# Turbulence ahead

2016's political storm clouds will impact emerging markets and the eurozone in 2017

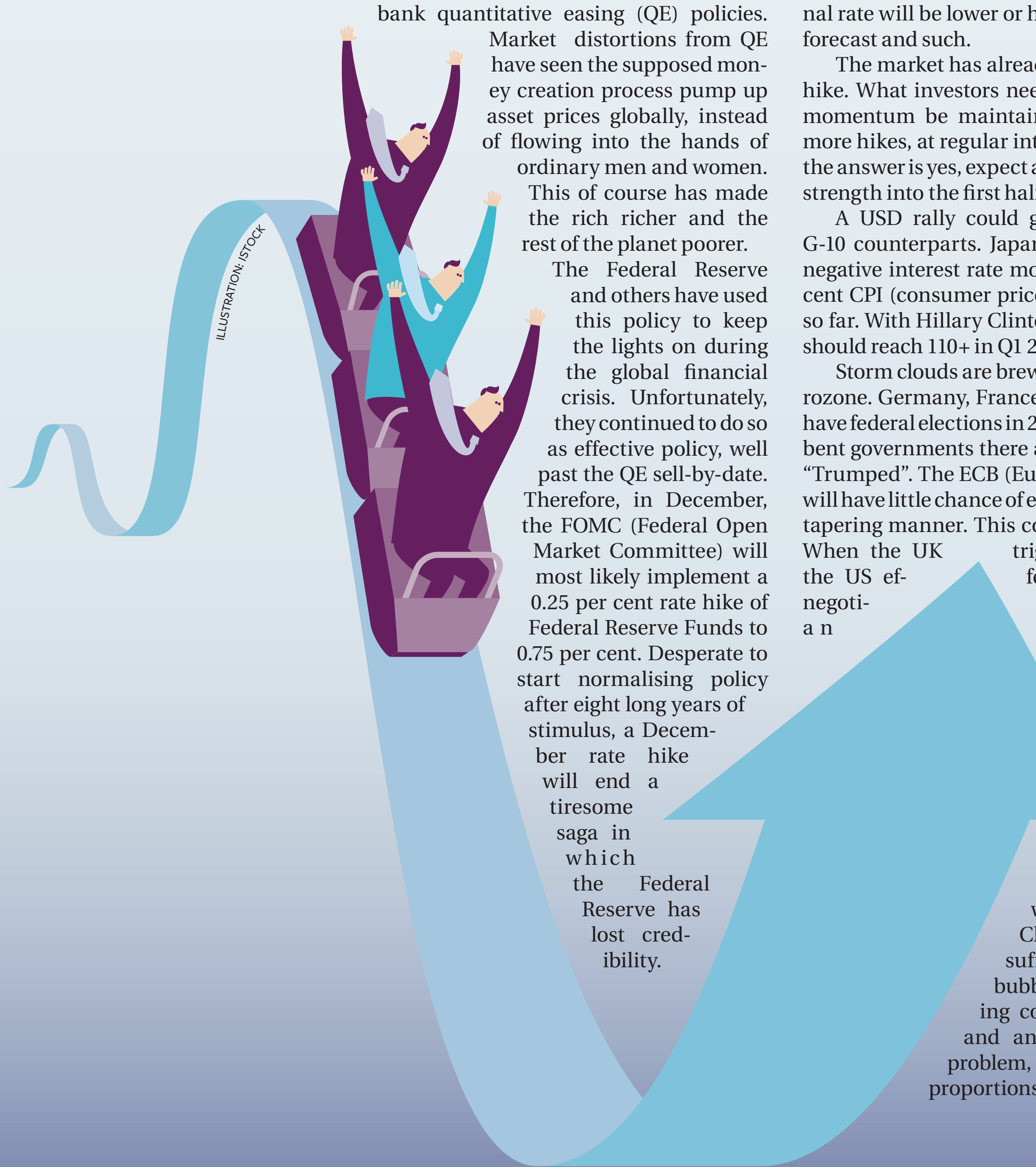
**By Jeffrey Halley**

THE protest vote against political elites, globalisation, income disparity, economic exclusion and falling living standards of the middle classes in the developed world has made its voice heard in no uncertain terms. The election of Donald Trump followed on the heels of a shock Brexit vote in July. Although Mr Trump does not pick up the keys to the White House until Jan 20, his fiscal supply side economic policies have given US yields and the US dollar (USD) a giant adrenalin infusion.

Mr Trump's relations with the Republican Houses of Congress are yet to be clarified and no doubt he will have a clearer path to enact policy than President Barack Obama ever had. What is for certain is that the US will now hit the pause button on globalisation. When they hit play again, the rules of engagement going forward will be very different, which could have negative connotations for emerging markets and Asia in particular.

The origins of this massive anti-establishment movement can be traced back to central bank quantitative easing (QE) policies. Market distortions from QE have seen the supposed money creation process pump up asset prices globally, instead of flowing into the hands of ordinary men and women. This of course has made the rich richer and the rest of the planet poorer.

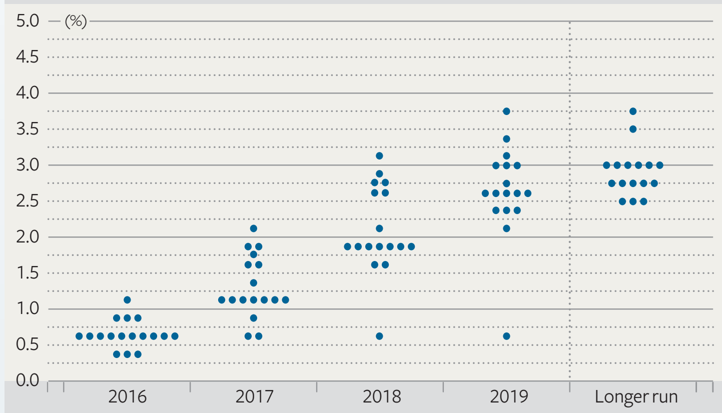
The Federal Reserve and others have used this policy to keep the lights on during the global financial crisis. Unfortunately, they continued to do so as effective policy, well past the QE sell-by-date. Therefore, in December, the FOMC (Federal Open Market Committee) will most likely implement a 0.25 per cent rate hike of Federal Reserve Funds to 0.75 per cent. Desperate to start normalising policy after eight long years of stimulus, a December rate hike will end a tiresome saga in which the Federal Reserve has lost credibility.




In anticipation of the rate hike, the market has been rotating into USD for some time. Globally, bond yields have also firmed after a negative interest rate frenzy this year. Most of the rest of the world is still solidly on an easing path, so the USD should continue to strengthen across the board.

The caveat, and it is a big one, is the Federal Reserve Governors "dot plots".

FOMC dot plot on interest rate projections




Source: FOMC

A dot plot is published after the Fed meeting and shows the projections of the 16 FOMC members' views of where the average rate of Fed Funds will be at the end of each calendar year from 2016 to 2019 and then beyond. A dot plot is important because it gives insight into the trajectory of US interest rates. The dot plot indicates if there will be another long pause before the next hike, if the terminal rate will be lower or higher than previously forecast and such.

The market has already priced a December hike. What investors need to note is, will this momentum be maintained and do we have more hikes, at regular intervals, ahead of us? If the answer is yes, expect a renewed bout of USD strength into the first half of 2017.

A USD rally could gain strength against G-10 counterparts. Japan is solidly in zero to negative interest rate mode; never has a 2 per cent CPI (consumer price index) target looked so far. With Hillary Clinton installed, USD/JPY should reach 110+ in Q1 2017.

Storm clouds are brewing for 2017 in the eurozone. Germany, France and the Netherlands have federal elections in 2017 and all the incumbent governments there are in danger of being "Trumped". The ECB (European Central Bank) will have little chance of exiting QE in an orderly tapering manner. This could extend into 2018. When the UK triggers Article 50, with the US effectively at its side with negotiations and along with an increasing US interest rate differential, the EUR/USD should drop to 1.0500 and possibly 1.0000, if politics get ugly. USD/SGD and USD/CNH will move higher. China is undeniably suffering from property bubbles, an overheating coal and steel market, and an indeterminate debt problem, possibly of biblical proportions, as well as currency outflows. Against a stronger USD on a TWI basis, USD/CNY should track higher towards 6.9000/7.0000.

The Monetary Authority of Singapore (MAS), has kept policy neutral in the face of a slowing economy, concentrating on medium-term price stability. In no hurry to change the shape of the curve, Singapore's government will do the fiscal heavy lifting via massive investment in infrastructure and upskilling of their populace. USD/SGD should drift up to 1.4300/1.4500.

US equities have yet to price in a concerted increase in interest rates, higher bond yields and the cold reality that the cost of capital is no longer zero per cent.

Other equity markets, including Japan and Singapore, have felt these chill winds already. Expect stocks and indices to come under pressure in early 2017, assuming the Fed stays on course. Stock markets won't crash, but they will rebalance to the downside as bond yields rise.

Gold is necessary in a portfolio as a hedge against uncertainty. Gold has topped out for now. Trend line resistance lies around the US$1,330/50 area. Higher USD rates will see gold lose some mystique in the short term. Expect a move back down to the US$1,200/1,230 area in Q1 2017. Investors wishing to add to their portfolio should exert patience and wait for the market to come to them. 2017's storm clouds mean some tactical additions to the portfolio on the dip could be a wise.

With Mr Trump as president, USD strength will continue. As the eurozone and Japan grapple with the limits of QE and zero to negative interest rates, higher US yields should see equities move lower to rebalance. Countries with dollar pegs and high current account deficits could struggle in the face of much higher USD funding costs.

The political storm clouds of 2016 will blow across the eurozone in 2017 making this region unloved for investors. Although gold should move lower against the USD, adding to a portfolio as a hedge against turbulence could be a wise move. W

**Jeffrey Halley is Senior Market Analyst, Oanda**