FOREIGN EXCHANGE 2019 OUTLOOK: DOLLAR STRENGTH OR DEPRECIATION?

“The million-dollar question for 2019 is whether the decoupling of the U.S. economy from Europe and China, which benefited the U.S. dollar hugely in 2018, is sustainable. We see gridlock in Washington as posing the greatest risk to the decoupling view and to the USD in 2019. We also expect trade war, which affected the U.S. less than other economies in 2018, to turn into a recoupling theme, regardless of how it plays out. We are turning more negative on the USD as the U.S. twin deficits come into sharper focus next year.”

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

Our view

Sustainability of U.S. decoupling: The U.S. dollar was last year’s best performing asset class and could be again in 2019 if U.S. decoupling from the rest of the world (specifically Europe and China) continues. However, we think that a recoupling (i.e., a reversal of 2018 divergence) is more likely. How that recoupling materializes will influence investment results. If the U.S. economy is doing worse in an environment in which the global economy is languishing, then Treasuries could be the best-performing asset class; if Europe and China are doing better as the U.S. benignly decelerates, then emerging markets would probably be a big winner in 2019.

Look beyond the Fed: With the Fed currently priced to hike only about two more times in this cycle, an increase in pricing is possible over the short- to medium-term. This represents an upside USD risk worth up to several percentage points. However, we do not expect growth and monetary policy divergence to be a sustainable tailwind for the dollar in 2019 as it was in 2018. Rather, we think that benign U.S. deceleration and avoidance of major global tail risks will provide global central banks with more confidence in signaling to markets the need for policy normalization. This is our baseline and should ultimately lead to policy convergence and a weaker USD.

Sell USD, but against what? While the case for a weaker dollar is clear to us, the question of whether to sell it versus low- or high-beta currencies is heavily dependent on the evolution of the trade relationship with China. The G20 gathering has produced a temporary de-escalation in U.S.-China trade tensions, but structural issues will take time to iron out. Tensions could still deteriorate before potentially improving sustainably. This favors selling the dollar against a low-beta currency like the Swiss franc (CHF), Japanese yen (JPY) or euro (EUR), or potentially against a currency more insulated from U.S.-China trade rhetoric, such as the British pound (GBP).

Fundamentals call for stronger JPY vs. USD: We have been bullish USD/JPY this year, but we see the yen reversing course and strengthening against the dollar next year. This is our first change in view on USD/JPY after turning bullish on the pair in September 2016.
**Global contagion risks**: Contagion risks were largely contained in 2018, but looking forward, contagion cannot be ruled out as we see a compelling case for “normalization” of market conditions across a number of asset classes. Higher U.S. yields and lower stocks could contaminate global markets, inducing generalized volatility and a broader economic downturn. The waning U.S. business cycle could also intensify risks. Turmoil is not our central scenario, but cheap levels of implied FX volatility offer attractive hedges for tail risks. The possibility for contagion is another reason why we prefer to express our directionally USD bearish view against low beta FX.

**Options volumes signal uncertainty**: The recent pickup in EUR/USD and USD/JPY options volumes suggests uncertainty ahead, as option market volume can be a leading indicator for realized volatility. Currency market volatility looks underpriced to us.

**Impact of Brazil’s elections**: Although Brazil Real (BRL) risk reversals have fallen significantly since investors turned bullish on Brazil’s elections, we believe there is room for further compression. We believe that foreign investors have taken a cautiously optimistic approach to Brazil compared to local investors and that there is scope for further demand in Brazilian assets.

**Calm before the storm**: We believe that USD/INR (Indian rupee) implied volatility can fall further in the short term but expect it to pick up next year due to both domestic and global factors.

**Weaker oil boosts Asian currencies for now**: USD/Asia has come off sharply in the last few weeks mainly on the back of softening trade tensions, but the main oil-driven currencies like INR and IDR (Indonesian Rupiah) have outperformed the rest of Asia given the weakness in oil.

**Key calls**

- While we have been bullish on the dollar in 2018, a contrarian call around this time last year, we believe that most USD gains are behind us and expect USD weakening against major currencies (JPY, CHF and EUR) in 2019 as divergence leads to convergence.

- Higher risk premium associated with political gridlock, twin deficits and late-cycle economic concerns will weigh on the USD in 2019.

- The dollar is only a uniform “safe haven” when the China-specific factors are driving risk off. The JPY and CHF offer the best risk-reward for USD shorts, however, as both benefit from rising U.S. or Europe risk and are underpriced relative to China risk.

- We believe GBP is more insulated from external factors and will benefit from avoidance of a hard Brexit outcome.

- A reduction in global trade tensions improves the likelihood of a durable EM rally. We see the South African rand (ZAR) as a preferred currency to play this theme due to relatively few near-term domestic drivers and ZAR’s strong correlation to EM FX.

- We believe the prospect of USD/CNY exceeding 7 is increasingly accepted onshore as USD purchases have risen. Sentiment for further yuan depreciation could increase if the CNY China Foreign Exchange Trading System Index falls below 92, a level supported since its inception.