BBGI GROUP Global Investments

Economic Research

WEEKLY ANALYSIS

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27 November 2018

No impact of stock market volatility on foreign exchange markets

Dollar temporarily at an advantage. Euro expected to rise. Depreciation of the franc. Upswing in emerging currencies. Pound still hostage to Brexit. Weak yen.

Key points

The increase in stock market volatility did not significantly impact foreign exchange markets

Limited rise of the trade-weighted dollar

The increasing pace of growth is temporarily lending strength to the Swiss franc

Swiss franc to depreciate in 2019

Still some stability for the Euro

Dollar at an advantage until the end of the year

US dollar comparatively less attractive in 2019

Upswing in emerging currencies

Yen to weaken further in Q1

Pound remains hostage to Brexit

The Yuan is increasingly international

The increase in financial market volatility did not significantly impact foreign exchange markets

Foreign exchange markets were indeed relatively unaffected by the upswing in volatility in the financial markets in October. The trade-weighted US dollar index did benefit from a safe haven effect, but it grew by only around +2%. The euro fell by -2.5% against the dollar and remained unchanged against the Swiss franc. The yen did not really strengthen despite the rising uncertainty, remaining relatively stable at approximately 113 against the dollar. However, it did appreciate by close to +3.3% against the Swiss franc and +3% against the euro. Even the yuan remained relatively stable against most major currencies, giving up just -1.3% against the dollar. Rising uncertainty in October thus did not have any real impact on foreign exchange markets. In our view, equity markets are unlikely to experience new and more worrisome and negative developments over the next few weeks, and in fact we anticipate a decrease in the volatility of financial assets. Currency markets are thus more likely to react to macroeconomic news, which could continue to benefit the dollar until the end of the year.

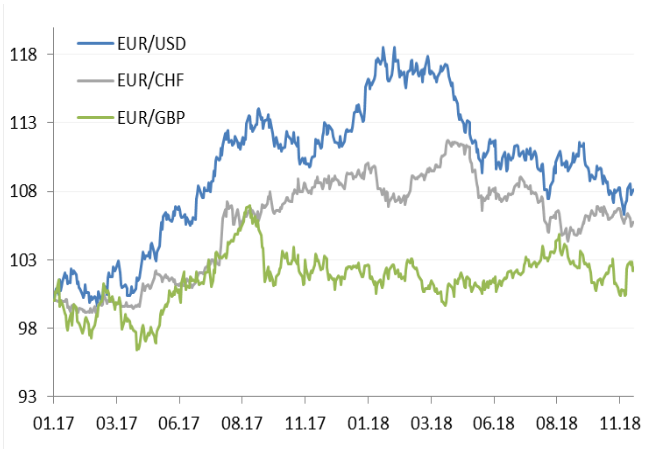
The increasing pace of growth is temporarily lending strength to the Swiss franc

Our long-term forecast in January 2015 for a return to a EUR/CHF exchange rate of 1.20 came true on 20 April 2018. We mentioned at the time that a push of the euro to 1.20 was likely in the long term, though certainly not tenable in the short term. Following the strong appreciation of the European currency, we were expecting a period of consolidation, before any upward trend in the exchange rate against the Swiss franc could materialise. The correction of the past few months occurred in an uncertain political context in the Eurozone, which led to an appreciation of the Swiss franc initially expected to be temporary.

Given the particularly favourable economic conditions currently in place in our country, we consider that the GDP growth differential is for now favourable to the franc. It would thus now be imperative for economic growth in the Eurozone to be significantly higher than what it is currently to envisage a new phase of weakness of the franc.

The interest rate spread between the franc and the euro has not changed significantly, and we continue to expect that the SNB will not increase its policy rates as fast as the ECB. In the meantime, the exchange rate will likely stabilise between 1.12 and 1.17 against the euro, as will the SNB's currency reserves, which decreased from 757 billion to 730.9 billion only because of the franc's appreciation. The Swiss franc should weaken against the euro, hitting 1.20 in 2019. It should also weaken against the US dollar, and head back above one-to-one in the coming months.

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



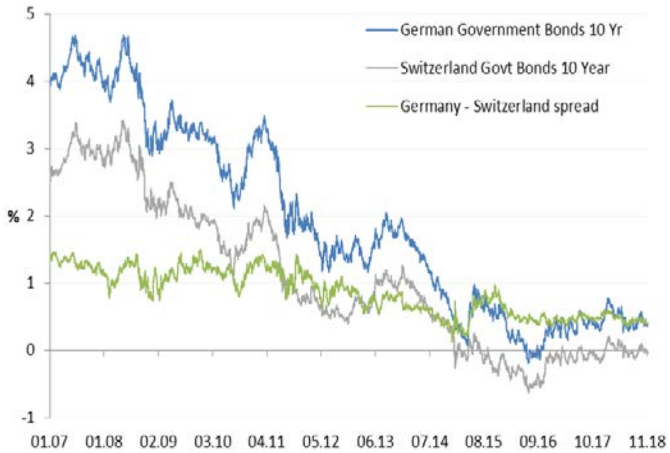
Sources: Bloomberg, BBGI Group SA

Still some stability for the Euro

In the short term, the euro has been negatively impacted by the Italian crisis. However, it is mostly the increase in the interest rate spread against the US dollar and diverging economic performances that are weighing on the currency. Given the ECB was worried about the strength of the euro in the first part of the year, it must now be reassured by its recent weakness. The euro will likely continue to stabilise against the dollar, while appreciating against the franc and once again approaching the CHF 1.20 level.

The long-term interest rate spread should, in our view, increase at the beginning of 2019 in favour of the euro. In the meantime, the ECB is very much forced to admit that favourable growth forecasts for the Eurozone are not, unfortunately, immune to the global slowdown and the rise in uncertainty. Volatility may increase amidst a political context in Europe which remains uncertain between the German elections, the Italian crisis, and the Brexit issue.

Interest rate spread (10 year)

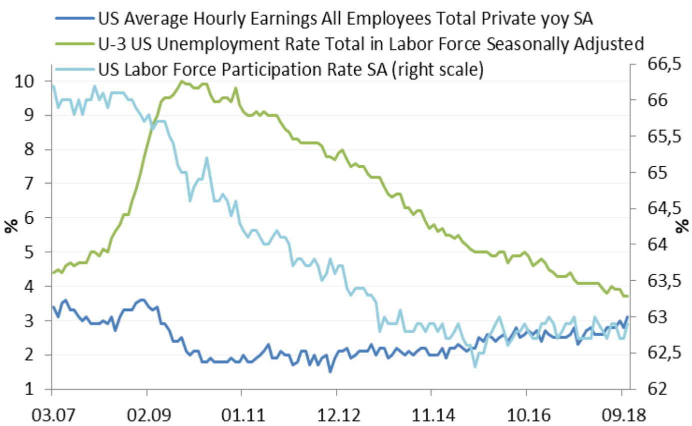


Sources: Bloomberg, BBGI Group SA

US dollar comparatively less attractive

Policies carried out have been favourable to dollar-denominated investments and to inflows into the US. The dollar is still benefitting from rather attractive yield spreads with respect to most currencies. However, we are approaching an inflection point in interest rates that could be less favourable to the dollar.

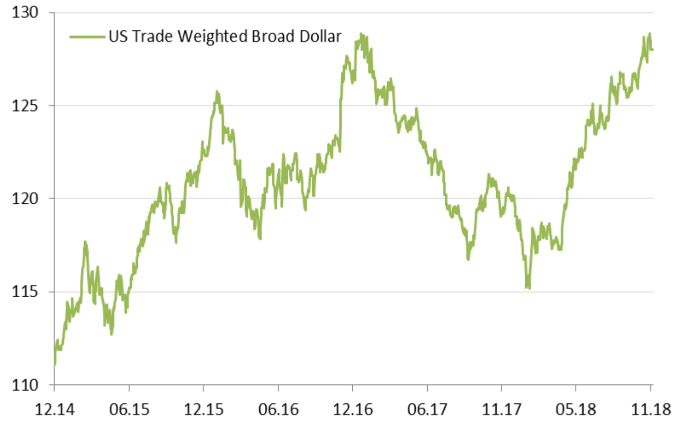
Hourly earnings, unemployment rate and participation rate



Sources: Bloomberg, BBGI Group SA

By 2019, yield spreads will likely shrink due to rising interest rates in the Eurozone and in other developed and developing countries. In the meantime, funds could once again start to flow into impaired emerging market assets and into the Eurozone, whose equity markets are attractively valued.

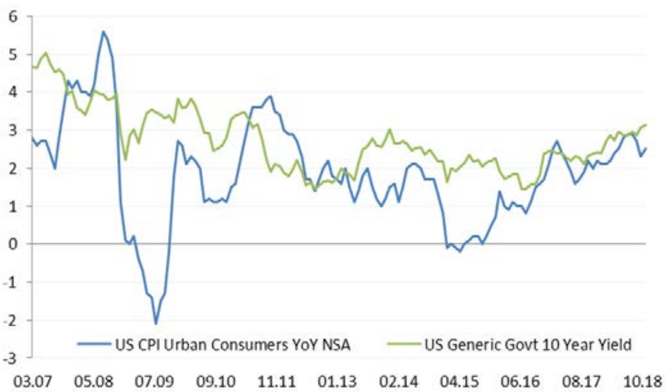
<u>**Dollar Trade Weighted**</u>



Sources: Bloomberg, BBGI Group SA

We maintain our bullish forecast with regard to the dollar/Swiss franc exchange rate, which could reach 1 to 1.05 francs. The US currency will likely very gradually lose some of its sheen compared to the euro and to emerging market currencies, as the stock market climate improves at the end of the year.

<u>**Inflation and 10-year US Treasury bonds**</u>



Sources: Bloomberg, BBGI Group SA

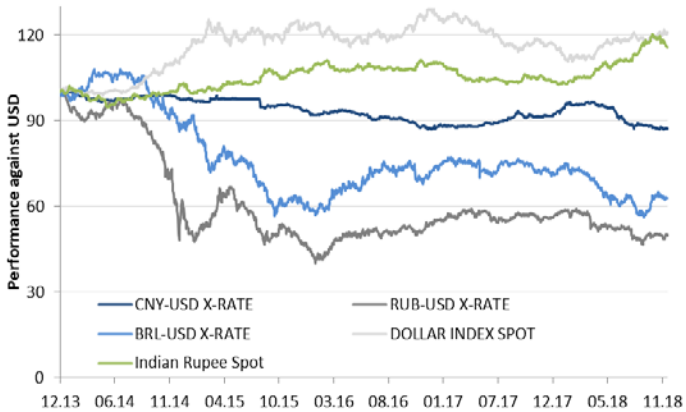
Yen still a little weaker in 2019

For several quarters we had been arguing that a weak yen was an essential prerequisite for any upturn in economic activity in Japan. A weak yen would provide a shot in the arm to the Japanese economy, enabling a more sustained pace of growth. We estimated that a 10% depreciation against the dollar, whereby the exchange rate would increase from around 105 in March to 115 in Q2, would be sufficient to contribute to an upturn. In our March analysis, we noted that the strength of the yen was in part linked to its status as a safe haven in an uncertain context and predicted an increase of the exchange rate back to 110-115 once financial market volatility decreased. Monetary policy still aims at weakening the yen, but available means remain limited.

We continue to believe that investors will abandon the yen due to an utterly unfavourable interest rate environment and to rate spreads that will continue to penalise the Japanese currency.

The implementation of monetary policy normalisation and the likelihood of further increases in long-term rates in the US will likely weigh more heavily on the value of the yen in 2018 and 2019. After reaching our objective of 115, the yen will likely stabilise before continuing to depreciate in 2019.

<u>**Emerging currencies (Normalised at 100)**</u>



Sources: Bloomberg, BBGI Group SA

The pound sterling remains hostage to the political situation

The pound is no longer suffering major blows, despite the lack of concrete progress on defining the post-Brexit trade framework. We continue to believe that the pound has entered a stabilisation phase against most major currencies, after having experienced its historic drop following the Brexit vote. We had predicted that the exchange rate would stabilise in H1 2018, as indeed it did after the negotiation process resumed in December 2017. We had then forecast further depreciation resulting from the return of uncertainties linked to the likely absence of an agreement only months away from the Brexit deadline.

The predicted increase in volatility essentially occurred in July and August via a correction, albeit limited, of the pound to a rate of 1.10 against the euro.

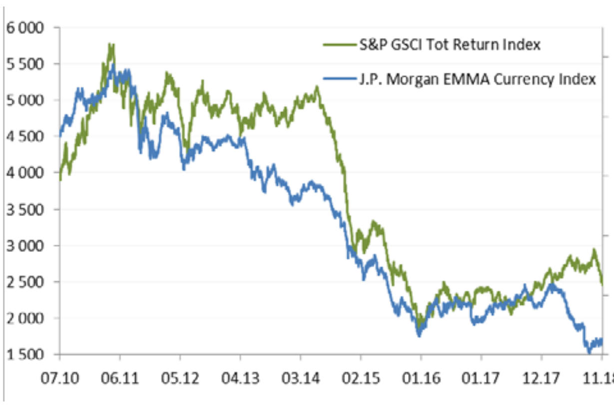
We believe the pound will likely continue to fluctuate within a relatively narrow band of 1.12 to 1.15 over the next few months, supported in particular by the slightly better economic performance in Q2. Changes in the British pound are very much linked to the current political situation surrounding Brexit. We believe that the likelihood of an agreement with the EU in October is still very low.

The yuan is increasingly international

Two years ago, we wrote that the IMF had lent credibility to the yuan by adding the Chinese currency to its special drawing rights (SDR) basket (10.92% allocation). The yuan thus became a central bank reserve currency just like the dollar, the euro, the yen, and the pound. We also discussed the impact of this decision on demand for the yuan and on global perceptions of the Chinese currency.

A recent IMF report noted that the proportion of reserves held in yuan of the 149 central banks that provide a detailed breakdown of their currency reserves has grown to 1.84%.

Commodities and emerging currencies



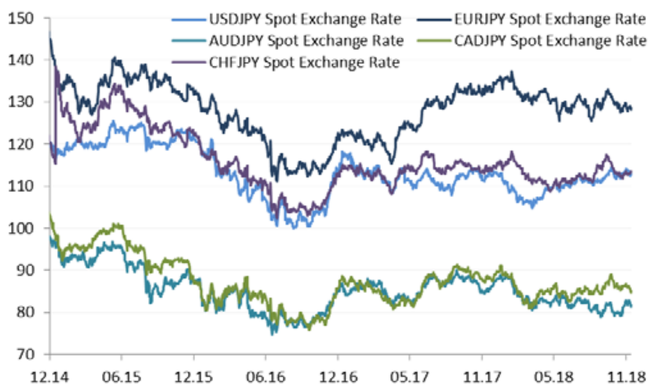
Sources: Bloomberg, BBGI Group SA

The recent +32.6% increase in yuan-denominated reserves is significant and places the yuan ahead of the Australian dollar for the first time in central bank reserve currency statistics.

Political pressure by the US in attempting to deal with its trade deficit could of course have a negative impact on the Chinese currency in the short term. However, this activity by the central banks attests to their growing confidence in the yuan, which is thus not expected to weaken over the next few years. Hence, demand for the yuan could increase with the internationalisation of the Chinese currency beyond central banks. China is making a concerted effort to move forward with opening up its financial markets, and the country's significant role in global trade will ensure that demand for the yuan will grow due to investment and transaction needs. The yuan thus has considerable internationalisation and appreciation potential, which will hinge on the attractiveness of yuan-denominated assets.

In 2018, volatility was once again high for the yuan. After a first phase of appreciation of nearly +5% against the US dollar in the 1st quarter, the yuan has slid more than -10% against the US dollar since March amidst more intense economic pressure. It is now once again close to the rate seen at the end of December 2017, at around 7 yuan to the US dollar.

Yen against USD, EUR, AUD, CAD, CHF



Sources : Bloomberg, BBGI Group SA

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