ETF Securities FX Research:
USD buoyant as market remains behind the FOMC
Currency volatility takes centre stage

Summary

- After hiking rates for the first time in nearly a decade, the US Federal Reserve (Fed) remains data dependent but expects a gradual pace of rate tightening. Pricing indicates that the market remains behind the Fed’s curve, expecting two rate hikes in 2016.
- Currency volatility will remain until investors become convinced that the global recovery will not be derailed by China slowdown.
- The future path of rate hikes is now the most important element of US monetary policy. The pace of rate rises will be the key for US Dollar (USD) direction now that the Fed has begun its latest tightening cycle.
- US Dollar to peak by end-Q1 2016 as market expectations catch up to Fed projections.

The economic recovery continues

In December 2015, in a highly telegraphed move, the FOMC increased rates for the first time in nearly a decade, by 0.25%. Over the past five tightening cycles, the Fed hiked rates seven times in the first 12 months.

Nonetheless, concern over Chinese growth appears overblown, with the World Bank forecasting somewhat softer, but not disastrous Chinese growth of 6.7% in 2016. Although uncertainty is likely to be a consistent element within the financial landscape, the US recovery will continue in 2016. The World Bank’s latest growth projections show that the US economy will grow 2.7% in 2016, compared to 2.5% in 2015.

Joining the dots

With the US jobs market in robust shape, pipeline inflation pressure should be the Fed’s focus. If the Fed is too slow in raising rates in 2016, inflation expectations will begin to gain momentum and the only cure is a more aggressive rate profile. Global inflation expectations are rising and there is evidence of inflationary pressure in the system. Core and trimmed inflationary readings are around 1.7-2.0%, suggesting underlying price trends are not as benign as the headline indicates. Wage growth is already 2.5%, which is likely to strengthen as the US jobs market continues to improve.

The Fed’s latest economic projections indicate that the median expectation is for four rate increases in 2016. If such policy prevails, the market will remain behind the curve.

Currency volatility remains elevated

While the dot plot shows that two FOMC members forecast official rates to remain unchanged last year, the vote for a rate hike was unanimous in December. This clearly suggests that

Investments may go up or down in value and you may lose some or all of the amount invested. Past performance does not guarantee future results.
Fed Chair Yellen believes in the recovery and the potential for the labour market to generate price pressure and that she is convincing the more dovish members of the need for tighter policy.

1994

Investors currently appear to fear a ‘1994’ type scenario when the beginning of tighter Fed policy triggered a bond market collapse. We expect that a bond market collapse (a sharp spike higher in long-end rates) is unlikely: the Fed’s inflation fighting credibility has increased as inflation expectations have fallen over the past 40 years, resulting in a lower starting point for the current rate tightening cycle. While the Fed may be able to raise rates more gradually given its better credibility, its rhetoric must be clear: the US economy is moving towards full employment and in turn inflation expectations must be contained.

Bonds as a policy tool

We expect that the Fed’s policy of re-investing dividends from its QE bond purchase programme is likely to keep the long end of the US Treasury bond curve contained. Such a policy reduces the chances of a ‘1994’ scenario. The elevated nature of the Fed’s balance sheet will continue to provide stimulus alongside rising official rates – a situation that will result in a flattening of the yield curve, rather than a parallel shift higher. The Fed’s use of bonds as a tool of monetary policy lessens the potentially adverse economic impact of policy tightening, because long end yields are restrained. As a result, we expect that a ‘1994’ type bond collapse is unlikely during this first year of the new tightening cycle.

Fed raised rates, it has been a bumpy ride. Market bullishness on USD’s prospects, has faded somewhat. Net long futures market non-commercial positioning has moderated for the USD, while options pricing has pushed the price of call options closer to that of put options in recent weeks. Meanwhile, the market is pricing two further rate rises for 2016, compared to the Fed’s four.

Implications for the US Dollar

The market is currently pricing in a stronger USD over the coming three months, but futures market positioning has declined in recent weeks.

Although the US Dollar has maintained its strength since the
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