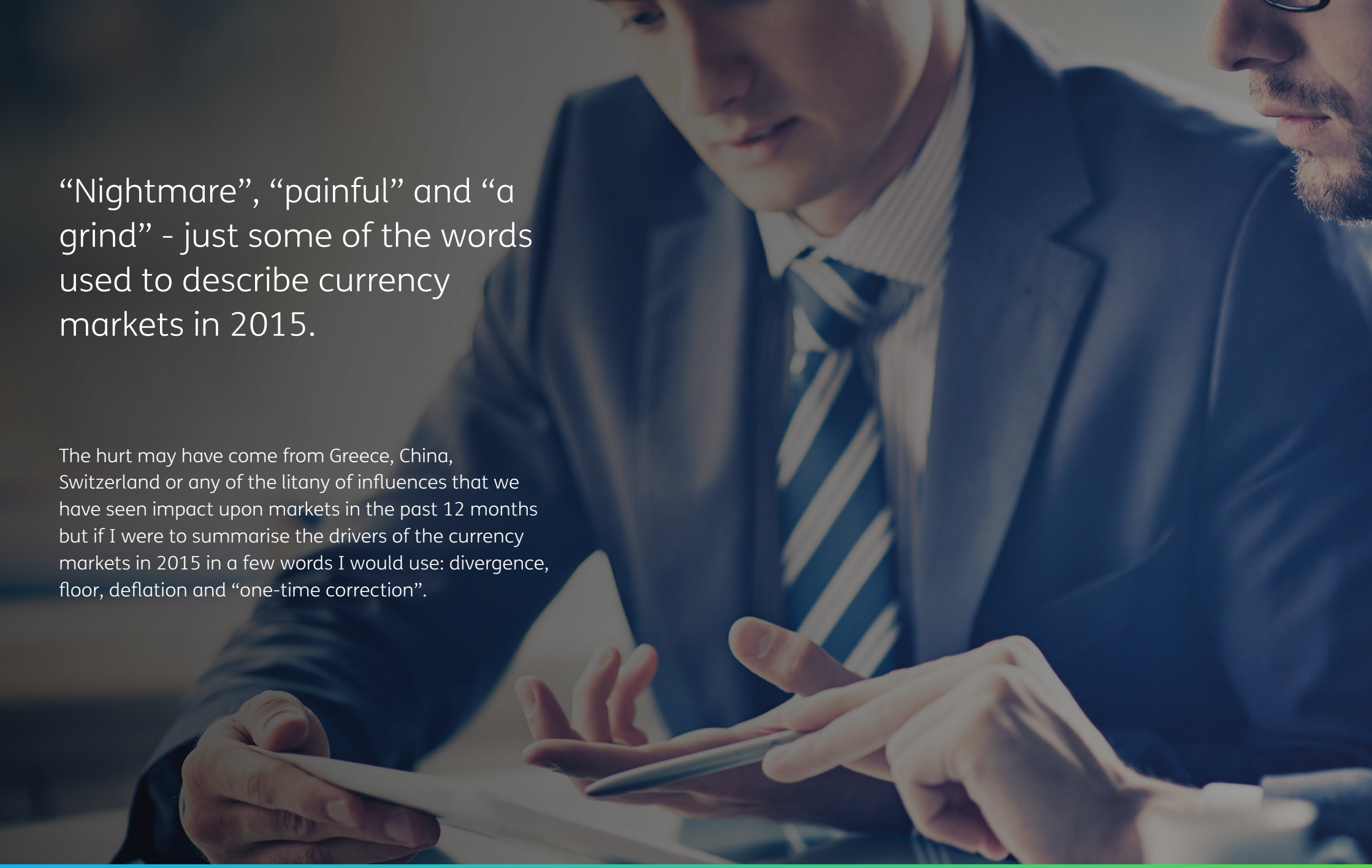
4 things that drove markets in 2015 and 3 to watch in 2016

Industry Insight

WorldFirst



“Nightmare”, “painful” and “a grind” - just some of the words used to describe currency markets in 2015.

The hurt may have come from Greece, China, Switzerland or any of the litany of influences that we have seen impact upon markets in the past 12 months but if I were to summarise the drivers of the currency markets in 2015 in a few words I would use: divergence, floor, deflation and “one-time correction”.

Divergence

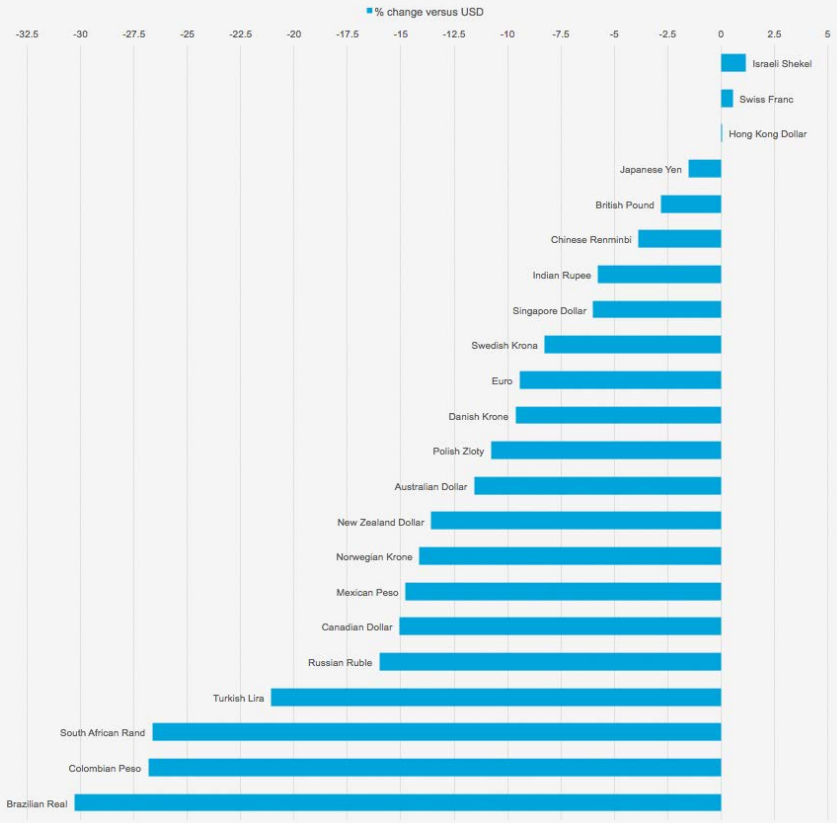
Almost all year has been spent positing and predicting when the Federal Reserve would raise interest rates. Taking the stabilisers away from the US economy is a sea change in central bank policy. As of this week we have finally seen the first step.

The reasons for a rate rise – growth, the labour market, eventual inflationary pressures and the need to move away from ultra-cheap money – now easily outweigh the risks that a strong dollar and wobbly emerging markets would bring.

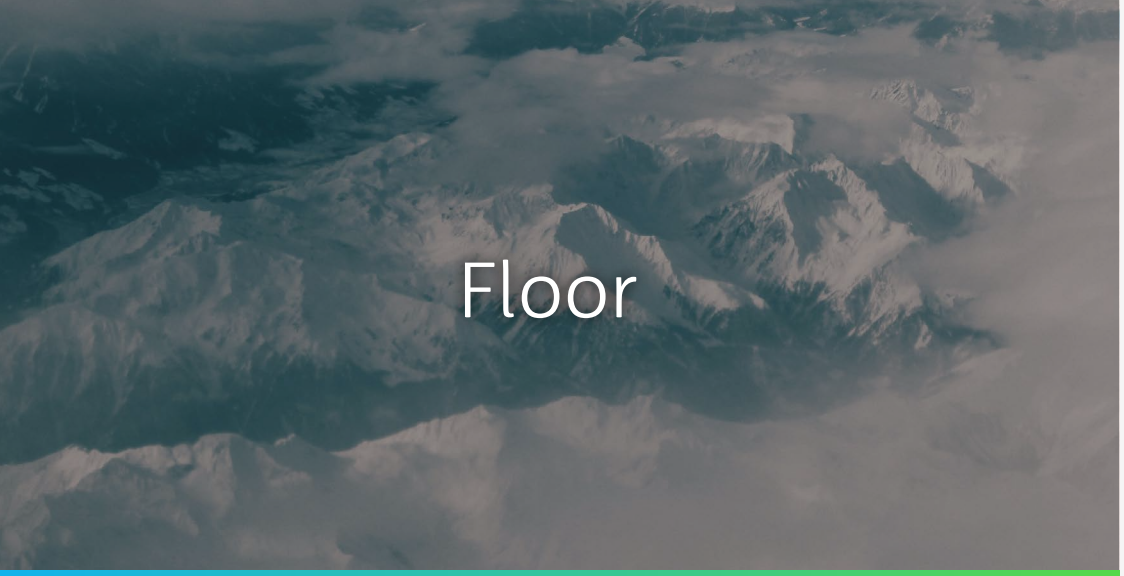
Of course, for every central bank out there looking to raise rates there are a fistful who have cut rates, extended quantitative easing or undertaken outright operations to weaken their currency. This year alone we have seen over 40 central banks amend policy in reaction to currency imbalances, low growth, poor inflation or competitive devaluation.

The graph on the next page shows this in a rather clear context.

Wider major currencies losing against the USD



Will this divergence continue through 2016? It looks like it will. For every rate hike, through 2016 we are set to see opposite reactions from bodies such as the European Central Bank, the People's Bank of China and the Bank of Japan. The key for the Fed and the Bank of England is to make sure that this divergence does not become too wide and thereby leads to overstrong currencies, lower inflation and worsening trade conditions.



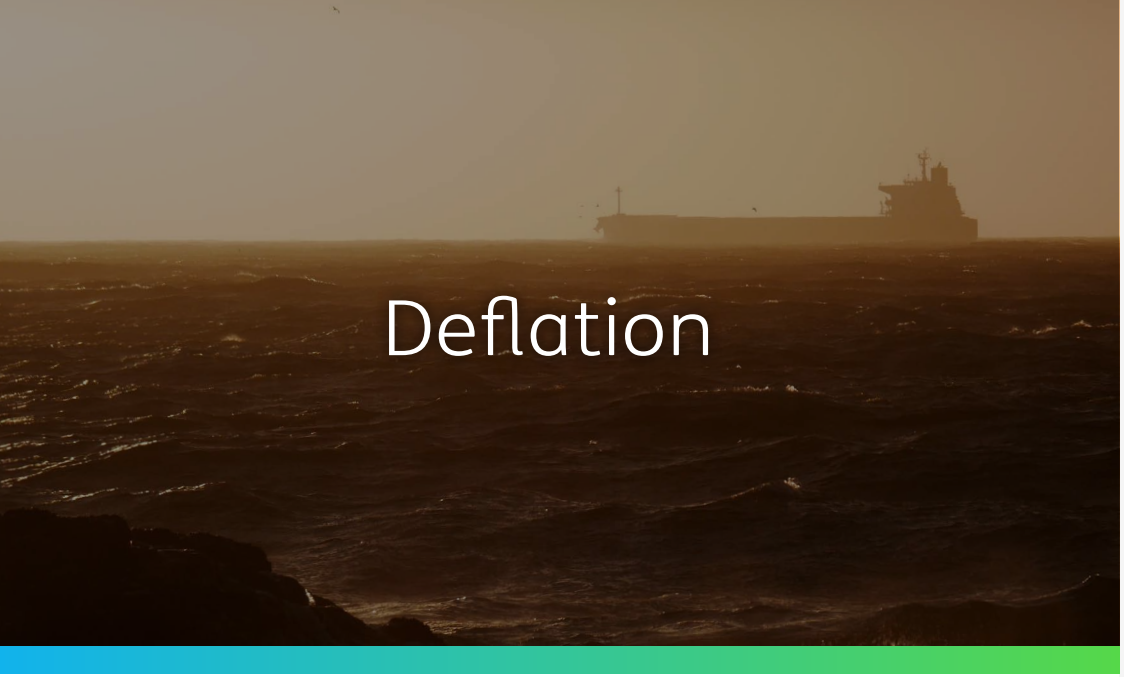
Floor

2015 had barely started when the Swiss National Bank initiated the largest currency move I have ever seen. By cancelling their floor in EURCHF that limited the value of the Swiss franc from breaking the 1.20 level, the Swiss National Bank ended a 3½ year monetary policy experiment.

The main motivation of the SNB was a capitulation in the face of a tide of euro selling that was forecast as a direct result of the European Central Bank's decision to launch a QE program. A desire for a safe haven asset has also driven CHF buying and pressured the 1.20 floor. We have seen Russian money move into Swiss assets in the past year as an escape from sanctions and a haven from the collapse of both the rouble and the oil price. CHF had become almost too safe.

The SNB's imposition of negative interest rates on deposits is designed to halt these flows but will do little in the short term. Longer-term policy will likely see a peg of the Swiss franc reintroduced, however not against a single currency. More likely this will be constructed to sit against a basket of currencies (USD, EUR, GBP, JPY etc.) to allow for a more blended reaction of the CHF and a more rounded monetary policy outcome. We could also see the Swiss National Bank allow for further, more negative rates to weaken the currency.

EURCHF in 2015



Deflation

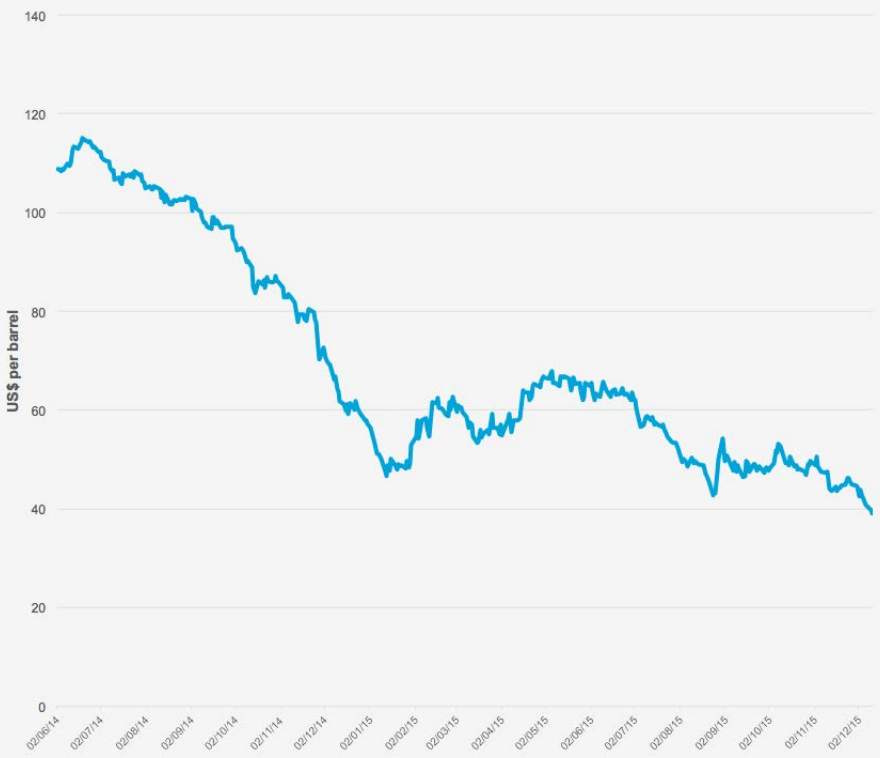
The global price of oil has fallen rapidly over the past year. Between June and November 2014 oil fell from $113 a barrel to $80. By January it had hit $46 and has averaged $55 through 2015. The falls have been driven by a collapse in aggregate demand globally as manufacturing operations and industrial output slump in emerging markets while new supply also came online. More commodities, lower demand and any GCSE economics student is going to be able to tell you what that meant for prices.

The ensuing pressures on prices were felt almost instantaneously and represented a double-edged sword for policymakers in developed and developing nations. Europe, the UK and the US, where central banks have spent trillions in the past five years trying to increase consumer expenditure, were able to allow higher disposable income to take up the fight for them. Lower inflation and outright flirtation with deflation was the sour portion of that lollipop and central bank policy has reacted appropriately.

In emerging markets and commodity currency countries – places that rely heavily on the mining, refining or the processing of these raw materials – the toll was a lot harder and the central banks of nations such as Canada, Russia, New Zealand, Mexico and Australia stepped in to cushion the effects.

Inflation, however, is a yearly statistic and we must remember that base effects will see that initial drop in oil prices fall out of the calculations in the coming months. How strongly it rebounds is the crucial economic story of 2016.

Crude oil since mid-2014



One-time correction

Economists started the year predicting that the Federal Reserve would be the main agent of economic change in 2015. It stood to reason that the US central bank would raise interest rates and roll back the crisis-proofing of the world economy as early as September of this year.

Then August 11th happened. The devaluation of the Chinese yuan alongside similar falls in Korea, Indonesia and Vietnam stopped the optimism in its tracks. Market panic picked up as falling global demand, issues of oversupply in commodities and capital, along with the belief that China would miss its 7% growth target, put pressure on international trade.

The ensuing collapse in emerging market stocks (pictured), worries over tit-for-tat currency war retaliations and competitive devaluation, when countries compete against each other to achieve a lower exchange rate for their own currency, started to reverberate around the globe, resetting the global recovery. This in turn has also added extra worry for businesses in 2015 who sell overseas due to fluctuations within currency markets.

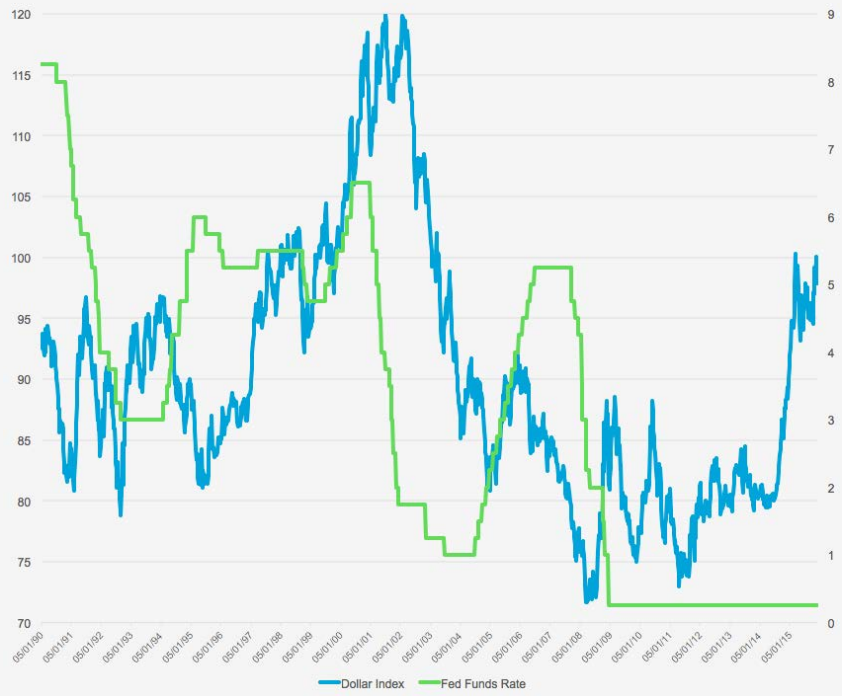
As we move into 2016 it will be the ability of the Chinese authorities to stabilise economic growth that will shape the global outlook. China at the moment is feeling the blowback of years of investment driven growth with industries chock full of unproductive factories, a housing sector with a significant stock overhang and ensuing high debt levels in local government and corporate balance sheets.

So what about **2016?**

A strong dollar

The Federal Reserve is set to raise interest rates through 2016 and economic logic would suggest the dollar should strengthen. Funnily enough in the world of currency markets it is not as simple as that. As we can see in the chart below, if you look at the performance of the dollar in the 90 days after the Federal Reserve began a program of raising interest rates (1994, 1999, 2004), the dollar actually lost ground against its G3 competitors.

Higher rates and a strong dollar?



However, this time is likely to be different. Firstly, the divergence argument is still very much alive and well. In previous hiking cycles the Federal Reserve has been joined by other central banks in tightening monetary policy in tandem. That is certainly not the case through 2016 with the Bank of England the only other central bank that may start to increase rates.

Secondly, credit spreads are improving which has been driven by yield hungry investors. The negative and weak dynamics of commodity markets are good news for consumers too.

Thirdly, risks of another global downturn will continue to favour the US dollar as the true currency of safe haven flows. There are reasons to be optimistic in 2016 around global growth but risks from China, Eurozone and Latin America balance will still exist.

Changes in the strength of leading currencies will undoubtedly have an impact on UK businesses in 2016 who make currency transfers. A World First survey recently highlighted that over half of UK SME's s surveyed are being 'kept awake at night' by currency volatility and those businesses that are most prepared to manage fluctuations will experience less impact on their business.

Political turmoil

Political risk is toxic for currency markets. 2014 had the Scottish referendum. 2015 had another Greek debt crisis and the UK elections. 2016 is set to continue that trend with the US Presidential elections and a possible referendum on the UK's membership of the European Union. Ongoing situations such as the conflict with ISIL and the refugee crisis will continue to dominate with economic consequences.

The race for the White House is a bunfight at the moment but we have to believe that the Trump bandwagon will see the wheels come off eventually. Improved economic fundamentals tend to favour incumbent parties or candidates and GDP and jobs numbers will soon be batting for Hillary Clinton in our opinion.

The build up to a UK referendum on EU membership will be a major source of instability on the GBP and the prospect of a possible 'Brexit' makes pricing the risk of the referendum a thankless task at the moment. With major events such as the Paris terrorist attacks and increased migratory flows across Europe causing variances in UK public opinion, such uncertainty will continue to impact on pricing. The referendum is an obvious weight on sterling over the next two years and assigning that price is almost impossible in the short term.

The China syndrome

If there is one economy that has the ability to make or break the world economy in 2016 it is China's. Nobody is quite sure just how much the Chinese economy has slowed through 2015 and questions remain as to how accurate their 2015 Q3 growth figure of 6.9% actually is.

Recent numbers from the Chinese economy have confused the picture; record trade surpluses courtesy of collapsing imports, retail sales boosted by 'Singles Day' and a manufacturing sector performing at its worst level since 2012. Analysing China is a difficult thing at the best of times.

As we move into 2016, the Chinese economy will continue to be affected by similar issues faced in 2015. There are simply too many smelting operations, refining plants and manufacturing facilities for current levels of both global and domestic demand, while levels of local and municipal debt mean that regional governments are unable to ride to the rescue.

More support from Beijing is likely. This analysis may be towards the cynical end of the spectrum but with the CNY recently added to the IMF's Special Drawing Rights basket, the People's Bank of China may attempt to weaken the yuan to garner export competitiveness. Deflationary pressures are on the rise in China as a result of falls in manufacturing production and this only adds to our belief that the Chinese authorities will move to stimulate both fiscally and monetarily in the near future - by Chinese New Year (8 Feb) at the latest. With that in mind, we forecast that the Chinese economy will grow at around 6.0% through 2016.

Conclusions

Central bank policy divergence came from US growth and labour market strength and will continue to be felt through a strong dollar and a weaker euro in 2016. Deflation will be forced out by stronger commodities but pay growth may disappoint. China will continue to rebalance away from its limited consumption economy.

The outlook for currency markets is not as simple as higher volatility. While that is likely to be the case, especially if global market falls or weak inflation proves less of an impediment to the Fed's policy of normalising interest rates than currently thought, we will continue to see outflows from emerging markets and divergent monetary policy. Holders of Asian and other emerging market currencies are likely to have their feet held to the fire in the coming months as a result.

With the average UK SME making 20 international payments a month, developing an effective currency strategy will be critical for businesses in order to navigate the economic uncertainty of the year ahead.

2015 was painful and 2016 will be far from straightforward.

These are the views and opinions of our Chief Economist and should not be relied upon as advice. If you would like to discuss how to protect yourself in 2016, please get in touch:

877.966.8656 **corporate.usa@worldfirst.com**