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2017

The Year Ahead

Market Outlook 2017: What the IronFX award-winning FX Strategy team expects in the Year Ahead

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Year ahead 2017: Monetary easing to take the sidelines; Fiscal stimulus is knocking at America's door

Market outlook: Themes for 2017

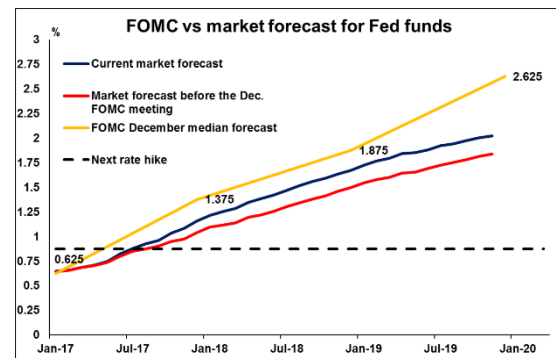
- Monetary stimulus is no longer the only game in town
- Fiscal policy could play a much bigger role, at least in the US
- Higher global yields, but not in Japan
- Political risks in the Eurozone
- "Brexit" to drive sterling
- Yuan may be headed for further depreciation

If there is one single phrase that could characterize 2016, it would probably be *the year of surprises*. The year kicked off with a bang, as concerns over a slowdown in China led to a "risk off" environment, causing global equity markets to tumble and safe havens to thrive. Then in June, UK citizens shocked the globe by deciding to divorce the EU, sending the pound into freefall. The US electorate had the final say though. The election of Donald Trump in early November as the next US President triggered a speculative euphoria among investors that the globe is entering a new era in which the days of low inflation are behind us. Will 2017 be equally exciting? Quite possibly. Looking ahead at it, it seems to be anything but a dull year.

US – Will the Fed dance to Trump's beat?

The election of Donald Trump marked a turning point for the US economy, with the reflation theme dominating market action in recent weeks. Trump's promises for fiscal stimulus were taken seriously by market participants after the election, who began to speculate that such policies will lead to higher inflation in the future. This was evident by the surge in US 5y/5y inflation expectations and US treasury yields. In turn, expectations for accelerating inflation fueled bets that the Fed would have to respond by raising interest rates faster, a factor that has driven the dollar much higher during the last two months of this year.

Even though the overall policy direction of the upcoming administration is somewhat clear, with market participants pricing in greater fiscal stimulus, the exact details of such policies remain largely a mystery. We expect the size, composition, and implementation of the new government's measures to play a major role in determining how quickly the Fed will raise borrowing costs in the coming years, and thereby the forthcoming direction of the dollar. In case everything proceeds according to Trump's pre-election rhetoric and current market expectations, PCE inflation, the Fed's favorite measure of inflation, could quickly rise above the 2% target through a cocktail of increased government spending, lower taxes and higher tariffs on imports. This scenario would imply faster rate hikes than currently projected by the "dot plot" and thus, could keep the upward trend in the dollar intact, perhaps throughout the year.



Having outlined the optimistic scenario, we have to note that we see two major risks surrounding the greenback's performance. The first is a potential market disappointment regarding the size and implementation of Trump's fiscal plans, as well as his ability to push his reforms through Congress. No data or numbers have been formally announced yet, which suggests that investors (and some regulators) are discounting the impact of future fiscal stimulus without knowing how large that package may actually be, or whether it will be fully approved by Congress. In our view, the market may be somewhat too complacent about the possibility of Trump encountering opposition from a Congress that was until recently, conservative on the fiscal side. In fact, the House Republicans' budget for the fiscal year 2017 envisioned a return to a balanced budget in 10 years without raising taxes, which implies that there would have been less, not more, fiscal stimulus in the years to come. To be clear, we are not

saying that Trump won't manage to push a highly expansionary budget through Congress. Our argument is that investors may be underestimating the risk of Republicans opposing huge deficits paid for by an increase in public debt, and that we may end up only with a part of his initial proposal being passed in terms of size. Needless to say, that could very well lead to a sharp correction across the asset classes that have priced in the "Trump effect" following the election outcome, including the dollar.

The second risk relates to the change in voting rights among the FOMC in 2017. The Committee is set to become slightly more dovish next year in our view, as policy hawks such as Loretta Mester and Esther George will lose their privilege to vote. As such, although the "dot plot", which now points to 3 hikes throughout 2017, includes the assessment of both voters and non-voters, a theoretical median "dot" representing only the voters could potentially be lower. Bearing this in mind, we see the risks surrounding the number of hikes that will actually take place in 2017 as skewed to the downside, possibly 2 instead of 3. This view is also supported by market pricing, which at the time of writing indicates roughly 2 hikes in 2017 according to the Fed funds futures.

Eurozone – Political risks and ECB policy to dominate the euro

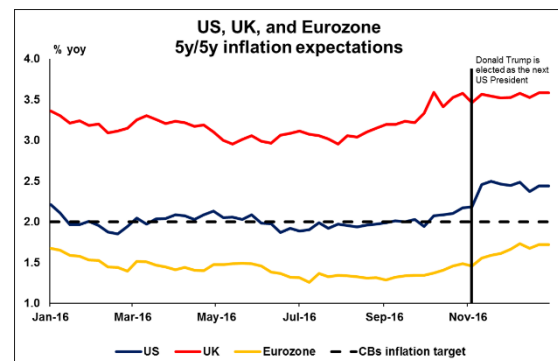
Turning to the Euro area, 2017 should be anything but monotonous for the bloc and euro traders. Political risks in terms of elections in the Netherlands, France and Germany, as well as the triggering of Article 50 by the UK will likely provide ample headlines to drive the common currency.

Out of the elections, news headlines have focused more on France. The battle will be fought between the Republican candidate Francois Fillon, a former Prime Minister, and the leader of the far-right National Front party, Marine Le Pen. The risk here, at least as far as financial markets are concerned, is the possibility of Le Pen being elected, mainly due to her Eurosceptic views and the fact that she wants to hold a "Frexit" referendum. Thus, the prospect of her being elected as French President represents an existential threat for the European Union, one much greater than "Brexit" in our view, considering that France was among the founding members of the Union and is also a member of the Eurozone. Without trying to predict how French citizens will finally vote, we expect the period ahead of the actual election to be marked by heightened uncertainty, which may weigh on the euro in the first half of 2017 as investors price in increased risk of European disintegration.

The other big force behind the euro's direction in the upcoming year will probably be ECB policy. At its December policy meeting, the Bank extended the minimum duration of its QE program by 9 months to December 2017, though at a reduced pace of EUR 60bn per month from EUR 80bn previously. Even though this was initially interpreted as QE tapering, President Draghi quickly reassured market participants that this is not tapering, but simply a "less for longer" decision. What's more, the Governing Council indicated that it's willing to increase the program in terms of size and/or duration if the outlook becomes less favorable, diminishing even further the likelihood that the ECB will taper its asset purchases anytime soon.

Bearing in mind the Bank's dovish stance and that the Fed looks ready to continue hiking in 2017, we believe that the dynamics of monetary policy divergence combined with Eurozone's political risks could continue pushing EUR/USD south, and we may eventually see the rate hitting parity. However, we would need to see something larger coming into play for a clear break below that psychological area to take place in our view.

Having said all these, the main risk to our view would be a sharp pick-up in Eurozone inflationary pressures during the second half of the year, leading investors to speculate whether "ECB tapering" will be the next big theme in the market. Indeed, the bloc's 5y/5y inflation expectations have already surged in recent months and now lie close to the Bank's target of "close, but below 2%". This could be a first sign that Euro area's inflation is set to accelerate in the coming years. However, given that the respective US and UK 5y/5y inflation expectations stand well above the 2% mark, we believe that the ECB's policy will probably remain



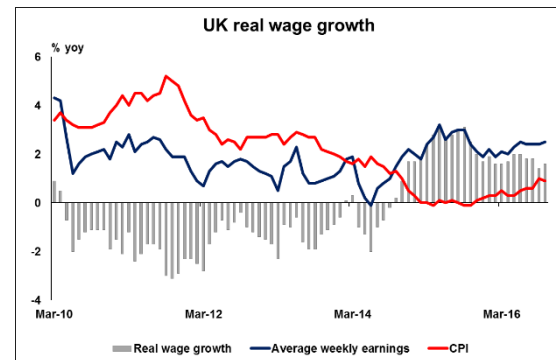
looser than the Fed's and the BoE's, which makes it unlikely for the common currency to notably outperform the dollar and pound in case the aforementioned risk materializes.

UK – “Brexit”: Let the games begin

The “Brexit” story and accelerating UK inflation are likely to be the key themes for sterling traders in the upcoming year. Theresa May's government has signaled that the formal process of leaving the European Union will be triggered no later than March 2017. The real question here will be whether the subsequent negotiations are seen as delivering a ‘soft’ or ‘hard’ “Brexit” for the UK, with the former defined as retaining full, or close to full, access to the single EU market and the latter implying only a partial, or no access. Once the negotiations begin, signs of full access are likely to prove positive for sterling, while the opposite is probably true for the pound in case the writing on the wall spells “hard Brexit”.

In this regard, the Supreme Court's decision early in 2017 on whether Parliament should have a say in triggering Article 50, could determine sterling's near-term direction prior to March. Parliament is considered to favor a “soft Brexit” overall. Thus, if Parliament gets a role in this political divorce, the depreciation pressure on GBP could ease heading into the actual negotiations.

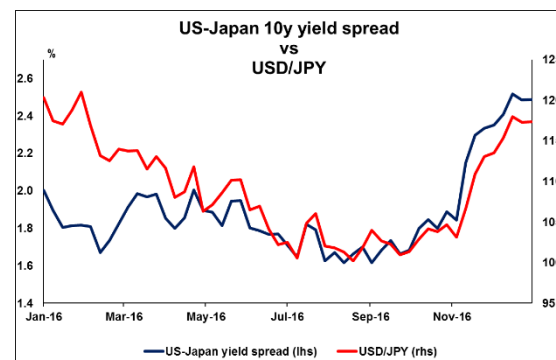
As far as the inflation story goes, the magnitude of the acceleration in the CPI due to the collapse in GBP will be closely watched for a variety of factors. Firstly, a strong case can be made that consumers' real income growth is likely to be squeezed by rapidly rising inflation. In the minutes of its December meeting, the BoE expected CPI inflation to rise to the 2% target within six months, and to overshoot the target later in 2017. This suggests that higher inflation may begin to affect the pace in which real incomes are rising, something that the Bank acknowledged in its December meeting minutes. Not only does rising inflation suggest slower increases in real incomes for consumers, it may also have significant impact on the BoE's rate path. The Bank has signaled multiple times that there are limits to the extent that above-target inflation can be tolerated, implying that excessive overshooting of the 2% target may force the Bank to tighten policy in order to curb inflation.



On balance, we believe that the risks surrounding sterling's path in the coming year are skewed to the downside. However, we remain skeptical as to how much lower sterling can fall, considering that much of the “hard Brexit” story may already be priced into the battered pound.

Japan – Will a weaker yen keep the BoJ on hold?

The BoJ received a wonderful present to end 2016; a considerably weaker yen. Following the introduction of QQE with yield curve control in September, the Bank vowed to keep yields on longer-dated JGBs at 0%. Subsequently after the US election, the rise in global yields combined with the BoJ yield control strategy, led to a notable depreciation in JPY across the board. By essentially placing a ceiling on Japanese yields in an environment where foreign yields are rising, the BoJ widens the spread between JGB yields and other G10 yields, thereby making the yen less attractive to hold. A weaker yen in turn, makes the Bank's job of returning inflation to target easier, as it could raise the cost of imported products and thereby the nation's general price level.



Bearing in mind the weaker currency and signs of improvement in the economic data, we believe that the days of big monetary policy surprises by the BoJ may have passed. We see the case for little or no action by the Bank in the upcoming year. The argument that the bar for further easing is high is enhanced by the fact that the BoJ may be running out of policy bullets and thus, may prefer to save as much ammunition as it can in case of unforeseen shocks.

Thus the question becomes: What does a passive BoJ imply for the yen moving forward? As we noted above, the recent rise in global yields has caused JPY to be the biggest underperformer among the G10 currencies against the dollar. As such, we believe that as long as we remain in an environment of rising global yields, while BoJ keeps its yield-control strategy intact, the yen is likely to continue to underperform the dollar as the yield differential between US and Japanese bonds continues to widen.

The risk to our outlook is the yen's status as a "safe haven" currency. Depending on how the risk events of the year play out, like the aforementioned elections in the EU and the "Brexit" negotiation, JPY may occasionally receive safe haven flows, which could dampen some of the depreciation pressure on the currency. This scenario may be especially true if investors also begin to focus again on the risks surrounding the Chinese economy, its high debt levels, and the possibility for further yuan depreciation.

China – Risks for further currency depreciation

Accelerated capital outflows have been the main story in China following the US election outcome. In our view, this acceleration has been fueled, at least in part, by expectations that the Chinese currency will depreciate further against its US counterpart under the Trump administration. Such expectations may have prompted investors to convert their yuan holdings into foreign assets as soon as possible, thereby exerting downward pressure on the yuan well ahead of Trump's inauguration.



One may argue that a weaker currency is a good thing for China, as it would make exports even more competitive. However, a rapid depreciation poses risks to financial stability, and makes the economy's transition towards a consumer-based structure even harder, as imports become more expensive. Thus, the Chinese authorities have sought to offset some of the depreciation pressure by using an increasing amount of foreign reserves in order to buy the local currency.

The problem with this approach is that it's not sustainable in the longer-term, as reserves will eventually run out. Another way to curb currency depreciation would be a tightening in monetary conditions that make the yuan more attractive to hold, but that method would risk slowing down the economy even further. Having said all these, we believe that the most likely outcome for 2017 is a gradual depreciation of the yuan, guided by the PBoC.

A gradually weaker yuan though, would raise the cost of imported products and raw materials to China. Something like that could weigh on the demand for many imported commodities, and in turn may adversely impact the currencies of nations that rely heavily on China for their exports, such as the AUD and NZD.

AUD – RBA: Neutral stance, but further easing remains on the table

The RBA maintained an overall neutral stance at its recent meetings in 2016, having cut rates twice earlier in the year. In the minutes of the December policy meeting, the Bank indicated that there's still considerable uncertainty in the jobs market, and that spare capacity is likely to keep inflation low for some time. Even though these comments would likely be seen as dovish, the officials also noted that further rate cuts could prove a risk to financial stability. Given this balanced tone, we believe that the Bank may keep its policy steady in the foreseeable future, though the risks to that forecast are clearly tilted to the downside.

A contraction in Q3 GDP, continued low inflation, and the risk of reduced commodity demand from China, are all factors that could provoke further action by the RBA, in our view. Bearing these in mind, and the ongoing risk of the nation losing its AAA rating, we believe that the Aussie may be the biggest underperformer among the G10 commodity currencies in 2017.

NZD – RBNZ may be done with rate cuts for a while

In a speech early December, RBNZ Governor Wheeler indicated that the key interest rate is likely to remain at current levels for some time, striking a balance between the factors that could lead to more rate cuts and the financial stability risks further easing could imply. Having cut rates three times in 2016, and with 2-year inflation expectations having stabilized after a surprise tumble in Q1, we share the view that the RBNZ is probably done easing, at least for a while. In addition, if one overlooks low inflation, New Zealand's fundamentals are remarkably strong, with robust GDP growth, an ever-improving labor market, and higher dairy prices in recent months.

Given these optimistic considerations, and bearing in mind the above-mentioned risks emanating from China, we hold a fairly neutral view regarding the Kiwi's performance in the coming year. Given that expectations for higher US rates may continue to support the dollar, we would expect NZD to underperform USD overall. However, given our view for a softer Aussie, we believe that AUD/NZD may be the ideal proxy to capture any potential Kiwi gains. Given that Australia's trade exposure to China as a share of exports is much larger than New Zealand's, the Aussie would probably be affected to a greater extent than the Kiwi in case such China risks materialize.

CAD – Lackluster economic data, though the bar for further BoC easing is high

The Canadian economy had an unfortunate year in 2016, to say the least. The year kicked off with oil prices plunging, which adversely impacts the Canadian economy as oil is by far the nation's biggest export. Then, the Alberta wildfires led to a decline in GDP for Q2. Nonetheless, the Bank of Canada held its easing powder dry on both occasions, proving that the hurdle for further easing is quite high.

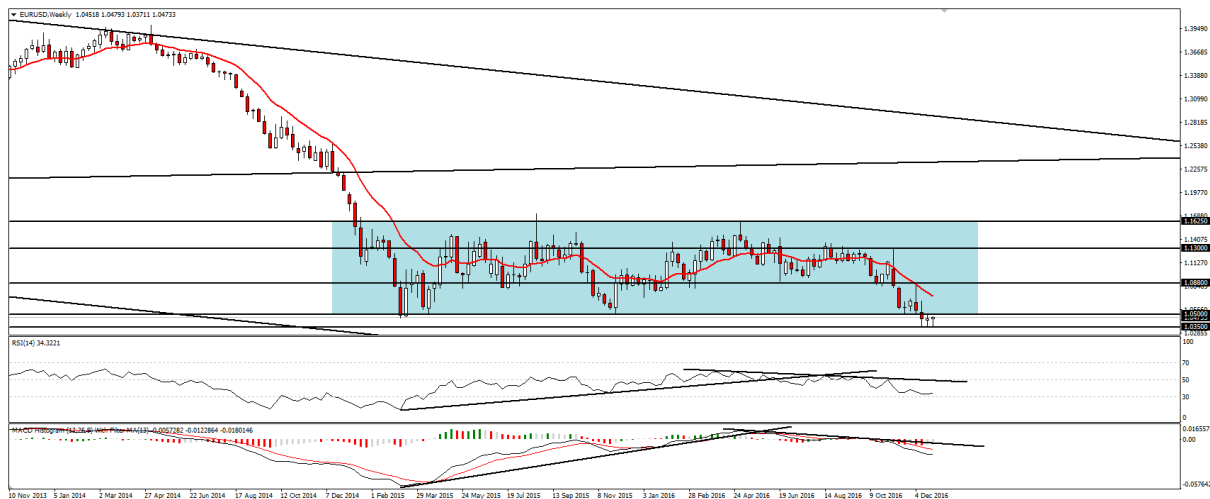
The situation has not improved that much heading into 2017. Yes, oil prices have risen notably on the back of the OPEC and non-OPEC agreement to cut production. However, whether the deal will be properly implemented and whether the member countries will abide by their quotas remains to be seen. For now, sentiment around the energy market remains elevated. On the other hand, the nation's CPI rate remains below the 2% target and as the BoC noted in its December statement, a significant amount of economic slack remains in Canada. Bearing these in mind, our base-case scenario is for the BoC to remain on hold throughout 2017 absent an economic shock, something Governor Poloz recently confirmed.

Assuming that oil prices remain relatively unchanged from current levels, and given our expectations for a neutral BoC, we believe that the path of least resistance for the Loonie may be to the upside in 2017. This view is enhanced by the fact that Canada has a huge trade exposure to the US economy, which is expected to accelerate in the coming year due to massive fiscal spending. Such an improvement in Canada's largest trading partner could lead to higher demand for Canadian exports and thus, may have beneficial spillover effects for the Loonie as well. However, considering the rising US bond yields and the remarkable dollar rally, we would avoid USD/CAD as a proxy for any potential strengthening of CAD. Instead, we prefer to call for CAD gains against the vulnerable JPY and EUR.

Technical outlook

EUR/USD

Weekly chart



EUR/USD has been trading in a sideways range between 1.0500 and 1.1625 since the beginning of 2015. During 2016, the rate remained stuck within that range, but following the December ECB meeting, the bears managed to push the rate through the key floor of 1.0500, signaling the downside exit of the aforementioned longer term range. The decline was short-lived though, with the bears stopping at around 1.0350.

In our view, the dip below 1.0500 turned the longer-term picture back to the downside and as such, we would expect a decisive close below 1.0350 to open the way for our next support territory of 1.0200, defined by the low of the 22nd of December 2002 and the inside swing high of the 10th of November 2002. Another break below that support could increase significantly the probability for reaching parity. In case we were to see a breach of that key psychological level, we believe that the next support area stands at 0.9850.

Shifting our attention to our weekly momentum indicators, we see that the 14-week RSI slid after it hit resistance near its 50 line and now stands slightly above its 30 line, while the weekly MACD lies below both its zero and trigger lines. These oscillators confirm the recent negative momentum and amplify the case that we are likely to experience further bearish extensions in the foreseeable future. Nevertheless, bearing in mind that the RSI appears ready to bottom near its 30 line, and that the MACD shows signs that it could turn up as well, we would stay mindful that a corrective rebound maybe on the cards before the bears decide to seize control again. A clear close back above the 1.0500 zone may confirm the case for such a retracement, and could carry extensions towards the 1.0880 resistance territory.

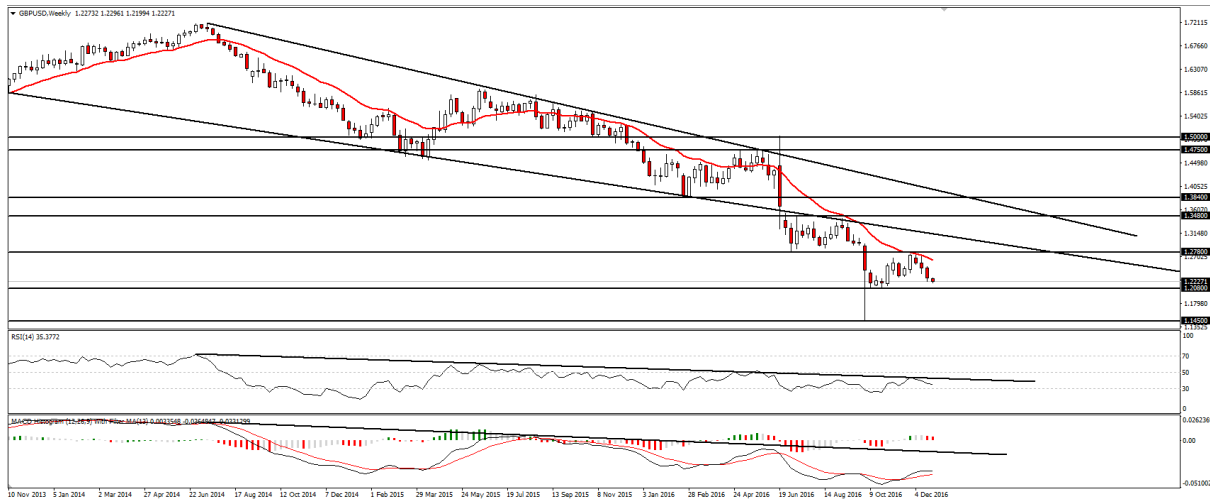
Monthly chart



Switching to the monthly chart, we see that in December 2014, the pair exited to the downside a huge triangle that had been containing the price action since 2006. Therefore, we believe that the major outlook of EUR/USD is negative, and that the last two year's sideways range was just a pause of a broader downtrend. With no evidence that the downtrend can be halted, we expect it to continue, at least in the first months of the New Year.

GBP/USD

Weekly chart



The pound was the G10 currency that suffered the most against the greenback in 2016, weighed on by the “Brexit” referendum and the subsequent uncertainty and headlines surrounding the outcome. However, the overall trend had been negative well ahead of the vote. On the weekly chart, the pair has been printing lower peaks and lower troughs below a downtrend line since July 2014. The referendum outcome helped the trend to accelerate and pushed the rate below the downside support line taken from back at the lows of November 2013.

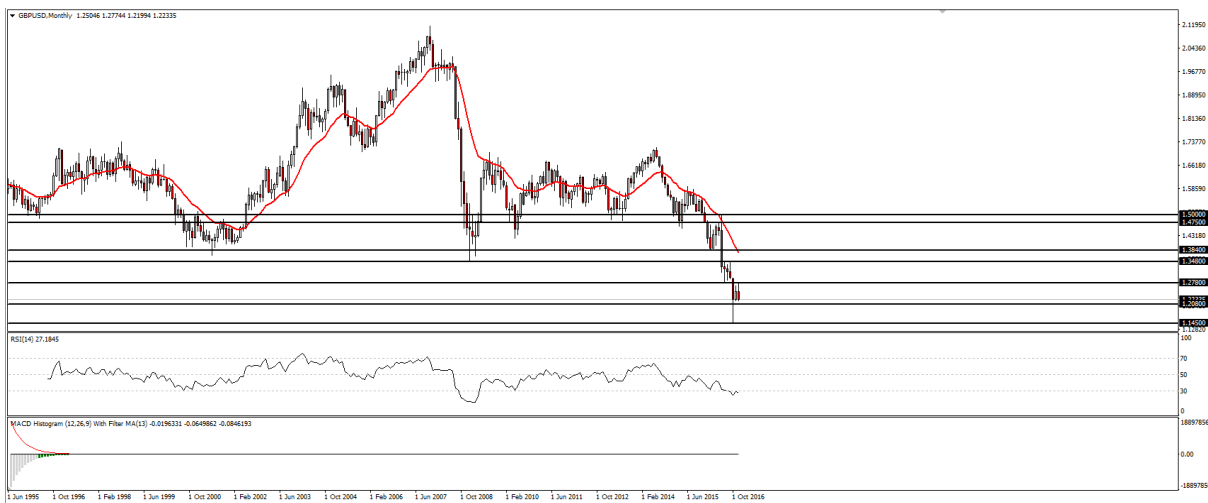
What's more, the 18-week moving average has started to follow the price action pretty well again. It provided good resistance in April and in early December. That moving average was proven as a solid

curving trend line during the July 2013 – July 2014 uptrend and capped the price action during the July 2014 - April 2015 down road.

The downtrend appears intact in our view and hence we expect the bears to remain in the driver's seat, and aim for another leg south. If they are strong enough to push GBP/USD below 1.2080, we would expect them to target once again the 1.1450 territory, defined by the collapse on the 2nd of October.

Our weekly oscillators detect negative momentum and corroborate our view that the rate is likely to take another hit in the foreseeable future. The 14-week RSI, already below 50, hit its downside resistance line and slid, while the weekly MACD, although above its trigger line, remains within its negative territory and appears ready to turn down again.

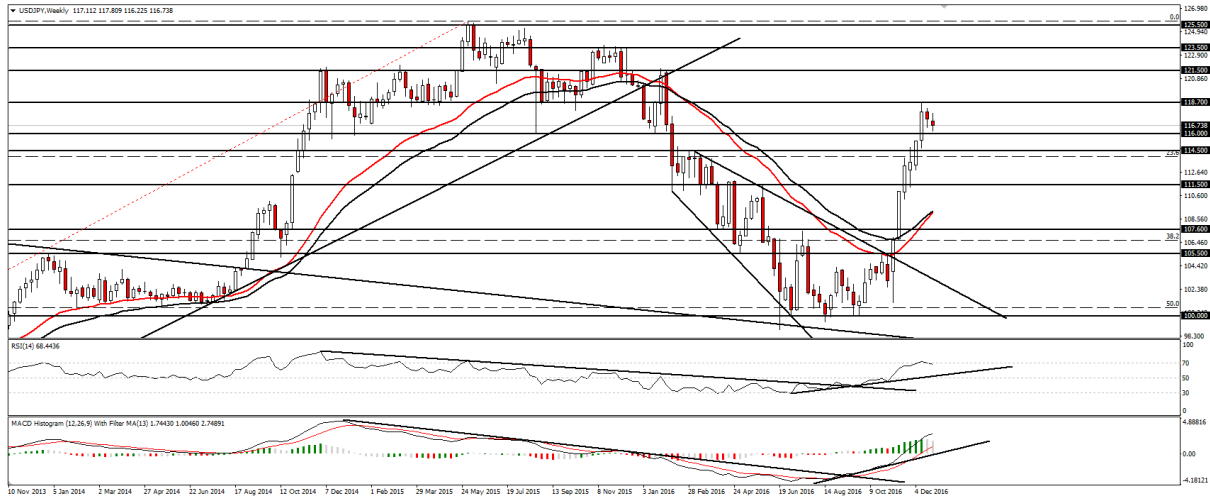
Monthly chart



Changing the timeframe to the monthly chart, we see that following the EU membership referendum, market participants drove the action below the 1.3480 support (now marked as a resistance) area, defined by the low of January 2009, and traded in levels last seen in June 1985. This confirms the overall negative sentiment towards this pair and adds to our view for another try lower. We would treat any near-term recoveries that stay limited below the aforementioned hurdle as a retracement of Cable's major down path.

USD/JPY

Weekly chart

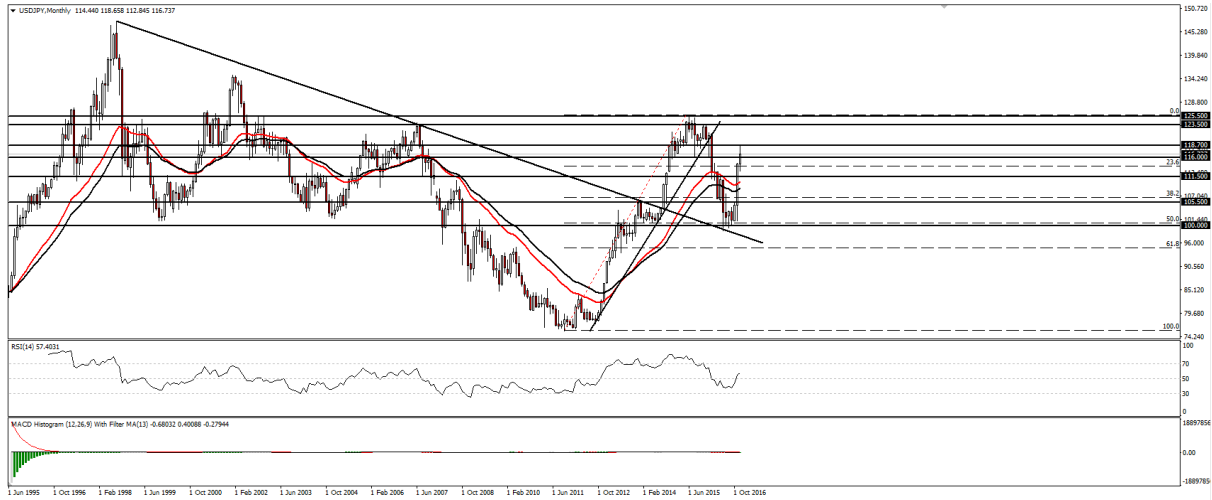


At the beginning of 2016, USD/JPY fell below the 116.00 territory, signaling a medium-term trend reversal that was eventually stopped near the psychological barrier of 100.00, which happens to stand slightly below the 50% retracement level of the prior larger uptrend, from October 2011 until June 2015.

After several tests near the 100.00 mark and following the US election outcome, the pair surged and emerged above the 115.50 barrier and the downside resistance line taken from the peak of March 2016. This has turned the bias back to the upside. The subsequent surge appeared unstoppable, until the rate hit resistance at 118.70 before retreating somewhat to hit support near the 116.00 barrier. We believe that the latest setback is just a corrective phase of the prevailing uptrend and that the bulls will take charge again at some point and push the rate higher. A decisive close above 118.70, would confirm a higher high on the weekly chart and is possible to see scope for extensions towards the 121.50 area, defined by January's peaks. Another break above that resistance could target the next one at 123.50. The following resistance zone is near the 125.50 level, defined by the peaks of May and August 2015.

Nevertheless, although both our weekly oscillators stand within their positive territories, the 14-week RSI turned down after it hit resistance slightly above its 70 line, while the weekly MACD shows signs that it could start topping. These indicators make us believe that the current retreat may continue for a while before we experience the next wave higher. A dip below 116.00 could confirm the case and is possible to target our next support of 114.50.

Monthly chart



Zooming out to the monthly chart, we see that the rebound from near 100.00 coincided with the test as a support of the prior downside resistance line drawn from back at the peak of August 1998. On this chart, it is also clearer that the rebound happened near the 50% retracement level of the October 2011-June 2015 uptrend. All these add to our view that the outlook of USD/JPY is back positive and that we are likely to see further upside as 2017 gets underway.



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