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Regime change

Despite a steady outpouring of market-moving news over the past year, currencies have largely shrugged off events, causing many investors to expect a new, lower volatility regime in the months ahead. But there are reasons to believe the prospect of higher volatility exists and with it the resumption of currency trends in 2017.

Currency investors were relatively stoical during some significant events in 2016, including the attempted coup in Turkey, shifting political sentiment in Europe and the US and mixed signals from key central banks. The main exception was sterling, which fell to a 31-year low against the US dollar after the UK electorate voted in June to leave the EU.

The Deutsche Bank Currency Volatility Index - which indicates investors' expectation of future currency volatility -reflected this, largely tracking sideways in 2016. Implied volatility was low despite events that ordinarily could have caused significant shocks to the market.

As we head into 2017, we believe the problems evident at the start of 2016 have not been solved but

merely kicked down the road. Bonds are even more fully valued now than they were at the start of 2016, while equity valuations are further out of line, with gains having relied on an ever lower discount rate and multiple expansion to justify current levels.

A lot will rest on the global growth outlook in terms of where we go from here. While it appears global growth is picking up, we would caution that recent upticks have largely been seasonal. There are tentative signs that inflation is also ticking higher. If real growth were to rise it would provide a supportive backdrop for risk assets and push up real interest rates, which would be broadly supportive for the US dollar, particularly against lower yielding currencies.

Risks to this scenario would, in my view, include a stronger-than-anticipated pick-up in inflation, something which would likely result in central banks being less accommodative. Risk assets would be expected to struggle in this environment and the US dollar would likely perform well against high beta currencies. The US dollar's performance against low-yielding currencies will depend on whether the Federal Reserve is seen to be ahead of or behind the curve in terms of normalising policy.

In either case, a pick-up in volatility could materialise across all markets. This may well present currency investors with greater opportunities as new trends emerge. A situation where the sideways move in currency markets and low volatility environment extends into 2017 could occur if the pick-up in global growth begins to fade and inflation remains muted.

Meanwhile, it's worth noting how stable the US has been with respect to growth and policy. Growth has been firm enough for the output gap to close but at a relatively slow pace. Moreover, the asymmetry of risks is skewed towards too little rather too much inflation, meaning policy makers have been happy to stand back and risk an overshoot in inflation to the upside.

However, as time goes by, we move ever closer to a time when policy makers will have to attempt to slow growth to a point where the labour market is no l onger tightening. Getting this policy shift just right is a tall order. Too much tightening risks causing a slowdown; too little could lead to inflation and delayed, but perhaps greater, monetary tightening later on. Both are likely to inject volatility into the foreign exchange market.

Putting the question of volatility to one side, one core consideration for currencies is how a potential shift by the world's central banks from monetary to fiscal stimulus could play out. The euro area, for example, looks like it could benefit from a more fiscally focused response to economic weakness. However, the political construct of the euro area and the balance between those that have the room to ease fiscally and those that need to means the European Central Bank is likely to have to take the strain in supporting the currency for the foreseeable future. In contrast, the US and UK may have less need for a shift away from monetary to fiscal policy but politically it would be easier to deliver. To the extent that a country shifts away from monetary to fiscal policy easing, this should be relatively supportive for the domestic currency.

Reserve status for the yuan?

Another core question for investors in 2017 is whether China can continue along its current growth trajectory. In currencies, the corollary of this is the question of whether the Chinese renminbi can continue to make progress on its long march towards reserve status. Here, we note how in 2016 the yuan's status was enhanced by its inclusion in the IMF's Standard Drawing Rights basket.

Looking forward, we believe the renminbi is likely to continue to grow in importance as a traded

currency, even as the US dollar remains unchallenged as the global reserve currency. While other currencies such as the euro, pound and yen are included in the reserve baskets of many central banks, their weight is relatively small compared to that of the US dollar. Further liberalisation of China's capital account and the associated internationalisation of China's capital markets should allow the renminbi to continue to develop as an international unit of exchange. It's certainly likely that the yuan will be added to more central banks' reserve baskets over time but it's also likely to have a relatively small weight for the foreseeable future.

In other emerging market countries, we note that currencies are not all born equal. Some emerging market countries, such as Chile, for example, are large commodity exporters and so the movements of their currencies are dominated by changes in their terms-of-trade, which result from swings in the pricing for basic materials. Other emerging markets – Korea for instance – have no meaningful commodity exports and so their currencies tend to be driven by other factors. Factors such as commodity price swings and political developments in countries like Brazil and South Africa will likely create different drivers within emerging markets in the months ahead. While there will be differentiated themes within emerging market currencies, strong capital flows into the asset class is a tide that has helped to lift most boats.

If the US Federal Reserve follows a path of very gentle interest rate tightening against a background of firming global growth, we feel the general support for emerging markets is likely to remain intact. If, however, the Fed raises interest rates more sharply than currently discounted, especially if it is due to rising inflation, then this may have a more negative impact on emerging markets as an asset class.

What to watch in 2017

- An increase in currency market volatility.
- Bond yield instability which could indicate investors are bracing for a major shift across markets.

Fixed income in 2017
What next for inflation, liquidity and yields?

April LaRusse
Senior fixed income product specialist at Insight, a BNY Mellon company

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head of currency

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