# Key themes at play

Policy divergence, volatility, super taper tantrums and moves in commodities are likely to shape FX markets in the short-to-medium term

**By Bernard Aw**

THE dominance of the US dollar (USD) continues to sweep through the global financial markets. The far-reaching impact of the USD on financial assets makes the relentless uptrend a compelling play. We will continue to see the dollar theme underpinning the foreign exchange (FX) space in the near future.

The greenback has surged 25 per cent since June 2014 which naturally begets the question: Will the USD strengthen further?

Market view on the timing of the Federal Reserve's (Fed) first rate hike since 2006 is the key cause of the dollar strengthening. As expectations gain momentum with Fed rhetoric closely scrutinised, the USD rises in tandem.

In economic theory, a higher interest rate is positive for the local currency because it increases the allure of the country's financial assets from a yield-seeking standpoint. This pushes up demand for the local currency, although it may not always hold true. The highly anticipated interest rate increase is all the more distinctive in the current global environment of loose monetary policies.

However, recent weak US data have pushed back expectations of a Fed rate hike. It looks increasingly likely that any normalisation will occur in September at the earliest. The Fed is concerned that a premature rate hike would adversely impact the US economic recovery, while clearly being reluctant to commit to a specific timeline. They stressed that any liftoff rate move will be data-dependent. In other words, stronger signs of an improving US economy will solidify the hawkish bias.

Ironically, the dollar's strength may not be favourable to the US economy. Rising USD is eroding the export competitiveness of US goods and affecting corporate earnings, particularly American companies that derive a significant amount of their revenue from outside the US. In other words, this could have a dampening effect on the US economy. In addition, a rising greenback poses heightened default risks to countries that borrowed substantial amounts of USD-denominated debt. On a positive note, while US multinational corporations (MNCs) are feeling the pinch on profits due to a strong dollar, foreign companies are benefiting from a weaker local exchange rate after converting revenue repatriated from overseas operations into domestic currency.

We now look at four themes that are likely to shape the FX markets in the short-to-medium term: policy divergence, increase in volatility, super taper tantrums and moves in commodities.

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## Policy divergence

After an extended period of harmonious monetary policies, the Fed is going solo. Exiting its third massive quantitative easing (QE3) programme was the prelude to normalising interest rates. In contrast, the European Central Bank (ECB) and the Bank of Japan (BOJ) embarked on their versions of monetary pump-priming. This policy divergence exposes the variance in economic performance.

The US economy has been registering firm growth and consistent job gains, but a weak wage growth raises some concerns. In the meantime, a weaker euro, cheaper oil prices, the ECB's massive 60 billion euro (S$89 billion) a month bond-buying programme, and improving business confidence have contributed to the eurozone's recovery, although still fairly modest. While Japan's economy emerges slowly (but surely) from recession, it is still struggling to pick up momentum.

## Increase in volatility

Market volatility looks set to increase given policy uncertainty and geopolitical developments. At the heart of this uncertainty is the policy action of central banks. In the "dovish" contingent, we have the People's Bank of China, BOJ and ECB considering more easing options to spur inflation and shore up their economies should they fall short of targets. In the "hawkish" group, the Fed seems to be staying its hand on raising interest rates as the recent spate of soft US economic data weakens the policymakers' resolve. The market will be attuned to every official comment and data point coming out of these economies and react accordingly. This adds considerable upside risks to volatility across markets.

## Super taper tantrums

It is apparent from the experience in 2013 that once the Fed "genie" is out, it is difficult to put it back in the bottle. The International Monetary Fund highlighted possible "super taper tantrums" in April, which suggested that we could see a rerun of the wild swings seen in mid-2013 when the markets raised concerns that the US economy would not be able to handle the end of its QE programme. In turn, US 10-year Treasury yields climbed from 1.6 per cent to 3.0 per cent in 87 sessions. The "super taper tantrums" notion was subsequently rejected by Fed president Dennis Lockhart, who emphasised that any rate hike will be gradual.

## Moves in commodities

The global disinflation phenomenon was due to the collapse in oil prices earlier. Recent signs of stabilisation in crude prices may affect inflation expectations going forward. Recovery in commodities will raise inflationary pressure. If Japan starts to see inflation heading higher, we could see emerging talks of an end to the BOJ monetary easing programme.

## USD is still king

As we head into the second half of 2015, the USD looks to retain its vigour. This is primarily driven by improving signs of economic recovery in the US, by extension, and a clearer picture of the timing of a Fed rate increase. Subsequently, discussions on the pace of rate normalisation will gain more airtime. While reassuring communique from the Fed may mitigate markets' speculation, it may not prevent overreaction when interest rates start climbing.

The strong USD theme will see the euro remain under pressure. The "Grexit" possibility will also weigh on the single unit currency. As the deadlock in Greece's bailout negotiations drags on, would we see them closer to an exit from the European Monetary Union? At the same time, the Japanese yen is expected to weaken further, particularly if the BOJ decides to expand its monetary stimulus programme. On the other hand, the pound sterling (GBP) could receive more support from the Bank of England's shift to a somewhat hawkish bias. Attention to how the GBP moves post-election is warranted.

As always the case in trading, market sentiment plays a prominent role apart from fundamental factors. It is essential that traders are cognisant of the underlying themes surrounding the FX markets to get a better grip on potential market reaction.

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