G3 Forecast Revision July 2019

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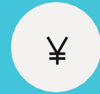

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Currencies

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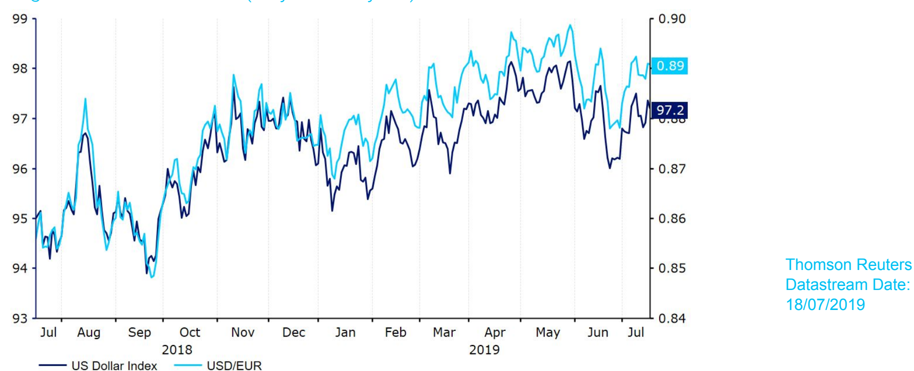
US Dollar USD

The US Dollar (USD) has lost ground against almost every other major currency since the beginning of June (Figure 1), driven lower by growing expectations that the Federal Reserve could be set for a rather aggressive pace of monetary policy easing during the remainder of 2019.

Figure 1: US Dollar Index (July '18 - July '19)



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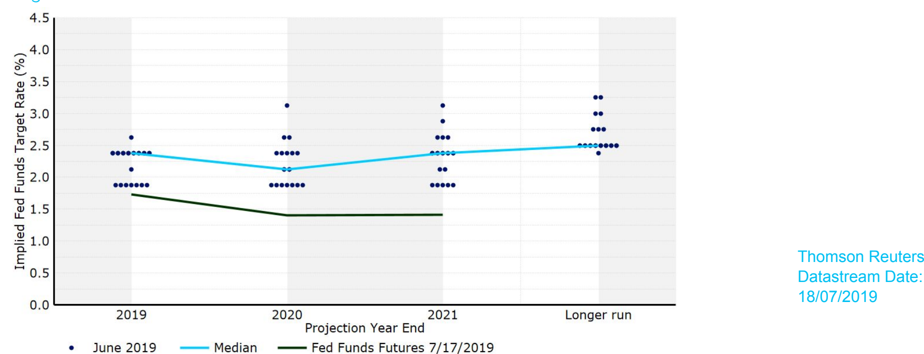
The Federal Reserve has embarked on a drastic U-turn in policy since its most recent interest rate hike in December. Amid heavy political pressure from President Trump, policymakers have shifted from signalling that additional hikes are on the way to all but confirming that rates will be cut for the first time in more than a decade at its July meeting. At the FOMC's latest meeting in June, the Fed gave its clearest indication yet that lower rates are on the way as it voiced heightened concerns over the recent escalation in US-China trade tensions.

Negotiations between the US and China over trade took a turn for the worse in May, with President Trump unexpectedly hiking the existing tariffs on $200 billion worth of Chinese goods from 10% to 25%. China has retaliated with fresh tariffs of its own, although the G20 summit in Japan in late-June did at least yield a temporary ceasefire on additional tariffs and a promise of a resumption in trade talks.

We have long contested that a deal between the US and China over trade is more likely than not and think that the latest truce is a step in the right direction that could pave the way for the striking of a trade agreement at some point in the coming months.

Amid the growing trade uncertainty, Fed Chair Jerome Powell stated in June that 'the case for somewhat more accommodative policy has strengthened' and that policymakers would 'act as appropriate' to sustain the country's economic expansion. The Fed also removed the word 'patient' from its statement, signalling that it is ready to act. Even more meaningful, however, was the Fed's revised 'dot plot', which for the first time showed that a number of committee members are now in support of lower rates in 2019. Eight of the seventeen FOMC members now expect to cut rates this year, with seven of those eight seeing multiple 25 basis point reductions (Figure 2). While the median dot for this year was left unchanged, the median dot for next year was shifted downwards. This marks a rather drastic departure from the previous interest rate projections in March.

Figure 2: FOMC June 2019 'Dot Plot'



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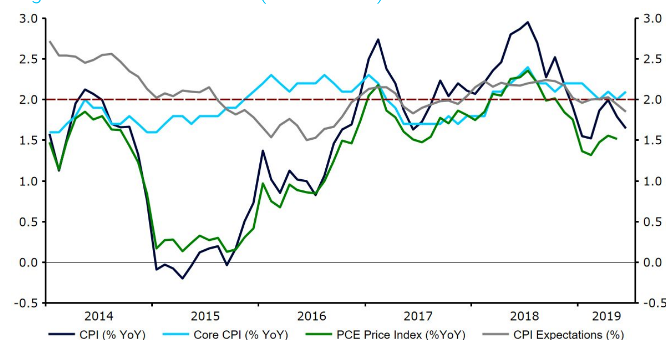
Increased appetite for cuts among the FOMC has a lot to do with the lack of inflationary pressure in the US economy. The main headline rate of US consumer price growth has been below the central bank's 2% target in each of the past six months, while the Fed's preferred inflation measure, the PCE index, came in comfortably below target at 1.5% in May (Figure 3).

US Dollar USD

It is also worth noting that expectations for future inflation, measured by the 5-year, 5-year Forward Inflation Expectations Rate, have also fallen, with the index now at its lowest level since June 2017. We note, however, that the core measure of inflation that strips out volatile food and energy components has remained above the 2% target. A still relatively solid labour market performance, most notably robust earnings growth, could keep prices elevated this year.

Figure 3: US Inflation Rate (2014 - 2019)



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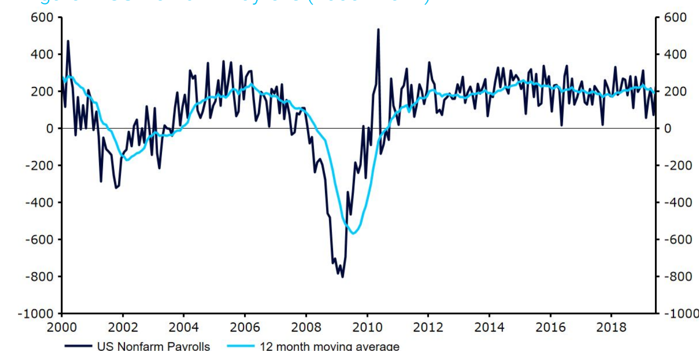
Despite growing external downside risks, the Fed has remained upbeat over the domestic economy, with its concerns largely focused on trade tensions. The US economy grew at a solid 3.1% annualised pace in the first quarter of the year, although much of this was driven by temporary factors, namely higher exports and an inventory increase, rather than strength in underlying domestic demand. With that in mind, US growth looks all but certain to have slowed in the second quarter of 2019, particularly given trade uncertainty is beginning to filter its way through to weaker business activity. ISM's non-manufacturing PMI has fallen, declining to a two-and-a-half year low 55.1 in June. A good gauge of the recent undershooting in US economic data is Citigroup's Economic Surprise Index, which has been deep in negative territory since mid-February. The Atlanta Fed's GDPNow forecast is currently suggesting that the US economy may have only grown by around 1.6% in Q2.

We do not, however, believe that there are any signs that an imminent recession or even a significant slowdown are on the cards. Year-on-year earnings growth has eased since increasing to a 10-year high in February, although still remains high by recent standards. The US economy also created a better-than-expected 224,000 net jobs in June (Figure 4). While the twelve month average is now back below the 200,000 level and at its lowest level since April 2018, we are far from the job creation levels that would warrant a sustained easing cycle.

Figure 4: US Nonfarm Payrolls (2000 - 2019)



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Following the FOMC's June meeting, it is clear that the conversation among the Fed's rate-setting committee has shifted from whether or not to cut rates to the speed and extent at which to ease policy. Fed funds futures show that the market is currently fully pricing in a rate cut in July and an additional two cuts during the remainder of the year. Our relatively optimistic view on global trade means that we think this aggressive market pricing is an overreaction and that we would need to see a significant deterioration in global macroeconomic conditions or another blow-up in trade talks in order for this to materialise.

US Dollar USD

Regardless, the Fed has made it clear that the next move in rates is downwards. We think that a cut at the Fed's July meeting is now inevitable. As we have mentioned, however, we do not believe that macroeconomic conditions are conducive for an aggressive pace of monetary easing. The market is making too much of the possibility of a 50 basis point cut, in our view, a bit of a throwaway comment by Chair Jerome Powell at the June meeting. We think that the Fed is instead likely to take stock and assess incoming data following its July cut before it decides on both the pace and timing of additional rate reductions.

That being said, we believe that the bar for Federal Reserve interest rate cuts is much lower than that of the European Central Bank and indeed most other G10 central banks. This, in our view, should be supportive of our forecast for a broadly weaker US Dollar against most major currencies. We therefore maintain our call for a gradual upward move in EUR/USD towards the 1.15 level by the end of 2019 and 1.18 by the end of 2020. We think that there is a growing consensus among US authorities for higher deficits, lower interest rates, lower taxes and a weaker US Dollar.

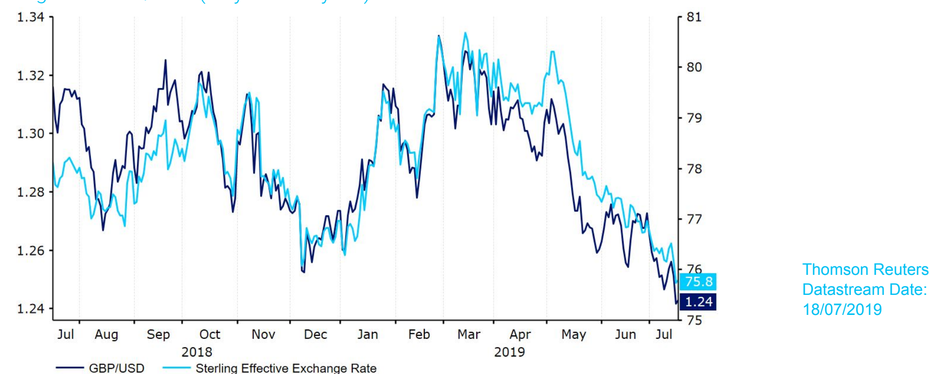
	EUR/USD	GBP/USD
Q3-2019	1.15	1.26
E-2019	1.15	1.32
Q1-2020	1.16	1.35
Q2-2020	1.16	1.37
E-2020	1.18	1.40

UK Pound GBP

> News headlines in the UK have continued to be dominated by Brexit developments in the past few months.

The failure of Prime Minister Theresa May to force her Brexit withdrawal agreement through parliament has heightened concerns that the UK could be heading towards a 'no deal' Brexit come the delayed 31st October EU exit date. These concerns have sent Sterling sharply lower against its major peers since the beginning of May, with the Pound extending its losses to around six-and-a-half percent versus the US Dollar in the past four months alone. Heightened Brexit concerns, combined with soft domestic data and increasing bets on Bank of England rate cuts explain why the UK currency is currently trading around its weakest position in trade-weighted terms since September 2017 (Figure 5).

Figure 5: GBP/USD (July '18 - July '19)



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UK Prime Minister May struck a deal with the European Union over a 585-page draft withdrawal agreement in late-November, but she was unable to force the deal through three separate parliament votes. While the margin of defeat for the third vote narrowed to 58 MPs, this was still far short of commanding a majority.

The key sticking point to Brexit has been the inclusion of the so-called Northern Irish 'backstop' in the withdrawal agreement. The backstop, a failsafe mechanism that ensures the avoidance of a hard border between Northern Ireland and the Republic of Ireland after Brexit, essentially ties the UK into the customs union for an indefinite period of time. This is something that the hard Brexiteers within the House of Commons have been firmly opposed to.

The subsequent collapse in cross-party talks designed to break the impasse between the Conservatives and Labour Party ensured that Theresa May's position as Prime Minister was untenable and ultimately led to her resignation in May. Attention in the market since then has been firmly on who will replace her as PM, with former London Mayor and pro-Brexiter Boris Johnson the odds-on favourite. The prospect of a Johnson-led Tory Party has unnerved investors and contributed to much of the recent weakness in the Pound. Johnson has appeared the least concerned of all the Tory leadership candidates regarding the possibility of a 'no deal' Brexit and has been the most vocal in the view that the UK will leave the European Union on 31st October come what may.

Heightened 'no deal' concerns have been reflected in the latest bookmaker odds, which are now placing around a one-in-three implied probability that the UK leaves the EU without a deal in place, up from around 16% a matter of weeks ago (Figure 6). While the House of Commons has voted in favour of rejecting a 'no deal' outright, it is worth noting that this amendment is not legally binding and the possibility of the UK leaving the EU without a deal in place at the end of October remains live.

UK Pound GBP

Figure 6: Implied Probability of No Deal Brexit (Sept '18 - July '19)

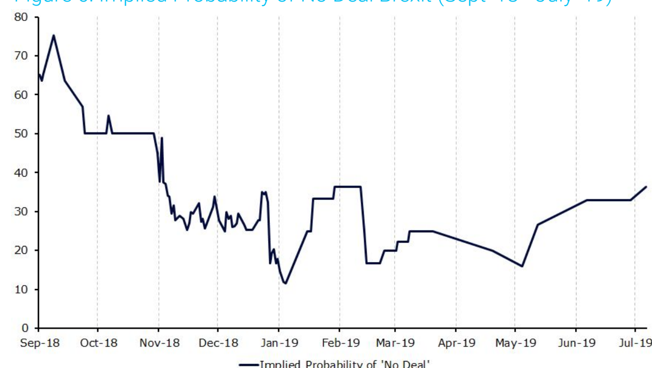

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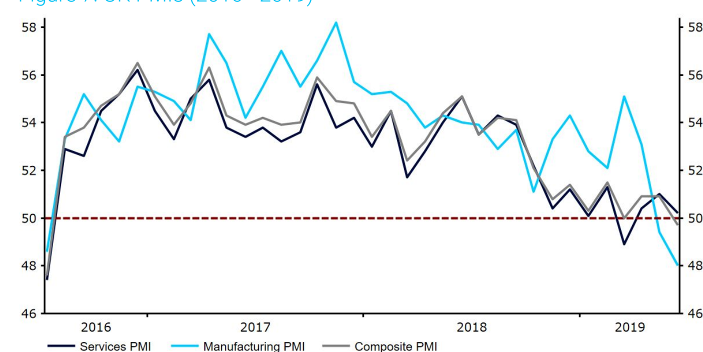
Figure 7: UK PMIs (2016 - 2019)



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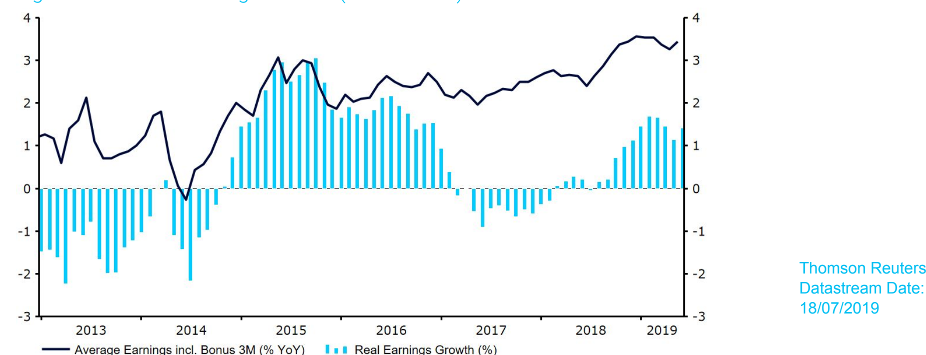
We're beginning to see the uncertainty over Brexit filter its way through to generally weaker UK consumer and business activity. The UK economy expanded at a decent pace of 0.5% quarter-on-quarter in the first three months of the year, but the latest indicators of economic activity ensure that growth is all but certain to have slowed in the second quarter. Recent PMI prints have been particularly soft and are all now around or below the level of 50 that separates expansion from contraction. The composite PMI, which represents a weighted average of activity of the UK's services, manufacturing and construction sectors, came in at 49.7 in June, the first time it has fallen into contractionary territory since the immediate aftermath of the EU referendum in July 2016 (Figure 7). The Bank of England is now forecasting the economy to post flat growth in the second quarter, a downward revision from the previous 0.2% estimate.

With domestic activity slowing and the Brexit saga dragging on longer than expected, market pricing has shifted from penciling in tighter Bank of England policy commencing in early-2020 to pricing in interest rate cuts. At its most recent meeting in June, the BoE once again reaffirmed its wait-and-see stance, stating that incoming data had been broadly in line with its May forecasts. Governor Mark Carney has, however, stated that the perceived likelihood of a 'no deal' has increased, while noting heightened downside risks to growth. We now expect to see the bank downgrade its growth forecasts at its next quarterly Inflation Report in August, while reiterating that easing is possible should a Brexit deal fail to be agreed. It is worth noting that UK inflation has also declined in the past twelve months. Core inflation came in at 1.8% in June, just above its lowest level since January 2017 and now (too) comfortably below the central bank's 2% target.

We do stress, however, that the UK labour market remains a bright spot and could encourage the BoE to reaffirm its view that 'gradual' and 'limited' interest rate hikes are required over the forecast horizon, provided we get a Brexit deal in the interim. The rate of UK unemployment has fallen again, declining to a fresh four decade low 3.8% in the three months to April. Earnings growth has also accelerated again to back around a decade high above 3% and in real terms is currently just above 1% (Figure 8). This is a very healthy level by recent standards and may provide support to UK growth should it filter its way through to an improvement in domestic consumer activity.

UK Pound GBP

Figure 8: UK Real Earnings Growth (2013 - 2019)



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	GBP/USD	GBP/EUR
Q3-2019	1.26	1.10
E-2019	1.32	1.15
Q1-2020	1.35	1.16
Q2-2020	1.37	1.18
E-2020	1.40	1.19

We think that Sterling will continue to be driven almost entirely by Brexit throughout the remainder of 2019. While we acknowledge that the risk of a 'no deal' has undoubtedly increased in recent weeks, we remain bullish on the Pound. Our base case scenario remains for an agreement to be forced through the House of Commons at some point before the 31st October exit date. It is clear that there remains little appetite for a 'no deal' among the majority of the House of Commons and indeed the EU. We are, however, increasingly of the view that this may require the calling of a general election in order to break the impasse.

That being said, we think that the path of least resistance for Sterling in the coming weeks is lower. Each day that passes without positive Brexit news edges the UK closer to an acrimonious 'no deal' exit from the European Union, widely regarded as the worst case scenario for both the UK economy and the Pound. Under such a scenario we would expect to see a sell-off in Sterling of anywhere between 5-10% from current levels versus the US Dollar.

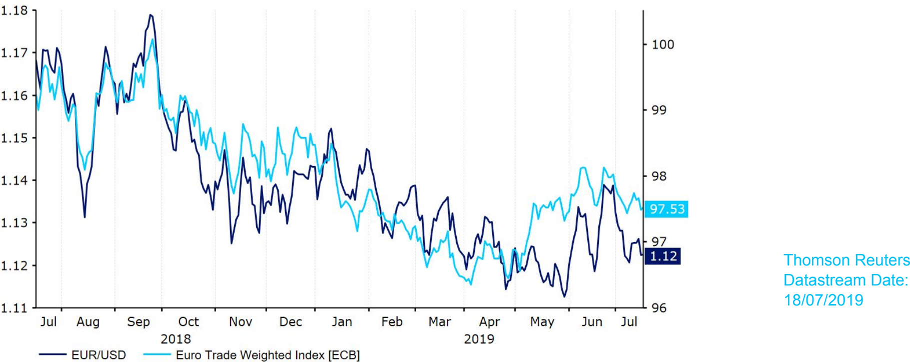
By contrast, any scenario that avoids a 'no deal' would, in our view, send the Pound sharply higher and ensure that Sterling ends the year as one of the best performing currencies in the G10. We do, however, revise lower our GBP forecasts across the board to reflect the delayed timetable for a Brexit agreement.

Euro EUR

> The downward trend witnessed in the Euro at the beginning of the year has recommenced itself since the end of June.

While expectations for Federal Reserve interest rate cuts have increased, the European Central Bank has also continued to strike a dovish tone, with President Mario Draghi suggesting that additional policy easing may be on the cards in the Eurozone at some point later in 2019. ECB dovishness, combined with a string of generally soft domestic economic data, sent EUR/USD back below the 1.12 level in July. The pair is currently trading over 2% lower year-to-date (Figure 9).

Figure 9: EUR/USD (July '18 - July '19)



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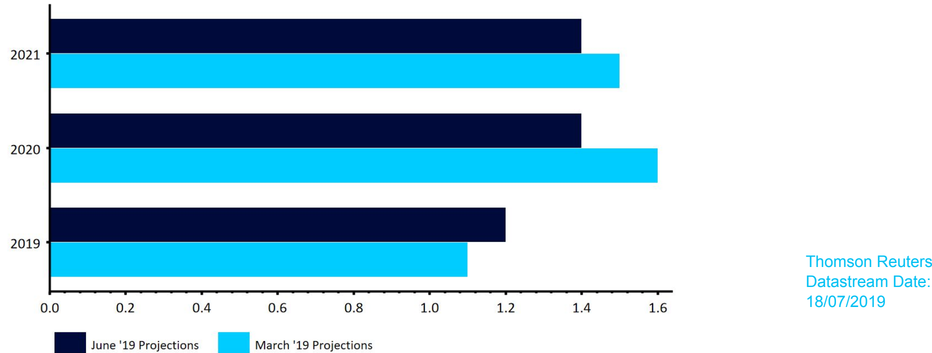
ECB President Mario Draghi caught the market off-guard during his 17th June speech in Sintra, Portugal. Draghi stated that 'lingering' downside risks were strengthening the case for ECB policy action, claiming that 'additional stimulus will be required' should the outlook for the Euro Area economy fail to improve. This policy action may entail interest rate cuts or even a restarting of the bank's quantitative easing (QE) programme. According to Draghi, there remains 'considerable headroom' for more QE and that 'further cuts in policy interest rates and mitigating measures to contain any side effects remain part of our tools'.

Draghi's comments mark a rather drastic dovish shift from the ECB that suggest the central bank is becoming increasingly concerned about global trade uncertainties. Policymakers made little mention to the possibility of additional stimulus at the ECB's most recent monetary policy meeting in June, with Draghi merely noting that 'some' policymakers had raised the possibility of rate cuts and a resumption in QE. The bank retained its forward guidance that the next move in rates would be higher, albeit pushed back its expected timing for policy tightening from the end of 2019 to the second half of 2020. Draghi stated that the threat of protectionism was the key reason for the change.

Figure 10: ECB GDP Growth Forecasts (% YoY) [June 2019]



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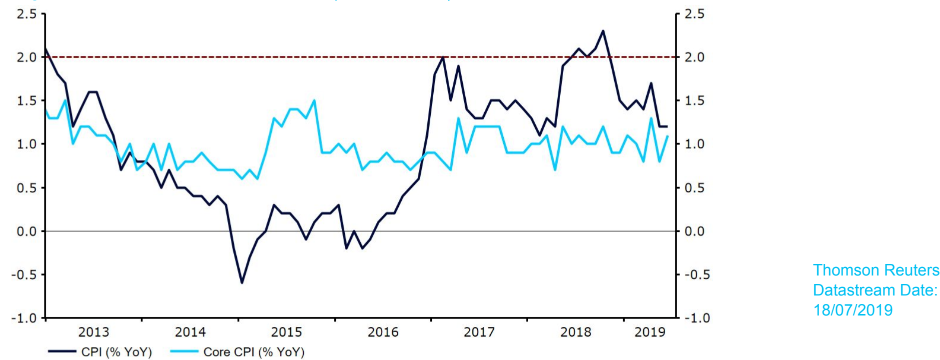
We did get some additional details on the bank's recently announced Targeting Long Term Refinancing Operations (TLTRO) programme at the June meeting. The programme, which will see the bank issue long term loans to European banks commencing in September, will set the interest rate 10 basis points above the average of the ECB's deposit rate over the life of each loan. This is slightly less generous than we had anticipated when the programme was first announced back in March.

Euro EUR

The shift to a more dovish stance from Draghi has followed another period of generally weaker-than-expected economic data out of the Eurozone. We have long reiterated that the ECB will maintain an accommodative policy stance so long as Eurozone inflation remains well short of the central bank's 'close to, but below 2%' target. Headline inflation came in at just 1.3% year-on-year in June, a modest improvement from a month prior when it hit its lowest level since April 2018. The critical core inflation measure, the main economic data print the central bank looks at when deciding on monetary policy, has also remained stuck well short of target, coming in at just 1.1% in June (Figure 11). It has hovered around the 1% mark every month for the past five years and has, as of yet, not shown any signs of an uptrend towards the bank's target. A robust labour market should begin to filter its way to higher inflation, although this has taken much longer than the central bank initially anticipated.

Figure 11: Eurozone Inflation Rate (2013 - 2019)



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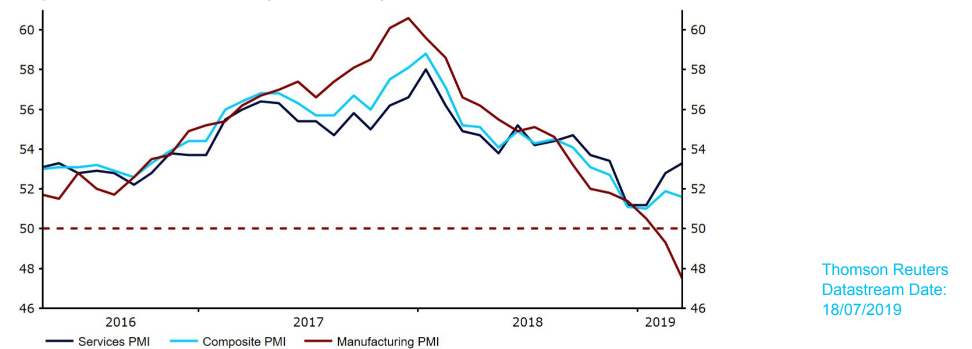
The Eurozone's economy has also slowed in the past year, which has helped increase speculation that ECB rate-setters will consider adopting an even more accommodative policy stance in the coming months. Growth in the first quarter of the year came in at 0.4%, an improvement on the previous two quarters but still a slower pace than the ECB desires. Overall activity in the second quarter of the year is likely to have remained soft, despite the latest PMI data showing tentative signs of an uptrend.

The crucial composite PMI has risen off five-year lows from earlier in the year, driven by a pick up in services (Figure 12). The manufacturing index has been on a sharp downward trajectory ever since the beginning of 2018 and has now been below the level of 50 denoting contraction for five months. Industrial production has also posted positive month-on-month growth on only two occasions since September 2018, although this measure did increase by a solid 0.9% month-on-month in May.

Figure 12: Eurozone PMIs (2016 - 2019)



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Following Mario Draghi's dovish speech in Sintra in June, financial markets are now placing in excess of an 80% implied probability of an interest rate cut from the ECB before the end of the year, a sharp increase on the approximate 20% that it was pricing in back in mid-May. Policymakers in the Eurozone are clearly concerned about growing downside risks to the outlook and the failure of the Euro Area economy to generate inflationary pressure.

While we therefore acknowledge that there is now a decent chance that the ECB follows in the footsteps of its G10 counterparts the RBNZ, RBA and (likely) Federal Reserve in cutting interest rates this year, there remains very limited room for them to do so. Calls for policy action as soon as the July meeting are far too premature, in our view. We instead expect the ECB to hold policy steady and leave the door open to lower rates or a resumption in its asset purchasing programme should economic conditions take another turn for the worse.

Euro EUR

Our view that the bar for Federal Reserve interest rate cuts is much lower than that of the European Central Bank should, we believe, provide decent support for the common currency during the remainder of 2019. We therefore maintain our forecasts for a gradual appreciation in EUR/USD back towards the 1.18 level by the end of next year.

	EUR/USD	EUR/GBP
Q3-2019	1.15	0.91
E-2019	1.15	0.87
Q1-2020	1.16	0.86
Q2-2020	1.16	0.85
E-2020	1.18	0.84

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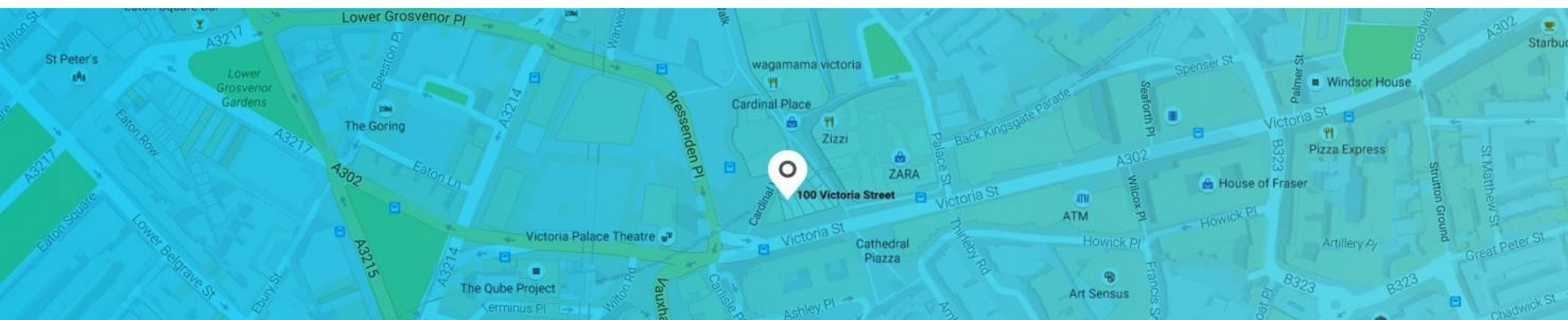

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