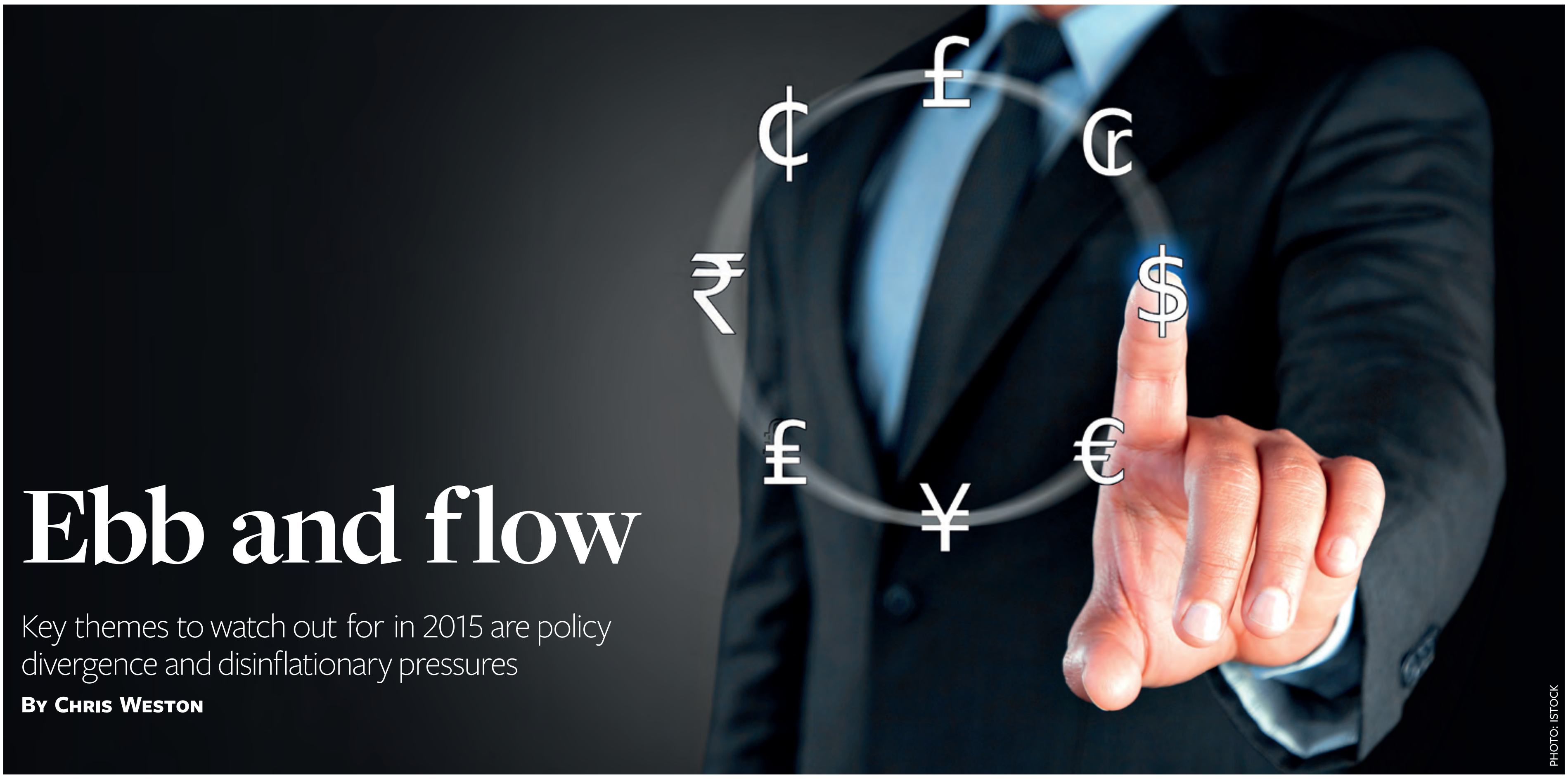

PHOTO: ISTOCK

Ebb and flow

Key themes to watch out for in 2015 are policy divergence and disinflationary pressures

BY CHRIS WESTON

POLICY divergence and disinflationary pressures will be among the key themes to watch out for in the year ahead for currency investors.

On the central banks' divergence front, the US Federal Reserve is expected to hike interest rates later this year, which will be its first time since 2006. On the other hand, the European Central Bank (ECB), Bank of Japan (BOJ), and People's Bank of China will continue on a path of further policy easing.

The other main event, disinflationary pressures, will likely be driven by sliding commodity prices and softer global growth, particularly in the eurozone, Japan and China. Coupled with a stronger greenback, the disinflationary path will be negative for commodity currencies in 2015.

US rate hikes

Ultimately, we should see the greenback strengthen further against most currencies from the impending rate hikes, which will also prompt some volatility and local investment opportunities.

For a preview of what might come, we can rewind to May 2013, when then-Fed chairman Ben Bernanke indicated the US might begin tapering its special asset purchases. That triggered capital outflows from emerging markets, especially in economies with large current-account deficits. Among those hardest hit then were India, Indonesia, Brazil, South Africa and Turkey; all saw their currencies depreciate by over 10 per cent within six months.

This time, the prospect of higher yielding assets in the US could again trigger a similar scenario, as investors shift their assets out of emerging markets.

Disinflationary pressures and commodity effect

The US dollar (USD) was, to little surprise, the top performing currency of 2014. It gained about 13 per cent over the year against the world's major currencies, based on Bloomberg data. The recent dollar rally has also resulted in lower-priced commodities such as oil. While that is great news for consumers and businesses in general, it is bad news for oil exporting countries.

The oil price slide has weighed on currencies of net exporters such as Malaysia, Russia and Norway. During 2014, the ringgit lost nearly 7 per cent, the rouble dropped by over 43 per cent, while the krone fell by nearly 18 per cent. This theme is likely to continue into 2015, as there are no significant changes in demand and supply fundamentals in sight yet.

US dollar

Most indicators point towards a bullish year for the greenback, particularly with policy divergence a key driver. With the ECB launching its own quantitative easing (QE) and Japan mulling over more stimulus measures, USD is set to gain the most against these currencies in 2015.

The greenback is likely to be supported as the Fed gears up for its first rate hike. Expectations are high that this could happen as soon as mid-2015. With the market slowly pricing this ahead of the event, the hike could end up being a "buy the rumour, sell the news" play.

Risks that could hold back gains in the USD include the slowdown in China's economy, which threatens to undermine the US economic growth. This could persuade the Fed to push back its rate hike schedule until the economy gets on more stable footing.

Euro

Bearish sentiment over the bloc's common currency has been building up with further signs of the eurozone's growth momentum waning as well as mounting concerns over geopolitical risks.

PMI (Purchasing Managers' Index) numbers for manufacturing and services have both been slipping in recent months. Disinflation also remains a worry with recent inflation figures hovering under 0.5 per cent, which is still far below the ECB's target of just under 2 per cent.

These soft macroeconomic data points raise expectations of further stimulus measures. As the ECB is rolling out QE this year by buying government bonds, further weakness in the euro (EUR) is likely. Considering the various indicators suggesting structural decline in the eurozone's economy, there may be significant downside for EUR/USD in the year ahead.

Japanese yen

In the closing months of 2014, the BOJ further loosened its monetary policy in line with its aim of achieving 2 per cent inflation. Last October, the central bank's aggressive easing measures saw it expand its quantitative and qualitative easing (QQE) programme. To enlarge the country's monetary base, the BOJ hiked the pace of annual asset purchases to 80 trillion yen (S$901.35 billion) from between 60 and 70 trillion yen. This was followed by news that Japan's US$1.3 trillion Government Pension Investment Fund would dramatically shift its portfolio to riskier assets, by buying more local and foreign stocks. Outflows from the pension fund could further weaken the currency.

Overall, the quantitative easing will help boost domestic liquidity, keep interest rates low, and raise the yen's (JPY) attractiveness as a funding currency. With US rates set to rise, further upside momentum for USD/JPY is likely. With Japan similarly struggling with its inflation target, further monetary easing to stave off deflation forces can be expected this year.

Australian dollar

The Australian dollar (AUD) has been under pressure on multiple fronts, particularly with the weak demand outlook and sliding commodities prices. For example, iron ore which makes up around 20 per cent of Australia's exports, ended 2014 by losing nearly half its value with prices pushing five-year lows.

The Reserve Bank of Australia (RBA) has expressed its concern that the currency is overvalued, and would be keen on a lower exchange rate to give some relief for the country's exporters. Until commodity prices turn around significantly, we are likely to see the RBA favouring a weaker AUD.

Singapore dollar

The Monetary Authority of Singapore is likely to stick to its stance to appreciate the local currency's (SGD) nominal effective exchange rate (NEER) at a "modest and gradual" pace. Hurdles to a change in policy direction remain high with risks now finely balanced between growth and inflation. We would likely need one side of the equation to pose a significantly bigger problem to spark any policy changes.

USD/SGD hit a three-year high of 1.32 in December, following the BOJ's surprise QQE2 move last October. The sharply weaker yen lifted the USD significantly against SGD NEER's basket of currencies. With the increasing correlation between USD/SGD and USD/JPY, we could see further weakness ahead for the Singapore dollar as it tracks the yen's fall.

Other downside risks for SGD include slowing growth in the global economy, particularly China, which could weigh on the local economy.

Chris Weston is Chief Market Strategist, IG