Economic Research

WEEKLY ANALYSIS

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Probable trend reversal for the dollar in 2018

Dollar increasingly likely to bounce back. Waning influence of European fundamentals on the euro. Brexit to weigh on the pound again. Beware of the overly strong yen. Further adjustment of the franc.

Key Points

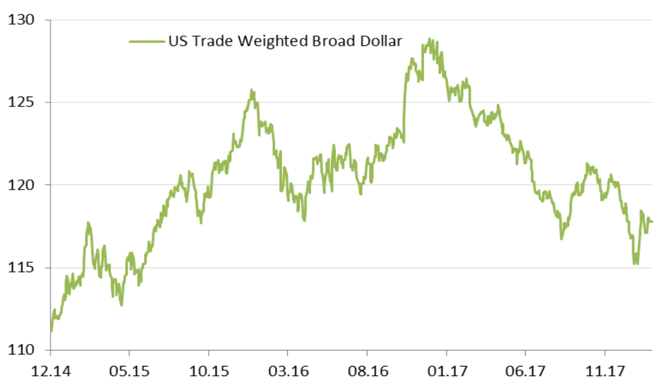
- The dollar is likely to strengthen after three years of consolidation and a 50% correction following the 2011-2016 bull market
- Speculative positions remain very limited
- Waning influence of European fundamentals on the euro
- The yen's strength is temporary and will likely be followed by consolidation
- The pound has weakened once again as Brexit looms larger
- The Australian dollar likely to rise further
- Positive surprises with regard to the Norwegian and Swedish crowns
- Favourable scenario for emerging currencies and those linked to commodities

Dollar to appreciate after three years of consolidation and a 50% correction following the 2011-2016 bull market

US economic momentum will likely most often be superior to that of other developed economies in H1 2018. Consequently, the interest rate spread will likely widen further across the yield curve and benefit the investors' interest in the greenback. The tax reform adopted in the US no longer seems to be considered an accelerator of economic dynamics that may require a radical change in monetary policy, at least by the members of the FOMC. It remains unclear whether this reform will support consumption or whether companies will invest more. But its impact on the budget will be significant and could widen the budget deficit again in 2018.

In recent weeks, the outlook for increased US debt and the budget deficit / GDP ratio have weighed on the dollar, but the good performance of the economy, labor market and labor costs have raised fears of a rise in risk inflationary and further interest rate increases that reinforces this positive factor. Speculation of a more rapid normalization of the Fed's monetary policy has reignited uncertainty and fears that interest rates will rise three to four times in 2018**.** We believe, however, that inflationary pressures will still remain limited, which should not motivate a toughening of the Fed's action. . This will very carefully measure the tightening risks of its monetary policy too fast on the growth rate of the economy. In this environment, the weakness of the dollar in 2017 seems unjustified. The depreciation of around -10% of the trade weighted USD index against a basket of currencies erased almost half of the dollar's gains between 2014 and 2015. The value of the US currency will thus undoubtedly adjust in the coming months, unless expectations of deteriorating public finances linked to the tax reform start to prevail and hurt the dollar.

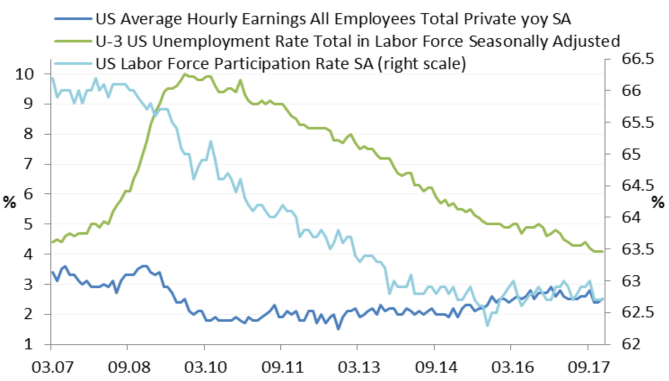
Dollar Trade Weighted



Sources: Bloomberg, BBGI Group SA

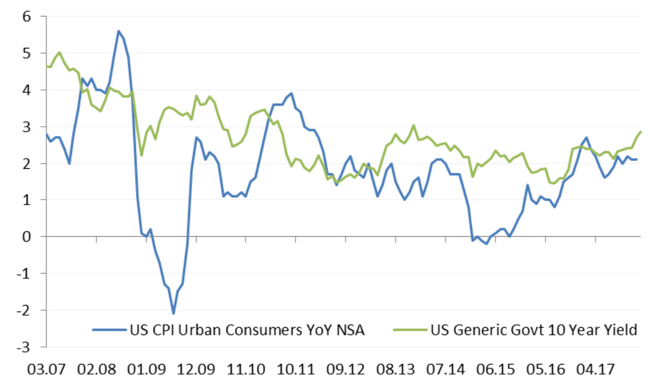
Ultimately, our forecasts are positive and support an increase above 1 Swiss franc to the dollar and close to 1.15 to the euro.

Hourly earnings, unemployment rate and participation rate



Sources: Bloomberg, BBGI Group SA

Inflation and 10-year US Treasury bonds



Sources: Bloomberg, BBGI Group SA

Speculative positions betting on a stronger dollar remain very limited

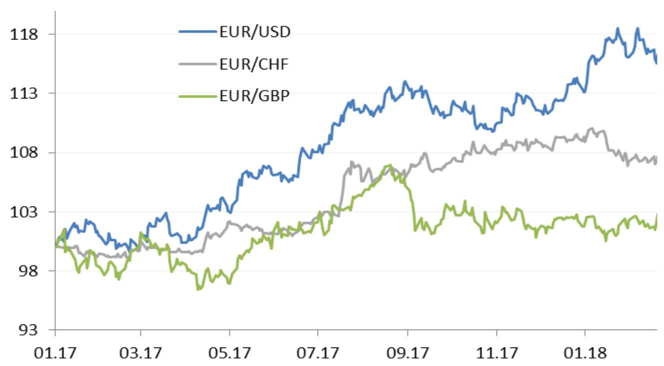
In this rather dollar-friendly environment, "Long dollar" CFTC speculative positions are still low, showing strong disinterest from investors. Yet this indicator deserves closer attention, as over the last decade every significant dollar increase has been preceded by a surprisingly low ratio. The last time the current level was reached in March 2014, the dollar appreciated +25% in the following twelve months. For the past few weeks, there has been a slight rebound in this indicator, suggesting a timid comeback of positive positioning.

We believe it is likely that the dollar will rise against most major and emerging currencies.

The rise of the euro is justified but it should now be limited

The rise in the Euro may already be an issue for the ECB, which might start worrying about its undesired effects on inflation prospects and European industry's competitiveness. So, if we estimate that the rise of the euro has certainly reached its zenith in the short term, it is likely that the undeniable improvement in Eurozone economic fundamentals and the prospect of an about-turn in monetary policy will rekindle investors' interest in the single currency in a second step. The change in the Euro/US dollar exchange rate has been one of the major trends in 2017. The approximately +15% growth in the Euro was certainly partly down to the weakness of the dollar, but it is first and foremost thanks to the, for many surprising, improvement in economic conditions in the Eurozone, making the single currency more attractive again. As such, the Euro has appreciated against many currencies, particularly against the Swiss franc. From the change in SNB monetary policy in 2015 onwards, we had forecast that the introduction of negative interest rates would in the long term lead to a gradual loss of interest in the Swiss franc, which could once again push the exchange rate towards 1.20. Despite the good results expected for the European economy in 2018, we believe that the phase of revaluation of the Euro is now strong enough to justify some profit-taking. We believe that the rise in the Euro should become less intense at the start of 2018. However, after this period of stabilisation, it is likely that the undeniable improvement in Eurozone economic fundamentals and the prospect of an about-turn in monetary policy will rekindle investors' interest in the single currency. Note further that the Eurozone's trade surplus has reached 25 billion euros, of which almost 20 billion was generated by the German economy, which is performing particularly strongly and whose growth rate could reach +0.7% in the first quarter, or +2.8% on an annual basis.

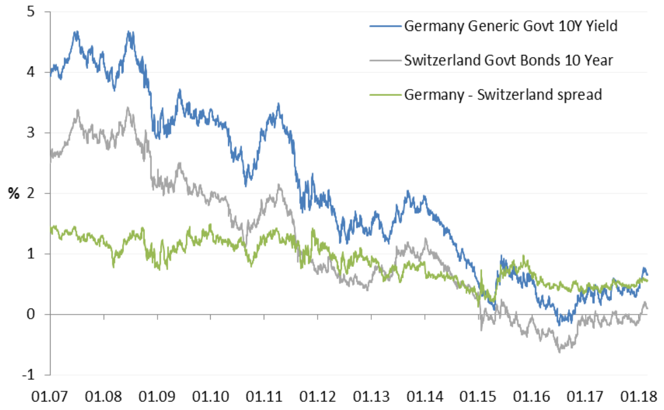
EUR/USD, EUR/CHF and EUR/GBP Exchange rates (Normalised 100)



Sources: Bloomberg, BBGI Group SA

However, we believe that it is now more likely to see rates normalize faster in the euro zone than in Switzerland and thus favor the Euro.

Interest rate spread (10 year)



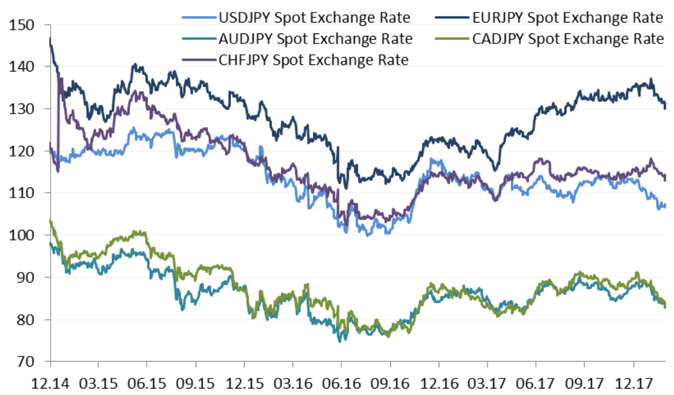
Sources: Bloomberg, BBGI Group SA

The yen temporarily regains its safe haven status

The Bank of Japan still does not have much room to act in terms of reaching its 2% inflation target. It has not changed its assessment of economic conditions and is maintaining its monetary policy unchanged, i.e., low interest rates and monetary injections. The Bank is still hoping that economic growth in Japan will be sufficient to drive inflation up toward the desired target. The short-term interest rate target is also unchanged (-0.1%), as is the aim of steering 10-year rates toward 0%. The correlation observed with movements in long-term rates will necessitate a slight definitional change in objectives, whereby the BOJ will likely set the lower limit of its target range at 0%. Governor Kuroda is unlikely to change the Bank's policies, which will remain a significant factor in the future decline of the Japanese currency. We continue to believe that the improvement in fundamentals will not have an immediate impact on the yen, which will continue to be disregarded by investors due to an utterly unfavourable interest rate environment The government's policy is thus still to weaken the yen, as interest rate spreads are likely to widen and penalise the currency. The on-going normalisation of US monetary policy along with expectations of further increases in long-term rates in the US will likely further weigh on the yen in 2018. A weaker exchange rate has been one of the key elements of the government's policy to boost inflation and exports. This policy remains relevant. The change in monetary policy is indeed not for 2018, even though it can be seen that the BoJ has significantly reduced the pace of its purchases of securities to the point that its balance sheet recorded its first almost imperceptible contraction in December. We do not believe that this event heralds a change in monetary policy, even though Governor Kuroda recently stated that he would normalise the BOJ's policy if its inflation target were reached.

The yen has benefitted from its safe haven status over the past several weeks, but the currency will likely weaken again over the next few quarters and draw closer to the high end of the band within which it has fluctuated over the past twelve months (USD 110, CHF 110, EUR 135).

Yen against USD, EUR, AUD, CAD, CHF



Sources : Bloomberg, BBGI Group SA

Uncertainty is back with regard to the pound

The British currency was not really impacted by the difficult Brexit negotiations in the last quarter of 2017, but that could change over the next several months. The relative stability of the pound, in particular against the euro, could indeed be replaced by a recurrence of volatility and a significant correction. The European Union has published a draft of the UK's withdrawal agreement, which will no doubt further highlight the differences, sometimes still irreconcilable, between the two parties as well as amongst British politicians. The red lines drawn by London regarding the customs union and the single market pose problems that are difficult to solve, in particular with respect to the possible reintroduction of a physical border in Ireland.

Uncertainty is thus back and will likely weigh on the pound. The exchange rate could slide, dropping to 1.07 against the euro, 1.30 against the dollar, and 1.25 against the franc.

Australian dollar likely to rise further

The Australian dollar was rather volatile in 2017, and although it rose +6% against the US dollar, it depreciated against the euro and the yuan, while remaining relatively stable against the franc. The Australian central bank could possibly proceed with a surprise initial rate hike in June given the country's excellent economic performance and a tight job market. The increase in commodities prices expected in 2018 will likely contribute to positive developments in the exchange rate against most currencies.

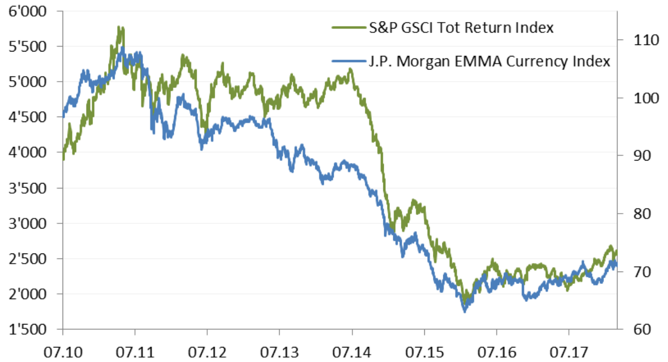
Positive surprises with regard to the Norwegian and Swedish crowns

In Europe, the Norwegian crown and the Swedish crown could also rise against the dollar and the euro. Policy rates in Sweden may also be raised more quickly than expected in 2018, given GDP growth of +3.3% in 2017. A readjustment of policy rates would be surprising with regard to a currency that appears to be among the most undervalued in real terms. The Riksbank could even adjust its rates several times, boosting the appeal of the Swedish crown, which is also rather undervalued against the dollar and the euro.

Favourable scenario for emerging currencies and those linked to commodities

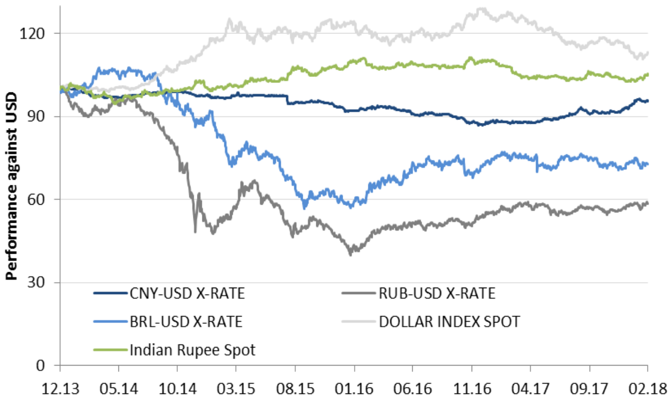
In Russia, Brazil, and Indonesia and in commodities-producing countries more generally, the upswing in the prices of industrial metals, precious metals, and crude has reversed downward trends and initiated a more robust course. The improvement in the general context driven by the upswing in commodities and a more solid global economic outlook will have an increasingly positive impact on the valuation of these countries' currencies. In contrast to the situations described above, in these countries it is the combination of factors such as improving GDP growth coupled with a better control of inflation and a reduction in policy rates that will drive the rise in exchange rates.

Commodities and emerging currencies



Sources: Bloomberg, BBGI Group SA

Emerging currencies (Normalised at 100)



Sources: Bloomberg, BBGI Group SA

The correction of some currencies that has occurred since volatility re-emerged in February has not been as excessive as is often the case when volatility and uncertainty in financial markets increase suddenly. This resilience is indeed a rather favourable sign, which corroborates our analysis that the positive performance of commodities and a general improvement in global economic conditions will have a positive impact on the valuation of these currencies.

Once volatility and the current consolidation in equity markets normalise, we suspect that emerging currencies will resume their upward trend.

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