moneycorp

Financing The World's Currencies:

Who will be the winners and losers in 2019?

Introduction

It is that time of year when we look into the unknown and predict how currencies will perform over the next twelve months. At the end of 2017, we made some bold predictions on the relative performance of the pound sterling, dollar, euro, yen, rouble and renminbi. In this forward-looking white paper, we look at the performance of our past predictions, explore the reasons why they were wrong (or right) and use our learning to forecast currency movements in 2019.

Three forecasts are required to calculate a future exchange rate. First, one must consider how two economies will perform in the future from assumptions today. Second, and more difficult, we must compare a currency's performance in relation to another. If we are wrong in any one of the three estimates (currency A value, currency B value, or relative strength of the two currencies) our forecast will be wrong.

Our 2018 Forecasts: How Did We Do?

For any forecasting analysis, it is important to assess the performance and quality of the methods used. This is necessary to give confidence to the reader and also understand where the method or assumptions have fallen short, if at all.

Twelve months ago, we made a number of forecasts based on assumptions about the main international currencies, and on this basis, we predicted general performance over the year. Given foreign exchange volatility, it would be easy to pick a day over the past twelve months to show we were correct in all our forecasts. So, to avoid any accusation of bias we consider our forecasting performance against several metrics. We compare our forecasts to the average exchange rate in the first and final six months of 2018. We also calculate the average exchange rate in 2018 to date. Finally, we include the most recent exchange rate to give as complete a picture as possible.

Exchange Rate	Exchange Rate at end of 2017	Forecasted Performance	First 6 Months Average	Last 6 Months Average	12 Month Average	Most Recent Exchange Rate
EUR/£	1.1355	Sterling ▲	1.1364	1.1242	1.1303	1.1068
$/£	1.3385	Sterling ▲	1.3763	1.2946	1.3354	1.2703
$/€	1.1769	No clear direction	1.2142	1.1517	1.1829	1.1474
RUB/$	59.0900	Dollar ▲	59.3942	66.1136	62.7539	67.3677
YEN/$	113.4070	Dollar ▼	108.7146	112.2434	110.4790	111.6931
RMB/$	6.6198	Dollar ▲	6.3665	6.8600	6.6133	6.8871
RUB/£	79.0920	Sterling ▲	81.6893	85.4480	83.5686	85.5554
YEN/£	151.7953	No clear direction	149.5864	145.3089	147.4476	141.8170
RMB/£	8.8606	Sterling ▲	8.7606	8.8804	8.8205	8.7431
RUB/€	69.5430	Euro ▲	71.8694	76.0136	73.9415	77.3425
YEN/€	133.4687	Euro ▼	131.6241	129.2561	130.4401	128.0959
RMB/€	7.7908	Euro ▲	7.7086	7.8994	7.8040	7.8968
Forecast Accuracy (Green Only)			70%	80%	60%	70%
Forecast Accuracy (Green and Amber)			90%	80%	100%	70%

Table 1 – Forecasting Performance from 'The World's Currencies: Who will be the winners and losers in 2018?', Moneycorp White Paper, December 2017

Our predictions were made looking into a highly uncertain environment with different key events to take place. Given their unique nature (Brexit negotiations in particular), forecast accuracy was difficult to predict. However, from Table 1, our forecasts were more than satisfactory and greatly exceeded the uninformed prediction success rate of 50 per cent. The models also maintained their performance in the second half of 2018 and, at the time of writing, are still 70 per cent accurate.

Notably, the British pound is at the heart of our erroneous forecasts. This was because we underestimated the time needed to complete Brexit negotiations. Given the level of uncertainty still in the markets today, it is unsurprising the pound has not yet appreciated but is something we expect to happen in 2019.

The Global Economy in 2018:
A Brief Retrospective

To understand future foreign exchange trends, we must first appreciate the key factors that drove currency performance in 2018.

The future can only be understood by looking into the past.

The United Kingdom

Without a doubt, the one thing everyone expected to be resolved was the United Kingdom's exit from the European Union, whatever deal that may have been.

With less than three months now to go until March 29 (Article 50's formally declared exit date), the complete lack of certainty has undoubtedly impacted sterling for the negative.

The stalled Brexit negotiations have impacted the UK's economy and in particular its services sector. The services sector is one area that will be severely affected in the event of no deal or a goods-only Brexit agreement. It also constitutes 80 per cent of the UK's economy. With the lack of certainty in the future, Services firms have found it difficult to recruit and sentiment is at its lowest since July 2016, according to a recent IHS Markit/CIPS survey (December 2018). This has contributed to a slowing UK economy and held back sterling's expected appreciation in 2018.

The United States

Donald Trump carried out all the economic promises he made during the US elections in 2016. The US has pursued an aggressive strategy concerning Chinese trade in an attempt to create a more balanced relationship between the two countries.

The US has also deregulated many of its industries and cut the US Federal Corporate Tax Rate to 21 per cent from 35 per cent. Each of these events, which were anticipated last year, have had the expected impact on the dollar exchange rate.

However, the dollar's gain is the US Stock Market's loss. Because of uncertainty in the global trading environment caused by the UK government's actions, equities have dropped 9 per cent since the beginning of the year. Strong economic growth on the back of US economic policies has also led the Federal Reserve to increase its interest rate in December 2018. Coupled with the loss of the House of Representatives in November's US mid-term elections, Trump's ability to pass his economic policies through US Congress has been much reduced.

The European Union

Although the European Union has been impacted by challenging Brexit negotiations, as an economic bloc it has also been affected by internal non-UK related events.

Most notably, a newly populist Italian government has brought slight economic instability to the region because it had not, until very recently, agreed to a budget with the European Commission.

Italy's economic challenges and lack of budget coherence with Eurozone policies contributed to the EU having its weakest economic growth in over four years. Concerns relating to the European Union budget exacerbated pressure on the euro, and the currency's 2018 performance was dampened as a result.

China

In 2018, the Chinese economy was impacted by US trade disputes, and this resulted in the renminbi's poor relative performance in comparison to other global currencies.

China's economy also slowed despite attempts by the Chinese government to inject some energy through tax cuts, bank deregulation and accelerated public funded infrastructure projects.

Russia

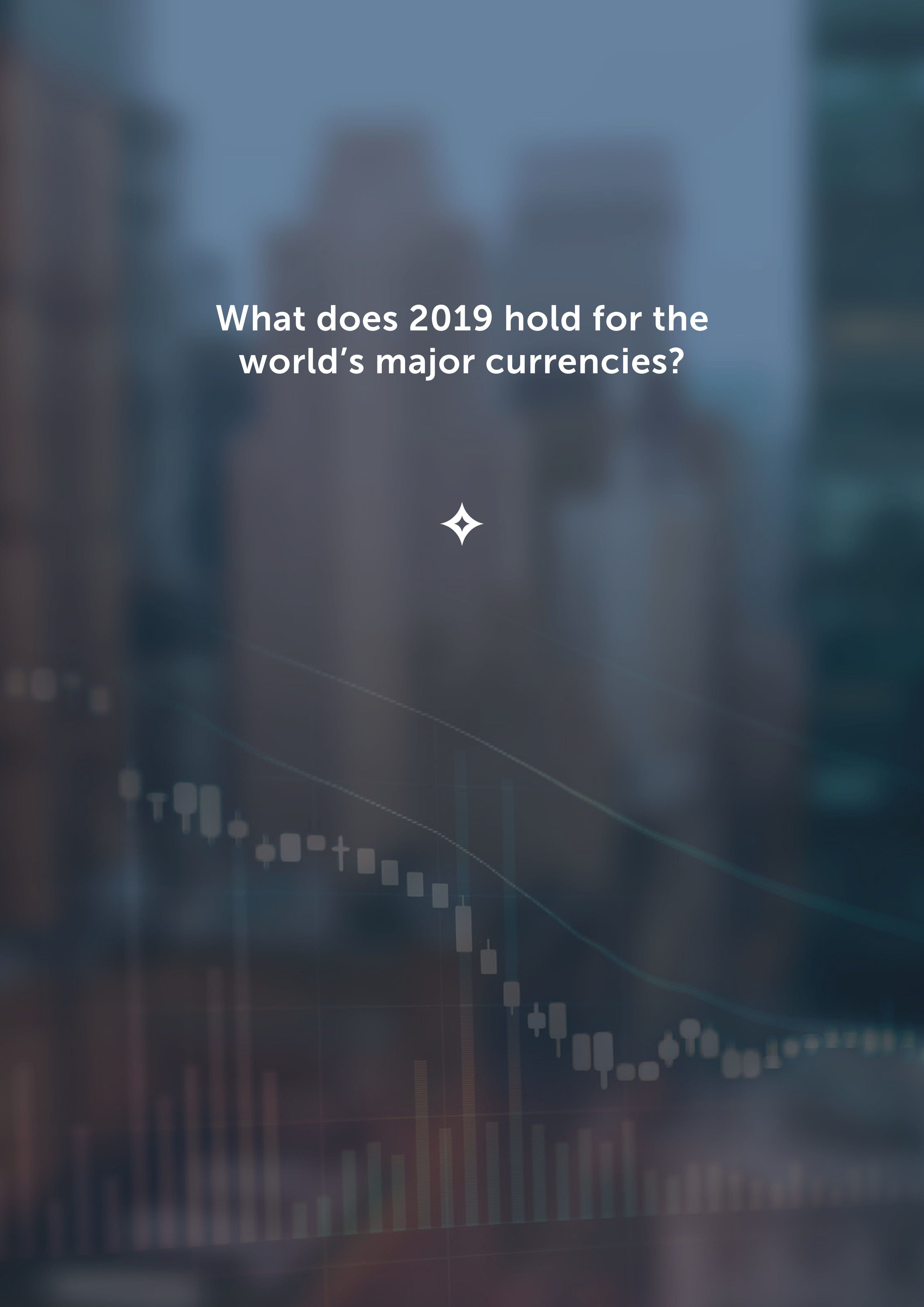
Russia's GDP grew at 1.5 per cent in 2018, up from 1.3 per cent last year.

This was lauded by the Russian President, Vladimir Putin, but it belied a sluggish economy that is overly dependent upon hydrocarbons. International sanctions relating to Crimea, Ukraine and the alleged poisoning of two Russian citizens in the UK has weakened the country's economy further.

Japan

Japan's economy continued to grow in 2018 as 'Abenomics' sustained a steadily improving business environment.

The new EU free trade deal agreed at the end of 2017 and to be implemented in 2019 improved sentiment further, and this was the basis of the excellent Yen performance over the past 12 months.



What does 2019 hold for the world's major currencies?

The US Dollar

Most of the short-term effects of the US economic reforms of 2017 and 2018 have already been felt. In fact, it is now likely there will be a weakening in the dollar because of compensatory actions by the Federal Reserve through its interest rate policies during 2018 and into 2019.

Expect to see the US economy slowing down over the next twelve months. Several factors will be significant in determining the strength of the slowdown. The US-China trade disputes will weigh heavily on the world's economies, and this is likely to lead to a drop in economic growth across the globe. International stock market volatility will also result in a slowdown in the US, and the strength of the US dollar will make exports more expensive for large US firms.

The main uncertainties in 2019 are political, and President Trump's fortunes will play a vital role in the US dollar's performance. The outcome of the 'Russia Collusion' investigation and the ability of the US government to manage a split Congress will be significant in just how poor the dollar performs over the next twelve months.

Forecast: All of the above lead to negative signals about the dollar's value in 2019.

The Euro

The euro has worrying headwinds to face if it is going to experience a similar strong performance as in 2018.

Many EU members have strained public finances, and it is possible some member states will find meeting the 2019 EU budget expectations a challenge. Italy has already gone through its budget crisis with an acceptable resolution, but it could be the first in a series of countries to be in the same position.

Oil prices tend to have an impact on Eurozone country economies, and if there is an increase in the oil price, this will reduce economic growth across the region and possibly increase inflation in some parts of the trading bloc. Oil price forecasts are varied for 2019 and there is little consensus on whether it will trend upwards or downwards over the coming months.

Since 2015, the European Central Bank has been running a quantitative easing programme to shore up the Eurozone economy. However, the ECB stopped buying Eurozone government bonds in December 2018, and this may affect member state finances over 2019.

In addition to these internal challenges, the euro's performance in 2019 will undoubtedly be influenced by what happens with Brexit and the US.

An upside for the EU is the Japanese free trade agreement, which starts in 2019. This will have a slow but steadily positive impact on the region's economic performance over 2019 but its beneficial effect will likely be swamped by what goes on elsewhere.

Predicting the euro foreign exchange rate over 2019 is made even more difficult because its relative value with respect to both dollar and sterling will be driven by as much as what goes on in the US and UK, as it is within the EU itself. Given the uncertainties facing all three trading entities (the US, UK and Eurozone), our forecasts must take into account the relative effects of Brexit, the US-China trade dispute and slowing economic growth in both US and Europe - not an easy task!

The British Pound

At the beginning of the year, it was expected that successful trade negotiations between the UK and EU would resolve a lot of the uncertainty in the capital markets.

Unfortunately, we seem to be in a worse position than we were twelve months ago with absolutely no clarity on either the final Brexit deal or whether the UK Parliament will vote it into law.

As of writing, the UK faces different possible futures, and all of these will affect sterling.

There are five possible scenarios:

01.

A deal will be ratified by Parliament in January 2019,

02.

A Brexit deal will not be agreed by March 2019 and Britain will enter into unknown territory,

03.

An alternative arrangement will be delivered by March 29 or before an extended Article 50 deadline later in the year,

04.

There will be a second referendum on whether Britain will stay part of the EU,

05.

Negotiations continue into 2020.

Scenario	Impact on Pound	Reasoning
Deal Ratified by UK Parliament in January 2019	Strengthens	A lot of the uncertainty regarding the UK trading environment will be resolved. A reduction in the uncertainty risk premium will increase demand for sterling.
No-Deal Scenario	Weakens	Although global goods tariffs are currently very low, even within the WTO framework, it will take months to improve non-tariff frictions for international exports and imports. International supply chains will be disrupted in the short-term causing a fall in economic output, mainly in the UK. The uncertainty risk premium will remain high, which will deflate the value of sterling in the short-term.
A revised Brexit deal will be delivered after March 29 but before the end of 2019	Weakens then strengthens towards the end of the year	This assumes that Article 50 will be extended for a period. The uncertainty risk premium for sterling will increase after a failed January Brexit deal vote in UK Parliament. As progress is made in trade negotiations, the uncertainty will fall, and this will improve the value of sterling.
Second referendum sometime in 2019	Strengthens then an uncertain outcome	The fact there will be a second referendum on UK's membership of the EU will give hope of a 'Remain' verdict. This will strengthen sterling in the run-up to the new referendum. If the outcome is to exit, expect sterling to weaken sharply just as it did in 2016. If the result is to remain, sterling will continue to perform well over the remainder of the year.
Negotiations continue into 2020	Sterling stays in the same band as 2018	This scenario extends the negotiating period for another twelve months and so expect the same performance as in 2018.

Table 2: The Impact of Different Brexit Scenarios on the Strength of the British Pound in 2019

As Table 2 presents, there are a variety of possible outcomes in 2019 that will drive the performance of sterling over the coming twelve months. Brexit uncertainty has dominated the British political and business environment since 2016, and it is sure to continue over the coming months.

Amidst all the noise, one thing is clear: The outcome of the Brexit negotiations as presented in Table 2 will swamp all other economic issues when it comes to forecasting sterling performance in 2019.

Forecast: It is difficult to predict how sterling will perform in the first six months of 2019. However, expect to see significant strengthening in sterling between July and December 2019, as the uncertainty is likely to erode when we move towards a new trading relationship with EU, whatever that may be.

The Japanese Yen

Japan will continue to see steady improvement in its economy as 'Abenomics' provides stability and growth to the country.

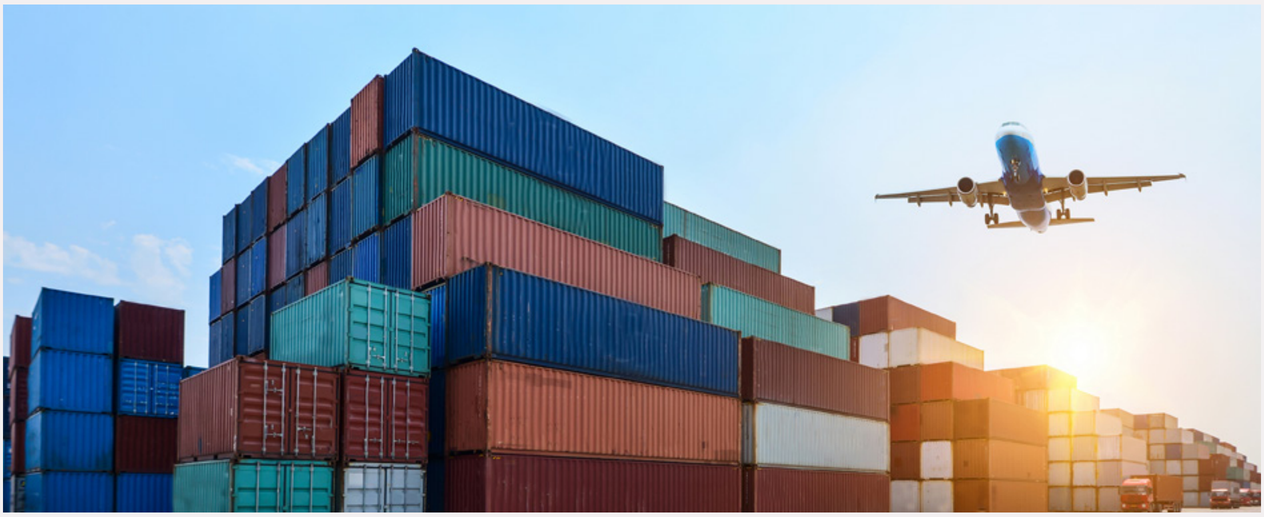
Since the stagnancy of the 1980s and 1990s, the Bank of Japan has been pursuing a sustainable strategy in slowly growing the Japanese economy. Moreover, Japan will benefit in comparison to other major economies simply because it is unlikely to experience the same volatility of their large trading partners.

In the currency markets, uncertainty comes with a risk premium and the lack of uncertainty in Japan will increase the value of the Yen. With its steady growth and free trade agreement with the EU starting in 2019, the Yen to do well in 2019.

Forecast: A strong year for the Yen.

The Chinese Renminbi

The Chinese economy is facing several challenges in 2019, and it is not clear how it will effectively traverse them given their significance.



Internally, China has undertaken different initiatives to energise its economy but, given the size of the country, it has only been partially successful to date.

Externally, their trade dispute with the US and geopolitical pressures have seen barriers develop between the two countries. A scheduled Vice-Ministerial meeting in January between the US and China may bring a breakthrough but given a 1st March start date for new US sanctions to come into effect, the pressure will be on to China to achieve a deal that will have to be good for the US.

If there is a breakthrough in trade talks, China will likely have to lose out in some trade deals. If there is no breakthrough, China will face stringent trade sanctions. In both scenarios, China will be worse off in the short-term, and this will impact the strength of the renminbi.

Forecast: Renminbi will continue to underperform in 2019.

The Russian Rouble

The Russian economy will be facing positive and negative issues in 2019.

On the downside, planned tax rises will likely reduce spending and wage growth. Russia is dependent on oil for its economy, and so any improvement in the oil price will impact the rouble. As stated earlier, there is little agreement among oil price analysts on how the oil price will perform in 2019, so our position on the rouble is a neutral one. Taken together, it is not likely the rouble will see too much change over the 2019 period

Other Emerging Markets

Emerging market currencies had a dreadful year in 2018 because of the strength of the US dollar.

However, if as expected, the dollar and renminbi perform poorly during 2019, demand may pick up in less developed country currencies. The downside is that the US and China drive economic growth and so there may also be downward pressure on emerging market currencies.

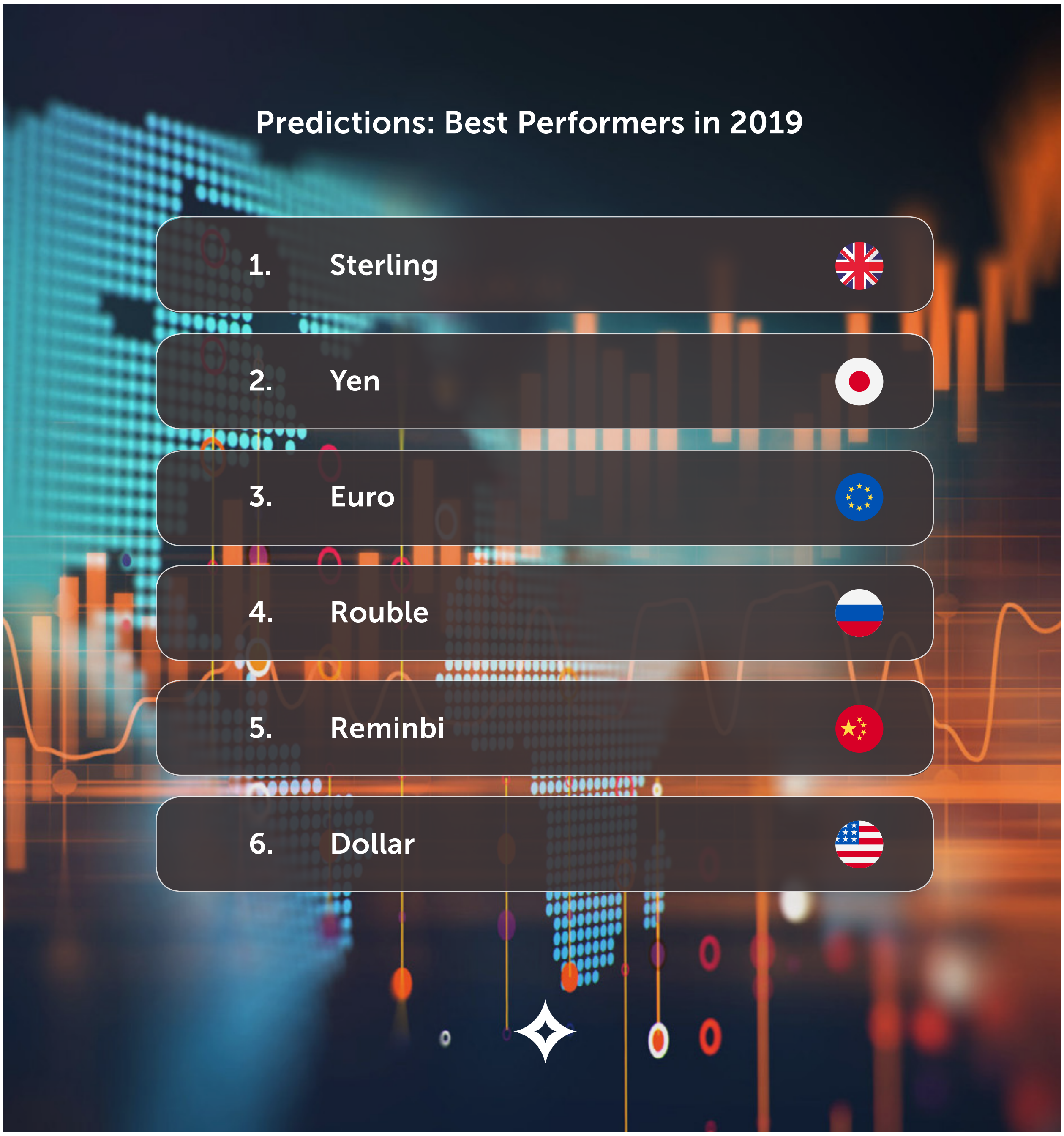
Keep an eye on both India and South Africa as both countries look set to lead the economic rebound among their emerging market counterparts.

The winners and the losers revealed

So who will be the big winners and losers among major currencies in 2019? Like 2018, we predict both Japanese yen and sterling will be the best performers in the next twelve months.

Following up are the euro and the rouble. Both face uncertainties in 2019 from various areas. However, they are likely to fare better than the renminbi and dollar, which both have challenges over the coming twelve months.

At the bottom of the table, the US dollar is likely to perform worst of all the major currencies because of expected adverse changes in its economy over 2019 and a rebound from its strong performance in 2018.



moneycorp

About the author

David Hillier is Executive Dean and Professor of Finance at the University of Strathclyde Business School. He is the author of the largest franchise of Finance textbooks outside of the US and has visiting appointments at universities in Italy and Thailand. David is recognised as being in the top 3% of the most prolific finance researchers in the world over the past fifty years (Heck and Cooley, 2009) and appears regularly in the media as a business commentator. His YouTube channel of Finance lectures (professordavidhillier) has attracted more than 60,000 views worldwide.

Contact us

To find out more about how a customised foreign exchange strategy can help you save money:

Email: corporate@moneycorp.com
T: +44 (0) 207 823 7800 and quote the white paper.