GLOBAL FOREIGN EXCHANGE 2017 YEAR AHEAD: THE GLOBALIZATION OF ANTI-GLOBALIZATION

“The twin ground shifts of the approval of Brexit in the U.K. and the election of Donald Trump in the U.S. were brought on by a backlash against globalization, increasingly viewed as the culprit for wage stagnation, growing disparity of income and wealth, and the loss of national identity. The anti-globalization trend appears here to stay. While a move towards a looser fiscal/tighter monetary policy mix in the U.S. will be positive for the USD, a strong USD will increase the risk of trade friction between U.S. and China, leading to higher foreign exchange volatility and decline in cross-border transactions.”

– David Woo, head of Global Rates, FX, and EM Fixed Income Strategy and Economics

Our view

U.S. rates (finally) will have global impacts
After three years of being a sideshow on the global stage, U.S. rates are back. U.S. rates are headed higher to start the year, and the U.S. rate outlook in no small part should drive the foreign exchange and emerging markets outlook for 2017. The potential for higher rates from fiscal easing and inflationary potential in the U.S. is clear, and so is the likelihood that the impact of these measures in the world’s largest economy will not be limited to its borders.

While the U.S. fixed income sell-off is likely to continue spilling over into other bond markets, yield differentials are still likely to move in favor of the dollar. In addition to fiscal easing, other potential measures such as the repatriation of overseas U.S. corporate earnings – low-hanging fruit for Washington – should further benefit the dollar.

USD/JPY likely to be the main foreign exchange beneficiary of the Trump win
The dollar’s strength will likely be particularly pronounced against the JPY, given that the Bank of Japan is pegging 10-year JGB yields at zero. Japanese investors, who already have bought record amounts of U.S. bonds this year and suffered losses, may have reached their limits. However, long-dated USD/JPY forward outrights are near their lowest levels in more than a year, so further purchases are more likely to be currency unhedged.

MXN is oversold but BRL faces more headwinds
Emerging markets fixed income was the best-performing asset class in 2016. However, its gains have been nearly wiped out since the election by a mix of higher U.S. rates and a stronger dollar. Despite this, long positions remain crowded, liquidity conditions are poor, and downside risk remains; the BRL remains one of the most crowded currencies, although MXN, in particular, already has priced in much bad news.

The best hedge against trade friction escalation, long USD/CNH

The rise of populism means that policies will become less predictable and less market-friendly, especially in international trade; the risk of trade friction will likely be higher than in recent years. One possible flashpoint for 2017: a weaker dollar supporting President-elect Trump's trade policy conflicting with a weaker RMB meant to address the ill effects of China's debt-fueled expansion.

Contagious populism should benefit the GBP

Major elections are scheduled next year for France, the Netherlands, Germany, and Italy could see early elections. Strong showings by anti-globalization forces could further undermine support for the European project. While these forces may not actually take power, investors are likely to demand greater risk premiums ahead of these votes; sterling may be one beneficiary relative to the euro.

Key calls

- **Buy USD/JPY** – With the Bank of Japan pegging 10-year JGB yields at zero, this highly rate-sensitive USD cross may continue to be the biggest beneficiary of the Trump win.
- **Sell BRL/MXN** – The MXN is oversold, but the BRL will be vulnerable to the divergent paths between Brazil's easing and the Federal Reserve's tightening cycles.
- **Sell EUR/GBP** – The double-headed impact of Brexit and Trump could bolster the anti-globalization parties in Europe ahead of key elections next year.
- **Sell EUR/RUB** – Likely OPEC production cuts and possible economic sanctions relief for Russia are bullish for the RUB.