FX GIANTS

GIANTS IN TRADING

2018

FXGiants

YEAR AHEAD REPORT

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Year ahead 2018: Start of Monetary Policy normalization on the horizon.

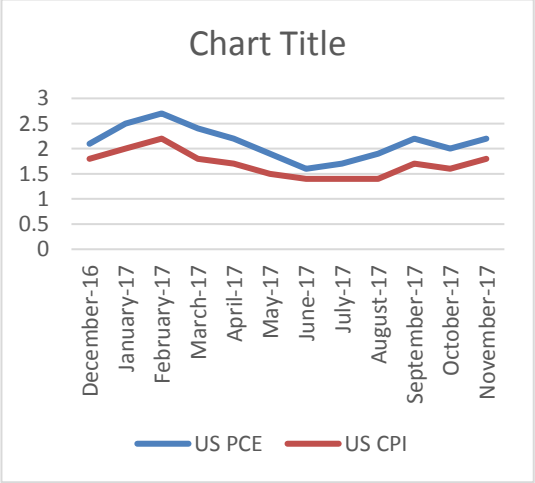
Market outlook: Themes for 2018

- Monetary policies to start normalizing slowly and carefully
- Increased efforts to regulate cryptocurrencies
- Political risks in the Eurozone
- "Brexit" to drive sterling
- NAFTA to be modified

As ancient Roman God Janus, 2017 had two faces, one looking backwards and one forward. 2017 was a year shaped by events of 2016 such as the Trump election and the Brexit referendum, but had also its own surprises, as the rise of the cryptocurrencies, monetary policy easing reducing slowly and the increased North Korea threat. What does 2018 keep in store for us? Will monetary easing indeed come to an end or will the extraordinary policies become ordinary? Will the Brexit negotiations end with a soft Brexit deal or a hard one? Are the political risks and differences going to weaken the Eurozone and split the EU, or are they to be overcome and strengthen Europe as a whole? What will be the effects of the new US tax law in the US economy? This report will try to give as many and meaningful insights to these and other questions, while keeping the individual investor in the core of its attention.

US – Living the results of the new tax law

The first year of the Trump administration was at least unpredictable, as it was generally speaking out of the norms the average voter was accustomed to, until now. Besides any new possible surprises and the usual unpredictability from the US President, the greatest political risks ahead for the USA, would stem from the midterm elections in 2018. In November 2018, the new House of Representatives and the new house of Senate will be voted. Should the Democrats win the majority in either of the two houses Trump's administration legislative power will be heavily constraint. Wins like the recent tax plan will become more difficult if not impossible and government shutdowns more possible. Should only the Senate be won over by the Democrats, many more investigations could be expected into Trump's administration. Also, the Trump administration will have more difficulties in appointments which require the Senate's consent. All in all, should there be a Democratic win in Congress, far more instability or at least constrain on the Trump's administration side should be expected. The issue could get even more complicated as the midterm elections will also decide the governors in a number of states as well as the majority of the state legislative chambers. Current polls show a grim picture for the Republicans, however on the other hand it is still too early for any predictions.



On the economic level the effects of the new Tax Law remain to be seen in 2018. The new tax law was designed with the intent to create new jobs, increased profit for companies as they would be taxed less, increased investments and a possible repatriation of US companies abroad. However the overall effect could be muted as there would be less income for the US administration and hence a low fiscal policy on the governments side. Should the Trump administration attempt to increase the fiscal stimulus it could be the case, that the national deficit would increase resulting in even higher debt.

Given that demand may be less in 2018, as media reports suggested that China may curtail its US Bond buying program, bonds will have to increase yields in order to compensate, leading to a negative spiral for the US economy. Also, it could be the case that European nations, may reply to the lower US tax rates by a corresponding lowering of theirs, however this may not be needed at all, as there are a number of European countries (ie. Ireland) which host US high tech companies where the current tax rate is significantly lower than the new US effective tax rate.

Currently, the US economy seems to be robust, as various financial data indicate. The consumer price index rate is currently at 2.1% which is considered as quite healthy and the personal consumption expenditure rate, the Fed's favorite, was at +1.8% for November, just 0.2% below the Fed's target of 2%. The new tax plan is expected to boost these figures as new jobs are to be created. The unemployment rate is also low at 4.1%, indicating a rather tight labour market. Wages rate of increase remained at rather low levels, actually at +1.8% in December, however should the new Tax law deliver the new jobs promised in conjunction with the rather tight labour market there could be some enhancement of the wages increase rate. Last but not least, the final GDP growth rate for Quarter 3 (Q3) for 2017, was at 3.2% which is also considered as quite healthy. Overall, the prospects for the US economy seem quite promising and should there be any signs of overheating, we could expect an intervention by the Federal Reserve Bank (the Fed).

The Fed which has a dual mandate, to keep inflation rate and unemployment rate at acceptable levels, uses primarily two instruments to achieve that. The first would be the interest rate and the second is the asset purchasing program. The Fed had announced in September 2017 that it would reduce its asset purchasing program, however that did not happen yet. We see the case for the Fed to start curtailing the program within 2018 either by not reinvesting in maturing assets, or even should it want to increase the pace of divestment it could start selling some of its assets. Regarding the interest rate, the Fed has already started to hike from December 2017 as it increased its interest rates from +1.25% to 1.5%. There have been a number of predictions regarding the number of possible rate hikes in 2018 by the Fed. Some analysts suggested two potential rate hikes within 2018, while others have suggested as many as four rate hikes. We see the case for the Fed to raise interest rates three times within 2018, thus reaching a target of +2.25%, as currently, most members of the Federal Open Market (FOMC) consider an interest rate of equal or greater than +2.125% by the end of 2018 according to the current dot plot of the FOMC, as appropriate. Having said that, it should be noted that both the number of rate hikes and whether the Fed is going to curtail its asset purchasing program is dependent on the developments of the US economy, as well as whether of the FOMC members and the Fed members, will adopt a more hawkish or dovish attitude. The FOMC could have a more hawkish tone, as Mr. Neel Kashkari who until now had a more dovish attitude will no longer be a member of the FOMC. Also, it will be interesting to see whether the switch of the Feds Chairman (Ms. Yelen is leaving, Mr. Powell is coming) will have an effect to the overall policy decisions.

Eurozone – Political risks and ECB policy to dominate the euro

On the other side of the Atlantic, the Euro area could have an interesting 2018. The political side seems to be uncertain, the economic prospects for the Euro seem very good and in the monetary policy front there seems to be a switch of policies ahead.

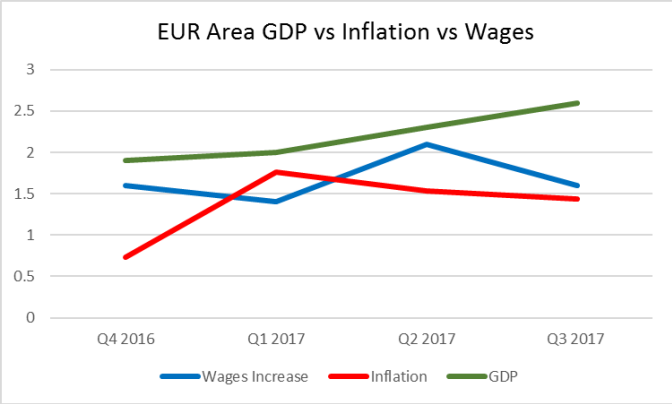
One of the political risks, which surround the Eurozone concern the elections in Italy and possibly Germany. In Germany, there seems to be an unprecedented difficulty to form a coalition of parties which could govern the country and play a key role in the Eurozone and the European Union in general. Negotiations between parties, produced until now little results leaving a weak possibility for a coalition to form. Even should there be such a coalition, it could be the case that the governing program agreed by the parties could be so weak that it will prevent them from entering any structural reforms or play a leading role in the EU. Currently it seems that the CDU, CSU and SPD could form a coalition, however as the negotiation process is still ongoing, the result remains to be seen. Should there be no result, the two options available would be either a minority government which currently seems to be rejected by Merkel and the CDU, or new elections near the end of March 2018. Should there be new elections current polls show that the result would not differ significantly from the September 2017 election and in this way the deadlock could be prolonged. More or less, the issue provides instability for the Eurozone and Europe in general and could weaken the Euro.

Instability increases as Italy is also about to hold elections in the beginning of March 2018. Currently the 5 Star Movement leads the polls while center left PD comes in second and is losing ground. The risks stem from various sources. On the economical level the 5 Star movement, seem to have abandoned any views about leaving the Eurozone, however the Movement proclaims that Italy should be allowed to increase its budget deficit by more than 3%, increasing fiscal policy for social reasons. Such a fiscal rebellion could prove to be a game changer for the Eurozone as other countries (ie. Greece, Spain and Portugal) may want to follow.

On the political level the 5 Star Movement seems to lack any alliances which would give it the necessary majority to govern. Should Italy's elections result in a hung parliament, instability may be prolonged as Italy may have to have new elections. On another political front concerns were raised that the extreme right may gain on power and promote a xenophobic agenda, which is already advocated by other extreme right wing parties in Europe.

Also on the political agenda with economic effects, France and Germany may pursuit a wider reform in the Eurozone. Such reforms could include measures such as a common Eurozone Budget (which could fund public works, new technologies and research as well as higher education). A common Eurozone budget could also function as a "shock absorber" in crisis periods for the Euro. Other ideas may include suggestions such as a common or a minimum common company tax rate, a common finance minister and all point towards a more federal Eurozone. Measures like that could positively affect the Euro, however it should be noted that they could also boomerang as national interests of the member states may prevail over further federalization.

Other political issues such as the EU's stand towards the refugee crisis, the polish judiciary reform, Catalonia's independence, Romanian governmental instability, the Greek debt, and the Hungarian elections could play a significant part on the European political stage, however they are expected to have little impact upon the EUR.



On the economic level the Eurozone seems to be quite healthy, as reflected by financial data and the course of the EUR against its major counterparts. Starting with Eurozone's inflation rate which currently remains below ECB's target rate of 2%, at the low level of +1.4% and essentially prevents a faster recall of ECB's monetary policy normalization. The inflation rate could be boosted somewhat should there be an acceleration of the wages increase which was in Q3 for 2017 at +1.6% on a quarterly basis. Increased pressures for further acceleration can be identified in Germany which could prove to be of pivotal role for the whole of the EUR area. Having said that, it should be noted that there seems to be room for further reduction in the unemployment rate which in November was at +8.7% and could tighten the labour market further. Last but not least, the increase of the GDP reached a 2.6%, which could be one of the best if not the best since the beginning of the decade when the crash started.

In the short term we see the case for the ECB not to give up on its current Quantitative Easing Program and such a development could hurt the EUR short term wise, as the market may have had higher expectations on a quicker stopping of the ECB asset purchasing (QE) program.

On the long run (in 2018) , the monetary policy regarding the interest rate policy is currently not expected to be changed, retaining the refinancing rate at 0% throughout the year 2018, with expectations running as late as mid 2019 for a rate hike to happen. On the other hand, ECB may start gradually reducing its QE program, by buying bonds at least until September 2018. Such a development could reduce the yields as supply will be low. Any signaling for an early end or a possible earlier rate hike could strengthen the EUR.

Please be advised that during 2018, a number of ECB officials are about to leave the ECB as their term is ending, highlightening the end of Mario Draghi's term. Should there be a more hawkish replacement, ECB's tone could change somewhat.

UK – "Brexit": Things just got serious

The UK political stage is strongly dependent on any further developments arising from the Brexit negotiations. Should there be any further developments favoring a soft Brexit, the GBP should strengthen as there will be a better outlook for the UK economy. 2017 gave the UK a present, as the EU ratified that the Brexit negotiations had advanced significantly, signaling the entering into the second stage of the negotiations. The negotiators now, will discuss topics such as trade relationships between the two parties which are considered as far more complex.

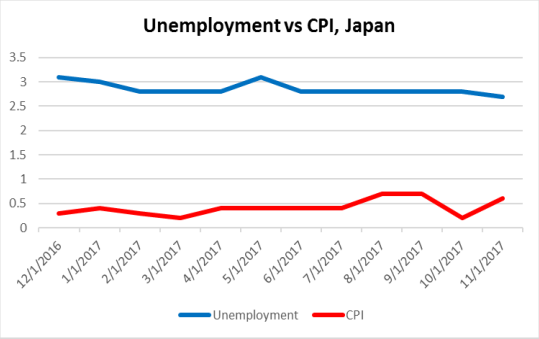
The UK political stage seems currently split between a harder and a softer Brexit and the UK government, seems to be pressured by both parties having little flexibility to negotiate. On the other side the until now unilateral stand of the EU member states could slowly fade away as national interests arise, making the negotiations even more complicated. Currently, we see the case for the Brexit negotiations to end up in a softer Brexit deal modelled after the EU-Canada relationship. However, such a scenario could leave UK's financial sector exposed heavily, implying major losses for the UK economy, and we expect there to be a special arrangement between the two parties. .
On the homeland front, the health and housing policy of the UK government have provided for significant criticism towards the government and could prove to be a significant risk for Theresa May. As Labour party seems to be strengthening, any mistakes such as last year's snap election decision could prove to be fatal for the current British government.

On the economic level the UK could be a source of worries as a number of indicators may have room for some improvement. For starters, the CPI rate is currently at +3.0% which is significantly higher than BoE's target of 2%. The overall effect of the high inflation rate compresses households purchasing power, as average earnings increase at a rate of +2.3% (as in November). On the other side the unemployment rate was at 4.3% in October, signaling for some hope as the labour market seems to be somewhat tight. Should the above, be combined with a GDP growth rate of +1.7% (as at 3rd Quarter of 2017), there could be some hope for wages increase somewhere in the third quarter of 2018. However, everything is dependent on a smooth transition during the Brexit negotiations.

A further measure which could be taken by the Bank of England (BoE), would be to raise interest rates in order to cool down the economy somewhat and reduce the inflation rate. A side effect of such an interest rate hike would be some slackening of the labour market, however at the current stage the UK, as seen in the economic analysis above, has a rather tight labour market. A lot of ink has been spilled about this issue by various analysts, some pointing out that there may be two interest rate hikes by 2020, while others predicted even as much as two rate hikes in 2018. We see the case for the Bank of England to raise its interest rates once in 2018 by 25 basis points and that being in Quarter 3. Should that be the case we expect the GBP to strengthen, even in the anticipation of the rate hike.

Japan – Politically stable however monetary policy may gradually shift

The Japanese political stage seems to stable. Prime Minister Shinzo Abe and the Liberal Democratic Party (LDP) won the general elections in October by a wide majority. Hence the rather fresh mandate in combination with the wide majority LDP enjoys in the Japanese lower house should strengthen the argument for a stable political system in Japan. The large majority won in the last general elections should also provide help for Mr. Abe to secure also a third election, as president of the LDP, hence providing again more stability in the political stage.



The only question mark that may arise on the political horizon would be a possible attempt to change the constitution in order to enable the Japanese defense forces to expand their roles. Should there be a referendum with a negative result for the Prime minister, Abe's position could be in jeopardy. However we consider such a possibility as rather remote currently. On the financial side we see the case, for the government to continue to pursue policies aligned with the general aim of increasing the inflation rate. Japan economy's main issue would be the current inflation rate which was for November at +0.6%. Bank of Japan (BoJ) has currently a target for the inflation rate at 2%, and expects to reach its target in the next two years. Expectations and efforts by the government, concentrate on a possible wages increase as the unemployment rate was at an incredibly (compared with other economies) low of 2.7% also for November, while the Japanese economy is projected to grow with a GDP growth rate of 1.8% in 2018, by various analysts. Should that be the case, we could see the employment market tightening even further and thus providing wages increases, as labour could prove to be scarce. A wage increase in its turn, could lead to a gradual increase in the inflation rate.

On the monetary side, BoJ currently provides an ultra-loose monetary policy as it keeps interest rates at -0,10% and sustains a large asset purchasing program with Japanese Government Bonds summing up to 418 trillion Yens, by the end of November 2017. The question for 2018 currently set by various analysts, is not if BoJ is about to increase its interest rate but whether it will reduce its large asset purchasing program, as a measure to cool down the economy somewhat. We see the case for a possible increase in the current interest rates in early 2019. We expect that some efforts to reduce the current Asset purchasing program may take place in 2018, however it all comes down to the inflation rate at the moment and should it happen it may be in gradual manner so as to avoid any possible spike in the strengthening of the JPY.
A secondary issue for BoJ may arise as Haruhiko Kuroda's term will be drawing to an end in April 2018. A possible change in the leadership of the BoJ could initiate also a possible change in the tone of the BoJ.

Canada: Instability rises as NAFTA is in the balance

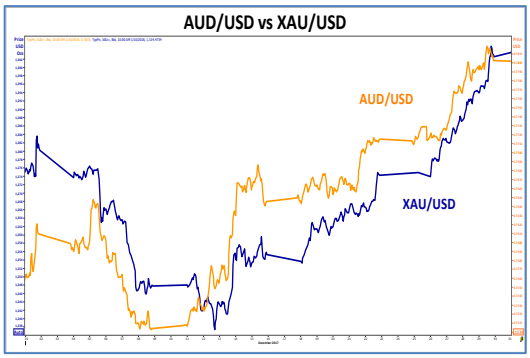
On the inner political stage of Canada there seems to be a relative calmness. Despite Justin Trudeau's ambitious and transformative political goals and expected increased opposition, the current governing party seems to enjoy the trust of the voters, as it finishes first in recent polls. Hence, our main concerns would not relate to the inner political stage as much as abroad of Canada, as the NAFTA agreement is being renegotiated. A possible restructuring or even abolishment of the NAFTA agreement could raise a number of concerns for the Canadian economy, as well threaten the political stability of the current government. We consider the case for the NAFTA agreement to collapse altogether as rather unlikely at the present, despite few signs of progress until now and some signs for a total collapse. More probable, would be a scenario where the NAFTA agreement is renegotiated and restructured as a result of the negotiations. We see the case, for the issue to come to a close, near the end of the 3rd quarter or even in the 4th quarter of 2018. Having said that, current US government's unpredictivenes should be noted as a significant surprise factor.

The economic outlook is dependent on the economic outlook of oil and the future of the NAFTA agreement. However given that the oil prices have surged in 2018, fueled by the production cuts of OPEC and Russia, and the production cuts were recently extended until the end of 2018, and assuming that oil prices will continue to be in high levels or even higher than currently, there could be a positive outlook for the Canadian economy on that perspective. The Canadian economy in quarter 3 had a GDP growth rate of 1.7% and is forecasted by various analysts to reach 1.8% by the end of 2018. On the other hand, the unemployment rate was in December at 5.7%. The CPI rate in November was at 2.1%. Overall, the financial data could be characterized as rather good to strong, however there seems to be room for further improvement, maybe with the exception of the CPI rate which is near the Bank of Canada's target of 2%. Our main concern about the Canadian economy however focuses on the high household debt as analyzed by the recent OECD report. Especially we would like to stress out the overall effect of further market tightening and debt servicing costs.

Bank of Canada hiked rates in mid-January from 1.00% by 25 basis points reaching 1.25%. Currently the bank is forecasted to hike rates maybe two or three times, reaching 1.75% in 2018, all in an effort to normalize its monetary policy. However, it could be the case that the high household debts in conjunction with the uncertainty provided by NAFTA, could reduce any rate hikes as the economy may still require a rather accommodative monetary policy.

AUD – RBA: Neutral stance, but further easing remains on the table

The Australian political stage felt a small earthquake in 2017, as a court ruling decided that citizens with dual citizenship could not be elected in parliament. This development led to a scrutinizing investigation as to which politicians have a dual citizenship and ultimately some were forced to resign on these grounds. The result was for the Australian governing Liberal/ National coalition to lose the slim majority of one vote it had in the House of Representatives. Hence political uncertainty will increase at least in the short term together with policy making delays.



On the economic level, the Australian economy could be affected mainly by two factors, the price of commodities as well as the Chinese economy. The latter could have an adverse effect as the Chinese economy may slow down, however the recent appreciation of the Yuan against the AUD, should it continue, could benefit Australian exports somewhat. The commodity prices could drop somewhat, at least for iron ore and gold and may provide also a negative effect for economic outlook of Australia. The main financial indicators for the Australian economy have improved over the past year.

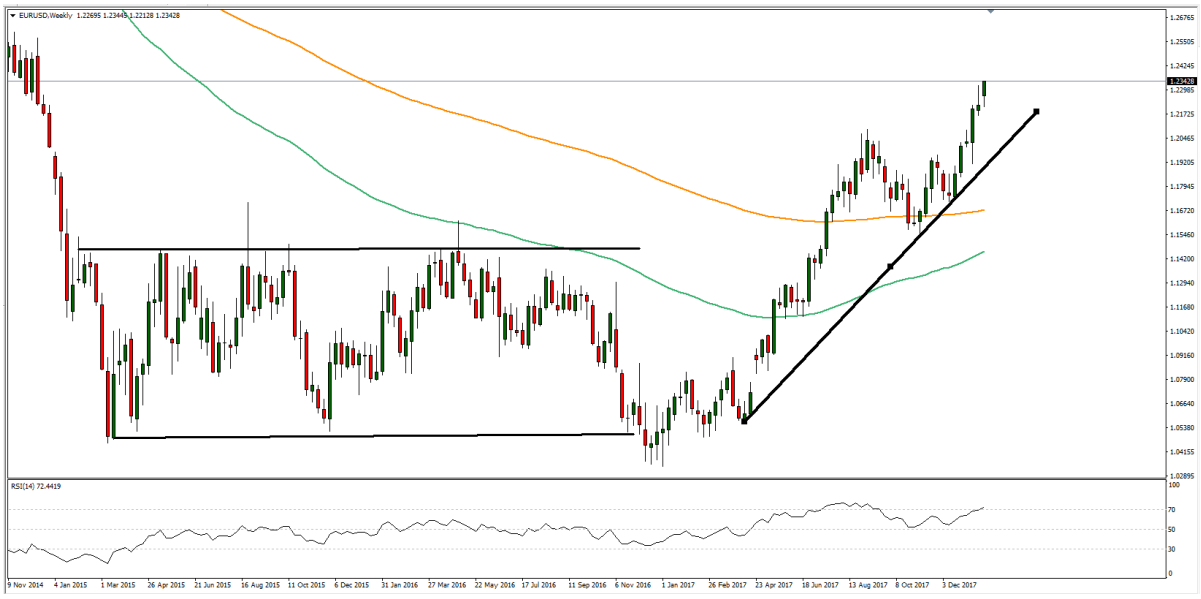
Specifically the CPI rate has accelerated to +1.8% from 12 months ago when it was at +1.3%. The unemployment rate has dropped to 5.5% from last year's reading of 5.8% and the wage price index has accelerated to 2.2% from last year's respective reading of 1.9%. Last but not least, the GDP has grown in a rate of 2.8% in quarter 3 on year on year basis compared to 2016 quarter 3 reading of 2.1% and is forecasted by the RBA to continue to grow by a rate of 2-3% in 2018. Overall the picture seems to be improving, however the risks mentioned above may have the final say in the country's economic path.

On the monetary policy side the Reserve Bank of Australia has kept its interest rates steady at 1.5% since end of September 2016, which is a record low for more than 7 years. After the recent improvement of the financial data there have been extensive discussions as to whether the RBA will increase its interest rates in 2018, with some analysts forecasting two interest rate hikes within 2018. We see the case, for the RBA to raise interest rates once in 2018 and that it could happen after the first semester. The reason for that being that the RBA may want to retain further flexibility in light of the economic risks that may lay ahead. We also share the current view of the RBA that growth may tighten the labour market further, however there some slack may still remain. If the aforementioned is seen with a current low rate of wages increases and the rather high household debt then caution could be advisable as the effects of tightening the monetary policy may have adverse effect on unemployment, wages increase rate and debt servicing costs.

Technical outlook

EUR/USD

Weekly chart



EUR/USD has been trading in a sideways range between 1.0500 and 1.1470 since the beginning of 2015. During 2016, the rate remained stuck within that range, but following the December ECB meeting, the bears managed to push the rate through the key floor of 1.0500, signaling the downside exit of the aforementioned longer term range. The decline was short-lived though, with the bears stopping at around 1.0350. The pair rebounded somewhat, reentered the aforementioned range and on the 10th of April 2017, started to move along an uptrend line which is continued until today, mirroring the good financial data of the Eurozone.

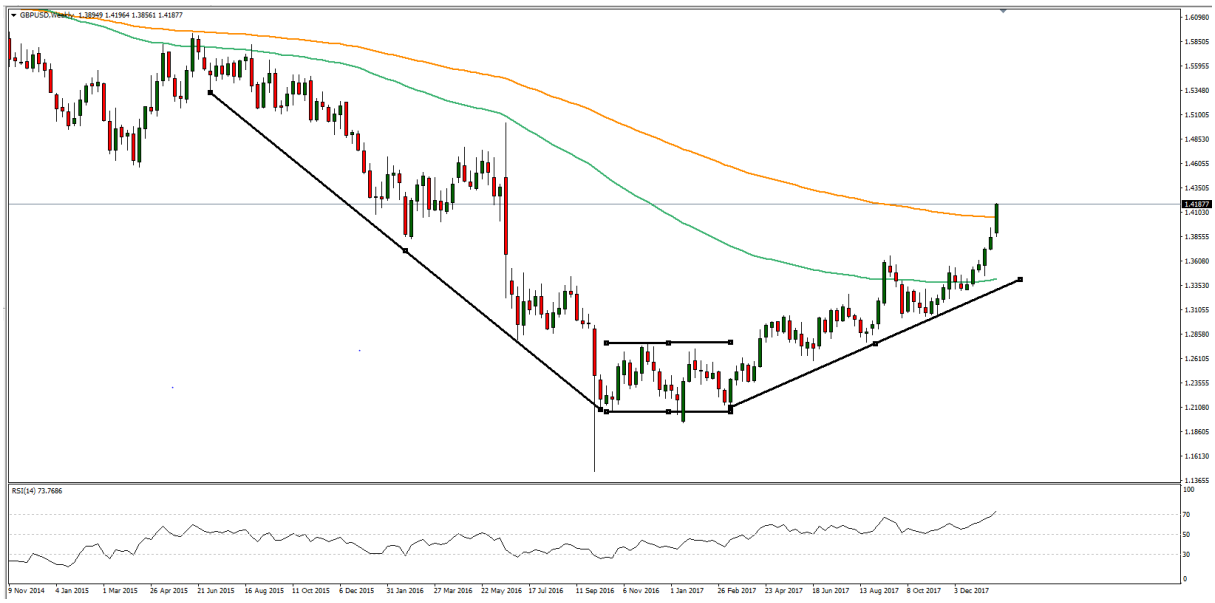
Currently, we expect the pair to continue to follow the current trend line in 2018. However we would like to draw your attention in the last quarter, as fundamentals may push the pair even higher in that period. Specifically, in October the US will have their midterm elections and Republicans may lose as currently predicted and thus the US Dollar may weaken. On the other side of the pair, we may experience the effect of the reduction in the quantitative easing program of the ECB and in that light the EUR may strengthen. Hence, we expect that the pair may experience higher volatility in that period than usual with the risks tilted to the upside.

Technically we would like to point out that the pair has broken the ranges that kept it captive, and the Relative Strength Index seems to remain pretty close to 70. The 100 moving average supports the clear upward trend while the 200 moving average moves sideways with a light bullish tone, confirming the 100 moving average.

Looking at the big picture of the pair one could summarize it in that the pair had a bearish market from May 2014 until the end of ti, then it continued on a sideways manner for two years and has rebounded by entering a bullish market since the beginning of 2017. Should it reach the pre drop 05/2014 levels, the prospect would be to reach 1.40.

GBP/USD

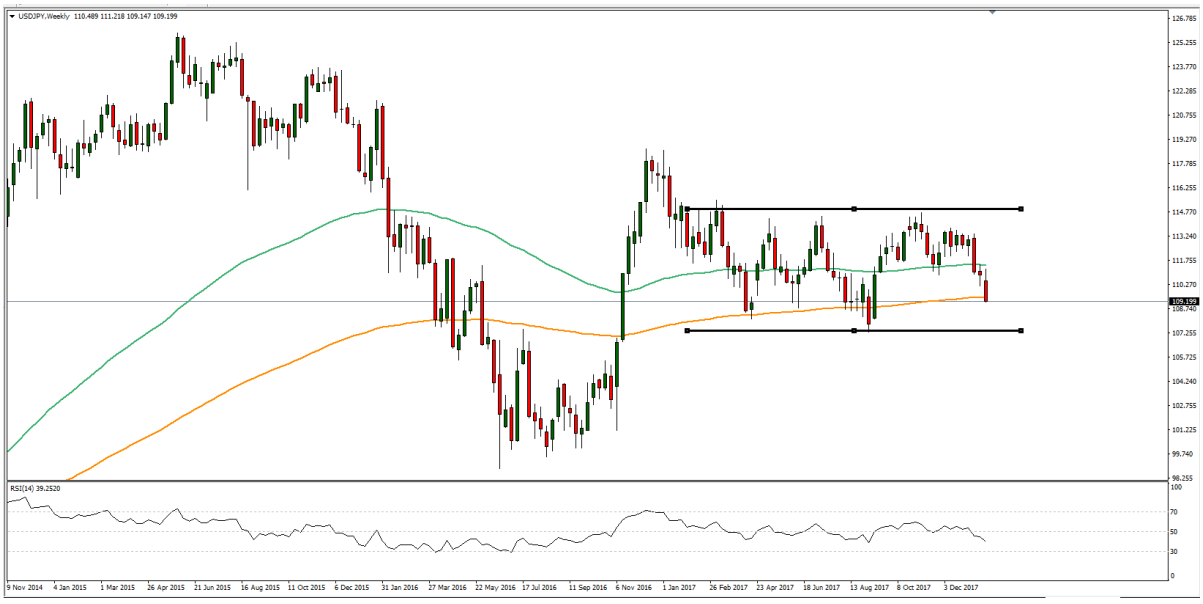
Weekly chart



The big picture for Cable is that it has been dropping on a scaled manner from July 2015 until October 2016 reaching a low of 1.2060, continued to trade in a sideways manner between the ranges of 1.2060 and 1.2770, until mid-March 2018 and then followed an upward trend until today. Technically, we would like draw your attention to the fact that at the current point the relative strength index has reached 70, while the rise of the cable has become steeper in the past month. Currently we see the case for Cable to continue its climb, however we expect that the pair's direction will be heavily influenced by the Brexit negotiations progress. Should there be indications of a soft Brexit that favors UK's economic outlook, we expect the pair to continue, in an upward trend.

USD/JPY

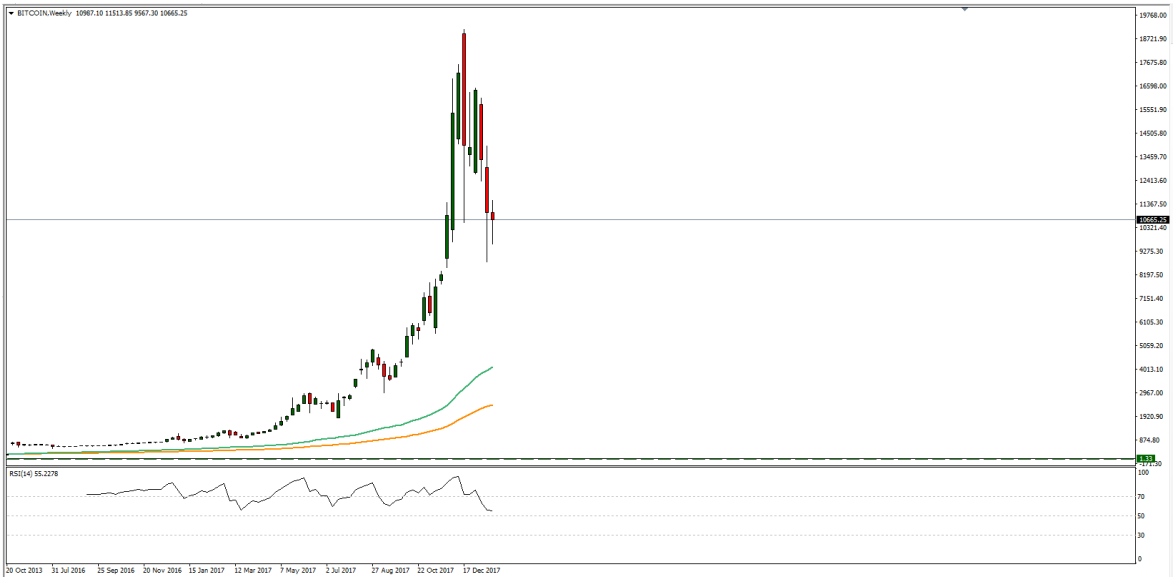
Weekly chart



In contrast to the big turbulence experienced by the USD/JPY in 2016, 2017 was a rather stable year with the pair trading within the ranges of 107.40 and 115.00. As mentioned in the Fundamental analysis for Japan before, we expect BoJ to change it's monetary policy in a rather gradual manner, in order to avoid any spikes in the strengthening of the Yen. We expect the pair to continue to trade in a sideways manner however and we also see the risks tilted to the upside as 2018 will be nearing its end during its 4th quarter. The reason for that being that any effects deriving from a possible change of policy by the BoJ, may escalate in that period and as further easing does not seem probable, we could see the yen rising slowly.

Bitcoin

Weekly chart



After its December 2017 surge, we considered that adding a further analysis for Bitcoin would be more than necessary, in an effort to satisfy our investors investing information requirements.
Fundamentally, we share the opinion that Bitcoin is here to stay, regardless if it is classified as an investment asset or a payment method. Fundamentally we see the case for the cryptocurrency's surge to be a result of number of factors. As a payment method, Bitcoin started to gain on recognition over time and as recognition got wider and wider its price also got higher. Another factor was the identification of Bitcoin as an investment instrument. Especially as worldwide recognized futures exchanges announced that they would introduce bitcoin to accommodate their client's needs. A third factor could be that mass speculation, mainly in Southeast Asia, on the increasing price of the cryptocurrency, again pushed the price even higher reaching an all-time high price on the 18th of December of USD19117.
Overall, we had an effect where the demand for Bitcoin was constantly growing while on the other hand the supply was fixed as further Bitcoin mining was becoming too expensive as it necessitated higher electricity consumption as well as more and more sophisticated equipment.
However, as the Bitcoin frenzy progressed, other cryptocurrencies also gained investors' attention as possible investment instruments. Hence the "supply" side had started to widen. Also, as various media suggested, large investors which had invested in Bitcoin, most probably in the early stages decided to cash in their profits, increasing the supply even further. Last but not least, increased warnings from a number of national regulatory bodies about bitcoin being a bubble, as well as threats about possible total banning of cryptocurrency trading reduced investors interest and drove the prices down, leading to a crash in the form of a small avalanche and the lowest price after its December peak, being USD 8791 on the 17th of January.

We see the case for the cryptocurrency to continue to fall in 2018. Main reasons for that being that large investors may continue to want to realize any profits as well as the possibility that national regulatory bodies may want to set the cryptocurrency market under regulations within 2018. We also share the view that the cryptocurrency market is still in its early stages and such high volatility could be expected, as a process towards the normalization of Bitcoin as an investment asset. Without regulation and should the high volatility not fade away it could prove difficult for large institutional investors to enter the market, as well as for its acceptance as a method of payment to be widened.

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