2018 FX Markets Review

BLOMINVEST BANK

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Trade war, rate hikes, Brexit and sanctions…

This is how popular currency pairs reacted to 2018's global events

The euro started 2018 on a strong note but was rattled by political instability and weak growth in the euro area and ended the year down by 4.39% against the dollar. The British Pound was rattled by major uncertainty surrounding Brexit and lost 5.59% against the dollar in 2018. Despite trade tensions, the dollar was strong in 2018 on the back of four Federal Reserve interest rate hikes and robust economic growth.

Euro/Dollar: A Review of the Most Liquid Currency Pair in 2018

The euro did not sustain the gains it recorded against the dollar at the onset of 2018. The euro ended the year down by 4.39% against the dollar with the pair reaching 1.1469 at the end of 2018 compared to 1.1996 at end 2017. However, the picture was not always this gloomy for the euro as it started the year strong against the dollar moving within the range of 1.20 – 1.24 throughout the month of January, a level not seen since the beginning of 2015.

Political events and the European Central Bank's (ECB) statements boosted the euro at the start of 2018. In his January speech, Mario Draghi, the head of the ECB, highlighted that "Incoming information confirms a robust pace of economic expansion, which accelerated more than expected in the second half of 2017". Moreover, the Eurozone's IHS Markit PMI stood at a staggering 58.6 in January, the highest since June 2006. The survey showed higher business and consumer spending in the services sector and reported the fastest growth in employment in 17 years. Meanwhile in Germany, the Eurozone's largest economy, a breakthrough in the talks to form a coalition government offered the market a sigh of relief. This positive buildup led the euro to what is in hindsight its highest level of the year, 1.2508, on the 1st of February 2018.

The tide shifted against the euro at the beginning of May. As of May, the euro/dollar broke below the 1.2 mark and would not climb back up to this level for the rest of the year. Back in April, disappointing inflation figures of 1.3% compared to 1.9% a year earlier hinted that a phasing out of the ECB's stimulus would be delayed as inflation remains far from the exit target of 2%.

While the euro was weighed down with weak inflation figures, the dollar made an advance in May. The dollar received a boost in May as the Federal Reserve announced three planned rate hikes in 2018 after it had already upped rates in March by 0.25% to a new range of 1.50%-1.75%. The euro-dollar lost 3% over the month of May and ended the month at 1.1690 against the dollar.

With the Italian crisis kicking-in, the euro/dollar remained near the 1.16-1.17 range. Italian politics made headlines with strong anti-euro sentiment rising within the country and with a crash exit of Italy from the Eurozone sparking considerable concern. Concerns are warranted with Italy being not only the third largest country in the Eurozone but also the most indebted with a massive 2.3 trillion euros worth of sovereign debt.

The euro rallied in the first half of June on news that the ECB is planning on tapering its bond buying program. The euro/dollar rallied and rose to 1.1789 one day ahead the expected ECB announcement and later eased back to 1.1567 on the day of the announcement on June 14th; Mario Draghi declared that the bond buying will stand at 30 billion euros per month until September and then taper back to 15 billion euros per month until the end of the year, when the bond buying will come to an end. However, it is Mario Draghi's statements about economic uncertainty and "no rush" to raise interest rates that prevented the euro from holding on to the gains accumulated in the first half of June.

August compounded a series of negative events which led the euro/dollar to hit the 1.13 for the first time in 2018. France's rail workers went on strike thus weakening the country's economic growth, UK talks hinted at a no-deal Brexit and the Turkish currency crisis sparked by US sanctions triggered major market jitters. More specifically, the depreciation of the Turkish Lira triggered contagion talks as Spanish, French, Italian, German and UK banks have a combined exposure of more than $160 billion to Turkish debt. Meanwhile, the dollar was going strong as the US posted a robust 4% GDP growth in the second quarter of 2018.

The next major blow to the euro came in October 2018 when Italy revealed its budget plans. The announced budget plan meant the fiscal deficit would stand at 2.4% of Italy's GDP in 2019. Although this remains below the 3% of GDP agreed upon by EU members, this level of fiscal deficit implies increased borrowing which Italy had promised to tone down.

For the last two months of 2018, the euro/dollar continued to fluctuate far from the year-start highs. The end of year period saw the euro/dollar chained to the 1.13-1.14 levels on the back of no-deal Brexit jitters, disappointing Euro area growth and the ups and downs of US-China trade talks. The euro ended the year down by 4.39% against the dollar as mentioned above.

As for the dollar, it managed to take the upper hand against the euro in 2018. In fact, the Federal Reserve's 4 interest rate hikes throughout the year and the solid growth (3.5% in Q3 2018) boosted the dollar, despite trade war tensions.

US Sanctions on Turkey Generated a Currency Crisis

The sizeable drop in the value of the Turkish lira in August was ignited by tensions between Turkey and the United States. Turkey refused to release Andrew Brunson, a jailed American pastor held for his alleged links to political groups blamed for the 2016 failed coup d'état attempt in Turkey. In rebuttal, the US slammed the Turkish ministers of Justice and Interior with sanctions and later doubled tariffs on steel and aluminum imports from Turkey to 20% and 50%, respectively. The sanctions led to a massive 76% dwindling in the Turkish lira against the US dollar, going from 3.789 at the end of 2017 to 6.6701 at the beginning of September.

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Turkey’s economy is particularly vulnerable to currency fluctuations due to its high external financing needs that could amount to $128 billion (two years of current account deficit and corporate debt maturing in up to 2 years). Turkey runs a large current account deficit forecasted to reach $56.85 billion in 2018 or 6.8% of GDP. Corporate debt amounts to around $200 billion, or 70% of GDP with half of corporate debt denominated in foreign currency. According to the Central Bank of Turkey, Corporate domestic debt issued by resident banks, other financial companies and non-financial companies maturing in up to two years amounts to around $14 billion. Moreover, Foreign Direct Investments into Turkey dropped from $13.3 billion in 2016 to $10.9 billion in 2017 and is forecast to drop to $8.3 billion in 2018, according to the IIF.

Despite resistance from the Turkish President, the Turkish Central Bank eventually raised interest rates. In the face of such a heavy deterioration in the value of the Turkish Lira, the Turkish Central Bank raised interest rates by 625 bps to 24%. The move eased market concerns, especially given the context of soaring inflation, and allowed the USD/TL exchange rate to ease around the 5.2-5.4 mark until year end.

The USD/LBP: A Solid Currency Pair

The Lebanese Pound has been pegged to the USD for more than two decades (although it is allowed to move within a specific range as shown in the graph above). The peg has been trading near the upper ranges recently due to extended political gridlock. For our views on the peg, here is a detailed analysis published on our blog: http://blog.blominvestbank.com/27400/peg-best-option-lebanon/.

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