A capital market participant reviews market developments based on TAC ECONOMICS research.

The Market Insight

January 2018

Capital markets commentator David Wigan offers his quarterly thoughts on the key trends shown by TAC ECONOMICS models and impacting the global financial landscape.

Key Messages

- EUR's surprise surge set to continue - 1.30 seen in 2018
- U.S. asset markets on the brink?
- China's 2019 growth may hit a 30-year low
- Look out for higher EM rates

EUR's surprise surge set to continue - 1.30 seen in 2018

Take-away

The turnaround of the euro against the dollar in recent months suggests a regime switch which may see a continued strong rally.

Ask almost any currency trader for the key economic factor that drives investment decisions and the answer will invariably be interest rates and anything that has an impact on them. The tight relationship between relative interest rates and capital flows, leading to currency appreciation or depreciation, is so entrenched in FX market thinking that betting against it for any significant period is seen as a risk seldom worth taking. In recent months, however, the relationship between the euro and the dollar has had advocates of FX market convention scratching their heads. Expectations are for the U.S.'s key 1.25 percent rate to rise (by as much as 150 basis points over 2018 if the impact of Fed balance sheet shrinking is taken into account), while the European futures curves suggest no tightening cycle before 2019. Given the differential, it's surprising that the euro has been on a tear, hovering around 1.23 against the dollar in recent trade, compared with 1.16 as recently as November.

In seeking an explanation for the euro's ascent, researchers at TAC ECONOMICS have focused on Europe's recent faster-than-expected economic growth, the resolution of political concerns around the German elections and the path of U.S. tightening. All of these make sense, but the more interesting question is what happens next? Convention suggests that interest rate differentials, and a likely capping of Bund yields, will eventually drag investment away from Europe and back into the U.S., lifting the dollar against its European counterpart. There is, however, a more radical theory, which would instead see a sharp appreciation of the euro, even from current levels, pushing the currency to as high as 1.30 by the end of the year. That scenario is based on a so-called regime switch, which would mean that the FX markets have stopped trading off rate differentials and related indicators and moved to real economic drivers. With Europe set to grow 2.5% to 3% in 2018, compared with 2.3% to 2.5% in the U.S., and amid signs that the U.S. is plateauing, the cyclical picture favours a rapid move to 1.25 and swiftly onwards and upwards.

If a regime switch has occurred, the key question for market participants is whether it is likely to persist, or will revert, and if the latter then when? Using non-linear tools, recursive partitioning models and decision trees, TAC ECONOMICS quants posit the regime switch is likely to remain for at least four quarters, at which point the models suggest a higher level of uncertainty, fuelled by the fact that regime switching in EUR/USD is relatively rare – the last such event was in 2007.

For emerging markets, the relative weakness of the dollar is good news, making life easier in terms of monetary policy during a period of Fed tightening that would normally be expected to have an inflationary impact as local currencies weaken.

There is, however, a potential sting in the tail. Regime switches tend to be brutal events, leading to large moves over relatively short periods of time. There is a possibility that the euro's appreciation will choke Europe recovery over the coming months, potentially killing the upward trajectory of the currency. TAC ECONOMICS researchers believe that won't happen, but do predict volatility.

Fasten your seatbelts – exciting times ahead in FX markets.

U.S. asset markets on the brink?

Consistent with TAC ECONOMICS' view of economic outperformance over the next four quarters are the firm's key messages for asset markets, with U.S. risks to the fore.

The big picture over recent months is one of "repressed volatility", pointing to a potentially violent eventual reversal. The first major change is likely be in U.S. corporate bond markets, where on a six-month horizon TAC ECONOMICS sees spread widening (Q3). Equity market models, on the other hand, show a positive directional trend outlook on both a three- and six-month horizon.

Spread widening in corporate debt markets is hardly a controversial call, given how tight markets have become, but there is a lesson from history, which is that wider spreads are almost always a precursor of a negative move in equities. And even in Europe, the directional trend is negative for corporate spreads, on both a three and six-month horizon, with a significant deterioration in five to seven-year A-rated credits in the short term.

How far and fast markets fall is likely to be a function of the tension between on the one hand still decent growth in the U.S., supported by tax cuts, and strong growth in Europe, and on the other hand the fact that excess valuations have continued to rise, pointing to higher risks for financial institutions and increased correlations going forward. With the U.S. tightening cycle continuing apace, the red lights are flashing, and we will not be surprised to see the smart money taking some risk off the table over the course of the year.

Chinese growth may drop to 5% in 2019

The risk of a significant slowdown in the Chinese economy is growing, with potential implications for emerging markets and global GDP growth. TAC ECONOMICS RiskMonitor tool highlights a forward-looking combination of factors pointing to a sharper than expected cyclical adjustment towards year-end. TAC ECONOMICS non-linear tools show that a “final surge” in the NBS manufacturing PMI to above 52.9 would be a critical indicator of overheating risk and more immediate reversal, against a December 2017 reading of 51.5.

The timing of the reversal is uncertain, but when it comes TAC ECONOMICS sees a fast and significant slowdown, potentially pushing growth to around 5 percent in 2019, which would be the slowest pace since 1990. Still, there are several mitigating factors, including a largely domestically-owned debt liability (albeit at 280% of GDP), the Belt & Road investment initiative, which aims to bolster trade routes around the globe, FX reserves of UA$3200 billion (November 2017) and low levels of public debt.

Still, given China’s record as a key driver of global GDP growth (it routinely contributes around a third) any sign of a slowdown needs to be taken seriously, not least by emerging markets, with Asian countries and commodity exporters on the front line.

Look out for higher EM rates

Notwithstanding the smoothing effect that a weaker dollar may have on EM monetary requirements (see above), the drum beat of faster inflation in emerging markets suggests that a prolonged period of monetary easing is set to come to an end. TAC ECONOMICS predicts a steady uptick in inflationary pressures (due to weakening currencies and higher commodity prices), amid increasing pressure on EM labour markets. EM unemployment is set to decline to around 8.5% in 2018, compared with 8.8% in 2017. TAC ECONOMICS doesn’t see any need for a sharp tightening, but rather a progressive upward curve in key EM rates from around the end of this year.

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