Trade Idea – Foreign Exchange

2016 review: Year of surprise

16th December 2016

Against all odds

- Surprises have been commonplace in 2016 and have ensured that volatility has remained a prominent feature of the world’s currency markets. The year can almost be divided into three distinct phases marked around the shock outcomes in both the EU referendum and the US presidential election. In the period up to, and the month following, the Brexit vote, concerns over the economic impact of the referendum and reduced expectations of monetary tightening in the US saw safe havens like the JPY soar against the GBP and USD (rising 26% and 16% respectively from 1st January to the 6th July). These moves moderated somewhat until the US election, where Trump’s shock victory ushered in a complete shift in market assumptions and a corresponding re-pricing of financial assets. This is the current phase that we find ourselves in, characterised by the strongest trade weighted USD in over 14 years and a sharply weakening JPY. Going into 2017, we see healthy prospects for US growth and inflation buoying the USD, while in Europe the single currency risks being pressured by political uncertainty.

US reflation?

- Markets appear to have interpreted Trump’s victory as a signal that the US will benefit from a large fiscal stimulus and infrastructure package in the years to come, helping to deliver both growth and inflation. While a lot of the details surrounding Trump’s future plan are currently uncertain, what seems clear is that the recent increase in inflation expectations have prompted the US Federal Reserve to pursue a more aggressive rate hike path. Should they follow through with the proposed three hikes in 2017 we see recent gains in the USD as being broadly sustained, although a near term pullback in the next few months may be due.

Populist sentiment tested

- In Europe, scheduled parliamentary and presidential elections in a majority of the bloc’s largest nations have potential to test the Euro. Matteo Renzi’s recent resignation is a signal that anti-establishment sentiment on mainland Europe remains

*All figures quoted are sourced from Bloomberg unless stated otherwise.

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elevated and the growth of populist parties is not as remote a risk as market participants once thought. Combined with a European Central Bank (ECB) committed to at least another 12 months of asset purchases, risks for the EUR appear skewed to the downside.

**Transitional Brexit deal to be brokered**

- Prospects for the GBP are centred on the progress of Brexit negotiations and the UK government’s ability to deliver an effective transitional agreement offering protection for Britain’s more exposed sectors, such as finance. We remain bullish on the currency and believe that it is currently trading near its structural nadir (see: [GBP reaches rock bottom](https://www.etfs.com)). However, it will remain volatile as markets scrutinise any plan Theresa May puts forward before the self-imposed March deadline for Article 50.

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- ETFS 5x Short USD Long EUR (5CH6)
- ETFS 5x Long USD Short GBP (USP5)
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- ETFS Bearish USD vs G10 Currency Basket Securities (SUSB)
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