13 July 2017

The US dollar erases its post-election rise: -5.3% YTD

Broken promises sent the dollar down. The euro benefits from strengthening fundamentals. The yen will not appreciate without inflation. Widening of the CHF-EUR spread.

Key points

- The US dollar was hit by negative economic surprises and broken promises from President Trump on Investment and Fiscal policy
- The « trade-weighted » USD is down -5.3% since the beginning of the year
- In contrast, economic and political factors support the euro
- The euro is up almost +10% in six months against the US dollar
- The yen will not appreciate without growth and inflation
- 700 billion to finally weaken the Swiss Franc : the yield spread has to reach 0.75% in order for the Swiss Franc to weaken

The US dollar hit by negative economic surprises

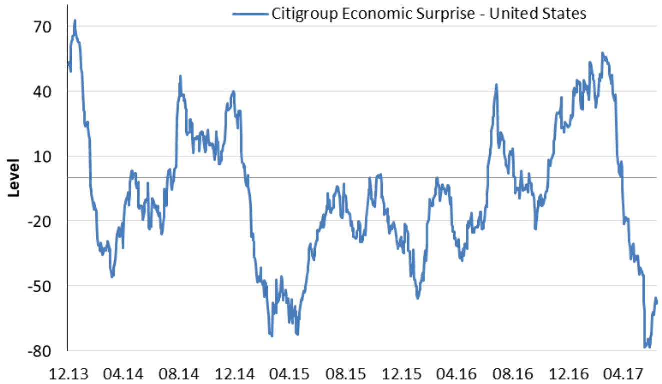
The dollar was still among strategists' favourite currency at the beginning of the year as Trump came into office. Six months later, economic surprises and disappointments have punctuated the dollar's gradual correction, while expectations of an acceleration of economic growth predicated on Trump's programme have seemed less and less sensible in view of the tangible lack of decisions and action.

Indeed, the effects of the growth-oriented policy trumpeted by the administration, which was to operate by stimulating demand, cutting taxes and boosting public spending, are not yet noticeable, and this has in turn affected consumer sentiment.

A lack of clarity in leading indicators, moreover, has also sown confusion. However, the Fed has not changed its views regarding the underlying strength of the US economy and the imminent return of inflation.

GDP growth is expected to come in at over +3% in Q2, which does not appear compatible with the current level of long-term interest rates. The decline in 10-year government rates from 2.6% to 2.1% between March and June coincides with the escalation of economic uncertainty. But these rates are likely to adjust in the second half of the year, unless GDP growth figures for Q2 disappoint again in July.

Economic Surprise Indicator



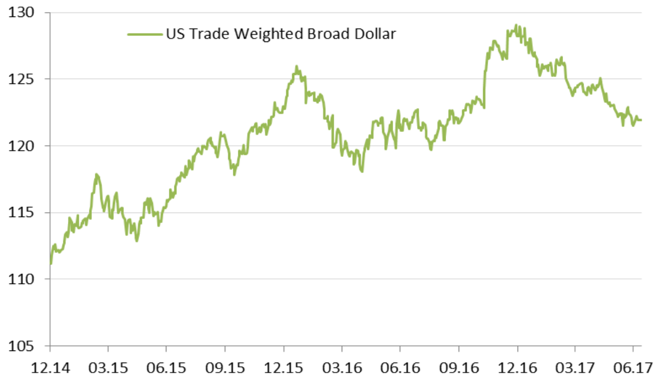
Sources: Bloomberg, BBGI Group SA

The dollar is unlikely to bounce back and remain on an upward course without the clear emergence of more positive trends in the American economy. This element is thus crucial with regard to future movements of the dollar.

In our previous forecasts we had mentioned that the dollar was likely at risk of depreciating following its +30% rise over four years and its accelerating upward trend in Q4 2016. Some short-term consolidation occurred over the last several months as anticipated, but a revaluation of the dollar is now increasingly likely.

However, this appreciation depends on stronger economic performance confirming consensus growth forecasts. A significant change in the US president's political process is also necessary. Only on these conditions do we believe the dollar might again rise against most major and emerging currencies.

Dollar Trade Weighted



Sources: Bloomberg, BBGI Group SA

The decline of the trade-weighted dollar has now reached -5.3%, erasing all gains made after the presidential election. We can thus conclude that the euphoria that had boosted demand for dollars based perhaps on an injudicious outlook and inflated expectations has collapsed.

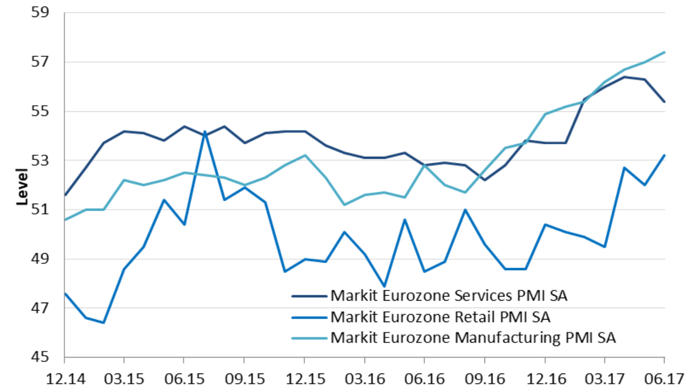
It is possible, however, that the US economy does not require the implementation of new budgetary or fiscal policies to grow. We shall see shortly if it is indeed able to continue on its upward trend and thus steer the dollar into a new phase of growth.

Economic and political factors are lining up in favour of the euro

One year after the EU and the euro were threatened with collapse following the British vote, it appears that the Eurozone, far from having lost its international credibility, is showing stronger economic performance, as political pressures are fading.

The positive economic surprises registered over the past several months and diminishing political risks have thus enabled the president of the ECB to communicate a slightly more optimistic message during the last meeting of the central bank. His economic projections are more encouraging, predicting close to +2% GDP growth for 2017, and slightly less for 2018/2019.

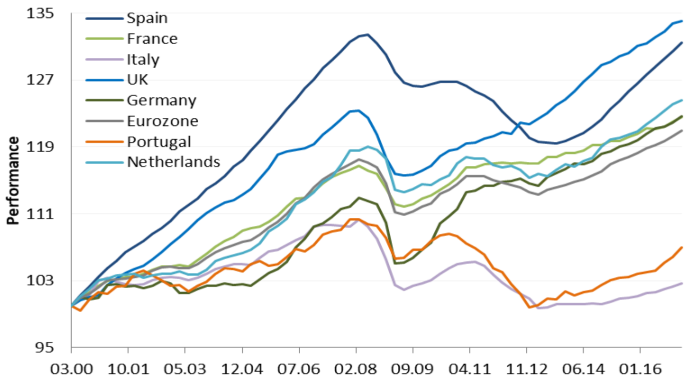
Eurozone – Leading Indicators



Sources: Bloomberg, BBGI Group SA

If the European economy does not suffer any major hits during H2, we believe the ECB will likely taper its programme at the beginning of 2018 before subsequently – and slowly – raising rates. In this context, stronger economic fundamentals have enabled the euro to progress close to +10% against the dollar over six months as well as +5% against the yen and +3% against the franc. Given the economic outlook, the euro now seems poised for strong appreciation.

European GDP Growth



Sources: Bloomberg, BBGI Group SA

Moreover, political developments in the Eurozone will sharply reduce uncertainties that had previously kept many investors away from the single currency. At present Chancellor Merkel is supporting the French president's aspirations to reform the Eurozone, alluding to the possibility of a Eurozone budget and a common finance minister.

The Christian Democrats released their manifesto supporting the creation of a roadmap for Europe and a European Monetary Fund (EMF) akin to the IMF and fostering greater European integration. The euro should benefit overall from the simultaneous improvement of economic and political fundamentals. A rise of the single currency is thus likely in H2.

No rise for the yen without growth and inflation

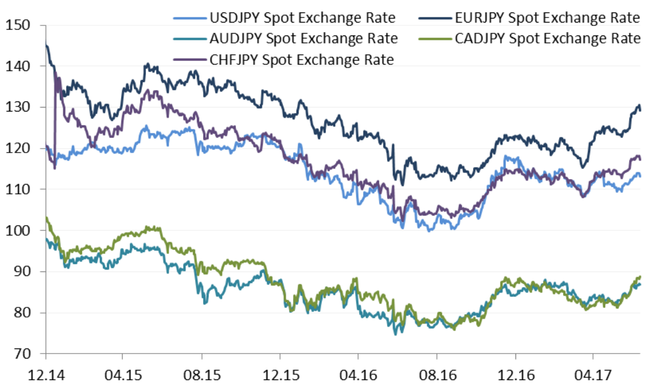
Uncertainty and doubts continue to prevail over any optimism that would have benefitted the yen. In our view, the improvement in fundamentals is not compromised by the downward revision of GDP growth in Q1 (from +2.2% to +1%). Anyways, this will not have an immediate impact on the yen, which will likely remain sidelined by a thoroughly unfavourable interest rate environment and by the absence of sufficient inflationary pressures.

Government policy still aims at weakening the yen, while interest rate spreads and the prospect of further rate hikes in the US will likely push the yen down further in 2017. The paradigm shift in the US has clearly supported the depreciation of the yen, which is now looking for direction. A weaker exchange rate was one of the key elements of the government's policy to boost inflation and exports. This policy remains current, and we believe the yen will go back to fluctuating between 115 and 120 yen against the dollar over the next several months.

An acceleration of economic growth seems essential for any trend reversal to firmly take hold with regard to the yen, which remains in a phase of depreciation against the dollar for now. The latest Tankan report by the BoJ is indeed showing that Q2 is likely to be solid, with its four major components continuing to rise.

The Japanese economy is thus faring better, but the yen is unlikely to appreciate unless inflation starts to rise significantly.

Yen against USD, EUR, AUD, CAD, CHF



Sources : Bloomberg, BBGI Group SA

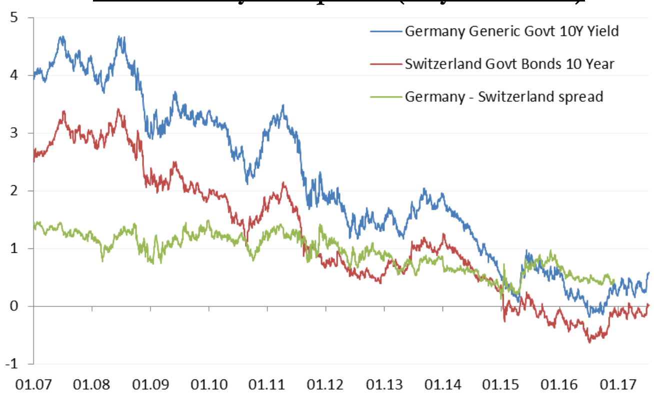
700 billion to finally weaken the Swiss Franc

One must sometimes stay patient when, like the SNB, one believes the Swiss franc to still be significantly overvalued and must then fretfully wait for the financial markets to come to the same conclusion.

Having accumulated 700 billion francs in foreign reserves, which represents over 120% of Swiss GDP, the SNB may be nearing the long-awaited moment when investors finally truly change their views with regard to the franc. Foreign reserves have remained basically unchanged over the past three months, indicating that economic and political conditions in the Eurozone in particular are improving and reducing interest in the franc. A widening short-term yield spread in favour of the dollar was not enough to weaken the franc, likely due to the macroecono-mic disappointments at the beginning of the year, but a rebound should follow economic acceleration in H2. Perhaps more importantly for the currency market is the shift in views that has occurred since the election of Emmanuel Macron and since the European economy has proved more robust and is now supporting the euro. We predicted this had to happen for yield spreads to widen in favour of the euro, which is a precondition for the Swiss franc to weaken.

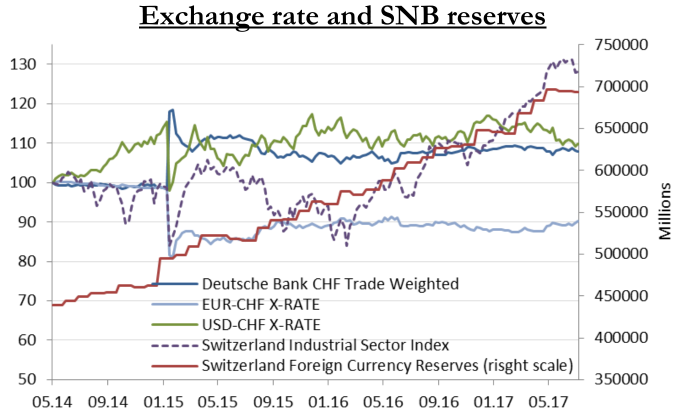
The rate spread is now much more favourable after the dollar-denominated rate increase, but it remains relatively unchanged against the euro at approximately 50 basis points. However, we believe rates are now more likely to normalise more quickly in the Eurozone than in Switzerland, thus favouring the European currency. The robustness of the European economy is now convincing enough for us to change our exchange rate forecasts. This spread would have to grow to 0.75% to allow the franc to depreciate. We also believe that it is increasingly likely that the franc will weaken against the major currencies in the second half of 2017.

CHF-EUR yield spread (10-year bonds)



Sources: Bloomberg, BBGI Group SA

Our exchange rate forecasts are still current. For now, the economic dynamics in the US and in Europe are still lacking the vigour required to drive further rises in the dollar and the euro, but further weakening of the franc is increasingly likely. This should push the dollar to over 1.05 and the euro to over 1.10.



Sources : Bloomberg, BBGI Group SA

Likely stabilisation of the pound

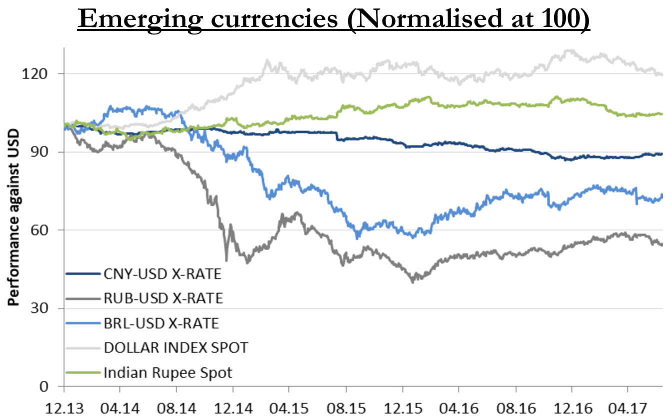
Already in Q4 2016 we noted that the British currency had likely reached a valuation level indicating prospects of a lasting consolidation pending greater visibility with regard to the country's economic outlook.

For several months, the volatility of the British currency has indeed been decreasing against the dollar, the euro and the Swiss franc, for instance. The BoE's decision to keep its monetary policy unchanged in May did not have any significant effect on the pound. The current trend is expected to be further verified in the next few weeks. We still believe the pound will stabilise between 1.10 and 1.20 against the euro. We thus expect more of a stabilisation than a real revaluation of the pound.

Positive outlook for commodities-linked currencies

In Australia, Canada, and commodities-producing countries more generally the rally in the prices of industrial metals, precious metals and crude have reversed the downward trend. The improvement in the general context brought on by the rally in commodities and the more robust global economic outlook will have an increasingly positive impact on the valuation of emerging currencies against the major currencies.

Emerging currencies will likely continue to benefit from a more favourable economic climate and appreciate selectively.



Sources: Bloomberg, BBGI Group SA

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