2019

Forex Market Outlook

Brought to you by
Kathy Lien and Boris Schlossberg

HIGH RISK WARNING: Foreign exchange trading carries a high level of risk that may not be suitable for all investors. Leverage creates additional risk and loss exposure. Before you decide to trade foreign exchange, carefully consider your investment objectives, experience level, and risk tolerance. You could lose some or all of your initial investment; do not invest money that you cannot afford to lose. Educate yourself on the risks associated with foreign exchange trading, and seek advice from an independent financial or tax advisor if you have any questions.

"My way is to divide half a sheet of paper by a line into two columns; writing over the one Pro and over the other Con. Then during three or four days' consideration, I put down under the different heads short hints of the different motives, that at different time occur to me, for or against the measure ...and thus proceeding, I find where the balance lies; and if after a day or two of further consideration, nothing new that is of importance occurs on either side, I come to a determination accordingly."

–Benjamin Franklin

2019 Forex "Ben Franklin" analysis

The Risk ON Scenario	The Risk OFF Scenario
1. UK and EU approve a Brexit deal 2. The Fed turns dovish halts rate hikes for at least 6 months 3. Trump/Xi negotiate a trade truce, tariffs are lifted and China opens market access and clamps down on intellectual property theft 4. EU economy stabilizes after soft patch in 2018 and Italian and French growth accelerates tempering populist revolt 5. Trump/US Congress vote for major infrastructure bill reviving CAPEX spending 6. Oil stabilizes trades above $60	1. Hard Brexit by March 15, 2018 2. Fed ignores market turbulence focuses on employment hikes 25bp in Q1 2018 3. US-China 90 day negotiation period passes, Trump hikes tariffs by 25% on more than 200B Chinese goods. 4. Italy and France slip into recession, Macron loses no confidence vote, populists win, EU sovereign debt spreads price in fracture 5. Oil at $30 - US energy sector in bankruptcy that spreads panic through all corporate bonds

<u>TRADING RANGES</u>

Risk ON	Risk OFF
USDJPY -> 120.00 - 125.00	USDJPY -> 105.00 - 100.00
EURUSD ->1.2000 - 1.2500	EURUSD -> 1.0500 - 1.0000
GBPUSD ->1.3500 - 1.4000	GBPUSD -> 1.1500 - 1.0500
EURCHF -> 1.2000 -1.2500	EURCHF -> 1.0500 - 1.0000
AUDUSD -> .7800 - .8200	AUDUSD -> .6500 - .6000
USDCAD -> 1.2500 - 1.2000	USDCAD -> 1.5000 - 1.6000
NZDUSD -> .7000 -.7500	NZDUSD -> .6500 - .6000

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Will the US Dollar Crumble in 2019?

Macro

2018 was a phenomenal year for the U.S. dollar. The trade weighted Dollar Index appreciated nearly 5% and is up more than 9% from its low in February. Emerging market currencies were hit the hardest by the rise in the dollar but major currencies like the Australian dollar also lost 9.5% of its value. And now the good times are over. In the past 2 months we've seen zero forward momentum. Instead the tide has shifted with the dollar falling against all of the major currencies. As 2019 begins, the big question is whether the greenback will unwind all of its 2018 gains. That's a tall order but pairs like USD/JPY were down for the year and many are not far from their beginning of 2018 levels. Either way, 2019 will be a challenging one for the U.S. economy and the U.S. dollar as America's longer ever expansion comes to an end.

The bad news is that a number of factors will inhibit growth in 2019 – volatility is rising, stocks are falling, borrowing costs are increasing, credit is tightening, housing is slowing and earnings growth is weakening. These trends, which are just beginning to emerge, will continue to dampen growth in the year ahead. Rising borrowing costs is a serious problem because it increases the cost of debt servicing for businesses at a time when share values are falling. The consequence is that businesses could cut back hiring and investment. Along with the tariffs, Chinese consumers are also reducing spending, which adds to the pressure on U.S. businesses. 2019 will also be a year filled with economic and political challenges in the U.S. With the stimulus from tax cuts fading, the weakening economy, decline in stocks, rise in interest rates and divided Congress will keep President Trump's hands tied.

None of this is good for the U.S. dollar. The greenback was a big winner in 2018 because U.S. growth led global growth but in 2019 the U.S. slowdown that could hamper global growth. USD/JPY is the most vulnerable to a decline that could take the pair as far down as 105.

Micro

The good news is that while this could prevent meaningful legislation, it could also force Trump to secure market friendly wins like a trade deal with China, infrastructure reform or middle income tax cuts. The U.S. economy is also slowing from strong levels. The unemployment rate is at a 48 year low and wages are growing at its fastest pace since 2009. Inflation is on target, gas prices are low and all of this translated into strong holiday speending. According to Mastercard Spendingpulse, between November 1 and December 24, retail sales rose 5.1%, which is the strongest pace of growth in 6 years. This tells us that the sell-off in stocks has not affected consumer demand and according to the table below which tracks how the economy has changed over the past year, the housing market appears to be stabilizing after a difficult first half.

With that in mind, it is unrealistic to expect growth to continue at the same heady pace in the year ahead because as interest rates rise, stocks fall and businesses reduce spending, wages and consumer demand will slow. Tighter financial conditions and fading stimulus will take a big bite out of growth in 2019 which will not only reduce the attractiveness of U.S. assets and the greenback but could encourage further reserve diversification out of U.S. dollars.

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United States Economy

Health of the Consumer	Latest		June		Jan
Retail Sales MoM	0.2%	↑	0.5%	↑	0.4%
Core Retail Sales MoM	0.5%	↑	0.3%	↓	0.4%
UMich Consumer Sentiment	98.3	↓	97.9	↑	94.4
CB Consumer Confidence	135.7	↓	127.4	↑	125.4
Labor Market					
Non-Farm Payrolls	155K	↓	213K	↑	148K
Unemployment Rate	3.7%	O	4.0%	↑	4.1%
Avg Hourly Earnings MoM	0.2%	O	0.2%	↓	0.3%
Inflation					
Consumer Prices MoM	0.0%	↓	0.1%	O	0.1%
CPI - Core MoM	0.2%	↑	0.2%	↓	0.3%
CPI YoY	2.2%	↓	2.9%	↑	2.1%
Producer Prices MoM	0.1%	↓	0.3%	↑	-0.1%
PPI - Core MoM	0.3%	↑	0.3%	↑	-0.1%
PPI YoY	2.5%	↓	3.4%	↑	2.6%
Housing Market					
NAHB Housing Market Index	60	↓	68	↓	72
Existing Home Sales	5.22M	↑	5.38M	↓	5.57M
Pending Home Sales MoM	-2.6%	↓	-0.5%	↓	0.2%
New Home Sales	544K	↓	631K	↑	625K
Housing Starts	1228K	↑	1173K	↓	1192K
Building Permits	1263K	↑	1273K	↓	1302
Manufacturing & Services					
GDP	3.4 (Q3)	↓	2.00 (Q1)	↓	2.6% (Q4)
ISM Manufacturing Prices	60.7	↓	60.2	↑	59.7
ISM Manufacturing	59.3	↑	76.8	↑	69.0
ISM Services	60.7	↑	59.1	↑	55.9
Trade Balance	-55B	↓	-43.1	↓	-71.6B
Industrial Production	0.6%	O	0.6%	O	0.9%
Market Indicators	**Latest**				
S&P 500 Index	2599.00	↓	2750.00	↑	2822.00
10 Year US Bonds	2.89%	↓	2.95%	↑	2.73%

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Monetary Policy

Monetary policy could also pose a problem for the dollar in 2019. The Federal Reserve was the primary central bank raising interest rates last year but that will change as other countries move to normalize monetary policy more aggressively. At the beginning of 2018, the Fed said they would raise interest rates four times. This year, they are telegraphing somewhere between 2 to 3 rounds of tightening after expectations were downgraded this past December. Now the Fed will still be raising interest rates in the first half of the year, which could lend support to the dollar but as the central bank makes it clear that less tightening is needed, the greenback will flounder. At their last meeting, Fed Chairman Powell told us that no future rate decisions are predetermined and everything is data dependent. This tells us that if the economy continues to slow, they'll delay raising interest rates. If it were to stabilize and start to turn upwards, they'll be inclined to move more quickly but as things stand currently, they'll be more conservative than aggressive with rate hikes. There's opportunity in the gap between Fed guidance and market expectations. At the start of the year, Fed fund futures are pricing in no hike in 2019. The dollar has only started to fall which means market positioning hasn't accounted for no tightening. The greenback will remain under pressure until data or the Fed Chair gives investors a reason to believe that a rate hike is coming and it will be so there's also opportunity to the upside.

Since we believe that the Fed will raise interest rates in the first half of the year, dollar weakness in the early months could give away to a recovery as the Fed talks up the next hike. This will followed by another leg lower when other central banks jump start their own tightening cycles.

Technical Analysis

U.S. Dollar/Japanese Yen, 1W, FXCM
O110.930 H111.407 L110.149 C110.251 −0.679 (−0.61%)
MA (200, close) 112.7881

1. Series of lower highs
2. Failure at 200 SMA suggests downside bias
3. Break lower targets 100-105 lows
4. Upside capped by resistance at 115-117 triple top

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EURO – Trouble Behind, Trouble Ahead?

Macro

As 2018 progressed the situation in Europe both on the political and economic fronts grew darker by the day. The same populist waves that swept over UK and US made their presence felt on the continent with Italy electing a radical new coalition that challenged the Eurozone budget rules, France seeing week after week of rebellion in the streets over new taxes and Germany's Angela Merkel seeing her grip on power diminish to the point where she decided to not run for party leader again. The political upheaval came at the worst possible time for the region as the economy began to slow materially into the second half of the year. Business sentiment was hurt badly by Trump's trade war rhetoric which was directed not only at China but at EU as well. By the end of the year growth had slowed to 1.6% while sentiment readings plummeted. Although the existential threat to the union remains very much the key macro risk going forward, the worst of the fury appears to have been spent as Italians and the EU commission came to a compromise on the budget, Macron tried to pacify the "gilets jaunes" by revoking the new tax and Merkel remained firmly in place for the foreseeable future. On the positive side, policymakers in the region are finally beginning to realize that a monetary union without a banking and fiscal union is an untenable structure and cannot be held together by the thin thread of authority of ECB. If the global economy faces a slowdown in 2019, the pressure on EU authorities to unify some of these functions will grow and if the institution refuses to reform EURUSD could see a move below 1.1000 as the risk of fracture rises significantly.

Micro

The micro story in the region is really a tale of two cities, with EZ economy performing well in the first half of the year only to see a severe slowdown by the end of the year, exacerbated by the growing trade tensions around the world. Although labor markets and consumer spending remained robust with unemployment rate at the lowest level since the global financial crisis business activity saw a sharp fall off with Eurozone PMI circling the drain at 52.7 just a few points away from the 50 boom/bust line. That contrasted sharply with 58.6 reading at the start of the year and shows the heavy toll on the economy caused by trade tensions and political upheaval in the region. Going forward the key question for the Eurozone is whether it can stabilize and resume growth in 2019. To that end, trade will play a crucial role in the economic fortunes of the Continent since any serious fiscal stimulus is out of the question given the strict budget rules of the European Union. In order for growth in EU to accelerate no deal Brexit would have to have to be avoided, US-China trade tensions would need to cool and Trump would have to drop his threat of increased tariffs on the EU auto sector which would be devastating to the region's economy. In short, 2019 looks ripe with risk for the region and policymakers could make matters worse if they begin to normalize monetary conditions too soon.

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Eurozone Economy					
Health of Consumer	**Latest**		**June**		**Jan**
German Retail Sales MoM	-0.3%	↑	-2.1%	↓	2.3%
German Retail Sales YoY	5.0%	↑	-1.6%	↓	4.4%
Eurozone Retail Sales	0.30%	↑	0.20%	↓	1.50%
Eurozone Consumer Confidence	-3.90%	↓	-0.60%	↓	0.50%
Labor Market					
German Unemployment Change	-16K	↑	-15K	↑	-29K
German Unemployment Rate	5.00%	↑	5.20%	↑	5.50%
Eurozone Unemployment Rate	8.10%	↑	8.40%	↑	8.70%
Inflation					
German PPI YoY	3.30%	↑	2.70%	↑	2.50%
German CPI YoY	2.30%	↑	2.10%	↑	1.70%
Eurozone CPI Estimate YoY	2.00%	○	2.00%	↑	1.40%
Eurozone CPI Core YoY	1.00%	↑	0.90%	○	0.90%
Business Activity					
EZ GDP YoY	1.6% (Q3)	↓	2.1% (Q2)	↓	2.5%(Q1)
German Trade Balance	18.4B	↓	19.7B	↑	17.4B
German Composite PMI	52.3	↓	55.2	↓	58.8
EZ Manufacturing PMI	51.8	↓	55.1	↓	59.6
Eurozone Composite PMI	52.7	↓	54.4	↓	58.6
Eurozone ZEW Survey	-22	↓	-18.7	↓	31.8
German IFO Business Climate	102.00%	↑	101.70%	↓	117.20%
German IFO Expectations	98.7%	↑	98.2%	↓	109.5%
German ZEW Current	58.2	↑	72.4	↓	95.2
German ZEW Survey Expectations	-24.1	↑	-24.7	↓	20.4
Market Indicators					
DAX	10864.00	↓	12579.00	↓	13281.00
German 10 Yr Bond	0.229%	↓	0.392%	↓	0.587%

Monetary Policy

Despite a clear slowdown in economic conditions, the ECB is determined to bring Quantitative Easing to an end and has no plans to change the schedule of the taper. The central bank terminated all new buying of bonds in December but did state that it would continue to reinvest proceeds from maturing bonds in what can be termed as “taper-lite”. Although rates in the region remain generally low with German 10 year still yielding just 23 basis points, credit conditions in the periphery are likely to tighten both from the impact of tighter monetary policy and the perceived greater political and economic risks in the region. That could pose a challenge to policymakers, especially if the PMI readings slip below 50. The situation is further complicated by the fact Mario Draghi will retire in October of 2019 and barring a severe market disruption the ECB is unlikely to change course and provide much stimulus to the economy, In addition, the leading candidate to replace Draghi is Jens Weidmann who is the President of BUBA (German Central Bank) and is considered a hawk. Generally, the Germans have always erred on the side of caution when it comes to monetary policy and should Mr. Wiedmann ascend to the leadership post, ECB monetary policy is likely to grow even less supportive of the economy in the region which could exacerbate the slowdown and could push the region into a contraction by the second half of the year.,

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Technical Analysis

EURUSD

Euro Fx/U.S. Dollar, 1W, FXCM

O1.13679 H1.14728 L1.13429 C1.14403 +0.00724 (+0.64%)

MA (200, close) 1.1311

1. EURUSD continues to hold 200 weekly SMA
2. The longer the base the more bullish the structure
3. Topside resistance at 1.1700 - 1.2000
4. Break of support targets gap at 1.0600

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GBP – Brexit Wrecks It?

Macro

Brexit, Brexit, Brexit. That story will dominate pound trade as we start the New Year with markets still in state of uncertainty as to how the UK exit from EU will unfold. There are three possible scenarios that face the market. Scenario one is UK Parliament approving Theresa May's Brexit deal with EU. For cable bulls this is the most appealing choice as it will keep UK in the customs union, allow the country's vital financial sector full access to the Continent's markets and will generally provide for the least disruption possible. PM May has already had to pull the vote once from UK Parliament after it became apparent that members of her own party would not approve the deal. The sticking point is the issue of Irish border between Northern Ireland and the Republic of Ireland. The way the deal is written, Northern Ireland will effectively remain under EU's administrative control indefinitely which has created howls of protest from the Tory hardliners who seek full UK sovereignty. The vote is scheduled for the week of January 12th and market players are hoping that absent any practical alternative the house will approve the deal. If that's the case cable could quickly rally to 1.3000 on massive relief flows. If the meaningful vote fails, UK legislators may opt for a second Brexit referendum, which would also be viewed positively by the market as the prospect of overturning the Brexit vote has risen markedly since the first referendum in 2016. With only a few months to go before the March 15th deadline, the prospect of a 2nd referendum could create chaos in UK politics and volatility in cable is sure to rise with every new poll headline. Lastly, with no agreement in sight UK policymakers could simply exit the EU without any deal - a choice that is unpalatable to all sides and one that could plunge UK into a deep recession as it loses access to key services such as transportation and pharmaceuticals.

Micro

The country's economy has already slowed materially with businesses investment at a standstill in light of all the uncertainty. The UK Services PMI - a measure of the 72% of UK GDP is within a whisker of slipping into contractionary territory. Consumer confidence is lower as well but Retail Sales and employment have held up remarkably well with unemployment rate at its best levels since the early 1970's and earrings have risen at a better than 3.3% rate on a nominal basis indicating that incomes continue to grow. On the other hand, housing which is such a crucial part of UK consumer's net worth has slipped badly with year on year prices growth slowing to the worst pace in five years. Overall, the UK economic picture is mixed, though surprisingly robust given the political upheaval, and may actually prove resilient in 2019 if the threat of Brexit is lifted. For now however, the micro picture just like the macro outlook is stuck in a state of suspended animation as markets await the final resolution the Brexit drama.

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UK Economy					
Health of Consumer	**Latest**		**July**		**Jan**
Retail Sales (MoM)	-0.5%	○	-0.5%	↓	0.3%
Retail Sales (YoY)	3.6%	↑	3.5%	↑	1.6%
GfK Consumer Confidence	-13%	↓	-10%	↑	-12%
Labor Market					
Unemployment Rate	4.1%	↑	4.2%	↑	4.3%
Jobless Claims Change	21.9k	↑	7.8K	↑	5.9K
Average Weekly Earnings (3MoY)	3.3%	↑	2.5%	○	2.5%
Inflation					
Consumer Prices (MoM)	0.2%	↑	0.0%	↓	0.3%
CPI YoY	2.40%	○	2.40%	↓	3.10%
Housing Market					
Nationwide Housing Price (YoY)	0.3%	↓	0.6%	↓	2.5%
Mortgage Approvals	67.1K	↑	65.6K	↑	64.6K
Activity					
GDP	1.5% (Q3)	↑	1.2% (Q2)	○	1.2% (Q2)
Trade Balance	-1.118B	↑	-1.2B	↓	-1.16B
PMI - Manufacturing	53.1	↓	54.0	↓	58.2
PMI - Services	50.4	↓	55.1	↑	53.8
PMI - Construction	53.4	↑	53.1	○	53.1
PMI Composite	50.7	↓	55.2	↑	54.9
Market Indicators					
FTSE 100 Index	6765.00	↓	7653.00	↑	7495.00
10 Year UK Bonds (Gilts)	1.270%	↓	1.384%	↑	1.234%

Monetary Policy

Much like everything else in UK, the monetary policy has been on hold due to Brexit considerations. In 2018 the Bank of England did become only the third G-11 central bank to hike rates since the Global Financial Crisis, but after an initial 25bp bump the MPC has decided to stand down until the Brexit issue is resolved. Even if Brexit is resolved in the most benign way for the UK financial services sector, with UK essentially continuing to have full access to EU financial markets, the BOE is likely to remain on hold for quite some time in order to insure that credit conditions reman conducive to growth. With UK inflation receding towards the 2% level the central bank is under no pressure to hike for the time being. Should a hard Brexit happen however, the BOE will find itself in a near impossible situation as it will face the need to open the credit spigot while at the same time battling what could be a crippling inflation shock. Governor Carney has stated that food prices could rise by as much as 10% if UK opts for hard Brexit as the country imports more than half of its food needs. The very likely drop in the currency will only add to the woes and exacerbate the situation. In contrast to the current conditions where a drop in the pound actually proved stimulative by making UK industry competitive as it enjoyed all the benefits of a unified market, the post hard Brexit scenario would bring the worst of both worlds by making goods and services more expensive for UK consumers while shutting off key markets for UK businesses. Little wonder that BOE is trying to avoid this outcome at all costs.

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JPY – A Little Help From My Friends?

Macro

Spotty - with little progress, is perhaps the best way to characterize economic conditions in Japan in 2018. The year started off on a strong note with GDP growth improving and even posting a very powerful 3% read in Q2 of the year - one of the very few nominally positive quarterly readings in Japan's multi-decade struggle with deflation. However, despite continued massive monetary infusion from BOJ growth faltered as the year progressed and global events negated much of the central bank stimulus. The trade war tensions between US and China hit Japan particularly hard since the country is a major exporter of both consumer and industrial goods. The drop in CAPEX in China is likely to hurt Japan's key machine tools sector even further and the country's exports saw a very sharp decline in growth from 12.2% at the start of the year to just 0.1% by the end of 2018. Therefore, 2019 looks particularly challenging for the Japanese economy as the fight against deflation shows little sustained success (The yield on 10 year JGBs slipped back to 0.00%) while global growth trends look particularly ominous for the export driven economy. If risk aversion flows continue to rile financial markets, the rise in yen will make conditions more difficult for policymakers who are pretty much out of options at this point.

Micro

Although the micro data looks deceptively stable with PMI Composite printing at 52.4 at the end of 2018 compared to 52.8 at the start of the year, other datasets show a troubling slowdown. Perhaps the most alarming data point is the sharp decline in household spending which rose to a very healthy 2.0% at the start of the year only to plummet to -0.3% by the end of it. If the Japanese consumer is retrenching that bodes badly for both deflation and aggregate demand. Indeed the inflation readings are once again moving the wrong way with CPI contracting from 1.4% at the start of 2018 to just 0.8% at the end of the year. One bright spot is income. With unemployment at only 2.4% labor cash earnings have risen to a respectable 1.5% by end of 2018 and if that trend can continue it could provide a much needed boost to growth by offsetting some of the declines in exports with a rise in domestic demand.

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Japan Economy					
Health of Consumer	**Latest**		**Jun**		**Jan**
Retail Sales (MoM)	1.2%	↓	1.5%	↑	-1.8%
Retail Trade (YoY)	3.5%	↑	1.8%	↑	1.6%
Eco Watchers Survey	51.0%	↑	48.1%	↓	49.9%
Consumer Confidence	42.9%	↓	43.7%	↓	44.7%
Household Spending	-0.3%	↑	-1.2%	↓	2.0%
Labor Market					
Jobless Rate	2.4%	○	2.4%	○	2.4%
Labor Cash Earnings	1.5%	↓	3.6%	↑	0.7%
Inflation					
National CPI YoY	0.8%	↑	0.7%	↓	1.4%
National CPI ex Food & Energy	0.30%	↑	0.20%	↓	0.40%
Activity					
GDP	-2.5% Q3	↓	3.0% Q2	↑	-0.6% Q1
Tankan All Industry Index	14.3%	↑	13.6%	↓	23.0%
PMI - Manufacturing	52.4	↓	53.0	↓	54.8
PMI - Composite	52.4	↑	52.1	↓	52.8
Trade Balance	-737B	↓	721B	↑	-943b
Exports	0.1%	↓	6.7%	↓	12.2%
Industrial Production	2.9%	↑	-1.8%	↑	-6.8%
Market Indicators					
Nikkei	20166.00	↓	22851.00	↓	23506.00
JGB 10 year	0.041%	↑	0.030%	↓	0.043%

Monetary Policy

Unlike its other G-3 counterparts the Bank of Japan remains resolutely dovish in its monetary policy stance as it continues to pump money into the economy. In fact it hinted that it may allow rates to turn negative once again as JGBs once again become harbors of safety. At its latest meeting members noted that. “Long-term yields should be allowed to temporarily turn negative” to keep monetary policy ultra-loose,” adding that,“Attempting to bring interest rates back up (via market operations) would be tantamount to monetary tightening.” The BOJ is clearly struggling with renewed bouts of global risk aversion which not only dampens demand as export growth slows, but also strengthens the yen as many high risk carry trades that utilize the ultra cheap financing of yen rates are unwound. This creates dual pressures on deflation and can overwhelm the Quantitative Easing program that the bank has in place. With BOJ already owning more than 43% of the JGB market and an estimated 75% of the ETF market there is little more that the central bank can do to further stimulate the economy. BOJ’s worst case scenario is a prolonged global slowdown that would create a long de-risking cycle strengthening yen further and thus wiping out all of the central banks efforts over the past four year to revive inflation. With policy generally out their hands, Japanese monetary authorities can only hope that other G-3 central banks respond proactively and ease conditions to avoid a synchronized global recession.

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CHF – The Stealth Trade of the Year

Macro

The Swiss franc remains the single biggest negative carry trade in FX with interest rates set firmly at -75 basis points yet demand for the currency remained strong in 2018 as the Swissie traded above parity to the dollar all year long and repelled attempts to take out the pre-SNB crash highs of 1.2000 in EURCHF earlier the year. As 2019 unfolds the Swissie may get even more of a boost if risk aversion flows pick up. Any further turbulence in global financial markets could trigger another stampede into the franc by investors looking for safe harbor trade despite the very real cost of negative rates. If UK forces a hard Brexit and Europe sees further populist upheaval in the periphery and at the core the SNB may be even forced to cut rates further. In short, despite its steep cost, the franc could be the go to currency of 2019 if a global financial stress increases significantly.

Micro

Although the Swiss economy remains remarkably robust, performing better than most of the Eurozone, despite the headwinds of a strong currency, the latest micro data is less encouraging. Most of the data points have decelerated markedly - none more so than the KOF Leading Indicators index which started the year at 107 only to end it at 98. GDP numbers have fared a bit better with growth staying even at 2.4% while the PMI Manufacturing data eased from the high of 65 but remains comfortably above the 50 boom/bust line of 57. The net take away from Swiss data is that the country's economy is feeling the broad slowdown in growth both from immediate European region and from the wider global trade tensions between China and US, but but for the time being it remains firmly in a growth mode even as that growth is likely to decelerate in 2019.

Swiss Economy					
Health of Consumer	**Latest**		**Jun**		**Jan**
Retail Sales (YoY)	0.8%	↑	0.3%	↑	-1.4%
SECO Consumer Confidence	-6.0%	↑	-7.0%	↓	5.0%
Labor Market					
Unemployment Rate	2.5%	↑	2.4%	↓	3.3%
Inflation					
Consumer Prices (MoM)	-0.3%	↓	0.0%	↓	0.1%
CPI YoY	0.90%	↓	1.10%	↑	0.70%
Activity					
GDP	2.4% Q3	↓	3.4% Q2	↑	2.2% Q1
PMI - Manufacturing	57.7	↓	61.6	↓	65.3
KoF Leading Indicator	99.1	↓	101.7	↓	106.9
Imports YoY	-1.5	↓	-0.4	↑	3.8
Exports YoY	1.0	↑	0.5	↑	-5.1
Market Indicators					
Swiss Mkt	8417.00	↓	8642.00	↓	9478.00
Swiss 10 year yields	-0.259%	↓	-0.059%	↑	-0.112%

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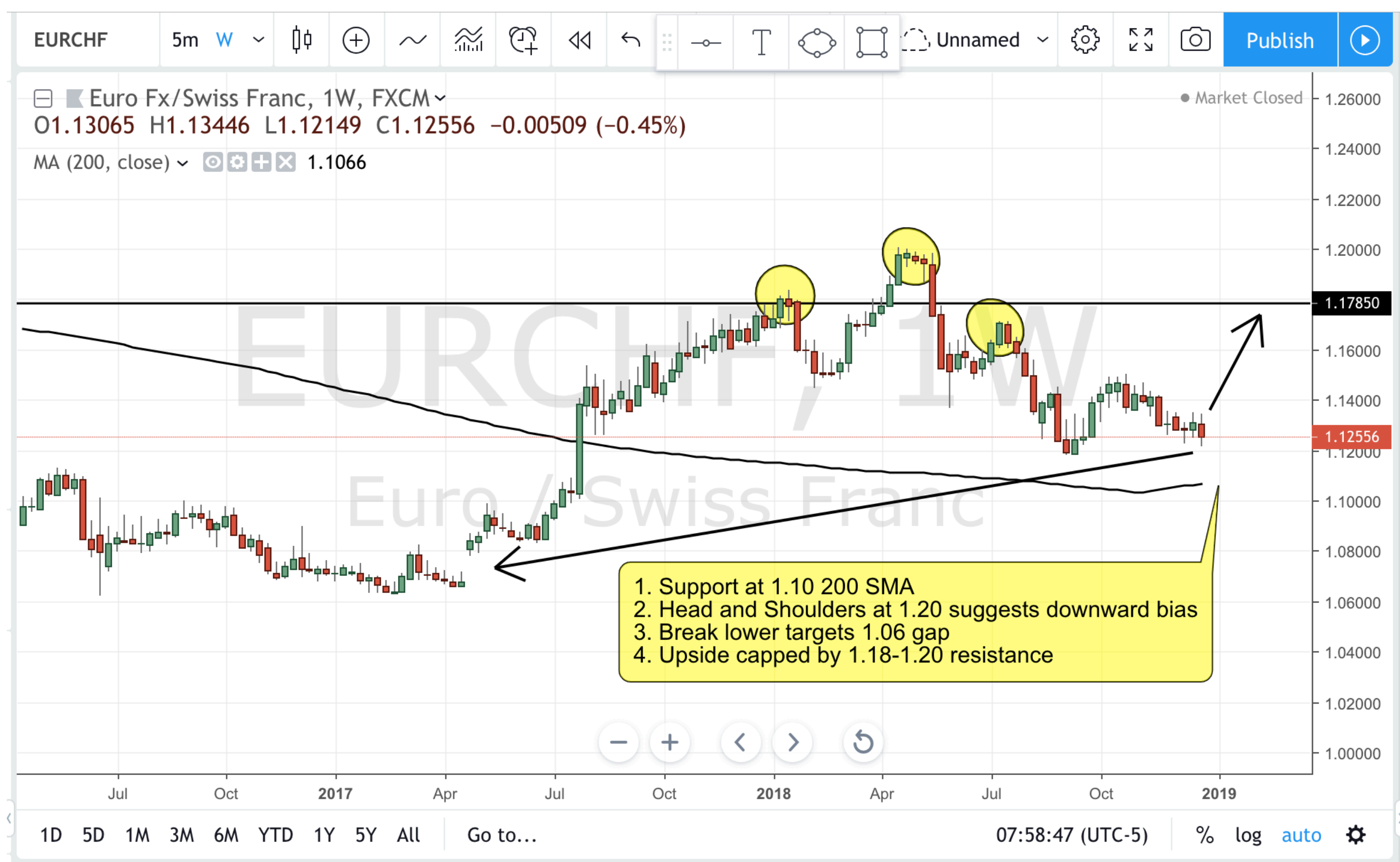
Monetary Policy

The SNB has not changed its policy stance over the past 4 years and is unlikely to normalize monetary policy anytime soon. Bloomberg noted that , “According to the Swiss Bankers’ Association, the effectiveness of SNB policy is diminishing as its risks increase. But as the four-year anniversary of the minus 0.75 percent benchmark approaches, President Thomas Jordan’s focus remains on the franc. He’s concerned that tighter monetary policy could push it too high against the euro, hurting exports and the wider economy.” The critics have pointed out that the ultra low interest rates have stoked a property bubble in the country with insurers and pension funds now exposed to that asset at far greater rates than historical norms. The SNB however believes that it can contain the worst of the excess by tightening lending standards, In fact the out of consensus scenario for 2019 is that SNB may have to take rates even more negative if another financial crisis develops in order to keep franc appreciating to parity against the euro and below 90 cents against the greenback.

Technical Analysis



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CAD in 2019 Early Pain, Late Gains

Macro

2018 was a brutal year for the Canadian dollar. The currency hasn't been this cheap since May 2017. Over the past year, the loonie lost more than 7% of its value against the greenback and 10% of its value versus the Japanese Yen. At 1.3600, USD/CAD is trading much closer to its 5 year high of 1.4690 than its 5 year low of .9930. The currency's decline boiled down to 2 things – oil and the U.S. dollar. The price of crude fell 25% last year but from its peak in October, it is down a staggering 44%. Western Canada Select, the spot price for Alberta oil is down only 18% but that's only after a sharp recovery in December as it is off 50% from its peak in May. Aside from the decline in oil, the Canadian dollar was also driven lower by U.S. dollar strength.

But it could have been alot worse. If not for the U.S. Mexico Canada agreement (USMCA), strong labor market gains and decent growth, the Canadian dollar would be much weaker. The USMCA agreement was the most significant development for Canada last year. It eliminated a major uncertainty that could have been very bad for the currency. It still needs to be ratified and while House Democrats could express some concerns, it will pass in 2019. ***In the coming year we expect early weakness for Canada's economy followed by late strength. For USD/CAD this means that we could see 1.40 before a move down to 1.30*.**

In the coming year the same drivers that carried the loonie lower could be the ones that drive it higher – probably not in the beginning of the year but certainly as the year progresses. Oil prices are low but in December OPEC countries agreed to cut production and if prices do not turn higher soon, the threat of further losses will prompt additional reductions. When that happens, the loonie could finally benefit from the falling U.S. dollar. By all counts, the greenback peaked in 2018 and is poised for further losses in 2019. The Canadian dollar was the only currency that failed to benefit at year-end because of oil but as crude prices stabilize, so will the loonie.

Micro

Starting with the bad news, the first 2 months of the year could be rough for Canada as growth will be dampened by lower oil prices, slowing housing activity and equity market weakness. Despite the USMCA agreement, Canadian steel, aluminum, lumber and solar panel exports are still subject to tariffs which means these sectors will struggle to recover. According to the table below, consumer spending growth stagnated towards year end, consumer price growth slowed to the point where CPI dropped below 2% and manufacturing activity is well off its highs. ***Data in the front of the year should be softer, giving the bears more reasons to drive CAD lower.***

The good news is that the labor market is very strong with more than 94K jobs created in the month of November. This was the single biggest one month job gain since April 2010 when 108K jobs were created. The unemployment rate is at a four decade low and all of this has helped to encourage strong GDP growth. Also population is growing at healthy pace and two major liquefied natural gas projects worth $50 billion Canadian dollars could provide some economic momentum mid year. This should be followed by fiscal stimulus ahead of the October general election where Prime Minister Trudeau is expected to win easily.

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Canada Economy					
Health of Consumer	**Latest**		**June**		**Jan**
Retail Sales (MoM)	0.00%	↑	-1.30%	↓	1.50%
Core Retail (MoM)	0.30%	↑	-0.10%	↓	0.80%
Labor Market					
Net Change in Employment	94.1K	↑	31.8K	↓	78.6K
Unemployment Rate	5.60%	↑	6.00%	↓	5.70%
Inflation					
Consumer Prices NSA (MoM)	-0.40%	↓	0.10%	↓	0.30%
CPI YoY	1.70%	↓	2.20%	↑	2.10%
Housing Market					
Building Permits (MoM)	-0.2%	↓	4.7%	↑	-7.7%
Housing Starts	215.9K	↓	248.1K	↑	217K
Existing Home Sales	-2.30%	↓	-0.10%	↓	3.90%
Activity					
GDP (MoM)	0.3%	↑	0.1%	↑	0.0%
GDP (YoY)	2.2%	↓	2.5%	↓	3.4%
Ivey PMI	57.2	↓	63.1	↑	60.4
Trade Balance	-1.17B	↑	-2.77B	↓	-2.54B
Manufacturing Sales (MoM)	-0.1%	↑	-1.3%	↓	-0.4%
Market Indicators					
TSX Composite Index	14024.00	↓	16258.00	↓	16286.00
10 Yr Bonds	2.027%	↓	2.142%	↓	2.168%
WTI Crude	$ 45.42	↓	$ 74.10	↑	$ 63.35
Western Canada Select	$ 29.52	↓	$ 53.14	↑	$ 38.45

Monetary Policy

Like the Federal Reserve, the Bank of Canada is widely expected to raise interest rates this year and the question is just how quickly. The Fed could lift rates again in the first quarter while the BoC could wait until Q2. What's interesting about the BoC is how quickly their views changed last year. Right after they raised interest rates in October, they said rates will need to rise to a neutral stance to achieve the inflation target and this was interpreted to mean that there could be a December or January hike. *However with crude prices falling 44% from October and December and the TSX index falling 14% during this same period, their outlook changed as the risks to growth shifted from the upside to downside. So in December, they find themselves with less wiggle room and like the Fed they resorted to saying that future moves will be "decidedly data dependent." This means there are no plans to raise interest rates in the early part of the year, which reinforces our view that USD/CAD is headed higher before it peaks and turns lower.*

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Technical Analysis

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AUD – Where's the Bottom?

Macro

Of all the major currencies, the one that performed the worst last year was the Australian dollar and while many worry that there could be more trouble ahead, we believe that the Australian dollar is nearing a bottom and will stabilize before turning higher. Fundamentally, the economy is strong. Thanks to low unemployment, population growth, government spending, resource investments and low interest rates, Australia was able to grow despite weakness in China. Unfortunately that resilience did not carry over to the currency which lost a big chunk of its value in 2018. In the past 12 months, the Australian dollar fell 10% against the U.S. dollar and 6% against the euro with AUD/USD ending the year at 2 almost 3 year lows. A large part of the weakness was caused by the slide in the Chinese Yuan but the Reserve Bank's neutral policy stance, which benefitted the economy also diminished the attractiveness of the currency at a time when the Federal Reserve was raising interest rates aggressively. Australia's perceived sensitivity to China and its status as a risk currency added to the pain as stocks sold off aggressively.

Unfortunately next year won't be a good one for China as the impact of the tariffs are fully felt. US growth will slow and the prospect of further losses in global equities means pressure on high beta currencies. AUD won't be able to escape the weakness but on a relative basis it could outperform. ***So while we are looking for AUD/USD to trade higher in the coming year, it won't be a linear move. Instead we expect choppy trading in the first part of the year with the potential for further losses before AUD finally stabilizes. If a trade agreement is reached between U.S. and China, we'll see a short squeeze that could take AUD/USD to 75 cents and beyond.***

Micro

But 2019 should be another good year for Australia. The drag from the slowdown in the mining sector will begin to fade, non-mining investment will increase, commodity prices should recover and consumption will be supported by rising wages and population growth. There are also a number of infrastructure spending programs set for New South Wales and Victoria, the two largest states and a big new program to help the disabled. On top of that the weakness of the currency will also go a long way in supporting the export dependent economy and all of this will help to buffer growth in a period of global fragility.

Now there are risks and they are big ones. Taking a look at the table below, GDP growth weakened significantly in Q3, business and economic activity slowed just as banks have taken it upon themselves to raise interest rates. The trade truce between the U.S. and China may not last. Not only is the bar set high for the U.S. to back off on its plans to raise tariffs to 25% from 10% but the arrest of a key Huawei executive soured relations. President Trump may be more motivated than ever before if only to reverse the slide in stocks and gain some approval from the markets. A face to face trade meeting is set for January. ***China clearly wants to end the trade spat and we think there's a good chance Trump will soften his stance in 2019, which would be enough to solidify a bottom in AUD/USD. However if we're wrong and the talks break down again, it would trigger a renewed decline that could take AUD/USD to fresh 10 year lows.***

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Australia Economy					
Health of Consumer	**Latest**		**June**		**Jan**
Retail Sales ex Inflation	0.2%	↓	1.20%	↑	0.20%
Westpac Consumer Confidence	104.3	↑	102.1	↓	105.1
Labor Market					
Unemployment Rate	5.0%	↑	5.4%	↑	5.5%
Employment Change	32.8K	↑	12K	↓	34.7K
Fulltime Employment	42.3K	↑	20.6K	↑	15.1K
Participation Rate	65.6%	↑	65.5%	↓	65.7%
Inflation					
Consumer Inflation Expectation	3.6%	↓	4.2%	↓	3.70%
CPI YoY	1.9%	↓	2.10%	↑	1.9%
Housing Market					
Home Loans (MoM)	-1.0%	↑	-1.4%	↓	2.10%
Building Approvals (MoM)	-13.4%	↓	1.6%	↓	12%
Activity					
GDP YOY	2.8% Q3	↓	3.4% Q2	↑	3.1% Q1
Westpac Leading Indicators	0.08%	↑	-0.22%	↑	0.27%
NAB Business Conditions	12.00	↓	15.00	↓	21.00
NAB Business Confidence	4.00	↓	6.00	↓	11.00
Trade Balance	3017M	↑	A977M	↑	-A628M
PMI Manufacturing	51.3%	↓	57.4%	↑	54.9%
PMI Services	51.1%	↓	59.0%	↑	58.7%
PMI Construction	46.4%	↓	54.0%	↑	52.8%
Chinese Data					
GDP QoQ	6.50%	↓	6.70%	↓	6.80%
Trade Balance	34.01B	↑	$24.92	↓	54.6B
Imports	21.40%	↓	26.00%	↑	4.50%
Exports	2.50%	↓	12.60%	↑	10.90%
Industrial Production	5.40%	↓	6.00%	↓	6.20%
Retail Sales	8.10%	↓	9.00%	↓	9.40%
Market Indicators					
ASX Index	5467	↓	6196	↑	6090
10 Year AU Bonds Yield	2.38%	↓	2.62%	↓	2.80%
Iron Ore Price	487	↓	467	↓	516
Shanghai Composite Index	2516	↓	2813	↓	3447

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Monetary Policy

After keeping monetary policy steady for more than 2 years, the RBA is in no rush to raise interest rates and they've even said that they could hold interest rates steady until 2020. The labor market is strong and wages are growing but there's still spare capacity. The countries leading banks have taken upon themselves to raise interest rates, which tightened financial conditions and eased credit growth. With the 90 day trade truce between the US and China, the RBA has no reason to alter their outlook before there is clarity on trade. Even then, China's economy is vulnerable to further weakness in 2019. Monetary policy won't provide any support for the Australian dollar in the coming year but if wages rise and data improves, the RBA could grow more optimistic and any positive language could trigger a short squeeze in the deeply oversold currency.

Technical Analysis

1. Deep downtrend persists
2. Lower highs suggest downside bias
3. 200 week SMA caps upside at .75
4. Break lower targets swing lows at .68

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RBNZ – One of the last to raise rates?

Macro

Like most of the major currencies, the New Zealand dollar fell victim to U.S. dollar gains in 2018. However unlike some of its peers, it did not underperform all of the major currencies. NZD fell against the U.S. dollar, Japanese Yen, euro and Swiss Franc but strengthened versus the Canadian and Australian dollars. Compared to AUD/USD, which dropped close to 10%, NZD/USD lost only 5% of its value. This divergence in performance of what should have been 2 closely linked currencies drove the AUD/NZD cross to its weakest level in 17 months. While there were many parallels in the performance of Australia and New Zealand's economy, NZD outperformed because the Chinese are more reliant on New Zealand's exports of milk, butter, cheese, meat and infant formula than Australia's exports of hard commodities. This helped keep growth close to trend throughout 2018. New Zealand's economy is also smaller than Australia's so China's voracious appetite for foreign imported formula and dairy not only supported exports but sheltered the economy from the slowdown. New Zealand won't be immune to weaker Chinese and global growth in 2019, but low interest rates and government spending should make it a decent year for the economy. With that in mind, risk aversion will still dominate beginning of the year trade, making NZD vulnerable to additional weakness.

While we believe NZD/USD will stabilize around 64-65 cents we expect the New Zealand dollar to underperform other currencies such as EUR and Canadian dollar. If a Brexit deal is reached, GBP/NZD could hit 1.95.

Micro

The good news is that growth has been solid over the past year. The country is near maximum employment as the unemployment rate hovers near a 10 year low. Businesses continue to hire, business investment is up and wages are expected to rise due to the lack of spare capacity. According to the Treasury's half year economic update which was released in December, "the economy is healthy" and "will continue its momentum over the next few years, underpinned by investment, productivity and wage growth." When Q4 GDP data is released in the front of the year, it should show the recovering from the past quarter's easing. The bad news is that Q3 GDP growth was significantly weaker than expected, dairy prices have been falling and consumer demand is weakening. The housing market is slowing and the pressure on China is growing. Inflation has increased to just under 2% but core inflation growth is softer. Nonetheless, between low interest rates and the weaker currency, we expect steady growth in 2019.

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New Zealand					
Health of the Consumer	**Latest**		**June**		**Jan**
Retail Sales Ex Inflation	0.0%	↓	1.1%	↑	0.1%
Credit Card Spending MoM	0.8%	↓	2.1%	↑	0.6%
Credit Card Spending YoY	7.8%	↑	5.7%	↓	6.3%
Card Spending Total	1.3%	↑	0.4%	↑	0.2%
ANZ Consumer Confidence	-1.9%	↓	-1.3%	↓	4.2%
Labor Market					
Unemployment Rate	3.90%	↑	4.5%	○	4.5%
Employment Change	1.15	↑	0.5%	○	0.5%
ANZ Job Advertisements	0.50%	↑	-1.60%	↓	3.10%
Activity Indicators					
GDP YoY	2.6% Q3	↓	2.8% Q2	↑	2.7% Q1
PMI Services	53.9	↑	52.8	↓	56.0
Business PMI Index	51.7	↓	52.8	↑	51.2
ANZ Business Confidence	-37.1	↑	-44.9	↓	-37.8
Trade Balance	-1560M	↓	-113M	↓	640M
Inflation					
CPI QoQ	0.90%	↑	0.40%	↑	0.10%
CPI YoY	1.90%	↑	1.50%	↓	1.60%
Global Dairy Trade Index	2885	↓	3136	↓	3553
Food Prices	-0.10%	↓	0.50%	↑	-0.80%
ANZ Commodity Prices	-1.80%	↓	-1.00%	↑	-2.20%
Housing Market					
REINZ House Sales YoY	-3.0%	↓	-1.6%	↑	-10.1%
QV House Prices YoY	5.4%	↑	5.1%	↓	6.6%
Building Permits	-1.50%	↑	-7.60%	↑	-9.60%
Market Indicators					
10 Yr Bond Yield	2.38%	↓	2.74%	↓	2.96%
NZX 50	8686	↓	8872	↓	8241

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Monetary Policy

The big question for the New Zealand dollar is whether the next move by the Reserve Bank will be a rate hike or a rate cut. Prior to the latest GDP report, the assumption was that the next move would be to tighten but a number of local banks changed their forecast at the end of the year to a call for easing. They attribute this shift to lower commodity prices (and in turn inflation), downside risks to global growth and a proposal to increase the capital ratio for the Big 4 banks that could slow the economy. Talk of a rate cut was sparked by RBNZ Governor Orr's comments in November – he said that while the central bank raised their inflation forecast, they are not taking a rate cut off the table because its been a challenge to lift inflationary pressure further and if GDP falls short of forecast, they may have to resort to easing. Its hard to say whether they will follow through but ***what's certain is that based upon these comments, the RBNZ could be one of the last central banks to raise interest rates. This very reason leads us to believe that NZD will underperform other currencies, particularly the ones where the central bank could raise rates in the coming year – namely EUR and CAD.***

Technical Analysis

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