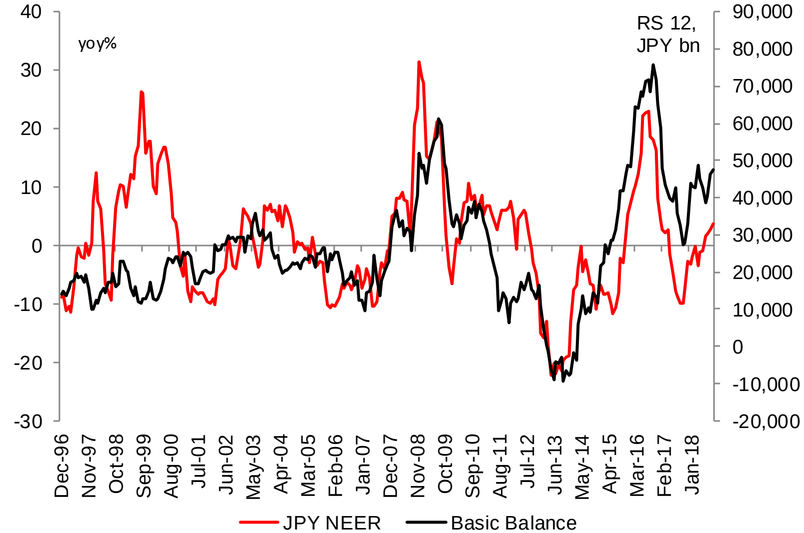


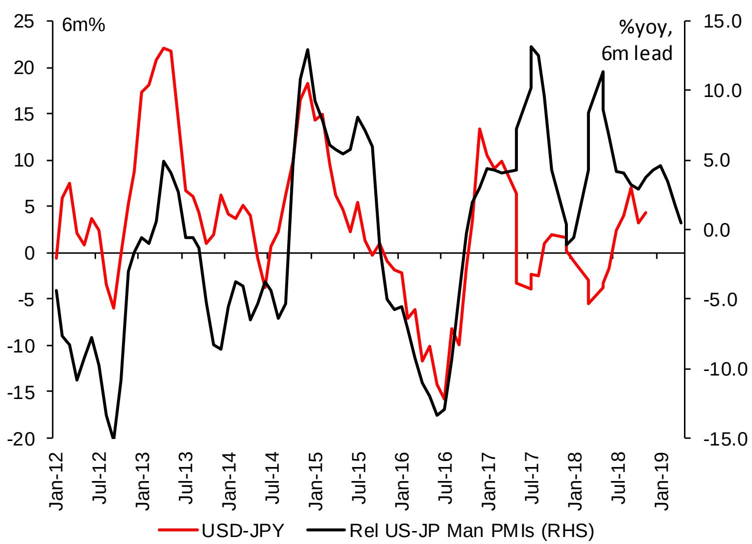


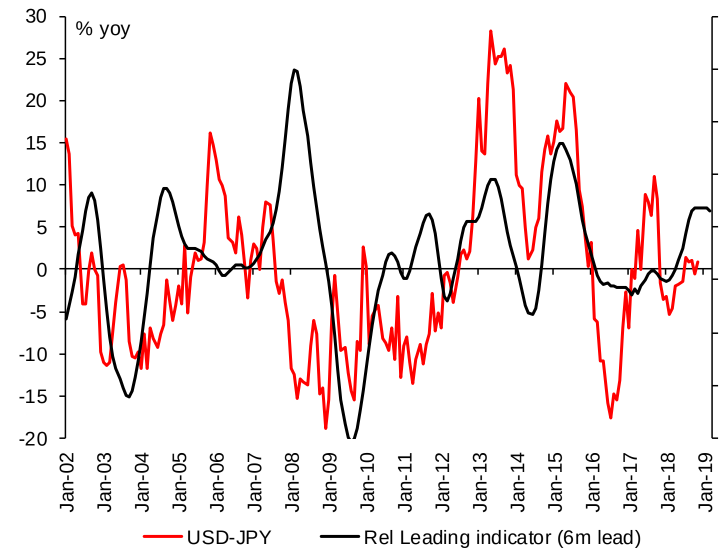
OCBC Bank Source: Bloomberg, OCBC

USD-JPY

- Expect BOJ to taper bond purchases in 2019. However, expect an overall dovish stance to be retained even though the tolerance band around the YCC target is being widened.
- USD-JPY may be underpinned in the immediate months, but JPY valuations to strengthen deeper into 2019 on yield differential arguments?



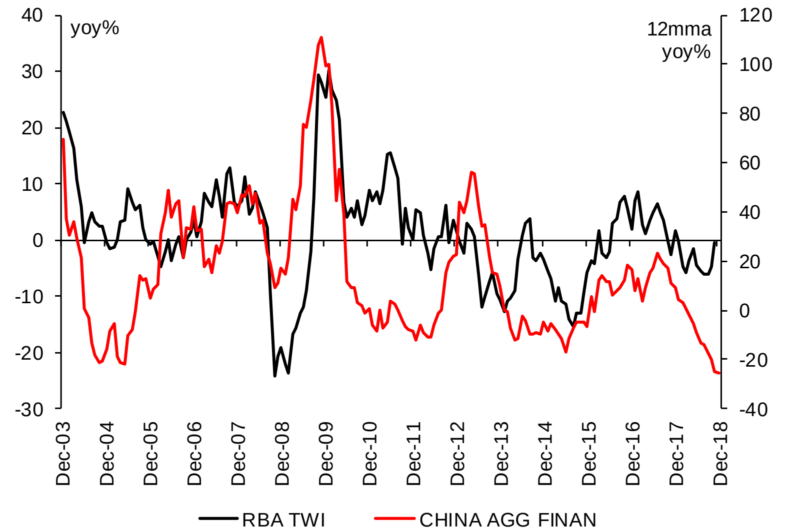


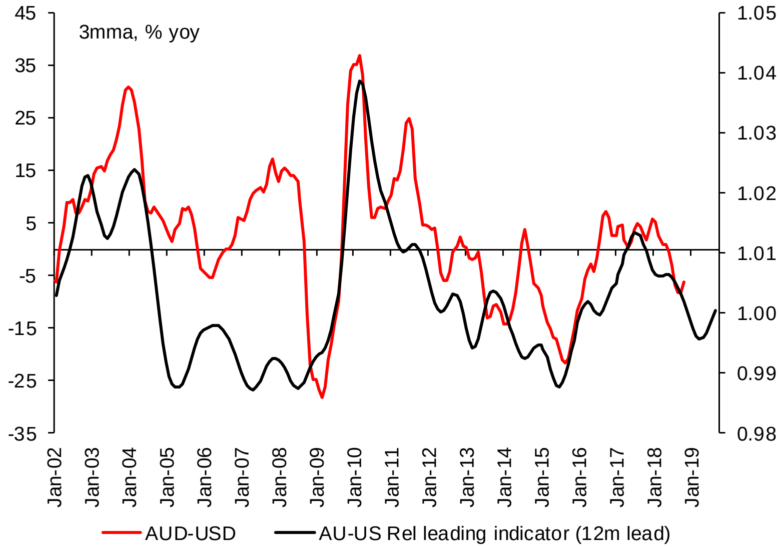


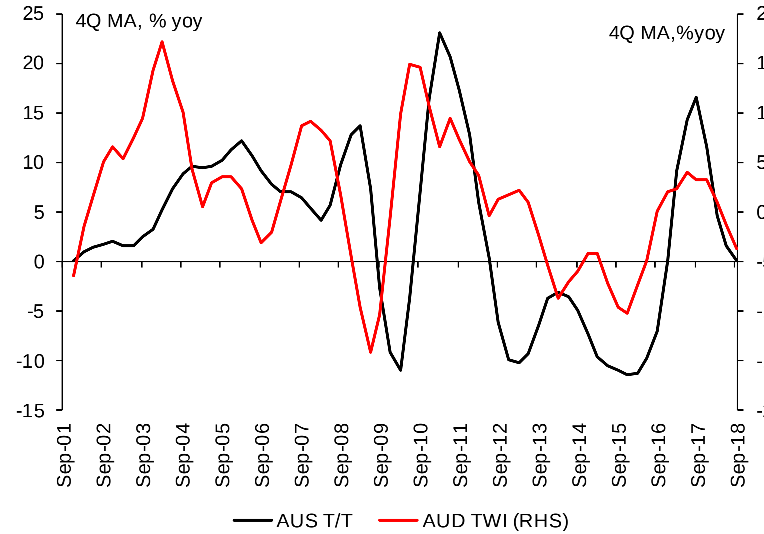
OCBC Bank Source: Bloomberg, OCBC

AUD-USD

- The AUD may remain vulnerable to downside pressure in early 2019, given its role as a proxy to East Asia and Sino-US trade developments. Skepticism on the structural basis rooted on the suspect global economic momentum.
- May not garner positive traction from the RBA as well, with rate hike expectations remaining far beyond the horizon.



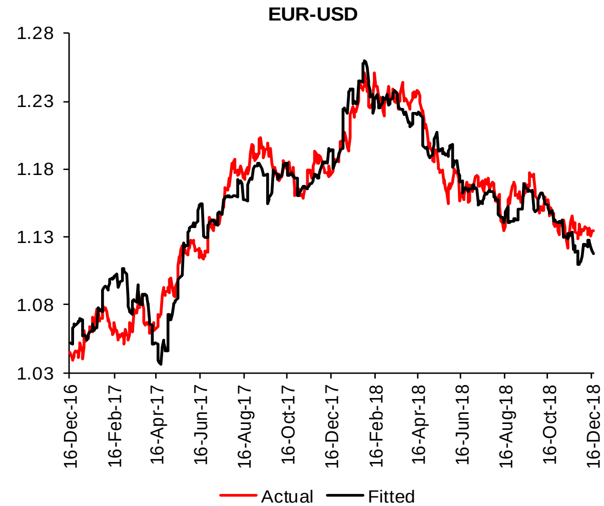


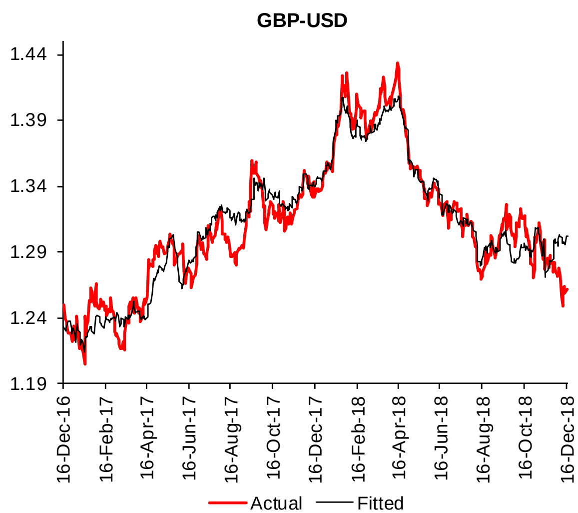


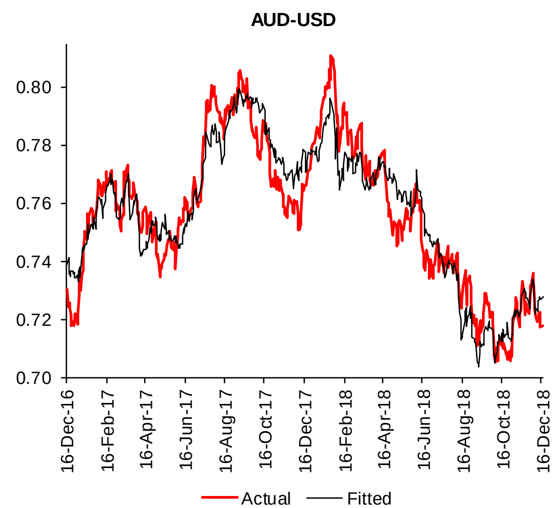
OCBC Bank Source: Bloomberg, OCBC

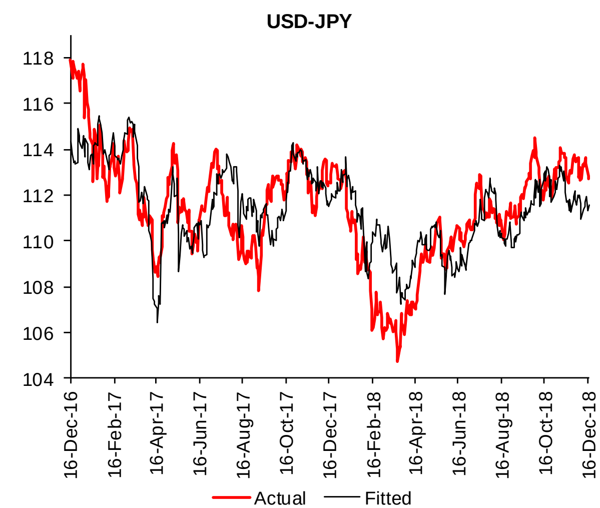
Implied valuation models

- From a structural perspective, implied valuations for AUD and JPY may be attempting to climb into 2019. Nevertheless, attempts by the JPY to close the gap may be frustrated by yield differential arguments.
- Meanwhile, implied valuation for EUR is still finding a bottom, while the implied valuation for GBP is essentially threading sideways. Any near-term attempts to close the valuation gap on the GBP may be met with healthy offers amid Brexit uncertainty.









OCBC Bank Source: Bloomberg, OCBC

EM Asia FX Outlook

EM Asia FX : Caught in the dance of the giants

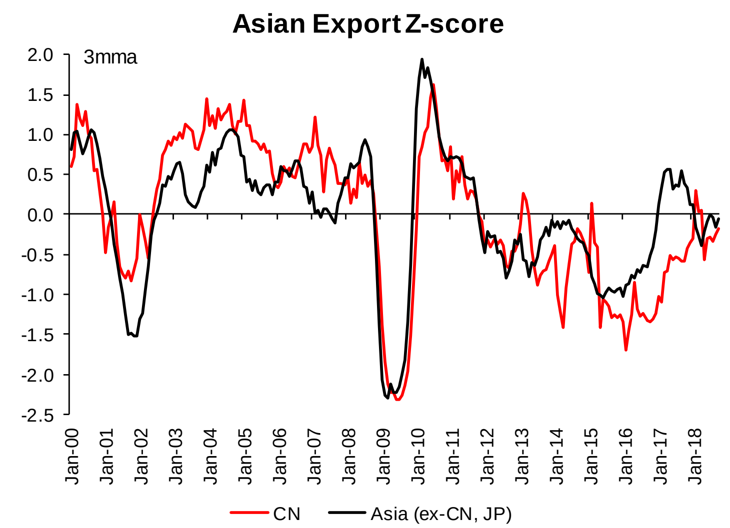
- A macro slowdown in Asia has been an ongoing development throughout 2018, though there is now greater awareness of it. At this juncture, we do not see any signs of a further headline negative shock for the Asian economies.

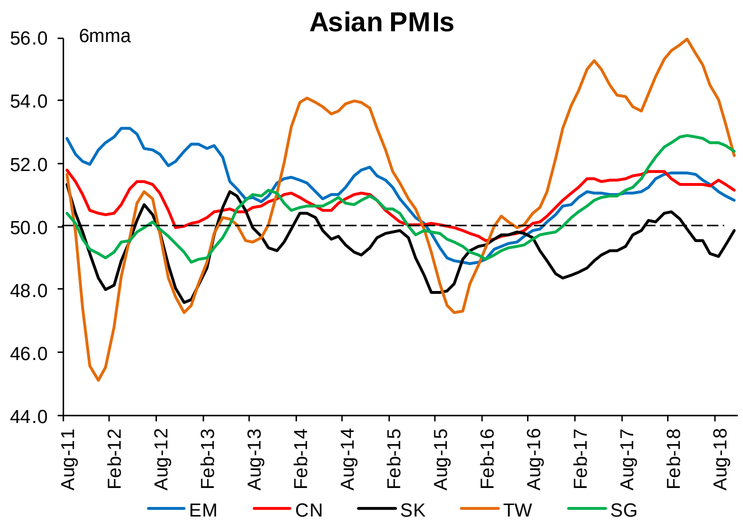
- RMB movement will be a by-product of policy action addressing larger domestic issues. Stabilization in the Chinese economy a pre-requisite for a sustained upswing in the RMB. EM Asian FX would require a confluence of a weaker USD and a stabilization in the Chinese economy (and therefore the RMB) for it to break out of its structural depreciation trend.

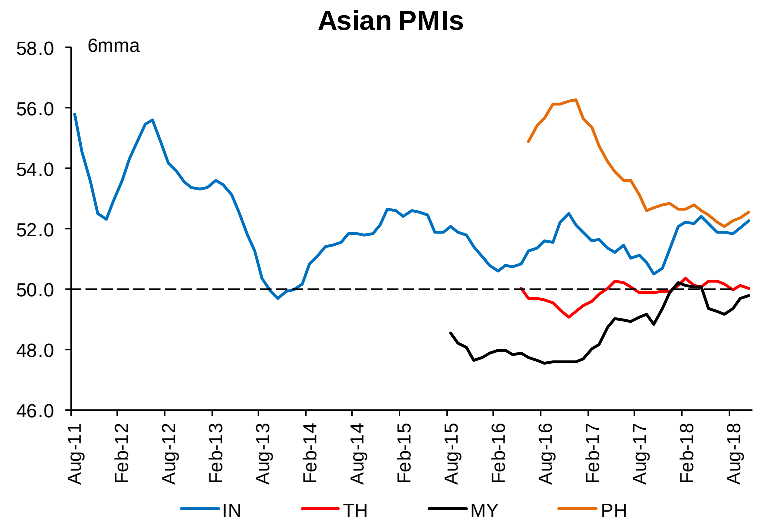
- Pending a concrete bottoming out of the global economy, Asian long-end govie yields may continue to remain under wraps, with Asian central banks now no longer likely to feel pressured to keep pace with the Fed in 2019.

Asian economies still softening

- With the exception of India and Philippines, Asian manufacturing PMIs are in outright contraction zone or a showing a downtrend throughout 2018.
- Exports attempting to stabilize, but remains essentially neutral by historical standards. Looking ahead, a dark cloud continues to loom on the trade front due to evolving Sino-US relations.



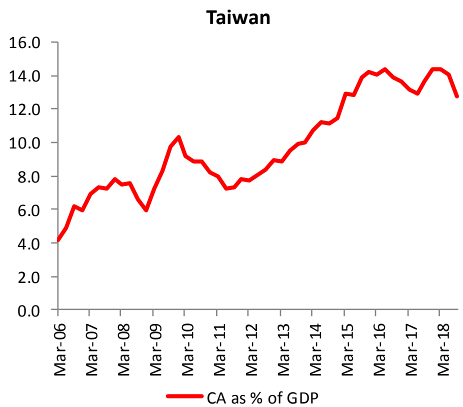


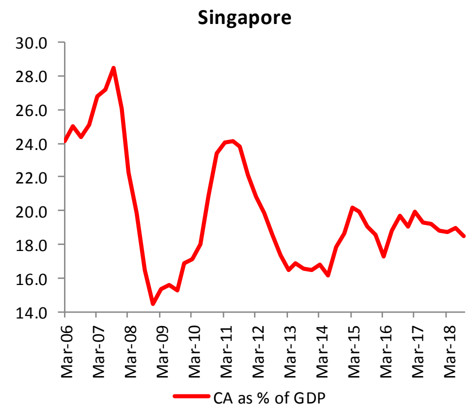


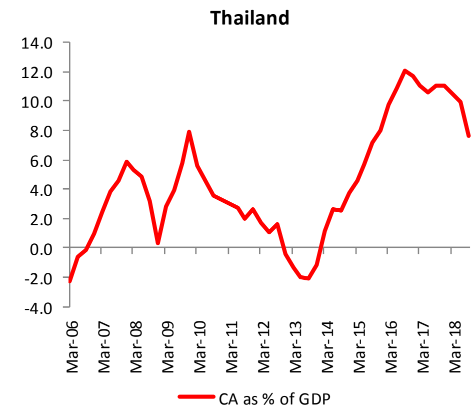
OCBC Bank Source: CEIC, Bloomberg, OCBC

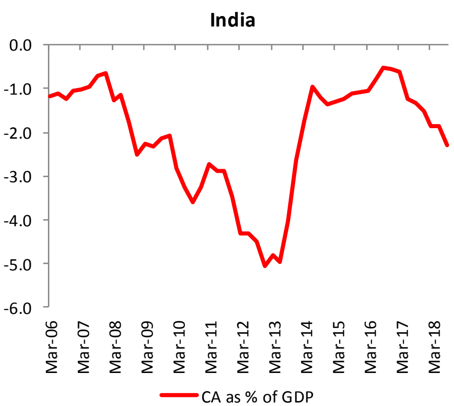
Asian current accounts – increasing weakness

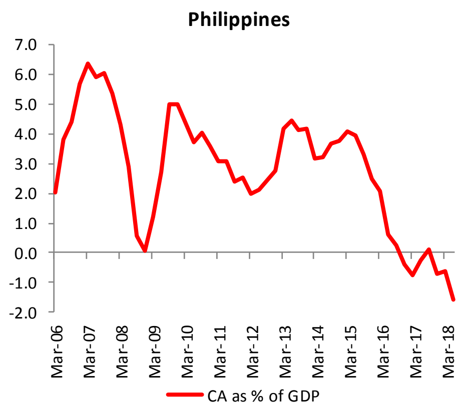
- Against the backdrop of a slowdown, expect current account deficit economies to bear the brunt of any investor jitters in the event of an EM shock. India, Philippines, Indonesia and Malaysia may remain vulnerable into 2019.

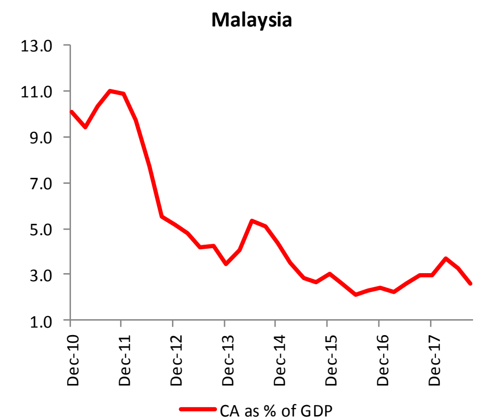












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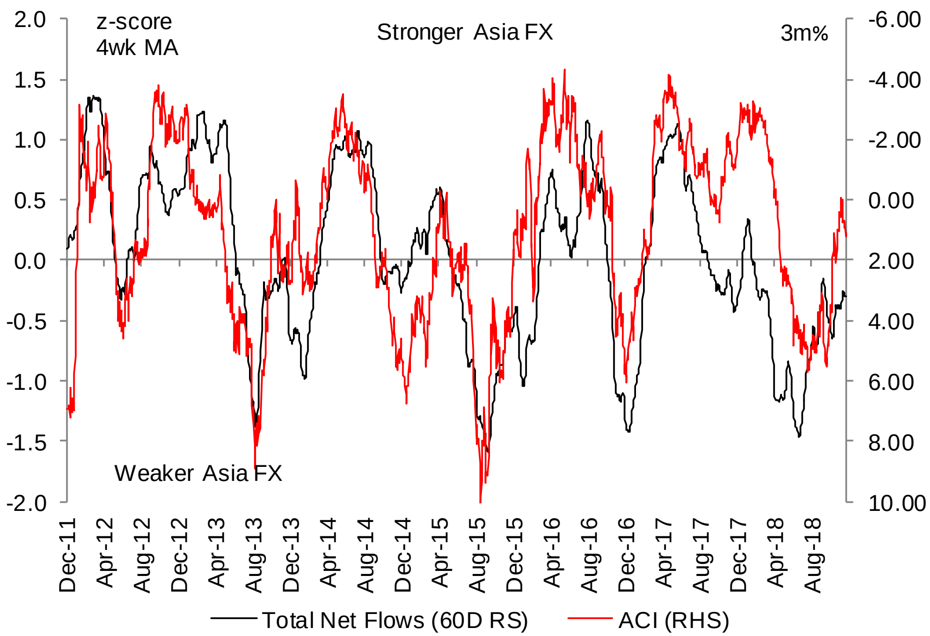
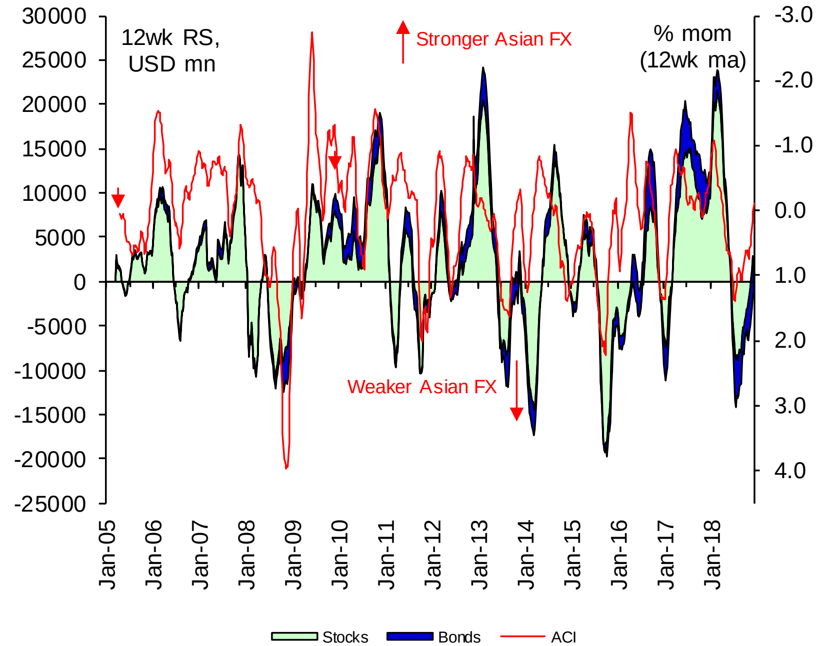
Limited implicit support from portfolio flows

- Portfolio flows, both actual and implied, stand at an effectively neutral position on aggregate terms, after recovering from a deep outflows.
- Although immediate negative pressure has eased, but weakening economic fundamentals may not be sufficient to drive sustained portfolio inflows. Thus, there may be little flow-driven impetus for EM Asian FX to outperform in the interim just yet.

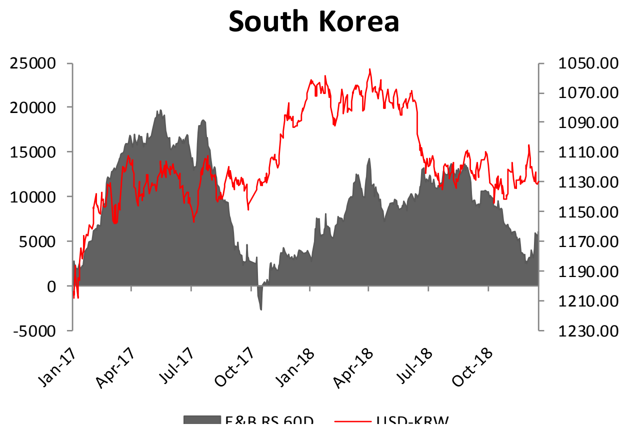


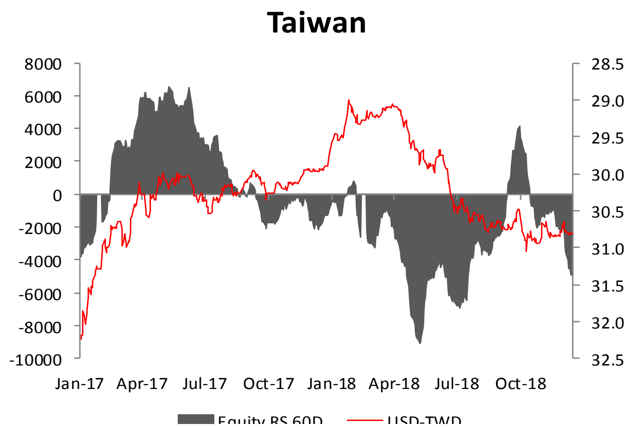


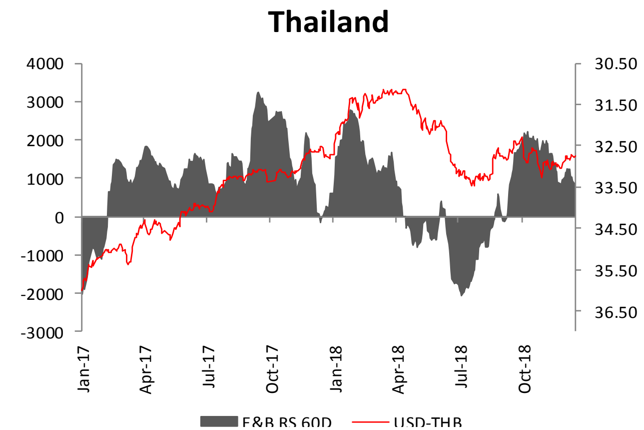
Source: EPFR, CEIC, Bloomberg, OCBC

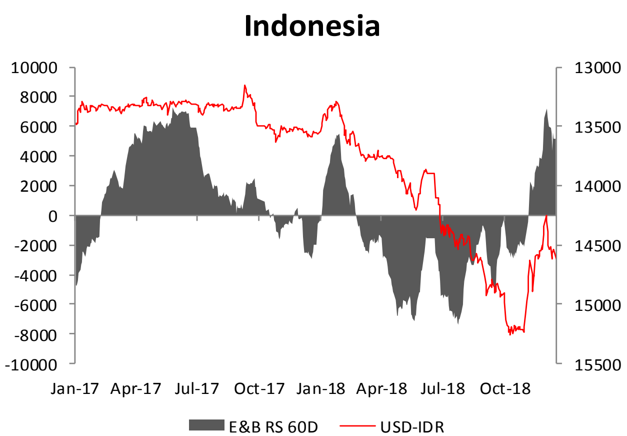
Portfolio flows: divergence at country level

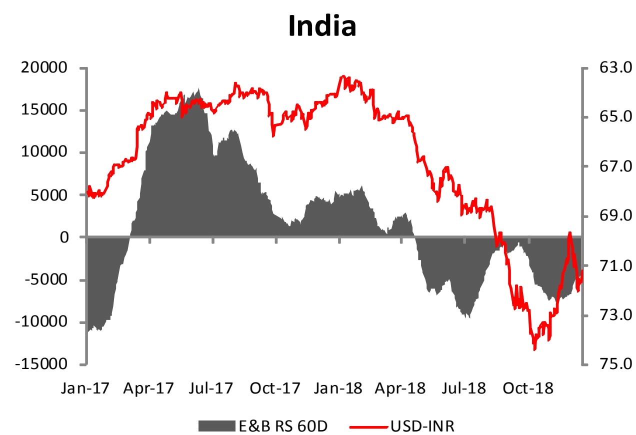
- South Korea, Thailand and Indonesia relatively more underpinned, while Taiwan and India struggles at this juncture. Going forward, Indonesia and India may outperform due to their larger real yield gap with the DM markets.

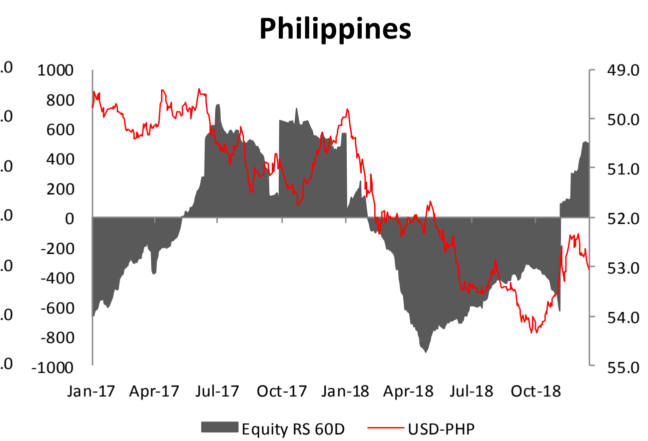








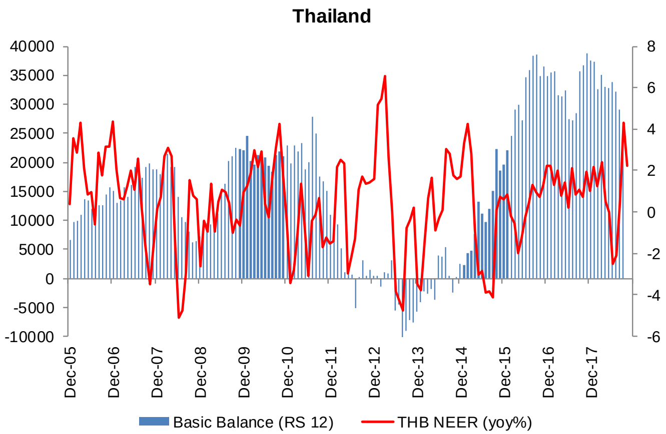


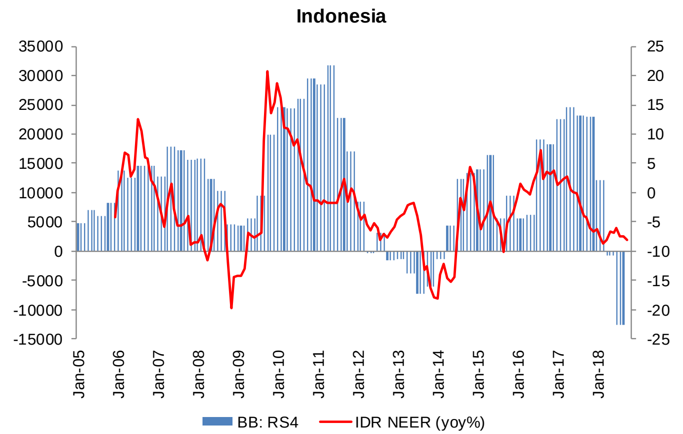


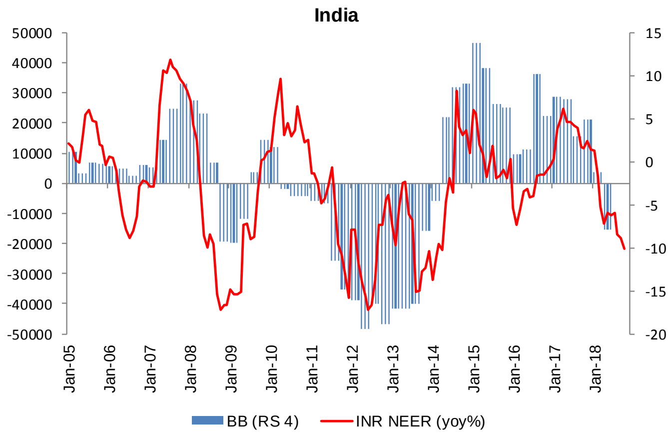
Source: CEIC, OCBC

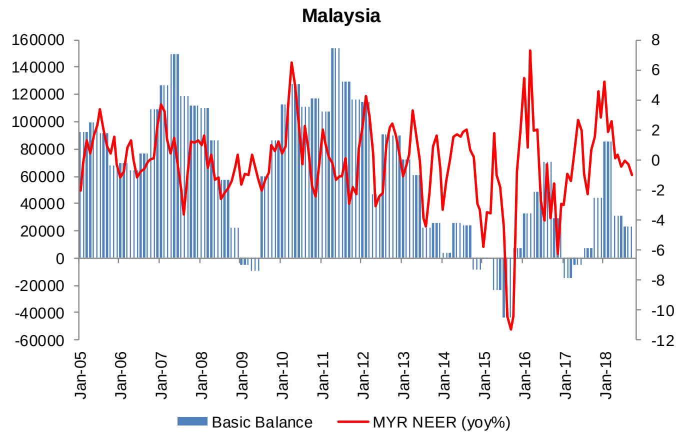
Basic balance still worsening in South Asia

- Basic balance across South Asia retains a softening trend, putting downside pressure on the IDR, INR, MYR, and to a smaller extent, THB. Nevertheless, near-term relieve may come in the form of lower crude prices.









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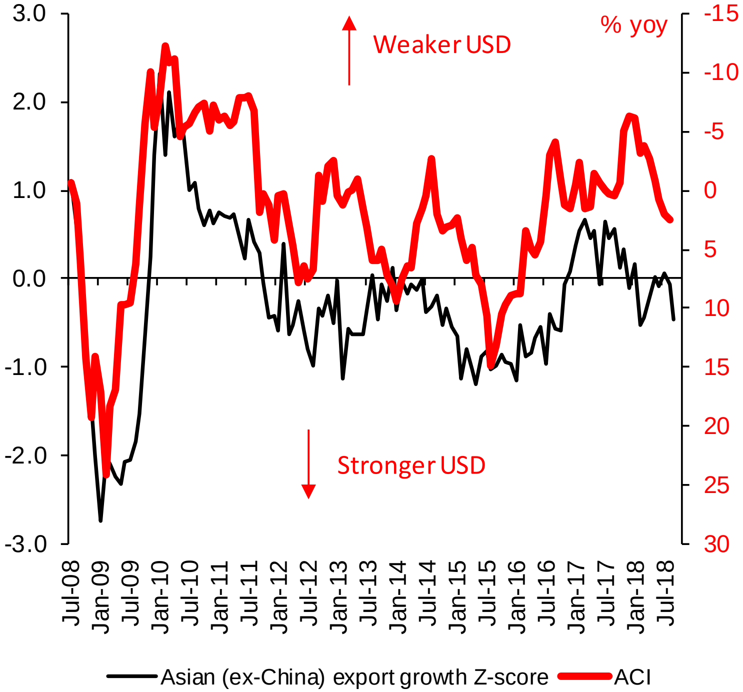
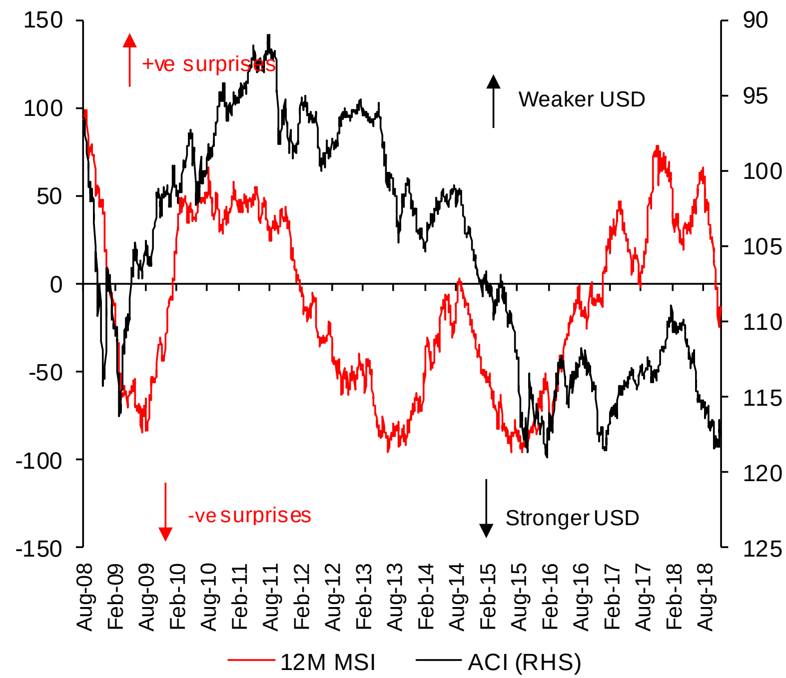
Fundamentals portend structural weakness

- Headline export data and Macro Surprises Index do not point to sustained strength in Asian currencies. In addition, Asian central banks have been tightening policy in a softening macro backdrop, often using financial stability as a justification.
- Into 2019, central bank driven drag may ease if a Fed-led readjustment of rate hike expectations rub off the Asian central banks.

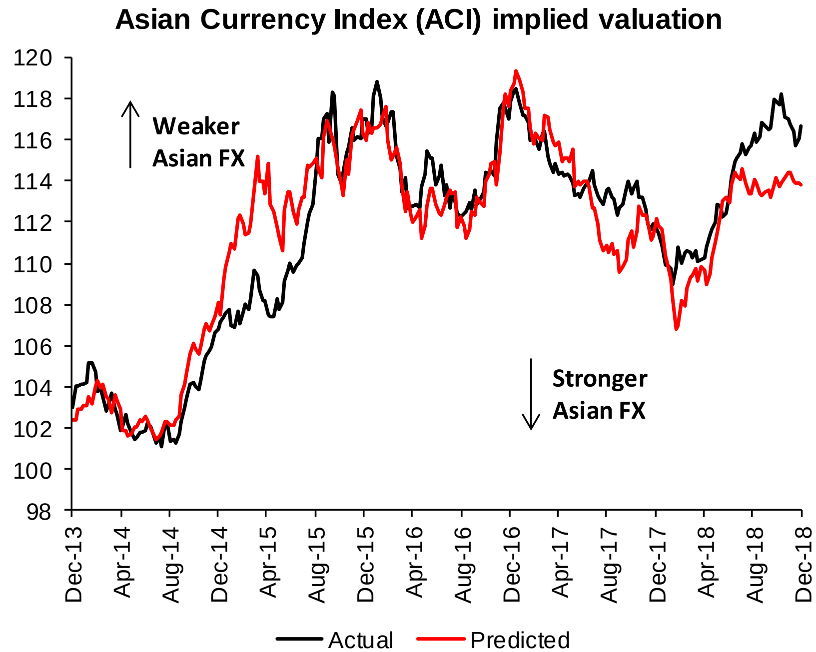


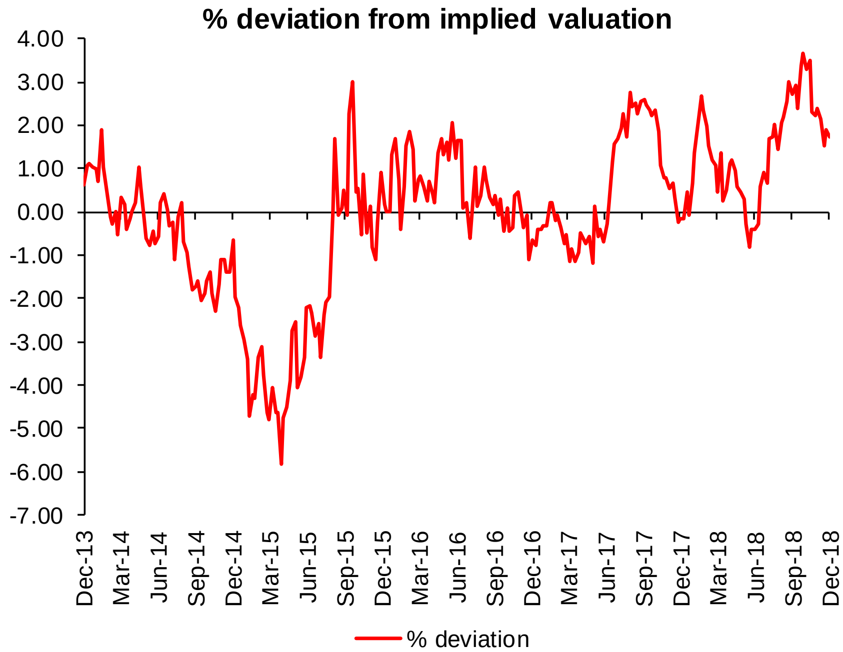


OCBC Bank Source: Bloomberg, OCBC

Caught in the dance of the giants

- EM Asian currencies as a whole remains undervalued at this juncture. Nevertheless, this gap may not be closed in the near term.
- To extract themselves from a structural weakening that started since 2018, Asian currencies will need a persistently weaker USD and a stabilization in China. These pre-conditions may not be in place until 2H 2019.

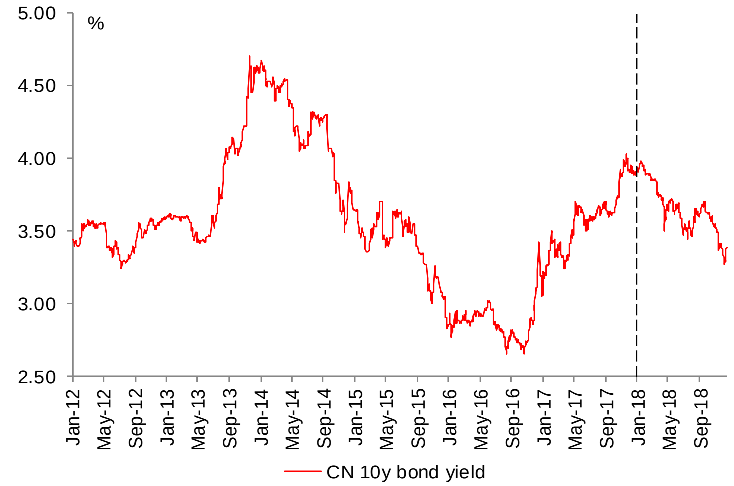


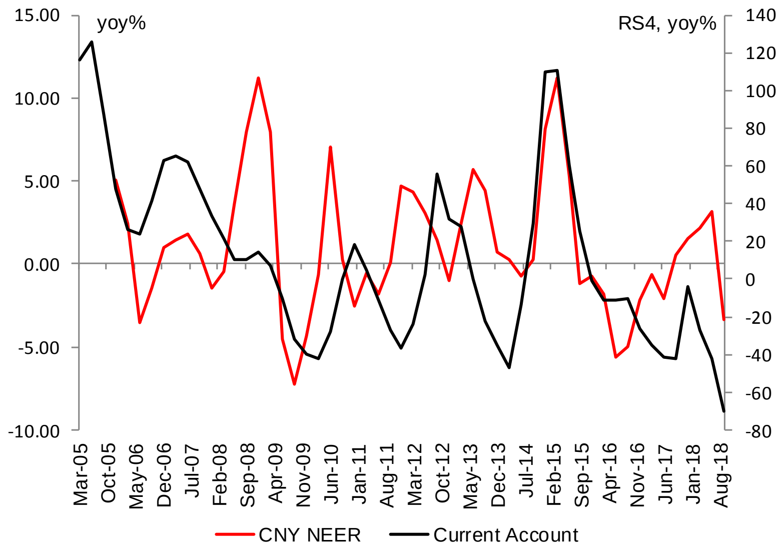


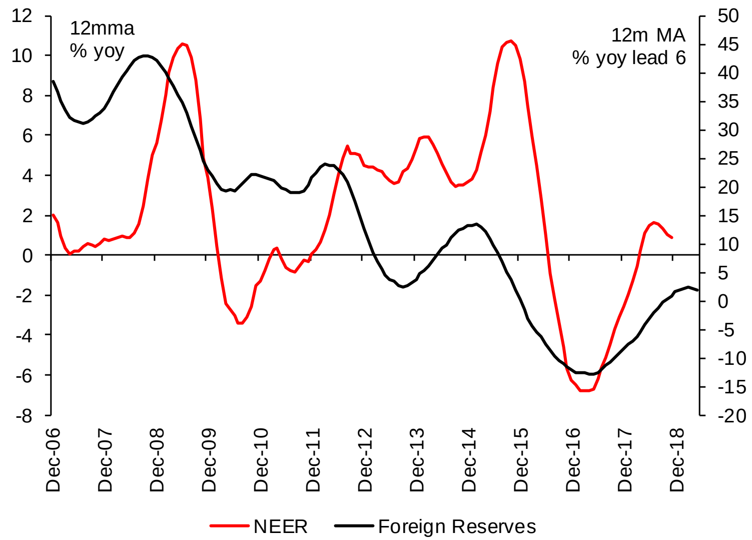
OCBC Bank Source: Bloomberg, OCBC

RMB beholden to larger issues in China

- The slowing domestic economy and ongoing trade tensions with the US may be more dominant in the Chinese strategic thinking. Therefore, RMB movement may be by-product of more urgent stimulus measures.
- In the interim, continue to watch the 10y CGB yield as a barometer for the Chinese domestic economy.



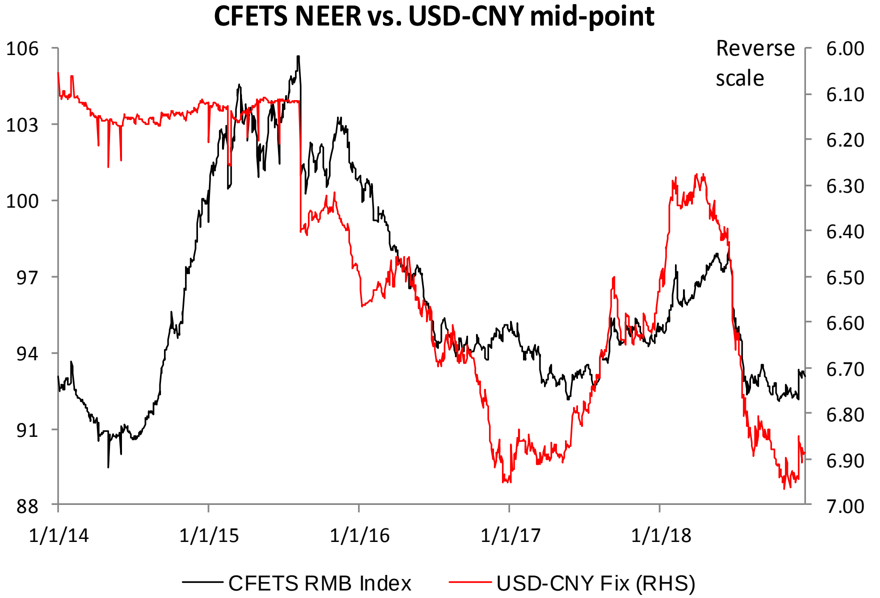


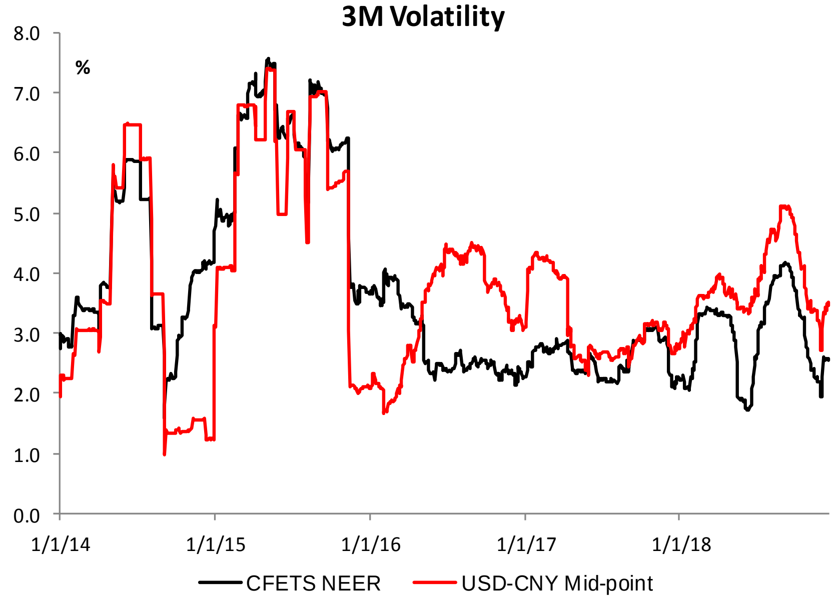


OCBC Bank Source: Bloomberg, OCBC

RMB beholden to larger issues in China

- Despite the thawing of Sino-US trade tensions serving as a near-term balm, depressed (and still deflating) Chinese govie yields and expansionary policies should negatively pressure the RMB.
- Structurally, we may need to wait for better economic prints and an improved net inflow environment in China for RMB depreciation pressures to ease.

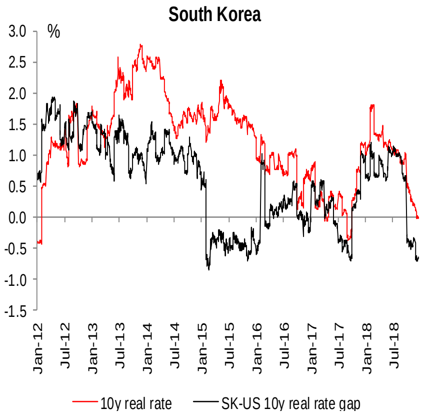


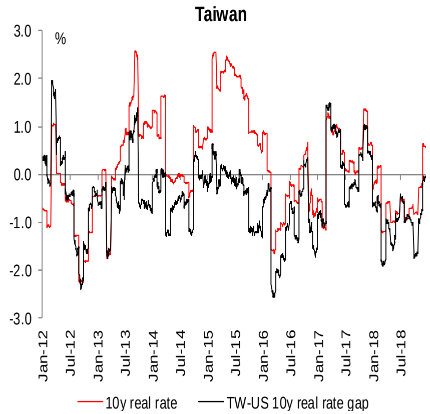


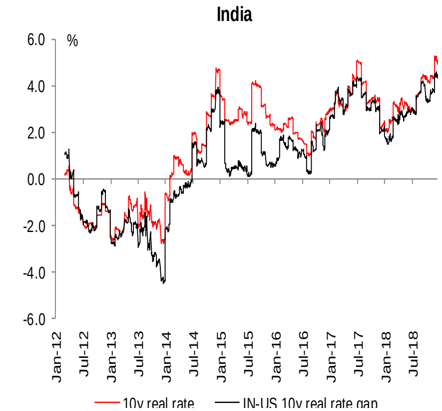
Source: Bloomberg, OCBC

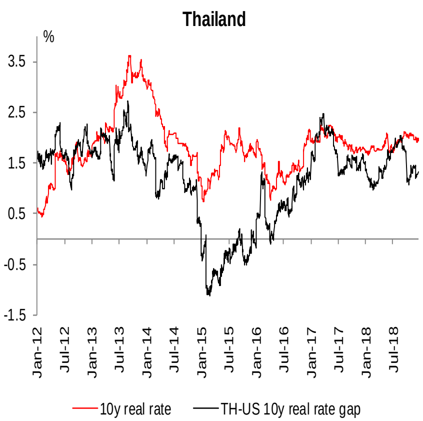
Less urgency for hikes at Asian central banks

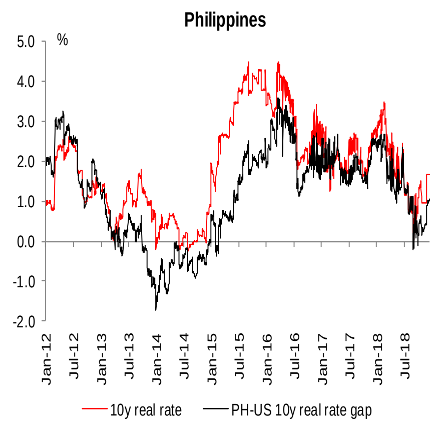
- No immediate need for significantly higher real rates in Asia on the growth and inflation fronts. Barring a EM currency shock, we see less urgency at the Asian central banks to keep up with the Fed's (already slowing) rate hikes. Expect long-end nominal yields to stay range-bound into 2019.

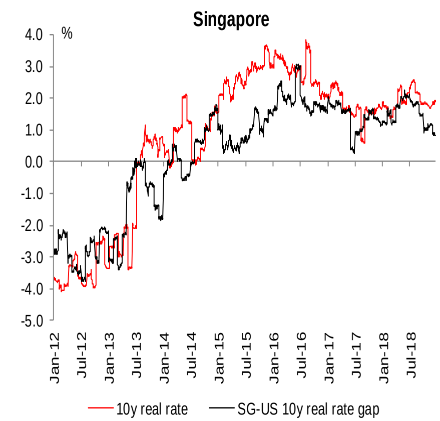


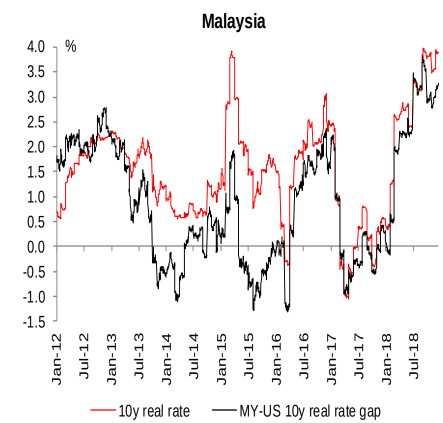








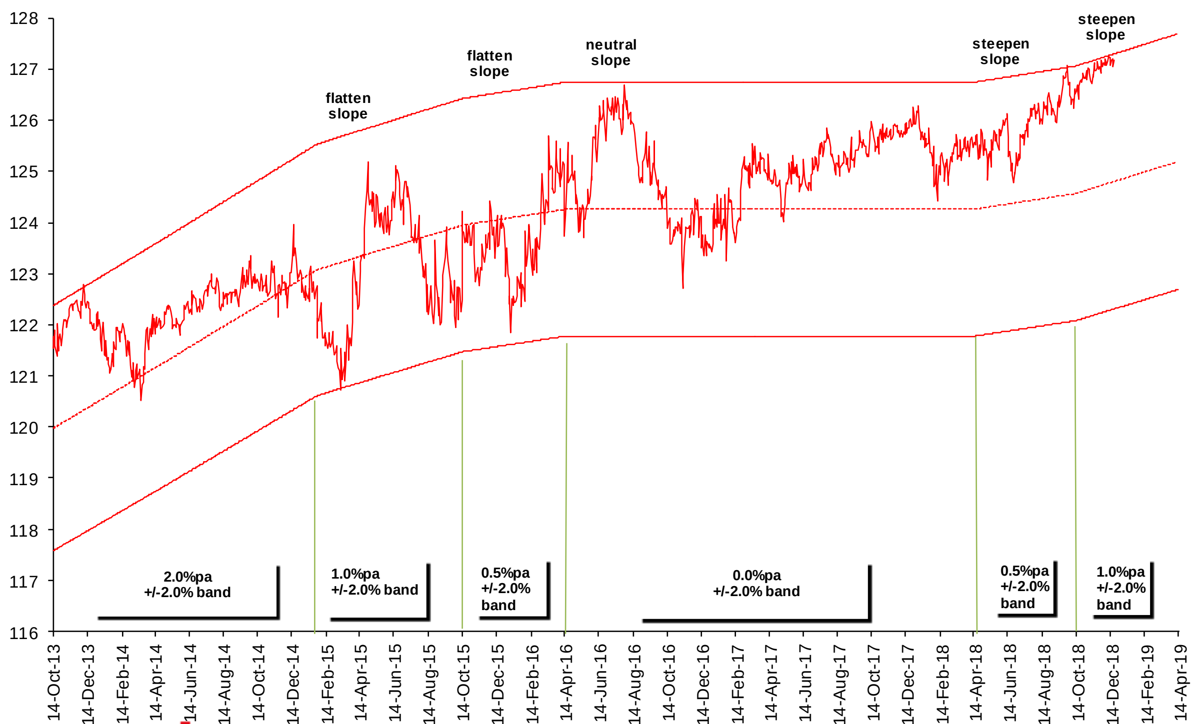




OCBC Bank Source: Bloomberg, OCBC

SGD NEER: Moving back to neutral stance

- With the SGD NEER estimated to be near the top end of the tolerance band, there may be limited scope for explicit SGD strength going forward. In this context, expect further decline in the USD-SGD to be a function of broader USD weakness.
- At this juncture, we think the USD-SGD may be biased higher in early 2019, before a confluence of an uncertain Fed and a stabilization in China deeper into 2019 provides the preconditions for a more sustained downtrend in the USD-SGD.



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Source: OCBC

FX Forecasts (correct as of 3 Dec 2018)

	Spot	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19
USD-JPY	113.49	113.80	114.29	112.76	111.22	109.69
EUR-USD	1.1364	1.1406	1.1322	1.1557	1.1792	1.2026
GBP-USD	1.2781	1.2604	1.2669	1.2944	1.3219	1.3495
AUD-USD	0.7367	0.7445	0.7425	0.7513	0.7601	0.7689
NZD-USD	0.6913	0.6993	0.6989	0.7093	0.7196	0.7299
USD-CAD	1.3204	1.3307	1.3283	1.3034	1.2786	1.2537
USD-CHF	0.9976	0.9907	0.9958	0.9831	0.9704	0.9578
USD-SGD	1.3673	1.3617	1.3643	1.3553	1.3462	1.3372
USD-CNY	6.8984	6.8600	6.8916	6.8010	6.7104	6.6198
USD-THB	32.80	32.70	32.86	32.44	32.01	31.59
USD-IDR	14229	14050	13968	13886	13805	13723
USD-MYR	4.1722	4.1616	4.1810	4.1281	4.0752	4.0224
USD-KRW	1110.65	1102.00	1109.33	1098.33	1087.33	1076.33
USD-TWD	30.743	30.630	30.622	30.389	30.156	29.922
USD-HKD	7.8209	7.8200	7.8091	7.7982	7.7873	7.7764
USD-PHP	52.31	51.80	51.47	51.15	50.82	50.49
USD-INR	70.15	69.15	68.56	67.98	67.39	66.80
EUR-JPY	128.97	129.80	129.40	130.31	131.15	131.91
EUR-GBP	0.8891	0.9050	0.8937	0.8928	0.8920	0.8912
EUR-CHF	1.1336	1.1300	1.1274	1.1362	1.1443	1.1518
EUR-SGD	1.5538	1.5532	1.5447	1.5663	1.5874	1.6081
GBP-SGD	1.7475	1.7163	1.7284	1.7543	1.7796	1.8045
AUD-SGD	1.0073	1.0138	1.0130	1.0182	1.0233	1.0282
NZD-SGD	0.9453	0.9522	0.9536	0.9613	0.9688	0.9761
CHF-SGD	1.3706	1.3745	1.3701	1.3785	1.3872	1.3961
JPY-SGD	1.2047	1.1966	1.1937	1.2019	1.2104	1.2191
SGD-MYR	3.0515	3.0562	3.0646	3.0460	3.0272	3.0081
SGD-CNY	5.0453	5.0378	5.0514	5.0182	4.9846	4.9505

OCBC Bank Source: OCBC

Disclaimer

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