



# FX GLOBAL MARKET TRENDS 2018

Central banks and the push towards  
policy normalisation





# Buy the rumour, sell the fact

Global central banks are turning the course. A decade on from the global financial crisis, the end of ultra-loose monetary policy is in sight. 2017 witnessed a subtle yet important shift in tone. At Sintra in the summer there appeared to be consensus about the need to reduce stimulus, with a noticeably hawkish turn. But delivering an exit from extraordinary monetary policy is harder to deliver than it is to talk about in the cosy confines of central bank meeting rooms. For starters, even a slight indication of removing stimulus sends currencies higher, delivering a form of tightening in the forex market that in turn forces central banks to stay looser for longer.

Here we outline the key themes and challenges facing four of the world's most important central banks.





A low-angle, blue-tinted photograph of the Bank of England building, showing its classical architecture with columns and a pediment. The Union Jack flag flies from a pole on the roof. A large, semi-transparent blue diamond shape is overlaid on the right side of the image, containing the number '1'.

1

# Bank of England

## One and done?

The Bank of England finally raised rates for the first time in a decade when policymakers met in November. But this was simply a 'correction' of the cut in August 2016. Heading into 2018 it's as you were, with rates at 0.5% and expectations for future rises limited.

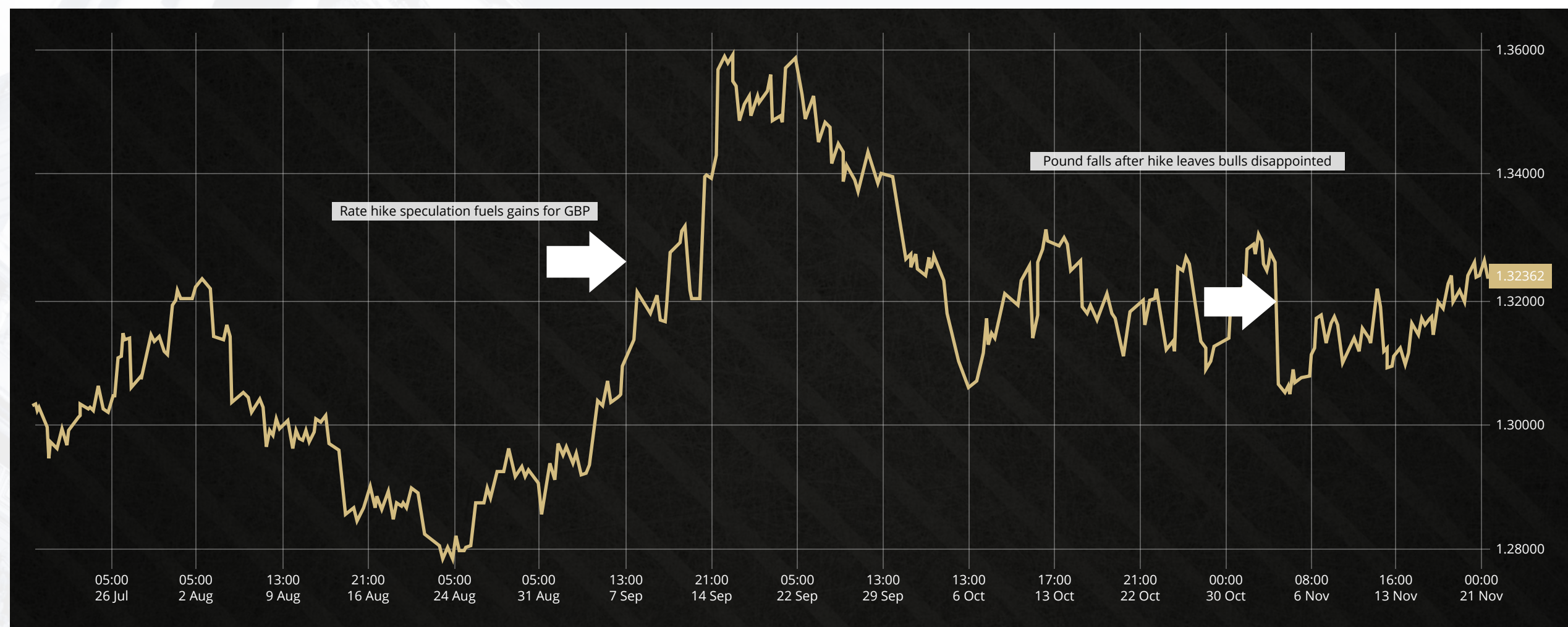


# GBP IN 2017 Hike Disappoints

Highlighting the task facing central banks, when it eventually came, the BoE's hike was something of a disappointment. Similar to the experience of the Federal Reserve and the European Central Bank, albeit over a shorter time frame, speculation about tighter policy drove up GBP but momentum faded when it was delivered (see chart) and the pound fell. A case, as we will look at later on, of how

foreign exchange markets are responding to policy signals well before anything actually happens. In the case of the GBP, the picture is complicated by Brexit, which makes it a special case. Nevertheless, there does seem to have been a response to more hawkish language and then a pullback on delivery.

## GBPUSD



Source: ETX Capital



## OUTLOOK FOR 2018

Expectations for further rate hikes are low. Markets anticipate maybe one hike in 2018. Mark Carney said in November that he anticipates raising rates twice “over the next few years” and the BoE’s November inflation report suggested a base rate of 1% by 2020.

Inflation is expected to come back down from the 3% mark towards the Bank’s 2% target. Coupled with growth that is behind G7 peers, the economic impetus for further hikes is low.

However, projections remain at the mercy of Brexit. A no-deal exit could result in an economic shock that requires a cut to rates. If the government secures favourable trade terms, the resultant boost in sentiment may necessitate higher rates, although the resultant tightening in the FX market from a stronger sterling would offset the requirement to tighten monetary policy quickly.

The Bank of England’s projections are uniquely dependent on a singular outcome of the Brexit process. Smooth (unlikely at present) could mean sterling appreciation (and arguably fewer hikes not more since the stronger pound would act to tighten policy). A rough exit could see the Bank cut rates again.

**“The Bank of England’s projections are uniquely dependent on a singular outcome of the Brexit process.”**







# 2

## Federal Reserve

### How many more?

The Fed continued to steadily raise interest rates in 2017 and policymakers expect 4 more in 2018. But inflation remains lacklustre and the risk of a policy mistake from raising short term rates too quickly may keep policymakers on the back foot.



# USD IN 2017 Fed disbelief, Trump trade unwound

The US dollar in 2017 was a slow-motion crash. Part of this was down to the Trump trade being unwound slowly as the hopes of seismic tax reform faded. The other

part was down to the lack of data drivers for the Fed to raise rates quickly. Such trends may well continue through 2018.

**“The Fed has consistently overestimated the number of hikes.”**

## OUTLOOK FOR 2018

Fed policymakers see four more hikes in 2018, yet the market is currently only pricing in two more at best. The discrepancy is not just caution; it's also down to experience. The Fed has consistently overestimated the number of hikes. In December 2014 the Fed estimated the federal funds rate would be in the region of 3.5% by 2017. By September 2017, rates were barely above 1% and the highest policymakers thought rates will reach in the long run is 3%.

Which takes us neatly to the dollar ramp and the persistent theme in FX markets: appreciation on policy signals, depreciation on policy action as it falls short of expectations.

Policy signals from around the middle of 2014 produced a rally in the dollar as markets anticipated an exit from QE. Once this was priced in, the dollar held ground until taking another leg higher at the back end of 2015 when the Fed finally hiked. After fading, another boost came after Trump's election win.

The important point is that all of the dollar's gains from the lows of 2011 were delivered in the pre-hike ramp of 2014. It was the very early policy indicators of that

year that pushed up the dollar – subsequent rate hikes have done little. Unless the Fed carries through on 4 hikes in 2018 against market expectations for no more than 2, it is hard to see how tighter monetary policy will be especially supportive of the dollar. Running counter to this thesis, there is considerable upside risk for the dollar if inflation does finally respond to the tightness in the labour market, which would support additional hikes.

Tax reform remains something of an unknown quantity. By the time of their September projections, not one Fed policymaker had factored in tax cuts to their forecasts.

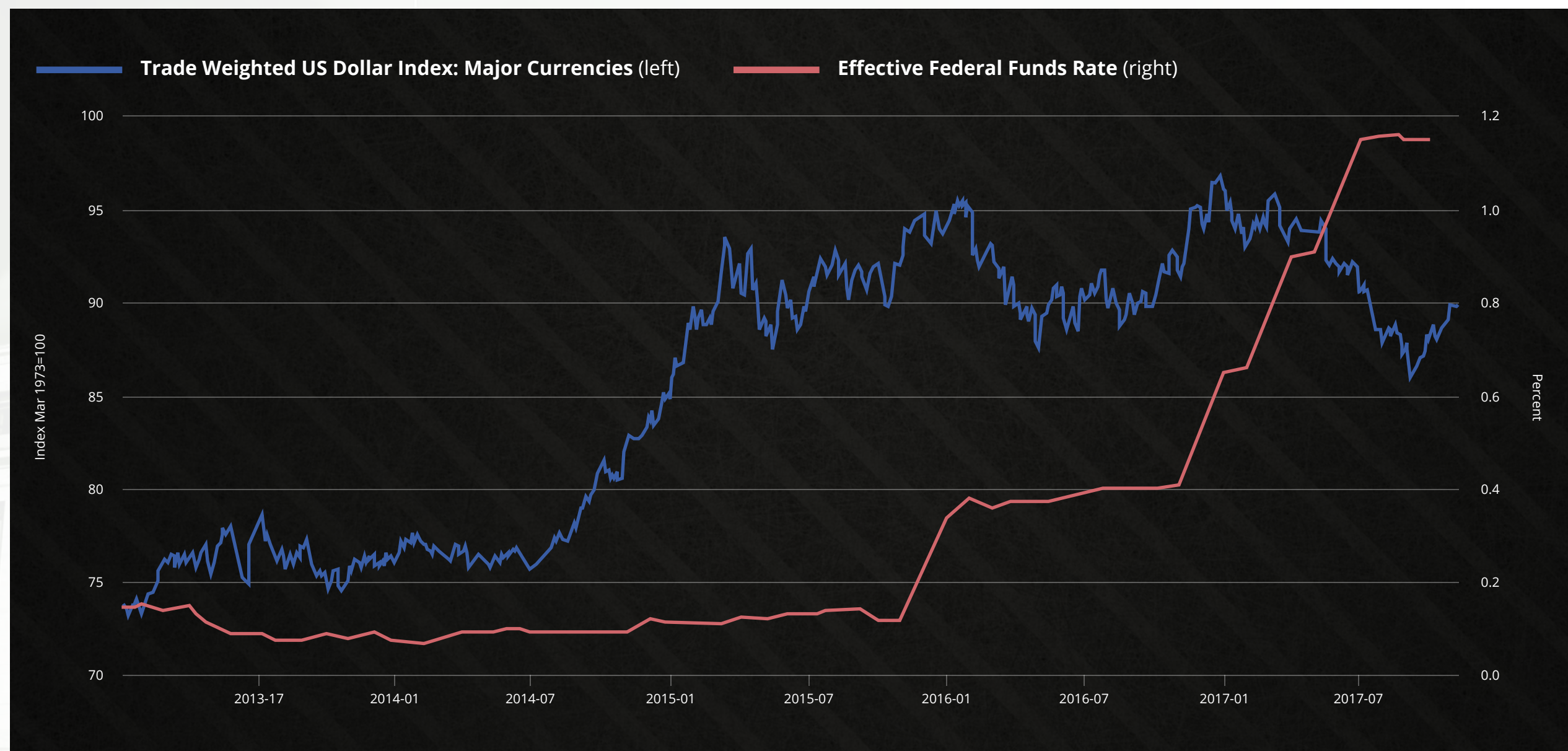
We must also factor in the Fed unwinding its balance sheet. Estimates for the impact this will have on real rates varies, but it ought to exert an upward pressure on yields. The key is whether this pushes up the longer end of the curve – allowing the Fed to hike short term rates more easily – or if the effect is more evenly dispersed along the path of the curve (which would make hikes less likely).



# Dollar's rally based on policy signals

Hikes have done nothing for USD

2



Source: Board of Governors of the Federal Reserve System (US)



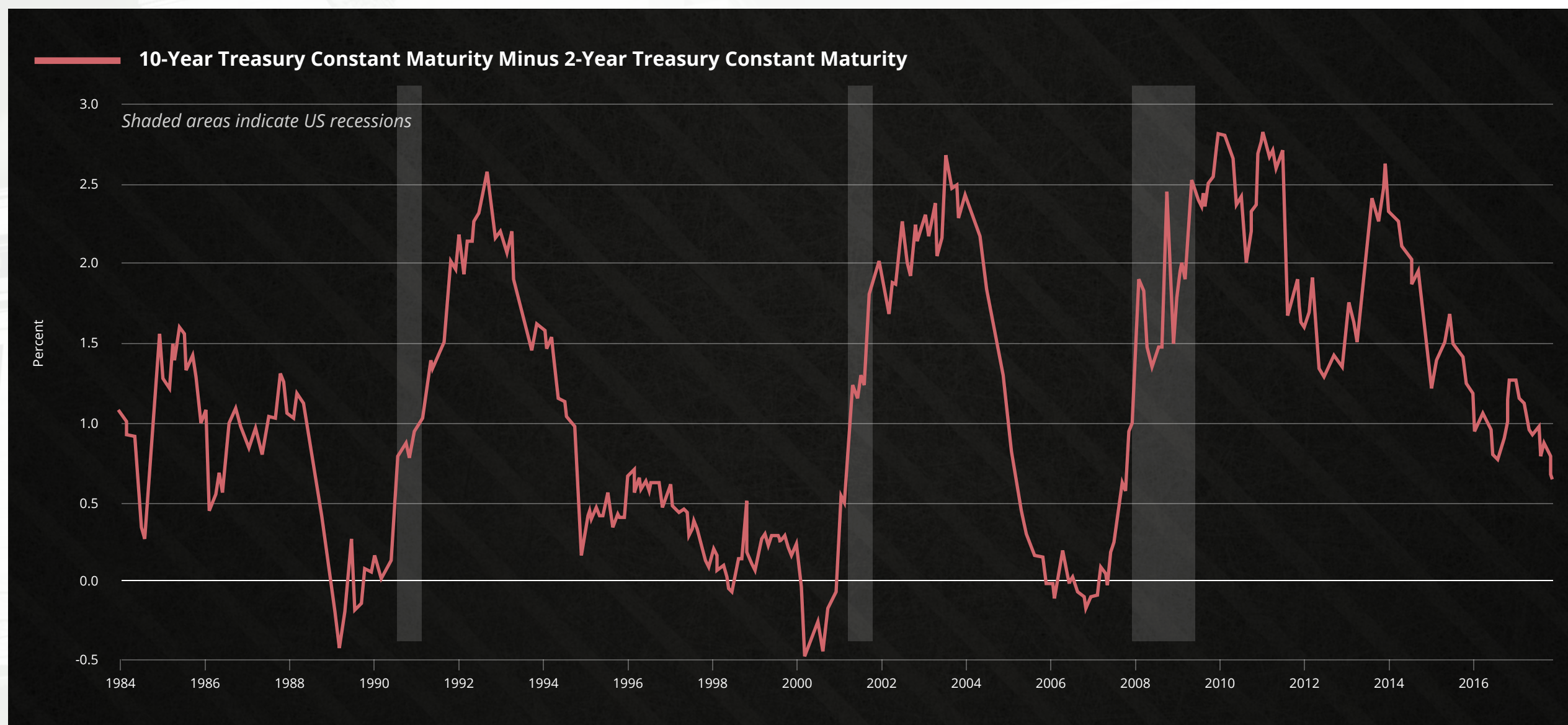
## THE YIELD CURVE

Rising short term rates and flat longer-date yields mean the yield curve has flattened considerably. Why does this matter? Quite simply a flatter yield curve is a sign markets don't expect much growth in future and is a sign they don't believe the Fed. If the curve goes beyond flattening and inverts – ie short-date debt carries

a higher yield than longer-dated debt - a recession usually follows (see chart). The risk for the Fed is tightening short-term rates too quickly without longer-end of the curve following suit.

### Risking a policy mistake

Do bond yields signal a looming recession?



Source: Federal Reserve Bank of St. Louis





# 3

## European Central Bank *Easy-peasy?*

With a resurgent Eurozone, the question is whether growth and inflation will accelerate enough to prompt market speculation about a faster move to the exit than the current leisurely pace. The euro enjoyed a strong year versus the dollar but any upside may be limited by the ECB's apparent unwillingness to tighten financial conditions. And the more the euro strengthens the greater the pressure to remain easy. In this regard EURUSD seems in a state of equilibrium until there are any new policy drivers – such as a surprise increase in core inflation. Higher oil prices may make for higher headline inflation, but this will likely be ignored unless the core rate manages to also improve.

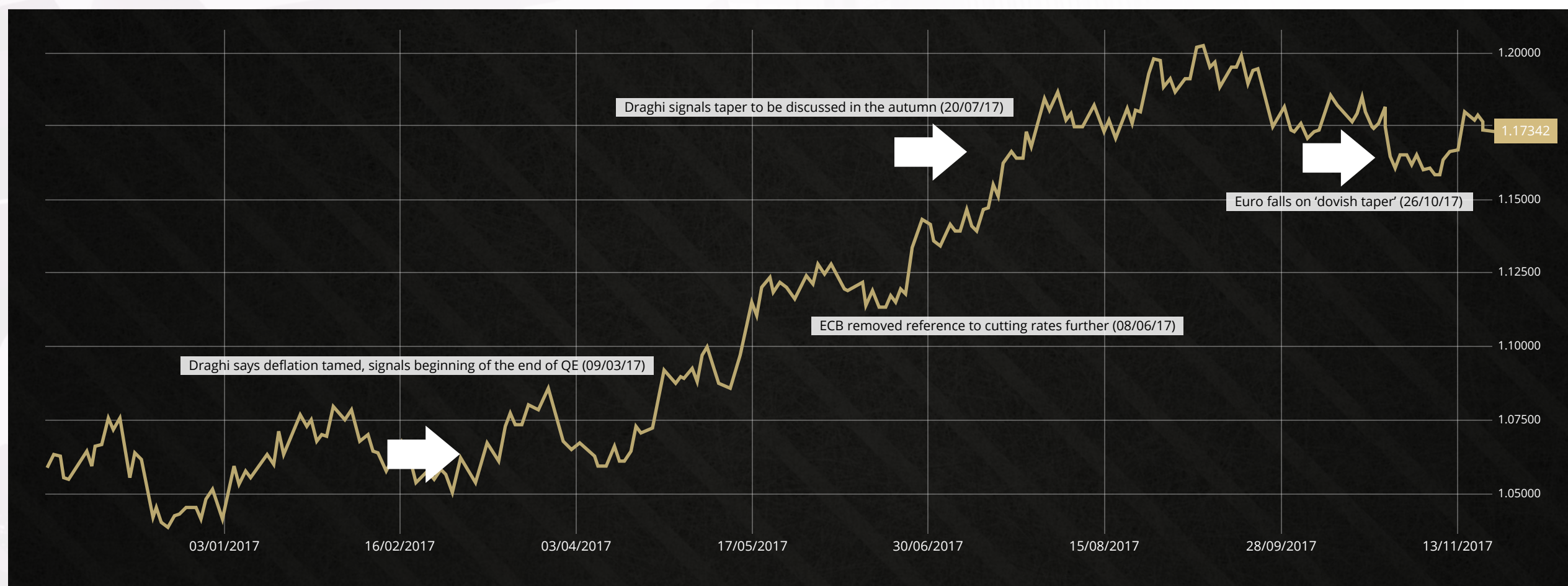


## EUR IN 2017 Ramp on taper talk

Once again, forex markets moved early to pre-empt any attempt at policy tightening by the European Central Bank (see chart). The euro ramped early in 2017 as talk of tapering fuelled a rush to buy euros. By the time the eventual

announcement on extending asset purchases eventually came, the euro rally was over. Indeed so dovish was the taper, markets began to price in the first rate hikes taking place even further out the time horizon.

### The euro's ascent in 2017



Source: ETX Capital



## OUTLOOK FOR 2018

First, QE continues, but we don't know how long for. In October the ECB confirmed it will continue QE at a monthly pace of €30 billion until the end of September 2018, or longer if necessary. We know for sure that QE will continue beyond September 2018 with Draghi saying the programme will not 'stop suddenly'. Moreover there appeared little sense that if conditions were to improve significantly that the ECB would seek to exit any sooner.

But could improvements in economic growth and, crucially, inflation spur market speculation that the ECB will tighten more quickly? The emphasis is on the speculation rather than assuming the ECB will act on better data – we know that the ECB is ultra-cautious and we also know that the forex market works light years ahead of any policy decisions.

**“The forex market works light years ahead of any policy decisions.”**





# 4

## Bank of Japan An end in sight?

The Bank of Japan has come under pressure to start discussing how it will eventually end its prolonged period of ultra-easy monetary policy. Governor Haruhiko Kuroda has so far rejected that demand, although he has recently suggested that the Bank of Japan could tweak monetary policy before achieving its inflation target.



# JPY IN 2017 As easy as it gets

Against the dollar, the yen has failed to match the gains of the euro in 2017. The lack of any signal of removing stimulus is the difference, but with the ECB 'taper' rally seemingly over, is now the time for the yen to outperform? EURJPY enjoyed

solid gains through to November, but a lack of any more hawkishness from the ECB might see this reverse in 2018.

## USDJPY in 2017 trending lower but increasingly stuck withing a range of 108-114



Source: ETX Capital

## OUTLOOK FOR 2018

Japan has matched much of the developed world as it enjoys a growth pick-up alongside moribund inflation. The Bank of Japan has dialled back its forecast for inflation from 1.1 per cent to 0.8 per cent for the year to March 2018. Inflation in the following year is

seen at 1.4%. Even this looks ambitious, yet there is a sense that the BoJ cannot simply continue to expand stimulus. Improving economic fundamentals and a global reflationary/tightening cycle could see the BoJ unable to keep rates in check.

The downside risk for the yen is if inflation remains elusive, the BoJ may expand asset purchases to control rates even further along the curve.





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