

# Quarterly FX Forecast

UK, Eurozone, USA, Canada, Australia & New Zealand  
July - September 2018



**HAWKFX**

Clarity Through Perspective

## Introduction

Although it did not feel like it at times, the British pound and the Canadian dollar came out of the second quarter of 2018 with a reasonably positive result. It was the US dollar, though, that minced the opposition.

Gains of 7.1% against sterling - ten cents - and 6.4% from the euro were only the half of it. The Greenback took 3.6% from the Canadian dollar, 4.6% out of the Australian dollar and went up by 6.4% against the Kiwi.

One can only wonder how well the US dollar might have done had it not been for the American president's

trade war. Not only are investors unconvinced about its longer-term benefits to the US economy, they have not the faintest clue what mischief might arise in the short term.

Another - now almost traditional - uncertainty also lingers. One day they will make a movie out of Brexit, but not until the end of the story is known. And that remains elusively beyond the horizon.



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## Economy

Gross domestic product growth in the first quarter of 2018 was a pitiful 0.1% according to the most recent figures. The second quarter got off to a better start, especially on the high street where retail sales rebounded strongly in April and May. Unemployment fell to a 43-year low of 4.2%, theoretically a positive factor for the economy although many workers are on zero or limited hours contracts because they cannot find regular jobs.

Despite the low rate of unemployment wage growth continues to be slow, to the bafflement of economists. At the last count total earnings were up by an annual 2.8%; more than the 2.5% by which the consumer price index increased but less than the 3.3% rise in the retail price index.

## Politics

It is two years since Britain voted to leave the European Union and the prime minister has yet to come up with a plausible exit strategy. The opposition is no more coherent on the matter, and the Brexit bickering is clogging up

the bandwidth of government. An increasing number of businesses now have to move operations to the continent, because they need certainty and cannot afford to wait until the last moment to discover how the new regime will work.

Theresa May's position is permanently under threat, not least from her defence secretary who has spoken publicly of his ability to "bring her down".

Apart from that, British politics is in pretty good shape.

## Monetary Policy

Until the Bank of England's (BoE) Monetary Policy Committee met in June there was little expectation of any increase to the interest rates: the May meeting had failed to deliver the expected rise, and that seemed to be that.

The minutes of the June meeting changed the game. Three of the nine MPC members voted for a higher rate. Two of those votes were priced in but the third, from BoE chief economist Andy Haldane, was not. Instantly, investors decided that a rate increase in August had become - and remains - a better-than-even chance.

What happens after that is a different matter. One of the higher-rate hawks, Ian McCafferty, will be leaving the committee after a six-year stint, to be replaced in September by Jonathan Haskel. At his confirmation hearing with the Treasury Committee, Mr Haskel made it fairly clear that he does not share Mr McCafferty's hawkishness.

## Key Economic & Political Events



## GBP / EUR

Sterling has traded very much sideways against the Euro over the last quarter, as Brexit optimism has faded. A poor run of data from Q1 didn't help matters, though that looks to have turned around in Q2 with a rate hike expected in August. In Europe asset purchases by the central bank will be wound down, though political tensions will likely continue to hamper the Euro.



## Economy

After a bit of a stutter in the spring Euroland's economy seems to be regaining some momentum. The provisional purchasing managers' index (PMI) readings for June, which measure the health of the private sector, indicated that a slight easing among manufacturers was more than offset by a pick-up in services. That said, the industrial production data for April - the most recent available - underline the question mark over manufacturing: output fell 0.9% and was up by no more than 1.7% on the year.

April's retail sales were also up by an annual 1.7%, having risen by a feeble 0.1% on the month. Unemployment was lower at 8.5% but still too high for comfort. The inflation and growth stories were respectable: Consumer prices were up by 1.9% in the year to May, bang on the European Central Bank's target and the eurozone economy expanded by 0.4% in the first quarter.

## Politics

Brexit is of considerably less concern to Euroland than it is to Britain. The eurozone has more - if not necessarily

bigger - fish to fry. Front and centre is Germany, where Chancellor Angela Merkel's coalition looks increasingly shaky. Immigration is a hot topic, and Mrs Merkel is carrying the can for allowing an influx of refugees. Her position as leader of the free world looks precarious.

In Italy, an odd-couple, a populist coalition of left and right - Five Star and Lega - looks unconvincing in the long term. There, as in much of the rest of Europe, migration is a major issue. Interior minister Matteo Salvini's call for a census of Roma people in the country rang all sorts of alarm bells.

At European Council level migration is also a big deal, but France and Germany are doing their best to put forward an agenda of reform. Their proposals include a European monetary fund to provide backstop finance and a European budget. Success is not assured.

## Monetary policy

In mid-June, the European Central Bank, at last, got around to announcing the end of its asset purchase (quantitative easing) programme. There will be no new bond purchases after the end of 2018. Probably, unless they become necessary. However, near-zero interest rates (the ECB's

deposit rate is -0.4%) will remain in force beyond next summer.

It was not exactly what investors had been expecting to hear. They had hoped that the ECB would be getting on with the job, so as to build up some interest rate ammunition in preparation for the next recession. Instead, it looks as though there could conceivably be no change to rates before the new president takes over from Mario Draghi in November 2019.

## EUR / USD

The euro followed the pound in a decline against the dollar, as economic data started to seem more fragile. The political situations in Germany, Italy and Spain added to euro fragility. The US economy remains strong, with an additional rate hike expected in 2018. This is in sharp contrast to expectations of a first hike from the European Central Bank in late 2019.



## Key Economic & Political Events





## Economy

The most recent data put US economic growth at an annualised 2.2% in the first quarter of the year. On a quarterly basis, as reported by most other countries, that equates to a 0.6% expansion.

Another closely-watched statistic, the monthly change in US nonfarm payrolls, is also looking healthy, with an average increase of 207k in the year to date; the averages for 2016 and 2017 were 182k and 192k respectively. Unemployment at 3.8% represented an 18-year low.

Retail sales are robust too. Monthly increases of 0.4% and 0.8% in April and May suggest that consumers are ready to spend. The point-and-a-quarter rise, to 99.3, in the University of Michigan's provisional consumer sentiment index bears out the upbeat consumer story.

Investors continue to believe in the president's tax cuts, which came in at the turn of the year. They are less enthused by his trade wars.

## Politics

"Trade wars are good, and easy to win." That was the message of Donald Trump when he gave notice of his forthcoming crusade. The reality might not be so clear-cut. Tariffs on steel and aluminium, originally aimed at China, were extended to America's allies. Those allies were more than a little irritated. They took their grievances to the G7 meeting in Quebec, where Trump gave them short shrift and refused to sign the post-meeting communiqué.

Subsequently, more tariffs have been slapped on, and America's one-time trade partners have responded in kind. The EU has imposed a 25% import tax on, among other things, US motorcycles. As a result, Harley-Davidson is moving some of its production abroad in order to maintain EU sales. Nobody saw that coming.

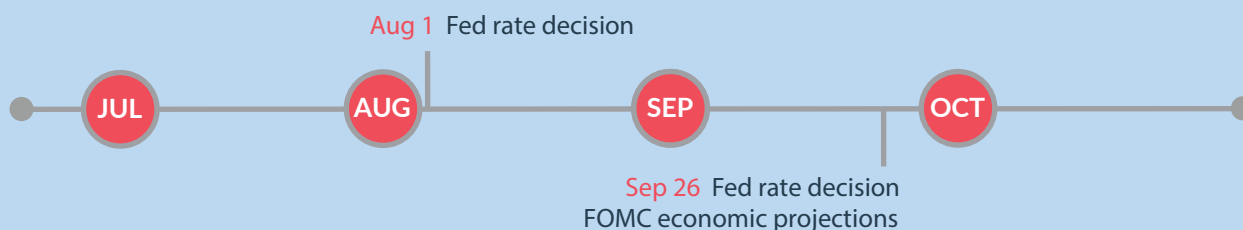
## Monetary policy

With Jay Powell four months into his term as chairman of the Federal Reserve there is no sign that it will be anything other than business as usual. In mid-June, as widely expected, the Federal Open Market Committee (the Fed's MPC) increased its target range for the benchmark Funds rate by a quarter of a percentage point to 1.75% -

2.0%. The accompanying statement implied another two rate increases before the end of 2018 with more to come next year.

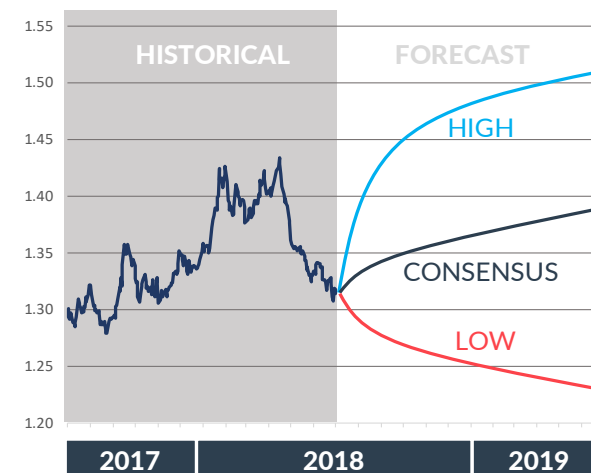
That outlook could change if the US president is serious about his trade war. It is difficult to find an economist who believes the US economy - or indeed the global economy - will prosper as a result of protectionist tariffs. Slowing growth could bring the Fed's tightening to a halt.

## Key Economic & Political Events



## GBP / USD

The highs in the early 1.40's didn't last, with optimism over the Brexit outcome giving way to concern. Meanwhile, as the data in the UK worsened, it continued strongly in the US. The Fed are expecting an additional hike this year, whilst we now expect only one in the UK. This has seen sterling drop to the low 1.30's (8.5% from high to low), though many feel there could be a bounce ahead as data strengthens in Q2.



## Economy

Iron ore and coal together account for more than a third of Australia's exports, worth around \$70bn a year. They are used for making steel, mostly in China, the rest elsewhere. America's president has decided in his wisdom to impose a 25% tariff on steel imports.

The tariffs will have a minimal direct impact on the Australian economy: exports to the US are less than 5% of the total, roughly the same as goes to India. They will, however, have an impact on China, Australia's biggest export customer by a mile.

Nevertheless, the economy is moving along quite solidly at the moment. A 2% fall in exports in April still left Australia with a healthy billion-dollar trade surplus. Gross domestic product expanded by 1.0% in the first quarter of the year. Job creation continues apace: 12k were added in May, and the rate of unemployment fell to 5.4%.

## Politics

With a general election looming in less than 12 months' time Prime Minister Malcolm Turnbull has been doing his best to burnish the Liberal Party's popularity rating. To that end, and to give a boost to the economy, he passed legislation in June that will cut income taxes by \$144bn over seven years.

The Liberals did not have sufficient numbers in parliament to pass the legislation on their own. The bill was stalled until the nationalist One Nation party lent its support. According to a politics professor at Flinders University, "it was the most significant victory in Turnbull's tenure and will give him a real boost as we approach an election".

## Monetary policy

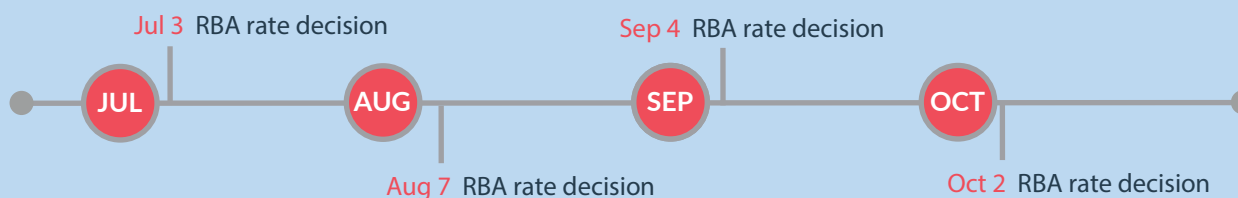
In August the Reserve Bank of Australia's 1.5% Cash Rate will celebrate its second birthday. It is difficult to find an economist who would bet against it celebrating a third.

Inflation at 1.9% is almost bang on target, and the only fly in the ointment is the monthly survey of inflation

expectations carried out by the Melbourne Institute. In May the public estimated that inflation would be 3.7% in a year's time. In June that estimate had risen to 4.2%.

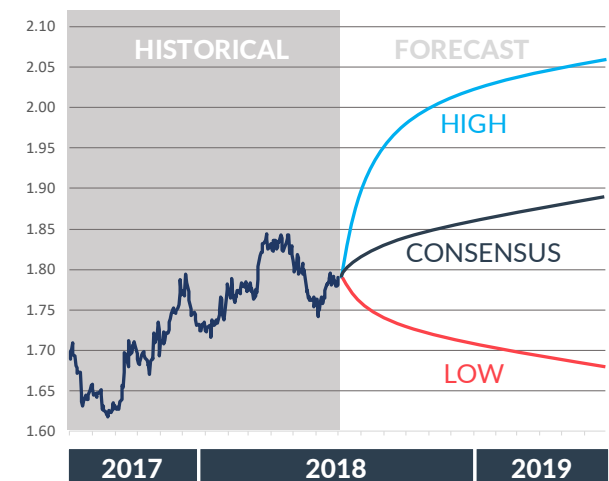
Central banks pay close attention to inflation expectations. The higher consumers see it going; the more likely is the central bank to raise interest rates.

## Key Economic & Political Events



## GBP / AUD

The Australian dollar has been on a generally softening bias, with concerns over a slowdown in China continuing. The tariff situation has the potential to further dent demand for commodities which are a mainstay of Australian growth. No changes are expected to Australian rates, whilst a UK rate hike and stronger data continue to support sterling.



## Economy

New Zealand's economy expanded by 0.5% in the first quarter of 2018, a little more than the euro zone's 0.4%, a little less than the United States' 0.6% and a whole lot less than Australia's 1.0%. It was not a poor outcome, but the comparison with Australia did not help matters for the Kiwi dollar.

Looking on the bright side, the balance of trade was positive for the last two reporting months, and visitor arrivals recovered in May from April's dip. Quarterly data showed a 0.6% increase in employment in Q1 with the rate of unemployment ticking down from 4.5% to 4.4%.

Less impressive were a miserable 0.1% quarterly increase in retail sales and, towards the end of June, a sharp deterioration in business morale: ANZ's Activity Outlook slumped from 13.6% to 9.4% and the index of business confidence from -27.2 to -39.0.

## Politics

Touchingly, the hottest topic in NZ political circles was Prime Minister Jacinda Ardern's new baby, which arrived on 21 June. Predictably, the leader of the National Party, Simon Bridges, got into trouble when he joked about the newcomer on a radio show. The New Zealand Herald reported that "The interview has been interpreted as Bridges being disrespectful to Ardern's baby, Ardern herself, and to the LGBTQ+ community". The paper also conceded that "It was only a matter of time before 'baby mania' became politicised".

In the practical world, the government has scrapped its KiwiBuild Visa programme after a study discovered that its costs could "blow out". New Zealand needs 30k more construction workers to fill gaps in the sector. A new scheme will simplify the process of hiring key workers from overseas without Immigration NZ needing to examine every case.

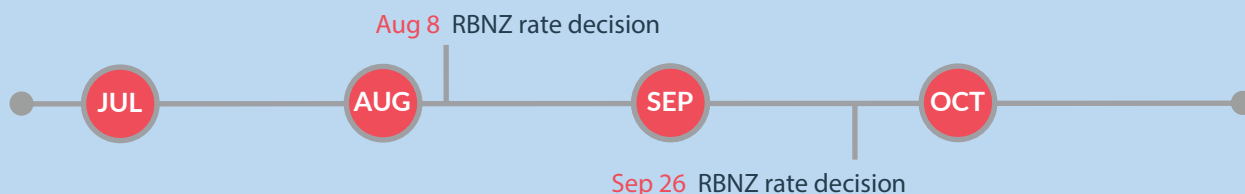
## Monetary policy

At its policy meeting on 28 June, the Reserve Bank of New Zealand (RBNZ) surprised no one when it held the Official Cash Rate at 1.75% for the 20th month. With inflation at

1.1% in Q1, its lowest level since 2016 and half what it was a year earlier, the RBNZ might be contemplating a rate cut.

In its statement at the end of June, the central bank said "The Official Cash Rate (OCR) will remain at 1.75 percent for now. However, we are well positioned to manage change in either direction – up or down – as necessary". For the moment investors are not looking for a cut, but that attitude would change if inflation were to slow further.

## Key Economic & Political Events



## GBP / NZD

Economic data in New Zealand has underperformed that of Australia with similar concerns over trade tariffs and a slowdown in China. The Reserve Bank of New Zealand has left interest rates at 1.75% but with inflation falling, may come under pressure to reduce rates whilst others are raising. This is likely to weigh further on the Kiwi, with a hike expected from the UK in August.





## Economy

The Canadian economic data in Q2 were a mixed bunch. The retail figures released in April and May were ahead of forecast while the number in June, for the month of April, showed an unexpected 1.2% monthly decline. The jobs figures in April looked good: those released in May and June were disappointing. Inflation fell short of the target every time. Growth for the first quarter was well below forecast at an annualised 1.3%, equivalent to a quarterly 0.3% expansion.

Despite all that, the Canadian dollar did better over the three months than its Australian and New Zealand peers. It helped that oil prices moved - it did result ultimately - higher over the three months. The increase was far from uniform but did eventually result in an 11% rise in the price of one of Canada's most important exports.

## Politics

Domestic Canadian politics were of little consequence. The primary influence was mostly 750km to the south in Washington DC, and briefly in Quebec. America's president

continued to bang the trade war drum, and he took it with him to the G7 summit hosted by Canadian prime minister Justin Trudeau in La Malbaie. The summit did not go as well as it might have done: Trump said afterwards that Mr Trudeau was "very dishonest and weak".

Since then the US administration has proceeded to impose import tariffs on allies and competitors alike, including Canada. The North American Free Trade Agreement looks increasingly like a dead duck. Mr Trudeau is fighting back, but the disparity in size between the US and Canadian economies makes it likely that his country will be the loser if Trump doesn't back down.

## Monetary policy

The Bank of Canada (BoC) has slowly followed the US Federal Reserve in raising interest rates. There were 12 months between the Fed's first and second increase (to 0.375% and then 0.625% in December 2016), and it was not until July last year that the BoC lifted its benchmark from 0.5% to 0.75%. However, it has moved twice since then while the Fed had increased its funds rate three times. Two years ago the BoC benchmark was 1.8% above the Federal Reserve's; today it is 1.4% below it.

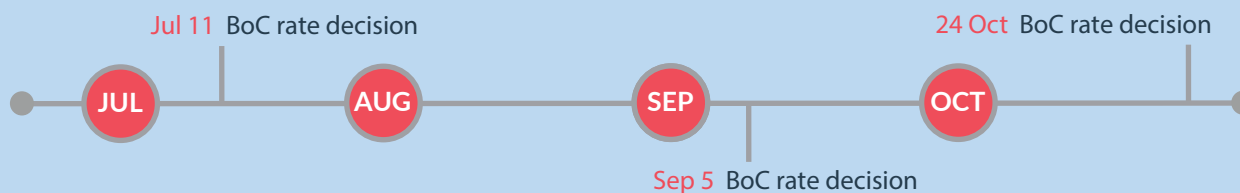
Until late June investors were teed up for a rate increase by the BoC at its 11 July meeting. Then Governor Stephen Poloz gave a speech in which he said the US trade war would "figure prominently in our upcoming deliberations". The implication was not that it would make an increase in interest rates more likely: the chance of one dwindled to no better than evens.

## GBP / CAD

The Canadian dollar has benefitted from stronger oil prices as the UK suffered a dip in economic sentiment. There remains significant uncertainty for Canada with US tariffs having the potential to affect the economy after a tetchy G7 summit. Following the recent strength from the Canadian dollar, it seems likely sterling will benefit if we get a rate hike in August.



## Key Economic & Political Events





## Downside risks

How long have you got? Trade wars, Brexit, European migration, slowing growth, a trend towards populist-nationalist politics; none of these bodes well for the economy, domestic or global.

Change comes slowly. The situation today is not markedly different from three months ago. However, it has not improved. The trade war is becoming entrenched. Brexit plans are still non-existent. The issue of migration divides European governments. Growth is running out of steam and every month advances the cause of unconventional politicians.

In our last report, the counsel was to prepare for volatility. We have seen no reason yet to change that opinion. Change comes slowly...at first.



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