FX Week

USD struggles as Fed tightens

While the USD has stabilized a little against a basket of major currencies it does not appear able to recover significantly even as the Federal Reserve continues to project higher interest rates and a stronger economy in the year ahead. Although US interest rates were raised last week to between 1.0-1.25% (the second hike this year and the third since December 2016), what was expected to be a 'dovish tightening' turned into one which was more 'hawkish' as the Fed stuck to its forecast for another hike this year and for more rises to come in 2018 and 2019. This was particularly surprising following a run of mediocre economic data causing investors to question whether a further rate hike this year is likely at all, with both bond yields and the USD remaining heavy.

Markets doubt Fed projections

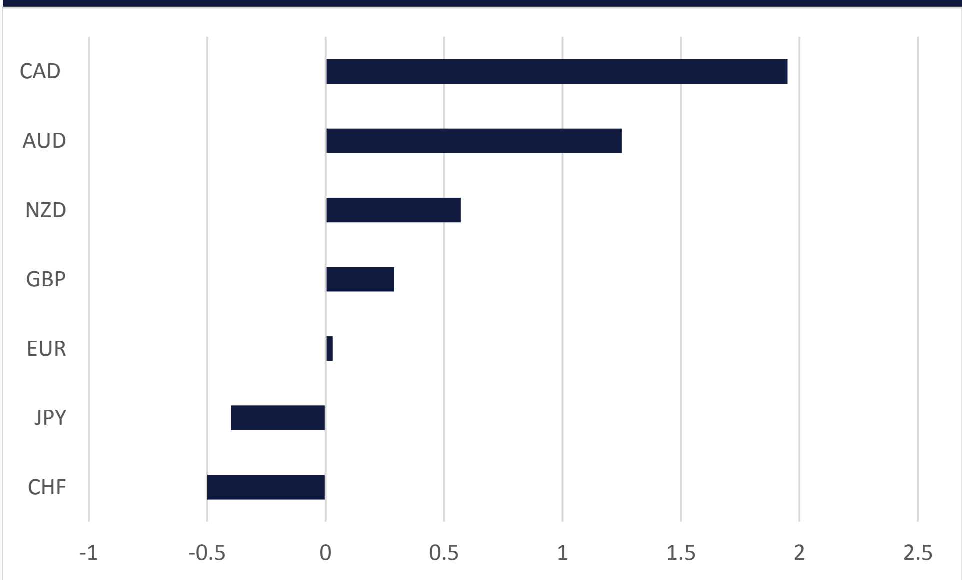
This reaction shows that the markets' believes that the Fed's projections for both the US economy and for the fed funds rate are too optimistic. The elevated levels of US equities also speak of forecasts for rate hikes that are not really believed either. While the markets were able to absorb weak growth data in Q1 as a seasonal phenomenon, they are becoming less tolerant of it carrying over into Q2, with inflation falling back and retail sales weaker than expected.

Not only did the Fed last week stick with its outlook for interest rates reaching 3.0% by the end of 2019, but it also outlined details of its plan to normalize its USD4.3 trillion balance sheet, saying that it intends to start the unwinding process this year if the economy evolves as anticipated. Yellen's tone was also surprisingly dismissive of the recent data softness, implying that the fall back in inflation will be temporary. However, investors are becoming nervous not only about the economic picture per se, but also about how political developments in Washington could intersect with a sluggish growth to produce a much less rosy outlook particularly next year.

And Trump's woes weigh and deepen

Congress will soon retire for the summer, probably without any legislative wins in the first five months of the Trump Presidency, and raising questions about whether there will be any in the whole of 2017. This adds to the risk of the economy slowing if it is unlikely to get the benefit of major tax reform, a regulatory overhaul, or a boost from infrastructure spending. The White House will already be in a potentially precarious position heading into 2018, when mid-term elections and the Special Prosecutors findings about the Trump campaign loom. A lack of progress on economic reforms will only compound such concerns, and they are already serving to impede the USD's ability to rally even as the Fed talks more hawkishly.

Weekly currency movement vs USD (%)



Source: Bloomberg, Emirates NBD Research

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Tim Fox
Chief Economist
+971 4 230 7800
timothyf@emiratesnbd.com

www.emiratesnbdresearch.com

The coming week will be a relatively quiet one for economic data with the housing sector seeing the main releases in the form of existing home sales and new home sales. Housing starts fell by 5.5% m/m in May, and there was also a dip in consumer confidence in June to 94.5 from 97.1 in May. This may not be of major concern in itself, but it does speak of the risks to growth if consumers and businesses start to lose faith in government policies, with Trump's own ratings diving to historic lows. Fed officials will likely be conscious of these risks and it will be interesting how they now couch their own comments in the wake Yellen's more hawkish rhetoric.

GBP firms on BOE hawkishness

Not helping the USD is that other central banks are becoming more hawkish including the Bank of England (BOE). The 5:3 vote by the BOE's Monetary Policy Committee to keep interest rates on hold was a surprise, with three dissenters voting to raise interest rates. A surprise rise in UK inflation in May, where the headline rate rose to 2.9% and the core rate to 2.6%, was probably behind the shift in mood but this is also occurring against a backdrop of more sluggish economic growth which would make an actual hike in interest rates difficult. Such a combination of weak growth and higher inflation is hardly a recipe for a strong pound, even though the threat of higher rates has temporarily put a floor under it after the chaos of the UK election. However, the political situation is still delicate, with the government still without a majority as talks with the DUP drag on. Brexit talks are due to start tomorrow against this unstable background, and amidst uncertainty about what kind of exit deal the UK will be able to secure. None of this appears particularly positive for GBP, and we still suspect that its latest rally could falter.

EUR well placed approaching summer

The EUR on the other hand looks better placed, with data remaining relatively upbeat and the political news broadly favourable. President Macron looks likely to complete a strong victory in the final round of parliamentary elections today, and an agreement was reached by the Eurogroup last week to avert a Greek crisis for another year, with bailout funds coming just in time for Greece to be able to make debt payments next month. Preliminary PMI readings on Friday will be the main economic highlights of the week, which should be broadly positive, while other sentiment surveys are expected to hold up as well. The EUR will likely consolidate around current levels, as the Eurozone heads into the holiday period for once in relatively good shape.

JPY loses ground with no signs of QE exit

USDJPY staged a good recovery at the end of last week climbing above 111.00 to make a fresh two-week high at 111.42. EURJPY GBPJPY and other yen crosses also climbed as the yen underperformed. This came as the Bank of Japan (BOJ) remained on hold, with its dovish message contrasting with those of the Fed and the BOE. The BOJ left both its policy and economic assessment unchanged, as expected, though it emphasized a determination to maintain accommodative policy in the face of low inflation despite an improvement in economic conditions, and noticeably declined to discuss an exit strategy from current QE policies. USDJPY has sustained weeks of underperformance but now appears capable of making further gains. Although our end Q2 forecast of 116 looks out of reach it would not be surprising to us if it pushes up towards 114 before the end of the month.

CHF also softer as risk recovers

The Swiss National Bank also left policy on hold at its quarterly policy review last week, and once again stressed that the CHF remains significantly overvalued. EURCHF remains well up on the sub-1.07 levels that were prevailing in April before the French presidential elections, and we expect this to remain the case unless the euro comes under heavy pressure which we doubt. The CHF and the JPY were the weakest currencies over last week as risk appetite appeared to return, and on the dovish stance taken by their respective central banks.

CAD rallies as BOC turns hawkish

By contrast the CAD was the strongest performer over the week, rising by almost 2% versus the USD, benefiting from hawkish comments from the Bank of Canada. Senior Deputy Governor Carolyn Watkins implied that the next move in Canadian interest rates was likely to be higher, highlighting that the economy's recovery is broadening across regions and sectors and that the BOC is assessing the need for maintaining the current stimulus, with interest rates currently standing at 0.5%. The main policy decision in the coming week will be from the New Zealand where the RBNZ is expected to keep interest rates on hold at 1.75% and suggest that it will remain on hold for some time yet.

FX Forecasts

FX Forecasts - Major						Forwards		
	16-June	Q2 2017	Q3 2017	Q4 2017	Q1 2018	3m	6m	12m
EUR	1.1198	1.1000	1.0500	1.0300	1.0200	1.1253	1.1308	1.1427
JPY	110.88	114.00	120.00	122.00	124.00	110.43	109.95	108.89
CHF	0.9733	1.0100	1.0500	1.1000	1.1000	0.9675	0.9616	0.9494
GBP	1.2785	1.2500	1.3000	1.3500	1.4000	1.2822	1.2858	1.2934
AUD	0.7621	0.7400	0.7200	0.7000	0.7000	0.7611	0.7602	0.7587
NZD	0.7254	0.7000	0.6700	0.6500	0.6700	0.7242	0.7230	0.7204
CAD	1.3213	1.3300	1.3400	1.3200	1.3000	1.3192	1.3176	1.3148
EURGBP	0.8760	0.8800	0.8077	0.7630	0.7286	0.8777	0.8796	0.8836
EURJPY	124.15	125.40	126.00	125.66	126.48	124.15	124.15	124.15
EURCHF	1.0902	1.1110	1.1025	1.1330	1.1220	1.0890	1.0877	1.0851
FX Forecasts - Emerging						Forwards		
	16-June	Q2 2017	Q3 2017	Q4 2017	Q1 2018	3m	6m	12m
SAR	3.7499	3.7500	3.7500	3.7500	3.7500	3.7534	-	3.7697
AED	3.6729	3.6720	3.6720	3.6720	3.6720	3.6744	-	-
KWD	0.3036	0.3050	0.3050	0.3050	0.3050	0.3043	0.3062	-
OMR	0.3850	0.3850	0.3850	0.3850	0.3850	0.3857	0.3870	0.3920
BHD	0.3772	0.3770	0.3770	0.3770	0.3770	0.3777	0.3783	0.3795
QAR	3.6698	3.6400	3.6400	3.6400	3.6400	3.6763	3.6838	3.7113
EPN	18.1425	18.0000	18.5000	18.7500	19.0000	18.5500	19.0600	20.0750
INR	64.428	64.500	65.000	66.000	67.000	65.0300	65.6700	67.0200
CNY	6.8105	7.0000	7.1000	7.2000	7.4000	6.8565	6.9025	6.9925

Source: Bloomberg, Emirates NBD Research
**Denotes USD peg*

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Emirates NBD Research & Treasury Contact List

Emirates NBD Head Office
12thFloor
Baniyas Road, Deira
P.OBox777
Dubai

Jonathan Morris
General Manager Wholesale Banking
JonathanM@emiratesnbd.com

Aazar Ali Khwaja
Group Treasurer & EVP Global Markets & Treasury
+971 4 609 3000
aazark@emiratersnbd.com

Tim Fox
Head of Research &
Chief Economist
+9714 230 7800
timothyf@emiratesnbd.com

Research

Khatija Haque
Head of MENA Research
+9714 230 7803
khatijah@emiratesnbd.com

Anita Yadav
Head of Fixed Income Research
+9714 230 7630
anitay@emiratesnbd.com

Shady Shaher Elborno
Head of Macro Strategy
+9714 2012300
shadyb@emiratesnbd.com

Athanasios Tsetsonis
Sector Economist
+9714 230 7629
athanasiost@emiratesnbd.com

Edward Bell
Commodity Analyst
+9714 230 7701
edwardpb@emiratesnbd.com

Mohammed Al-Tajir
Manager, FX Analytics and Product Development
+9714 609 3005
mohammedtaj@emiratesnbd.com

Aditya Pugalia
Analyst
+9714 230 7802
adityap@emiratesnbd.com

Sales & Structuring

Group Head – Treasury Sales
Tariq Chaudhary
+971 4 230 7777
tariqmc@emiratesnbd.com

Saudi Arabia Sales
Numair Attiyah
+966 11 282 5656
numaira@emiratesnbd.com

Singapore Sales
Supriyakumar Sakhalkar
+65 65785 627
supriyakumars@emiratesnbd.com

London Sales
+44 (0) 20 7838 2241
vallancel@emiratesnbd.com

Egypt
Gary Boon
+20 22 726 5040
garyboon@emiratesnbd.com

Emirates NBD Capital

Ahmed Al Qassim
CEO- Emirates NBD Capital
AhmedAQ@emiratesnbd.com

Hitesh Asarpota
Head of Debt Capital Markets.
+971 50 4529515
asarpotah@EmiratesNBD.com

Investor Relations

Patrick Clerkin
+9714 230 7805
patricke@emiratesnbd.com

Group Corporate Affairs

Ibrahim Sowaidan
+9714 609 4113
ibrahims@emiratesnbd.com

Claire Andrea
+9714 609 4143
clairea@emiratesnbd.com