QUARTERLY OUTLOOK

FOURTH QUARTER, 2018

October 1st, 2018 - Dr. Nektarios Michail, Market Analyst, HotForex

UNITED STATES

The US appears to be the strongest economy in the world at the moment, with macroeconomic announcements usually in support of this theme. In particular, data releases in September have thus far further promoted this strong growth regime, however, risks could lay ahead in the near future. First and foremost, the ongoing trade war with China can only be beneficial for the US in the short run, given that it will raise prices for most consumer goods if it continues for a longer period. In 2017, 22% of total US imports came from China, with approximately half of that already being targeted by the existing tariffs.[1] On the export side, only 8% of total US exports go to China, with the former having already imposed tariffs on approximately 80% of total imports from the US, giving less room to retaliate if more tariffs are imposed.[2] China's unwillingness to depreciate the Yuan means that most likely the cost will be passed on to the American consumer, moving inflation into higher levels in the final quarter of the year since it is too soon for importers to change their distribution and trade channels. The same holds regarding the new trade deal with Mexico, which also increases prices of goods. In the case where a Canadian tariff deal is also achieved then more inflationary pressures are to be expected. Naturally, tariffs will potentially decrease the current account deficit which would have a positive contribution to overall GDP growth, while tariff-ridden deals could also be beneficial for government income and assist in the stabilization of debt.

Higher inflation would make an additional rate hike in the December Fed meeting more likely, which would also be supported by potentially higher-than-expected Q3 GDP results. Further to this, with many economists predicting a downturn in 2020 the Fed would be in a much better place to both restrain the economy as well have more room to manoeuver if interest rates are higher. Despite medium-term worries we expect the **Dollar** to appreciate in value, mainly driven by higher growth and inflation and also aided by higher interest rate differentials, especially if two consecutive rate hikes are observed. Political tensions are likely to also cause short-term turbulence, especially in the case where the midterm elections result in Republicans losing seats in the Senate and the House of Representatives. Such a development may indicate that most of the proposals made by the Trump administration could be rejected, leading to political turmoil and weighing negatively on the **Dollar.** In the medium term, increased trade pressures could make the **Dollar** weaken, especially if associated with lower government spending and cost-push, supply side, inflation pressures arising from higher oil prices and wage demands due to the increase in consumer good prices.

The **USD10YR** bond yield is also likely to rise, as investors will seek higher returns to compensate for the higher cost of living due to increased inflationary pressures. Despite forward guidance on the gradual increase in policy rates having allowed for a slower adjustment to rate hikes, we stand by our belief that the major driver of rising bond yields is the return of confidence in the US economy combined with a shift to riskier assets which offer higher yields compared to bonds. Higher yields could mean that bond may also gain some attractiveness as investors may wish to include them in their pool of assets as a way of risk diversification. Still, bonds are prone to trade war risk, as increased uncertainty could result in increased risk aversion and hence more bond purchases, raising the price and lowering yields.

Favourable macroeconomic developments have been reflected in all three indices (**US30**, **US100**, and **US500**) which, despite their recent mild corrections, appear to be continuing their upwards trend. Higher inflation would be beneficial to the stock market as it would create room for more price-based profits, while higher spending could lead to higher volumes-based gains. Tariffs could also create some more profits for domestic producers although it could make obtaining the raw materials more difficult, but this could also be passed on to the consumers. The potential increase in interest rates could slow this increase, although much of this hike is probably already priced in and should not have a long-lasting effect. The indices still appear to have room to go, especially if beneficial political agreements are reached, including the confirmation of the trade deal with Mexico, a trade deal with Canada, a relaxation of the China tensions, and the reaching of a final agreement between Washington and Pyongyang, which should further boost morale.

[1] Source: Thompson Reuters Eikon.
[2] Source: United States Census Bureau.

QUARTERLY OUTLOOK

FOURTH QUARTER, 2018

EURO AREA

The **Euro** area has been quietly reporting strong and consistent GDP results, standing at 2.2% y/y for Q2 and 2.5% y/y for Q1. At the same time, the annual inflation rate stands at 2%, slightly higher than the "close to but below 2%" ECB target. [3] Such developments have resulted in a gradual strengthening of the **Euro**, in association with the end of the cheap money (QE) policies announced by ECB. In contrast to the past, growth appears to be rather universal: the vast majority of **Euro** area countries reported annual growth rates of more than 1.5%, with Italy presenting the region's weakest link, growing at an average of 1.2% in the first half of the year. [4] The country does not appear willing to push through economic reforms which would allow it to promote growth, reduce bureaucracy, and lower corruption. This unwillingness is also proven by the fact that Italy has seen 5 different Prime Ministers in the past 5 years. [4] While the latest government formation has vowed to promote radical change there has still been little movement to that end.

The major political issue still relates to the Brexit discussions, although these are expected to reach an agreement by the end of the year. The deal will most likely satisfy most of the EU's requests but some limited concessions are also expected from the European Union side. Confirming the nature of the Brexit agreement would be more beneficial for the UK in the short run as it will eliminate most of the uncertainty surrounding the final outcome, however, the EU should reap the longer term benefits given that a considerable portion of the UK financial services industry has already relocated to EU locations. Election-wise, not much is expected by the end of the year, with only Luxemburg hosting a general election in mid-October.

In the near future no major economic actions are expected from ECB other than the end of Quantitative Easing in December, which would set the path for interest rate hikes, most likely in the fall of 2019. We find the possibility of a rate hike before the end of Quantitative Easing as very low, given that the two policies would contradict each other. Furthermore, credit growth has not yet reached the point of intervention, with an overall growth rate of less than 4% in 2018, while the slightly expansionary fiscal stance also limits the need for action. [5] Overall, we estimate that the **Euro** could benefit from a Brexit agreement, however, economic growth would remain lower than the United States. The **Euro** could further appreciate in the medium term in the case that Italy deals with its existing issues and does not require official assistance. **The most important benefit of the Euro at this time is that it could pose a stable currency in contrast with a turbulent Dollar driven by political and economic volatility.**

Stock markets in Europe are showing the signs of political turmoil, based mostly on sentiment and despite the continuous improvement of economic performance. The **GER30** has been in a downwards trend since May in view of continuously worse than expected economic indicators, despite still maintaining an optimistic view about the German economy. PMI indices have consistently fared below expectations, despite always maintaining above the 50-point threshold. A similar pattern can be observed for the inflation rate which mostly came out lower than expectations. Nonetheless, the latest ZEW Surveys came out better than expected, signalling a potential turn of the Index towards higher valuations. **FRA40** has been following a long-term upwards trend, appearing to stabilize at high levels during the last few months, aided by stable inflation rates and strong results by its constituents, which chimed along with the overall picture of economic stability following Emmanuel Macron's election. The labour reforms passed last year appear to have improved employment in the country, with the unemployment rate decreasing by 0.4% in August compared to last year, a trend which is expected to continue. [6] The **NETH25** Index appears to be on a corrective move following a slowdown in the macroeconomic performance of the country. Nonetheless, GDP growth stood at 2.7% y/y, with inflation expected to continue fluctuating around the 2% level. [7]

In contrast, the **SPA35** has been in a long term downwards trend. Spain still has a way to go despite its improved macroeconomic performance and large reduction in unemployment as it still continues to register a 15.1% rate, the second largest in Europe after Greece. [8] BBVA's exposure to the sliding Turkish economy has not been helpful in this respect. [9] **EUR50** has been reflective of the fluctuations of the previously mentioned indices and has been fluctuating sideways despite the ongoing improvement in macroeconomic conditions in the region. This can likely be attributed to the persistence of uncertainty due to Brexit and the sub-par economic performance of Italy. Overall, the index could benefit from the worsening of trade between US and China as the European export sector could witness increased demand. Further to this, lack of policy action is expected to assist the **EUR50**, while the expected Fed rate hikes could put some negative pressure on it.
On the bond front, the **EUBund** has been reflecting the decrease in risk aversion across the continent, and along with the projected end of the easy-money QE policy, it has seen a decrease in price and an increase in yield while still remaining too low. With inflation continuing to be higher than the Bund yield, investors are likely to continue holding it only for diversification and risk-reduction purposes, with the yield expected to move higher as inflation continues to remain close to the ECB target.

[3,4,6,7,8] Source: Eurostat.
[4,9] Source: Thompson Reuters Eikon.
[5] Source: European Central Bank.

QUARTERLY OUTLOOK
FOURTH QUARTER, 2018

JAPAN

The Yen has moved downwards in the past months, predominantly a result of increased trade deficits. As a result of the **Yen** depreciation inflation has outperformed expectations. Fortunately for the Japanese economy, retail trade and consumer spending have also been registering small increases, although these have also contributed to the widening of the trade deficit. Despite the chronic problems of the Japanese economy, these developments appear to be beneficial, as they could signify an improvement in overall macroeconomic performance. BoJ is not likely to increase interest rates at this point or in the near future given that a weaker Yen is beneficial for the Japanese economy, though it could potentially return the rate to zero. Prime Minister Shinzo Abe will continue to be at the helm of the Liberal Democratic Party and should remain in his position for another three years, a sign that loose economic policies will continue. The **JPN225** reacted positively to this development, as well as to the widening of the trade deficit and has continued its upwards trend observed since mid-March. With expectations of a rate hike being low, and with positive developments expected in the near future for the Japanese economy, it is expected that the longer-term upwards trend should continue.

UNITED KINGDOM

Even though uncertainty regarding Brexit still continues, Sterling has seen good days recently in light of better-than-expected retail sales and inflation results, which pushed the currency higher. However, inflation results should be taken with a grain of salt, given that higher inflation is most likely due to the **Sterling** depreciation, which has increased firm (i.e. supply-side) costs. While no interest rate decisions have been announced in September, the UK may see the year off with a rate hike if inflation continues to stay above 2%. Naturally, this will also depend on the September and October GDP results, which would be free from the World Cup higher consumption effect in June and July. November is an important month for the country as it will likely pave the way for the finalization of the Brexit agreement, which would reduce uncertainty and possibly boost the **GBP**. In addition, November inflation numbers will be paramount to identifying whether a rate hike is to be expected, even though macroeconomic stability has not yet been achieved. In the case of a Brexit deal, the UK will likely reap the benefits of a currency appreciation, however, in the long run it could see its financial services industry decline as firms relocate to continental Europe.

The **UK100** has been moving in a downwards trend over the past month, appearing to make a comeback with the recent bout of positive news. The Index will likely react positively to a Brexit deal, as will the rest of the economy, however, higher inflation could erode some firm profitability while a rate hike could also limit the stock market's upside potential. With the **UK Gilt**, in contrast, the prevailing global trend has actually increased in price, reflecting the ongoing uncertainty as investors are less willing to hold risky assets. Positive macroeconomic news has contributed to the yield increasing over the past days, nonetheless this could just be a correction as it remains to be seen whether the UK's macroeconomic performance can persist.

AUSTRALIA

Australian banks have been facing increased funding costs as they tend to borrow in external markets and in USD. With the expected rate hikes, funding costs are expected to increase further despite no action taken by the RBA, which sees wage growth as too slow to justify rate increases. This could affect the already large amount of interest-only housing loans, standing at 40% of total loans in 2017. [10] Furthermore, the fourth consecutive decrease in house prices in the past four quarters is likely to endanger banks if it persists, given the large share of loans which rely on perpetual refinancing to remain afloat. As house prices drop, banks will be either unwilling to refinance them or demand higher interest rates, as collateral price will decrease. **The combination of the two could put the financial sector in trouble**, as newspapers are already reporting stories of housing problems and the RBA suggests that moving to actual principal and interest loans would significantly increase costs for consumers. On the political front, following the resignation of the Australian PM, the next election date is uncertain, though May 2019 is considered the latest date for House of Representatives elections.

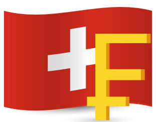
The **Aussie** has been on a persistent depreciating path with respect to the **Euro** and the **Dollar**, however a recent correction has been observed in view of stronger than expected labour market figures. As already suggested, the possibility for a rate hike still exists, but is more likely to happen in the last meeting of the year. Nonetheless, it is uncertain whether an increase in the rate will actually record any material impact on the economy. Despite currency troubles the **AUS200** still remains strong, reaching record highs in late August but mildly correcting since. The positive trend is expected to continue until definite conclusions can be reached about the viability of the banking sector and possible policy actions.

[10] Source: Reserve Bank of Australia.

QUARTERLY OUTLOOK
FOURTH QUARTER, 2018

CANADA

The **Loonie** has been on bid against the **Euro**, while it has also been gaining ground against the **Dollar**. BoC appears to endorse gradualism in interest rate hikes, with an interest rate change likely in the final meeting of the year (December) while no policy change is expected in the October meeting. The policy appears to have been justified by the latest CPI figures which confirmed that the July jump was a one-off event. Despite coming out lower than the forecasts, Q2 GDP still remained at an impressive 2.9%. [11] On the political and trade fronts, Canada has many incentives to join a trade union with Mexico and the US, specifically given the fact that many border jobs rely on trade. Nonetheless, officials have shown that they are more likely to promote the "no deal is better than a bad deal" dictum as they appear unlikely to continue with the talks if the Trump administration pushes through with unreasonable demands. The overall impact from an agreement is expected to weight positively on the **Loonie**, though if it is delayed it may not have such a large effect on the currency.



SWITZERLAND

The **Swissy** has benefited from the prevailing uncertainty in politics and trade conditions around the world, and has been on bid with respect to the **Dollar**, although it has been declining lately, perhaps partly due to FX interventions by SNB. In contrast, the **Swissy** has maintained its gains against the **Euro**. The macroeconomic conditions in the country appear to still be volatile with the latest figures coming up mixed as real GDP and industrial production increased but retail sales declined. The unemployment rate remains low. The boost in exports and industrial production have assisted the **SUI20** to climb higher, with expectations of moving to new highs if export growth continues. In order to support this export-led growth the SNB is unlikely to proceed with a rate hike in the near future, at least until the Brexit agreement is resolved, given that it already considers the currency to be overvalued and despite the fact that most Swiss goods are usually associated with inelastic demand.

EMERGING ECONOMIES

Following the trade agreement with the US, Mexico continues on its long-term growth path, as manufacturing exports continue their long-term upwards trend. Importantly, headline and core inflation are also declining from the 6.5% and 5% highs in 2017. [12] The **Peso (MXN)** has been gaining on the **Dollar** since mid-June, despite a small depreciation observed in August. As Mexico continues to grow the long-term trend of the Peso is expected to continue.

The **ZAR** faced strong pressure in August as a result of Trump's comments and has been trading at lows since. The fact is that the country has officially entered a recession, as the economy shrank by 0.8% in the second quarter of the year. Agriculture was the main sector registering declines following ANC plans to expropriate land from white farmers who possess large parcels of land without compensation, with the Agribusiness Confidence Index declining to the lowest in more than two years. This can potentially have its effects on the banking sector if farmers stop repaying loans. However, if the plan is not pushed through, the recession could end as soon as the next quarter, as the South African Reserve Bank has kept its interest rate at a two-year low.

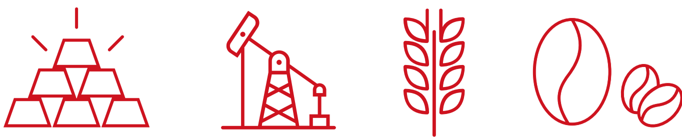
In Turkey, the **Lira** appears to have stabilized in view of the interest rate hike and the proposed plan to cut government spending in order to control the unfolding currency crisis and mounting inflationary pressures. The proposed austerity measures would slash growth 1.7% in 2018 and 3.2% in 2019. [13] Nonetheless, the plan lacks specific details and the Turkish administration is not clear as to how the expected decline in output will affect government revenue. The need for bank support is currently more predominant than ever, as bad loans are increasing. While the government has suggested a plan to monitor banks' health, no specific details have been laid out. Despite the efforts made by the Erdogan government to avoid further depreciation of the **Lira**, lack of a specific plan of action has not yet convinced the markets that the worst is over for the country.

[11] Source: HotForex Economic Calendar.
[12] Source: OECD
[13] Source: Thompson Reuters Eikon.

QUARTERLY OUTLOOK
FOURTH QUARTER, 2018

In Asia, the **Yuan** appears not to have been affected by the imposition of the Trump tariffs, trading at about 6.8 against the Dollar. The 10% tariffs should not bear much effect on overall Chinese exports, given that the Yuan has depreciated approximately 7% since June. In addition, tax incentives offered by the Chinese government should boost local firm profitability. Excluding trade, other issues which plague the country include bad loans, which have been on an increasing trend.

On the other hand, the impact of sanctions on the Russian economy and the **Ruble** is expected to be much milder given the limited trade ties with the US. As predicted in the September monthly outlook, an interest rate hike took place in order to protect from further currency depreciation, leaving the door for future rate increases open. The move was successful as the **Ruble** gained against the **Dollar**, with the Central Bank of Russia getting reputational gains by demonstrating a willingness to intervene not often observed in emerging economies.

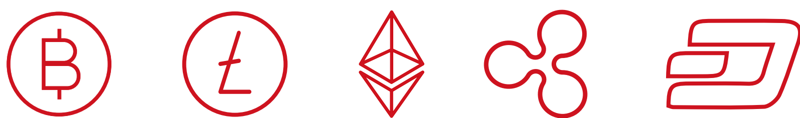


COMMODITIES

The downwards trend in **Gold** observed since March 2018 as a result of higher world GDP growth appears to have stabilised as the price of **Gold** is fluctuating around the USD1,200 mark. Uncertainty over US-China trade relations and the continued uncertainty regarding Brexit pushed it back up in late August, surpassing the USD1,200 mark after trading below that point in early August. Safe haven assets appear not to have lost their appeal amidst trade tensions and political uncertainty, as previously outlined. Nonetheless, positive news regarding developed economies could move the price downwards, while emerging market developments do not appear to have had important effects on the price of **Gold**. Interestingly, **Gold** has not reacted much to the imposition of tariffs on China, though the expected rate hikes by the Fed should put downwards pressure on the price.

Closely correlated with the path of **Gold**, **Silver** has been on a downwards trend since June after the ECB announcement that quantitative easing will stop by the end of the year. Similar to **Gold**, the Fed's intention to pursue a gradual increase of interest rates is also expected to have a negative impact on the price of **Silver**. No major changes are expected in the coming quarter, while in the longer term industrial demand for Silver appears to be increasing, which could perhaps push prices higher given that record **Gold-to-Silver** ratios have been observed recently. On the other hand, the continued increase in supply could also put downward pressure on the price.

The world's leading fuel source has been on an upwards trend since early 2018, despite the OPEC agreement to boost production by 1 mln barrels a day and Russian crude production jumping to record highs. **Oil** prices appear to be boosted by increased demand in the Asia Pacific region, as growth in consumption was anemic elsewhere. Short-run fluctuations in US crude inventories driven by gasoline demand can justify small bouts in volatility. The long-run forecast for **Oil** is that prices are expected to grow slowly but persistently, especially in the case that trade issues among the US and its partners are resolved.



CRYPTOS

Cryptos have been viciously attacked recently, with notable speakers and economists suggesting that their long-run value is zero. Markets appear to disagree, at least in the case of **Bitcoin**, as it does not appear to be heavily affected. The world's most popular coin has continued its drop in price, but does not appear to be able to persistently break below the USD6000 mark. The **Bitcoin** path appears to resemble a descending triangle, following a gradual but persistent reduction in price. Given its negative association with the price of Gold, Bitcoin could serve as a hedge against unexpected Gold movements, though its price volatility prevents it from being considered a safe haven asset, at least at the moment. The slow movements during the past days are indicative of market indecision to either break the USD6000 barrier or push upwards, however, a more evident trend should appear within the next quarter as the indecision cannot go on forever.

The other big cryptocurrencies, namely **Ethereum**, **Dashcoin**, **Litecoin** and **Ripple** have also been moving along a longer-term downwards trend, stabilizing at November 2017 levels. Despite technological innovations in the speed of payments associated with these cryptos, their prices are still highly affected by **Bitcoin** movements. Given the strong correlation between the coins, unexpected movements in one should also affect the others, especially if they are in line with the longer-term price path. The only currency which has managed to move rather independently in the past days has been Ripple, as its parent company, XPR, has been gaining momentum in the blockchain space. Nonetheless, it is yet uncertain of whether Ripple can set its own path and break ties with Bitcoin. Overall, the fourth quarter of the year will be catalytic as to where crypto prices should move in the coming year.

QUARTERLY OUTLOOK

FOURTH QUARTER, 2018

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