بنك الإمارات دبي الوطني
Emirates NBD

Weekly
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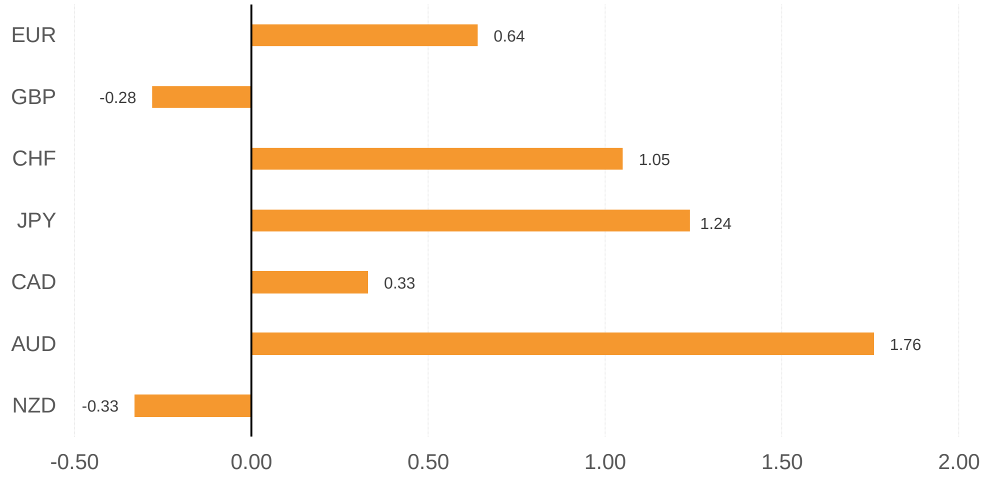
FX Week

Central bank constraints laid bare

Last week's monetary policy decisions in the US and Japan illustrate the constraints that central banks are operating under. The Fed is still finding it difficult to raise interest rates, despite improvements in the US economy, while the BOJ appears reluctant to cut them further for fear of hurting banks' profitability, instead choosing to tinker with its policy framework. The ECB was also recently reticent to make any further steps into negative rate territory, with its EUR80bn a month QE program also facing legal challenges. The Bank of England may still be promising lower rates to ward off Brexit risks, but the recent data makes the necessity of such cuts increasingly questionable.

The relative inaction on all fronts reflects the limits of monetary policy, but also the sense that even if the benefits of low rates are becoming more marginal, the prospect of raising them is even more unpalatable. In this context it is easy to understand the Bank for International Settlements' recent warning that monetary policy in the major economies has become 'overburdened' and that the financial markets have become too dependent on the actions of central banks. However, it may be also that the central banks themselves are too fearful of weaning themselves away from the provision of cheap credit. The risks to us are that if the Fed cannot find its way to continue normalizing policy soon, such paralysis will threaten a replay of the mistakes of Japanese policymakers over the last twenty years who were never able to escape from low rates, with the consequence that monetary policy there has become largely ineffectual. While this need not be the outcome, the longer the Fed prevaricates the greater those risks will become.

Weekly currency movement vs USD (%)



Source: Bloomberg, Emirates NBD Research

USD reaction to unchanged Fed relatively muted

The FX markets' verdict on the Fed's decision to leave interest rates unchanged last week has so far been quite muted. The USD softened initially on the news but subsequently recovered and actually ended the week relatively unchanged. Expectations are now firmly for a December rate hike with futures pricing a near 60% probability. Of course a lot can change in three months, which is one of the reasons we were surprised that the Fed did not raise rates last week when it had the chance. The split in the FOMC which was evident in the voting as well as in the dots will now in all likelihood become much more vocal. Rhetoric from Fed officials may be as important as the data in driving sentiment in coming weeks and months, with no less than twelve Fed officials speaking in the week ahead including Chair Yellen and Vice Chair Fischer.

Rhetoric to fuel volatility

In fact until the next payroll figures in a fortnight's time there will not be much front line economic data from the US, making the remarks from Fed officials all the more significant. The differences between Fed officials will play out publicly, creating the potential for volatility especially with Yellen noting in her press conference last week the Fed officials are 'struggling mightily' to understand each other's views. Unless the data turns more negative we suspect that the USD will remain broadly underpinned, especially with the majority on the FOMC (14 out of 17) thought to be in favour of a year-end rate hike. The start of the Presidential election debates this week will also be another dimension that markets cannot ignore. Clearly if one candidate is perceived to have 'won' the debate, this will be seen to enhance his/her election chances, with a Clinton victory likely to be perceived constructively for risk and the USD, and a Trump win less so.

Attention may also turn to the fundamentals in other countries as the principal drivers of currency moves in the near term. The Eurozone has seen sluggish data of late with the September PMI index slipping a little to 52.6 from 52.9. The coming week will see more EU sentiment data as well as unemployment and inflation data for the region, with expectations being that activity will remain subdued, potentially creating more calls for ECB action. The Italian government will also set the date for the Constitutional referendum this week, probably for some time in November. PM Renzi has threatened to resign if he loses the vote, which means the clock will start ticking to this possibility creating an additional source of uncertainty.

JPY reacts calmly to new policy framework

The USDJPY exchange rate is often seen as the barometer of market confidence in BOJ policy and the JPY has been broadly steady in the aftermath of the latest announcements about controlling the JGB yield curve, suggesting a degree of caution about whether the policy will succeed. The question is how long will the Japanese authorities give these latest policies to work, and how long will markets be patient before drawing stronger conclusions? Overall we would be surprised if these latest measures will yield positive results any time soon. To sustain a steeper yield curve really requires evidence that the Japanese economy is recovering and that inflation is rising. Japan's manufacturing PMI rose from 49.5 in August to 50.3 in September for the fourth consecutive monthly rise. However, doubts about the sustainability of this improvement persist. Monetary policy was supposed to be only one of the three 'arrows' of 'Abenomics', with fiscal policy and structural reforms the other two, but increasingly it has felt as if it is the only 'arrow' being used, and is itself is running out of effectiveness. If it was not for the prospects for a US rate hike still being alive, we suspect that USDJPY would already be lower.

GBP continues to lose ground

GBP lost ground last week, with the Bank of England's recent dovish message contrasting with the more hawkish one emanating from the Fed, as well as with the steady policy decision from Japan. Renewed weakness for the he pound came despite official data showing a 2% y/y rise in tourists visiting the UK in July, which is thought to reflect the broad drop in GBP in late June and early July following the Brexit vote. Until Article 50 is triggered by PM May signaling the start of the Brexit negotiation uncertainty will continue which could hurt business investment, with concerns mounting in particular about the financial sector's future relationship with the EU.

AUDNZD rallies as expected

The AUD sprung back sharply last week and was amongst the strongest currencies after the Fed failed to deliver a rate hike and the BOJ also left rates on hold. The NZD by contrast struggled as the RBNZ reminded markets that another interest rate cut will soon be on its way, probably in November. Last week we highlighted the likelihood that AUDNZD was nearing a floor and was at risk of rising back to 1.04 in the first instance. In the event this level was easily broken with the cross now eyeing a move to 1.06. The CAD's fortunes probably rely on the outcome of the OPEC meeting this week and its effect on oil prices. As we don't expect any meaningful agreement to freeze oil production we would not be surprised if the oil price reacts negatively, dampening the CAD in the process.

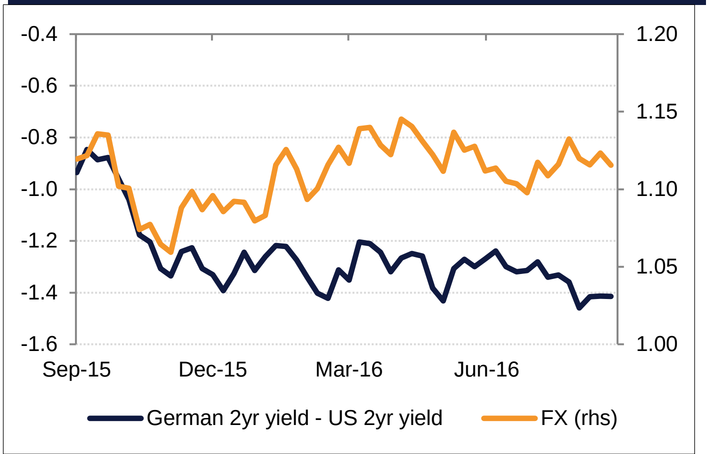
FX Forecasts

FX Forecasts - Major						Forwards		
	Spot 23.09	1m	3m	6m	12m	3m	6m	12m
EUR	1.1226	1.0900	1.0700	1.0500	1.0200	1.1268	1.1316	1.1415
JPY	101.02	104.00	108.00	110.00	112.00	100.65	100.21	99.33
CHF	0.9704	1.0000	1.0300	1.0500	1.1000	0.9656	0.9602	0.9493
GBP	1.2966	1.2800	1.2500	1.3000	1.3500	1.2987	1.3013	1.3070
AUD	0.7623	0.7300	0.7000	0.6800	0.6500	0.7605	0.7590	0.7559
CAD	1.3172	1.3200	1.3400	1.3200	1.3000	1.3165	1.3156	1.3134
EURGBP	0.8659	0.8516	0.8560	0.8077	0.7556	0.8678	0.8697	0.8735
EURJPY	113.37	113.36	115.56	115.50	114.24	113.37	113.37	113.37
EURCHF	1.0891	1.0900	1.1021	1.1025	1.1220	1.0877	1.0862	1.0833
NZDUSD	0.7242	0.7000	0.6700	0.6500	0.6200	0.7216	0.7194	0.7153
FX Forecasts - Emerging						**Forwards**		
	Spot 23.09	1M	3M	6M	12M	3M	6M	12M
SAR	3.7513	3.7500	3.7500	3.7500	3.7500	3.7570	3.7675	3.8003
AED	3.6730	3.6700	3.6700	3.6700	3.6700	3.6744	-	-
KWD	0.3015	0.2900	0.2900	0.2900	0.3000	0.3081	0.3170	-
OMR	0.3850	0.3800	0.3800	0.3800	0.3800	0.3860	0.3875	0.3933
BHD	0.3770	0.3760	0.3760	0.3760	0.3760	0.3775	0.3781	0.3804
QAR	3.6416	3.6400	3.6400	3.6400	3.6400	3.6466	3.6533	3.6663
EPN	8.8790	9.0000	9.2500	9.2500	9.5000	11.2000	11.7750	12.6500
INR	66.655	68.000	66.000	65.000	65.000	67.5100	68.4000	70.2200
CNY	6.5753	6.6000	6.7000	6.8000	6.9000	6.7370	6.7860	6.8600

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

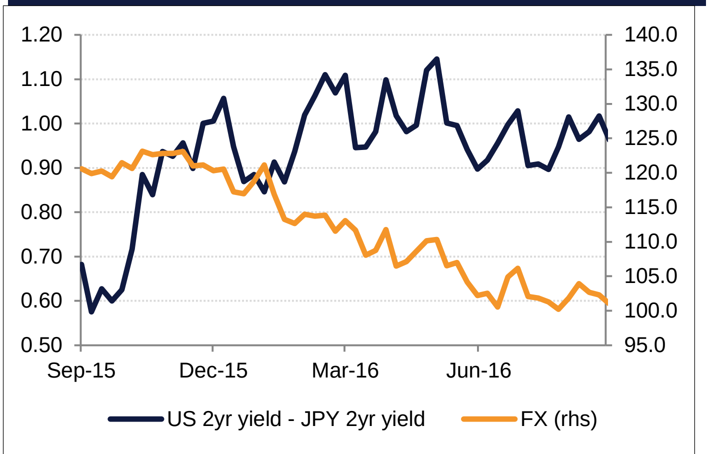
Major FX and Nominal Interest Rates

Interest Rate Differentials - EUR

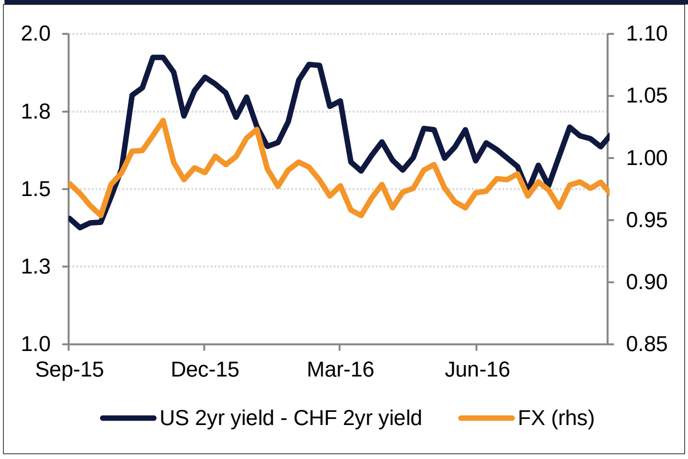


Interest Rate Differentials - GBP

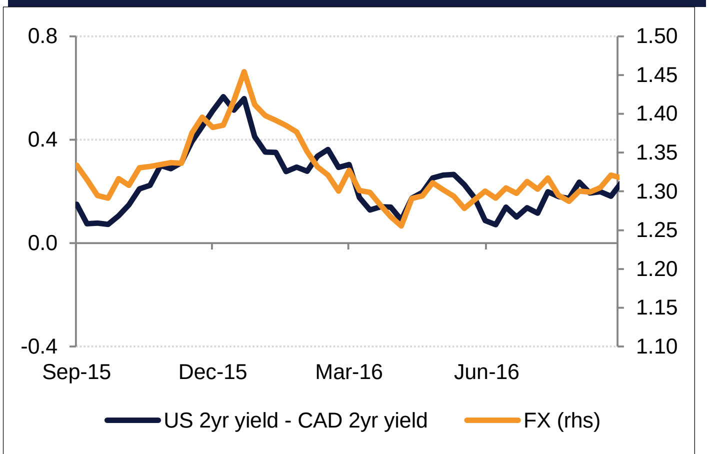
Interest Rate Differentials –JPY



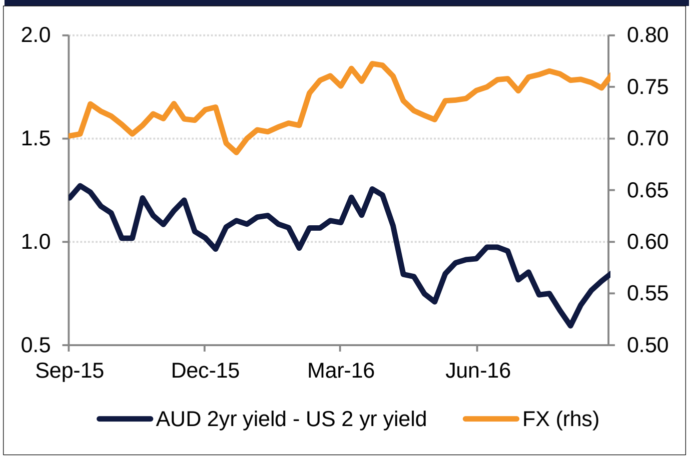
Interest Rate Differentials - CHF



Interest Rate Differentials - CAD



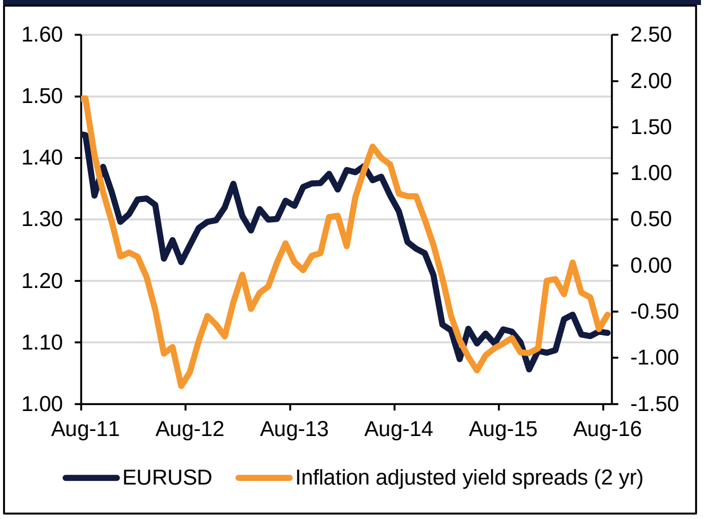
Interest Rate Differentials - AUD



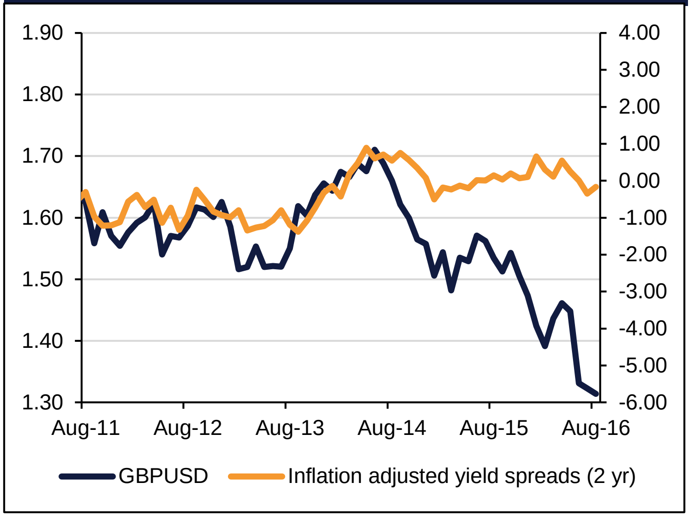
Source: Bloomberg, Emirates NBD Research

Major FX and Real Interest Rates

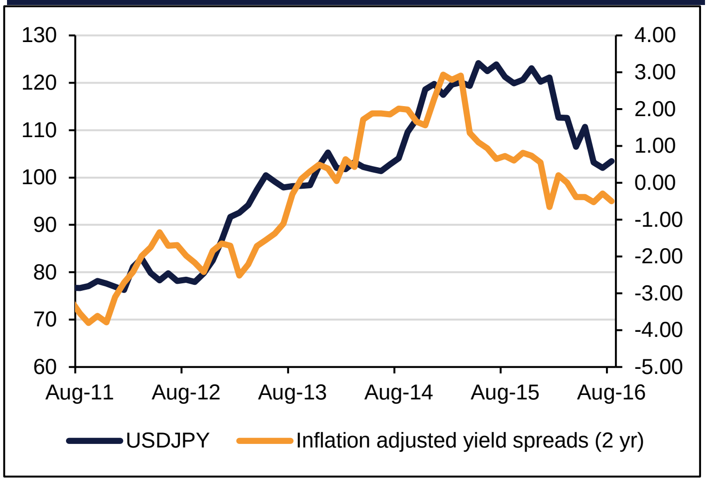
Interest Rate Differentials - EUR



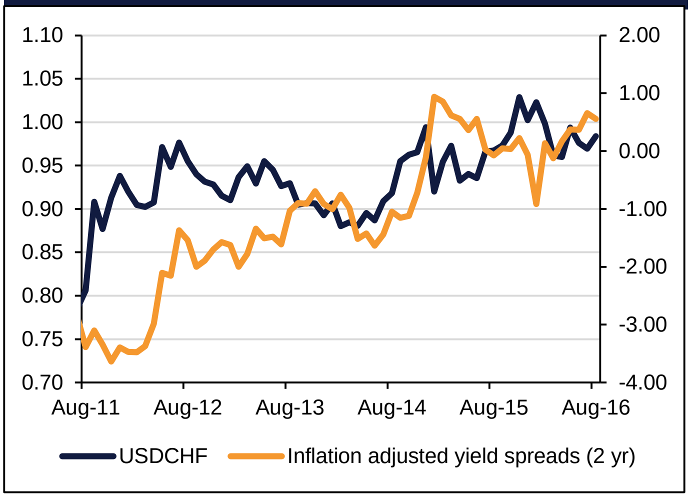
Interest Rate Differentials - GBP



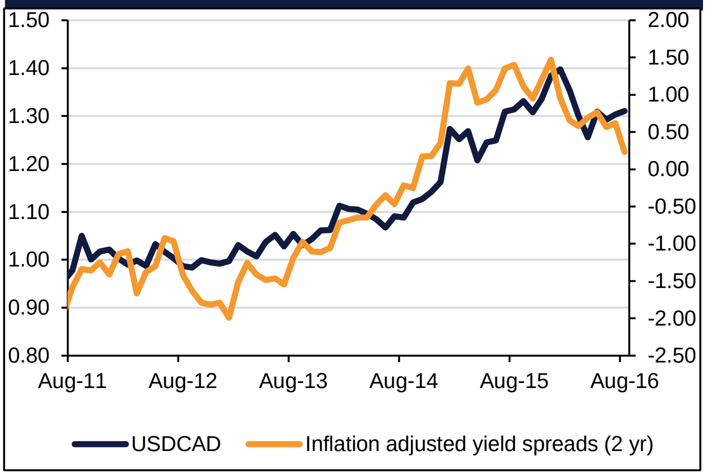
Interest Rate Differentials –JPY



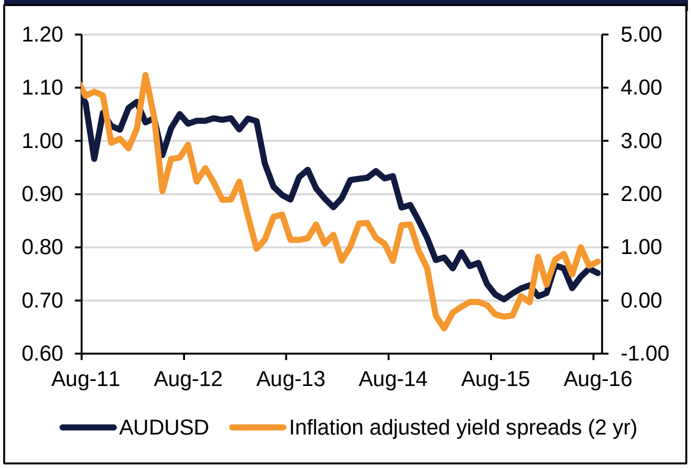
Interest Rate Differentials - CHF



Interest Rate Differentials - CAD



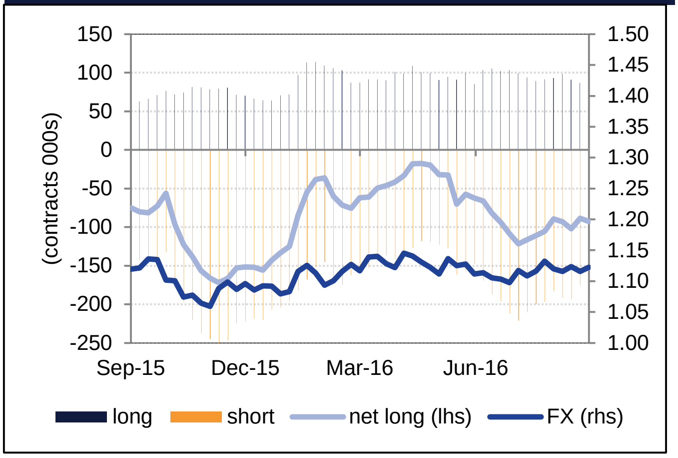
Interest Rate Differentials - AUD



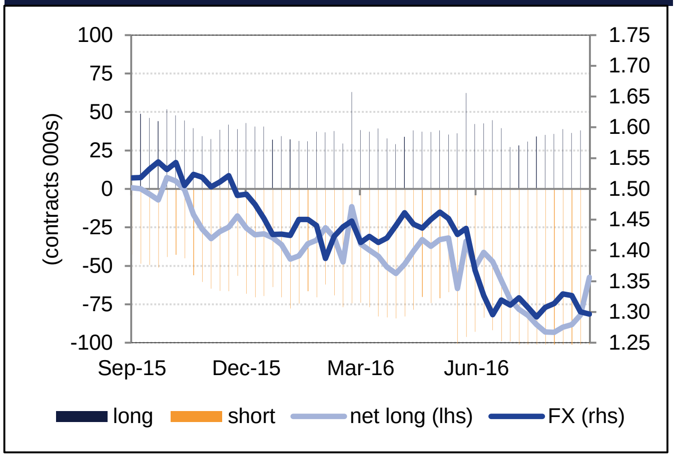
Source: Bloomberg, Emirates NBD Research

Major Currency Positions

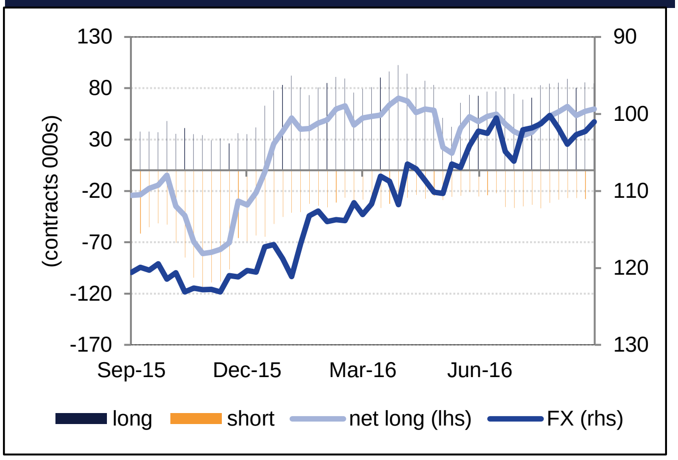
CFTC – Speculative Positions - EUR



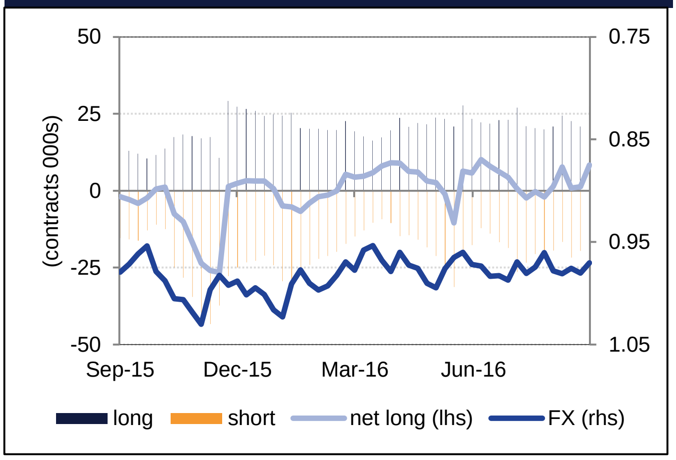
CFTC – Speculative Positions - GBP



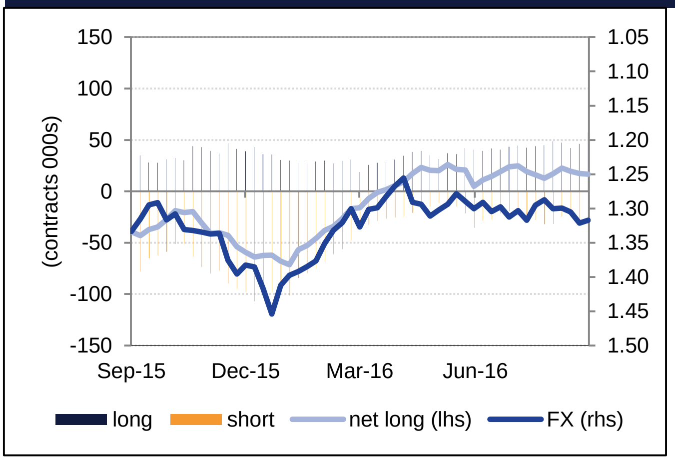
CFTC – Speculative Positions - JPY



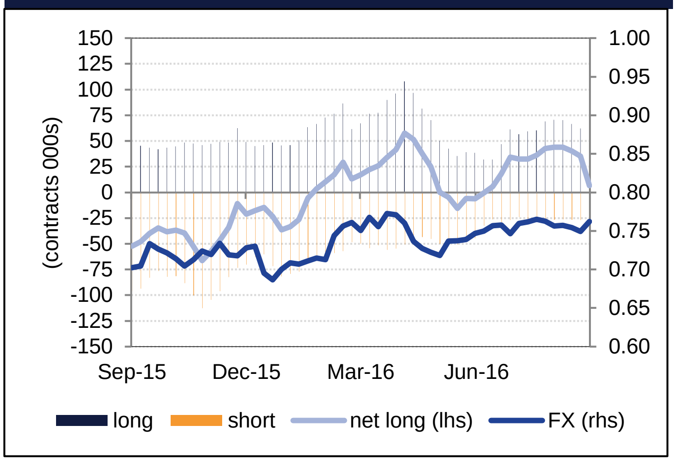
CFTC – Speculative Positions - CHF



CFTC – Speculative Positions - CAD



CFTC – Speculative Positions - AUD



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