Central Bank Policy: Looking Ahead

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BIS FX and Rates Team:

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Executive Summary

Central Banks play a prominent role within the economy, and are vitally important to the FX and Rates markets. With this in mind, we will be 'Looking Ahead' into Central Bank policy by producing a research report, considering policy developments into 2018. This will include forecasting policy developments, analysing macroeconomic trends, and presenting our investment suggestions with recommendations on how to proceed.

We will be looking into 10 of the World's most important Central Banks, providing a comprehensive information base to draw upon for our investment suggestions and conclusions.

Contents:

We hope this piece is informative and helps give a succinct understanding of our expectations for the FX and Rates markets.

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The Central Banks:

US Federal Reserve Bank

In the coming years, the Federal Open Market Committee (FOMC) aims to fulfil its mandate of encouraging maximum employment, price stability and long-term moderate interest rates. Additionally, the committee aims to convey total transparency to the public to explain its monetary policy decisions to reduce uncertainty in the economy.

Inflation, employment and interest rates fluctuate over time to suit the economic conditions of the country. Additionally, monetary policy decisions take time to kick in, so the Federal Reserve's decisions tend to reflect its long-term goals; however, the board's decisions depend on the long-term goals, medium term forecasts, and risks involved with the decision.

Inflation

The inflation rate in the long term can be affected by monetary policy decision and the Fed aims to keep price stability by maintaining a low but stable inflation rate. At the current rate of 2%, the Fed believes that this is the most consistent number under their mandate and it's the rate they aim to maintain. The FOMC will be concerned if the rate is persistently moving away from this number. However, in the long term, even though the Fed aims to maintain price stability, decisions such as increasing rates can lower inflation rates.

Employment

Employment is vastly determined by nonmonetary factors and usually depends on the structure of the economy and the labour market. However monetary factors can affect employment. As forecasted, the Fed recently hiked its interest rate from 1.25% to 1.5%, this could lower inflation, subsequently increasing unemployment. So long term there is no specific target for employment levels but for now the Fed aims to implement decisions in a way that will not cause employment and inflation levels to deviate away from the target range.

Interest Rates

Interest rates are one of the main aspects of monetary policy, currently sitting at 1.5% amid the recent hike. The Fed is also predicted to increase their rates 3 more times in 2018, and 2 more times in 2019. However, the Fed aims to keep growth at a sustainable pace and it doesn't want the economy to grow too fast that it inflation rises too quickly, but also doesn't want to lower it and cause a slow economy.

Forecast

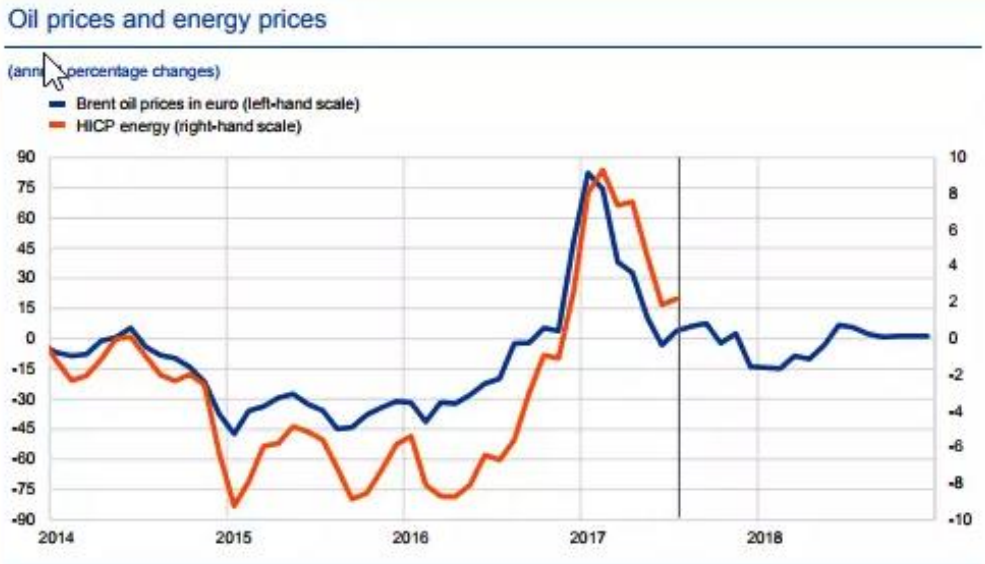
Variable	Median[1]				Central tendency[2]			
	2017	2018	2019	Longer run	2017	2018	2019	Longer run
Change in real GDP	2.1	2.1	1.9	1.8	2.0 - 2.2	1.8 - 2.3	1.8 - 2.0	1.8 - 2.0
December projection	2.1	2.0	1.9	1.8	1.9 - 2.3	1.8 - 2.2	1.8 - 2.0	1.8 - 2.0
Unemployment rate	4.5	4.5	4.5	4.7	4.5 - 4.6	4.3 - 4.6	4.3 - 4.7	4.7 - 5.0
December projection	4.5	4.5	4.5	4.8	4.5 - 4.6	4.3 - 4.7	4.3 - 4.8	4.7 - 5.0
PCE inflation	1.9	2.0	2.0	2.0	1.8 - 2.0	1.9 - 2.0	2.0 - 2.1	2.0
December projection	1.9	2.0	2.0	2.0	1.7 - 2.0	1.9 - 2.0	2.0 - 2.1	2.0
Core PCE inflation[4]	1.9	2.0	2.0		1.8 - 1.9	1.9 - 2.0	2.0 - 2.1	
December projection	1.8	2.0	2.0		1.8 - 1.9	1.9 - 2.0	2.0	
Memo: Projected appropriate policy path								
Federal funds rate	1.4	2.1	3.0	3.0	1.4 - 1.6	2.1 - 2.9	2.6 - 3.3	2.8 - 3.0
December projection	1.4	2.1	2.9	3.0	1.1 - 1.6	1.9 - 2.6	2.4 - 3.3	2.8 - 3.0

It can be seen that the unemployment rate is expected to be stable until 2019 and then in the long run expected to increase a little. This could be reflective of the higher interest rate hikes expected to occur in 2018 and 2019 that could affect inflation rates. But overall, looking at the forecast released by the Fed, their projections seem to be consistent, promoting the idea of stable economic growth, inflation, and how the economy can adjust to the rate hikes in the coming years.

European Central Bank

The primary objective of the European Central Bank (ECB) is to maintain price stability. They have defined this as by having a year on year increased in the Harmonised Index of consumer prices (HICB) of below 2% (HICB is a weighted average of the consumer price index for countries in the EU). The ECB also wants inflation to be less than (but close to) 2%. On 26th October 2017 at the last meeting they decided to keep interest rates unchanged at 0.0% but in a major policy shift, stated their intention to slash their asset purchase programme from 60bn to 30bn euros per month in January 2018 and lasting until September 2018. This could be extended if there is a not a sustained rate of inflation observed in line with their inflation aim. Therefore, inflation data out of the Eurozone is of importance if this target is to be met. The ECB sees the global recovery as supportive of Euro exports, despite recent Euro appreciation. Irrespective of this positive outlook, the ECB will be keen to keep market expectations of rate hikes low in order to limit Euro appreciation in the medium term. The threat of increasing their asset purchasing programme if Eurozone data disappoints may keep the Euro "range bound" through 2018.

Further to this, inflation was lower than expected in the third quarter of 2017, with a CPI rise of 1.4% in the 12 months to October, less than the 1.5% expected. This is reason to exercise caution in the Euro as the bank is struggling to hit its inflation objective of 2%. Despite this, gross domestic product for the Eurozone beat forecasts for the third quarter.



Source: Bloomberg and ECB calculations.
Note: The vertical line separates annual rates of change of oil prices calculated on spot prices from those calculated on futures prices of 14 August 2017, the cut-off date for the assumptions of the "September 2017 ECB staff macroeconomic projections for the euro area".

Due to the above graph, the ECB is expecting to see the inflation rate hit a low of 0.9% in the first quarter of 2018, attributable to the rates of change in energy prices (the most volatile component of HICP inflation). It is not considered a worry to the ECB but is a case to be considered prior to an extended move higher for the Euro.

An additional key risk for the Euro in 2018 is the Italian elections. Italy's "Five Star Movement", a populist party, are tipped to do very well and new leader Luigi De Maio wants to renegotiate treaties within the EU that are "capping the growth of Italy". The populist party have policies to increase spending, which are being seen as a risk to Italy's compliance to European fiscal rules and which could potentially jeopardise Italian finances further. This would naturally weigh heavily on the Euro

As this report shows, there is a feeling of optimism at the ECB, who will be hoping for a sustained, stable level of inflation in order to taper their asset purchase programme. Mario Draghi will be keen to talk down optimism where possible in order to keep a steady pace on Euro appreciation, but there is reason to feel optimistic based on this major shift in policy.

Bank of England

[1]"Monetary Policy Summary, December 2017 The Bank of England's Monetary Policy Committee (MPC) sets monetary policy to meet the 2% inflation target, and in a way that helps to sustain growth and employment. At its meeting ending on 13 December 2017, the MPC voted unanimously to maintain Bank Rate at 0.5%. The Committee voted unanimously to maintain the stock of sterling non-financial investment-grade corporate bond purchases, financed by the issuance of central bank reserves, at £10 billion. The Committee also voted unanimously to maintain the stock of UK government bond purchases, financed by the issuance of central bank reserves, at £435 billion.

In the MPC's most recent economic projections […] GDP grew modestly over the next few years, at a pace just above its reduced rate of potential. Consumption growth remained sluggish in the near term before rising, in line with household incomes. Net trade was bolstered by the strong global expansion and the past depreciation of sterling. Business investment, while

affected by uncertainties around Brexit, was projected to continue to grow at a modest pace, supported by strong global demand, high rates of profitability, the low cost of capital and *limited spare capacity*.

Unemployment was expected to remain low throughout the three-year forecast period, and domestic inflationary pressures were projected to pick up gradually as remaining spare capacity was absorbed and wage growth recovered. Nevertheless, *reflecting the diminishing effect of sterling's depreciation, CPI inflation was forecast to decline* from around 3% to approach the 2% target by the end of the three-year forecast period.

The recent news in the macroeconomic data has been mixed and relatively limited. Global growth has remained strong. Domestically, some activity indicators suggest GDP growth in Q4 might be slightly softer than in Q3. The measures announced in the Autumn Budget will lessen the drag on aggregate demand stemming from fiscal consolidation, relative to previous plans. The labour market remains tight, and surveys suggest this will continue. […]

CPI inflation was 3.1% in November. It remains the case that inflation has been pushed above the target by the boost to import prices that resulted from the past depreciation of sterling. The MPC judges that inflation is likely to be close to its peak, and will decline towards the 2% target in the medium term. […] the Governor will be writing an open letter to the Chancellor of the Exchequer, accounting for the overshoot […] and explaining the MPC's policy strategy to return inflation sustainably to the target. This letter will be published alongside the minutes of the February 2018 MPC meeting and the accompanying Inflation Report.

Developments regarding the United Kingdom's withdrawal from the European Union – and in particular the reaction of households, businesses and asset prices to them – remain the most significant influence on, and source of uncertainty about, the economic outlook. The Committee noted the progress in the Article 50 negotiations between the United Kingdom and the European Union*. In such exceptional circumstances, the MPC's remit specifies that the Committee must balance any trade-off between the speed at which it intends to return inflation sustainably to the target and the support that monetary policy provides to jobs and activity.*

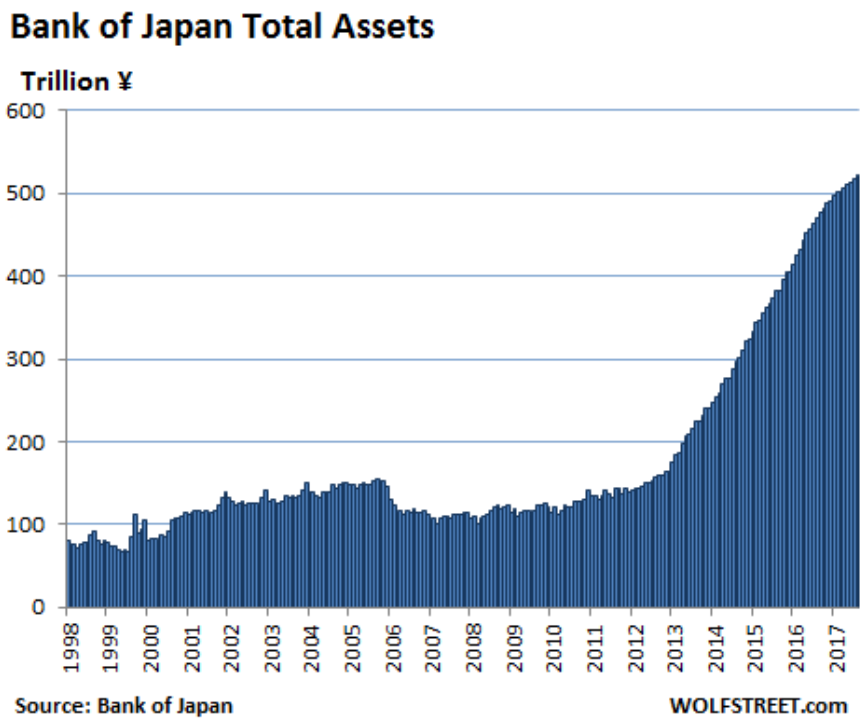
The steady erosion of slack over the past year or so has reduced the degree to which it is appropriate for the MPC to accommodate an extended period of

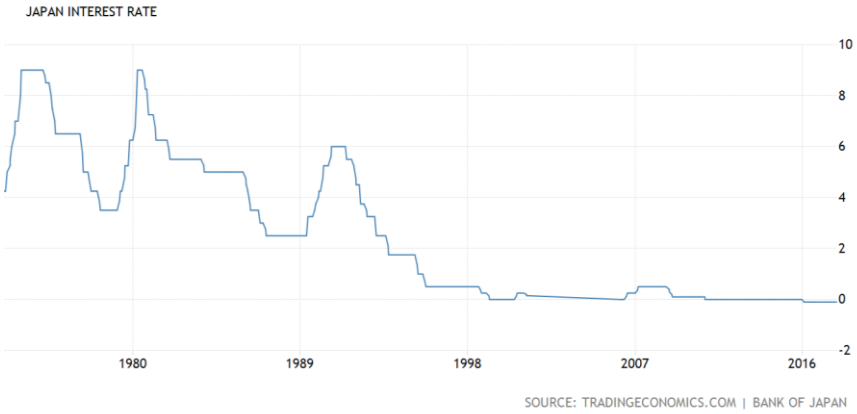
inflation above the target. Consequently, at its previous meeting, the MPC judged it appropriate to tighten modestly […]. At this meeting, the Committee voted unanimously to maintain the current monetary stance. The Committee remains of the view that, were the economy to follow the path expected in the November Inflation Report, further modest increases in Bank Rate would be warranted over the next few years, in order to return inflation sustainably to the target. Any future increases in Bank Rate are expected to be at a gradual pace and to a limited extent. The Committee will monitor closely the incoming evidence on the evolving economic outlook, including the impact of last month's increase in Bank Rate, and stands ready to respond to developments as they unfold to ensure a sustainable return of inflation to the 2% target."

[1] Verbatim from MPC minutes summary for 14th Dec, italicisations are that of David Filer.

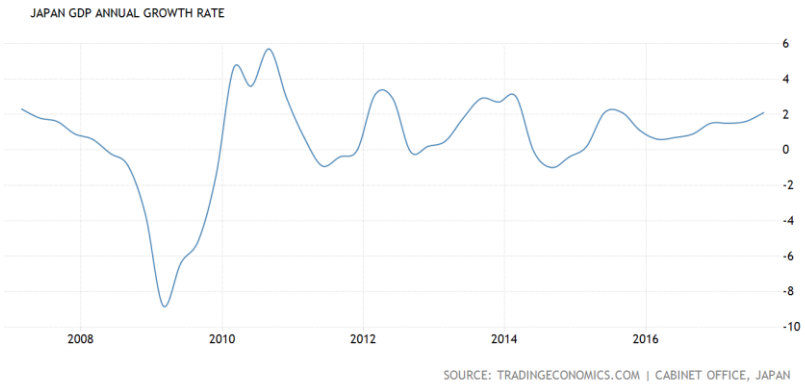
Bank of Japan

At the BoJ's last meeting in October, they kept short-term interest rate unchanged at -0.1 percent and kept the 10-year government bond yield target around zero percent. Like the BoE, the BoJ has a 2% inflation target, which it is aiming to achieve in 2019. Furthermore, the bank engages in "quantitative and qualitative easing" to allow Japanese companies to access cheaper funding. As of 30 November, the bank holds ¥521.6tn in assets, amounting to 96% of Japan's GDP (compared to the Fed's balance sheet which amounts to 23% of US GDP). It has recently begun to taper this: at its highest rate, the BoJ added ¥93.4 trillion (about $830 billion) to its balance sheet during 2016. Over the 12-month period ending 30 November 2017, it added ¥50.8, a reduction of 46%. The final wing to the BoJ's experimental monetary policy is Yield Curve Control, introduced in September 2016. Generally speaking, the longer the maturity, the higher the yield; Japan faces a flat yield curve as a result of QQE. By setting 10-year JGB's (Japanese Government Bonds) at 0%, it allows the longer-term yields to rise, forming a steeper yield curve. This means that banks should feel more secure in lending to households and businesses, stimulating the economy.





This is against an economic backdrop of very low inflation, with October's 0.2% year-on-year inflation a marked drop against September's 0.7%. Whilst this is better than the periods of 2009-2013 and Q2 2016, characterized by deflation, this is considerably lower than the BoJ's target for 2%. However, it is worth noting that post-2010, the Japanese economy has grown on average around 1% - 1.5% and has an unemployment rate of 2.8%, the lowest in 23 years.



After the repeated use of the phrase 'reversal rate' (a level of interest rates so low it stops stimulating the economy because banks become unprofitable and stop lending) by Governor Kuroda, there is speculation that the bank may seek to raise the cap on 10-year government bonds to above "around zero". This may signal an easing in monetary policy, which combined with the reducing popularity of PM Abe (for whom Kuroda is regarded as a 'lieutenant' in the implementation of 'Abenomics'), may push market interest rates up. Currently, the BoJ has offered to buy an unlimited amount of JGB's to maintain its 0% target which has led many to call this unsustainable.

Governor Kuroda faces reappointment in April, with analysts expecting Abe to either confirm him or appoint Etsuro Honda, who's seen as more dovish than Kuroda. Thus, it would seem that over 2018, a continuation of current monetary policy, combined with strong US growth figures would suggest that the Yen will continue to slide against the dollar.

In terms of risks, it is clear that Japan faces an uncertain future with a mixed set of economic figures. The OECD forecasts 1% growth for 2018 and 2019, although employment is set to peak next year. Government debt is at 220% of GDP, a record high for any OECD country, which poses a threat if the Bank of Japan (who own 41% of the outstanding stock of government bonds) begin tapering their purchase programme.

Swiss National Bank

For many years, Switzerland has been considered by many to be a safe haven with investors pouring money into the economy in an attempt to protect their assets. As a result, the Swiss Franc has climbed in value to appoint of overvaluation, with investors demanding the currency, making it hard for Switzerland's export based economy to survive. The vice chairman of the Swiss National Bank (SNB), Fritz Zurbrügg, continues to stress the currency is still vulnerable to these safe-haven pressure. In recent years, the Swiss National Bank has adopted an aggressive monetary strategy in order to devalue the Franc. Printing hundreds of billions in Swiss Franc, buying massive quantities of dollars and euros, adopting negative base rates of -0.75%, whilst purchasing huge levels foreign assets in an aggressive manor, have all been strategies in an attempt to weaken the Swiss Franc. The SNB holds close to $850 billion in assets on its balance sheet; 127% of the nation's GDP, of which 94% is invested outside of Switzerland. Operating similar to a Hedge Fund, has led to the U.S. Treasury adding the SNB to their watch list and warning them of potential currency manipulation. Furthermore, with the Fed recently raising interest rates, a potential divergence between the US and Switzerland are on the cards making the Franc less attractive to investors. With inflation in November at 0.8% year on year, and with inflation looking to remain low, yet improving throughout 2018, domestic demand and incomes along with unemployment should benefit as a result of the low interest environment. As the economy continues to strengthen and concerns with inflation start to fade, the economy can look to restore normalised monetary policy and move to a state when interest rates come out of the negative. Due to the negative interest environment, the household debt to GDP ratio is the highest of the 35 OECD countries, and certainly something to be addressed in the coming year. With the euro buying 1.17 Francs compared to 1.072 at the beginning of the year, we can expect this trend of devaluation to carry on into 2018. With the SNBN rising over 90% in the last five months, sentiment is high and belief is strong towards the Swiss economy. The SNB having $88 billion in US equities, the state of the Swiss economy is very much dependent on the way in which the US markets hold up this year, which we would expect to be strong. However, if we do see a bearish market it will be very interesting to see the way in with the Swiss National Bank react, and as to whether they will result back to reprinting money and further damaging balance sheets.

Bank of Canada

The Bank of Canada has recently hiked rates twice this year from 0.5% to 0.75% (July) then to 1% (September), due to better than expected economic growth, increasing inflationary pressures and a labour market operating close to full employment. Recent high economic growth predictions for 2017 (3.1%) have been fuelled by higher oil prices (a large export commodity for Canada) as well as favourable consumption and residential investment, due to higher real gross domestic incomes amongst Canadians and record low unemployment levels. Government infrastructure spending as well as business investment have also remained strong which have both positively contributed to Canada's real GDP growth and a recent appreciation of its currency. The hike in interest rates has attracted greater foreign demand for the Canadian dollar as investors seek for yield, which has pushed up its value.

Looking into 2018, it is clear that the bank is hesitant to provide greater detail on more interest rate hikes before recent increases are fully felt within the economy. It is anticipated that the current higher than expected economic growth will only be short lived, and interest rate increases will slowly filter into the economy pushing growth back to 2.1%. Despite unemployment being at an all-time low, the bank instead focuses on a labour market indicator which illustrates that long-term unemployment is still relatively high, and both working hours and wage growth are lower than anticipated. This illustrates how there are still opportunities for the expansion of employment in the labour market. These factors do not incentivize the bank to increase interest rates in the short term.

However, there are clear factors that support another rate hike in the coming months. The Bank of Canada will need to keep a careful eye the CPI index as inflation is expected to climb towards its 2% target. Business investment and consumer spending may also remain resilient despite the high household debt levels in Canada and recently higher borrowing costs, both of which would unexpectedly increase inflationary pressures. This may be coupled with improvements in wage growth, which will incentivize a tightening of monetary policy by the Bank of Canada as the economy reaches full capacity.

Looking past just economic growth, inflation and labour market characteristics within Canada. There are multiple contingent inflationary risks that may have negative or potential positive effects on the Canadian currency. As the US

shifts towards protectionist policies, its re-negotiation of NAFTA may weaken Canadian exports and therefore lower the currency value, as there will be less foreign demand for its goods. However, even with a negative NAFTA outcome, the US alone may have positive effects on the Canadian currency, due to their trading ties and neighbouring proximities positive US GDP growth will spillover into the Canadian economy, increasing business confidence, investment and exports.

Reserve Bank of Australia

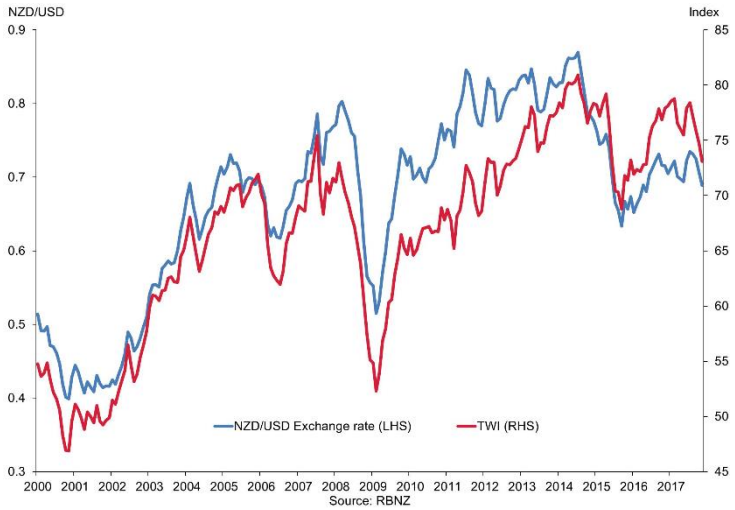
The Reserve Bank of Australia (RBA) has an inflation target of 2-3% on average over time. With inflation currently sitting at 1.8% and the cash rate at 1.5%, it is safe to say that the RBA is taking an expansionary stance looking to stimulate more spending and growth in the economy. Internationally, this is working very well with high levels of foreign currency exposure and investment, particularly in the housing and mining sector. While the Chinese authorities tightened their enforcement of capital controls in late 2016, the direct investment flows from China into Australia have been much larger since 2008 (which marked the beginning of a large stage in the mining boom). Focused heavily on mining in the early stages, these investments have caused a fruition in coal and iron ore extractions and thus exports. Being the largest exporter of both these bulk commodities allows Australia to negotiate favourable trade deals, particularly with China as their demand for these are approaching a peak. With projections of China's population and construction falling, their demand for commodities will soon drop as well after reaching its peak. To offset this, Australia would need to find other countries undergoing a large urbanisation or delve into a different industry which China may require – in this case it would be professional services. Crux of the matter is that the Australian dollar will always be a safe investment (both S&P and Moody's rated AAA), however it is heavily reliant upon the Yen and/or the Renminbi. The correlation between these two economies is very high and thus can be used as an indicator if one should fall or rise.

Reserve Bank of New Zealand

The Macroeconomy

New Zealand has a very open economy with minimal regulation. It is ranked third in the 2017 index of Economic Freedom. Trade is vital to their economy, and the value of exports and imports taken together equals 55% of GDP. The GDP growth rate in the economy for Q3 of 2017 is forecasted to be 2.7%. It is a low inflation economy, with a current rate of 1.9%, compared to the average of 2.7% since 2000. The exchange rate is long standing and flexible, with no exchange controls or restriction on bringing in or repatriating funds.

On the 23rd of September 2017, a general election took place, and a Labour-led coalition was formed. There are plans to reform the Reserve Bank of New Zealand which may affect policy decisions and consequently the exchange rate. Policymakers will have to ensure that policy decisions are consistent with returning the economy to full employment and indications that the interest rate would be kept low, but it remains to be seen if this will affect how the RBNZ run monetary policy as a whole. Since the election, the NZ Dollar has fallen 5.9% against the Sterling, and 6.7% against the US Dollar. A depreciating exchange rate may, in the short term, suit the economy's export-led economy, but given that the value of imports also makes up 25% of GDP, rising prices of US and UK imports in particular could see an adverse effect on inflation. Higher import prices and consequent higher costs for firms may lead to cost-push inflation as businesses pass the higher costs onto the consumers. This could potentially push inflation above its current low, stable rate.



The new coalition includes the anti-immigration New Zealand First party. New Zealand was in 2015 ranked the easiest country in which to start a business; one of the major election pledges of NZ First was to reduce foreign ownership of property, and perhaps more stringent controls on investment, leading to a

slightly tougher environment to conduct business than in the previous government.

Recent Policy

As of November 2017, The Reserve Bank has decided to leave the Official Cash Rate unchanged at 1.75%. This was decided on the back of improving global economic growth, stable commodity prices, near record levels of equity prices and low bond yields and credit spreads.

2018 outlook

New Zealand: **Demand, output and prices**

	2014	2015	2016	2017	2018	2019
	Current prices NZD billion	Percentage changes, volume (2009/2010 prices)				
GDP at market prices	239.5	3.2	3.5	2.6	3.2	3.0
Private consumption	138.1	2.9	4.3	4.1	3.3	2.7
Government consumption	44.8	2.6	2.2	3.8	3.4	2.2
Gross fixed capital formation	52.9	2.1	5.5	3.0	4.4	5.2
Final domestic demand	235.8	2.7	4.2	3.8	3.6	3.2
Stockbuilding[1]	1.1	-0.4	-0.1	-0.3	-0.1	0.0
Total domestic demand	237.0	2.2	4.7	3.8	3.5	3.2
Exports of goods and services	67.9	6.9	1.6	2.3	3.0	3.6
Imports of goods and services	65.3	3.7	3.4	5.3	4.4	4.3
Net exports[1]	2.6	1.0	-0.5	-0.7	-0.3	-0.2
Memorandum items						
GDP deflator	_	0.1	1.7	2.4	1.8	2.2
Consumer price index	_	0.3	0.6	1.9	1.9	2.3
Core inflation index[2]	_	1.1	1.3	1.5	2.0	2.3
Unemployment rate (% of labour force)	_	5.4	5.1	4.7	4.4	4.4
Household saving ratio, net (% of disposable income)	_	-2.2	-0.7	-0.3	0.8	1.5
General government financial balance (% of GDP)	_	0.0	0.0	0.5	0.1	-0.2
General government gross debt (% of GDP)	_	40.7	38.4	36.8	36.6	36.8
Current account balance (% of GDP)	_	-3.1	-2.5	-3.0	-3.2	-3.3

1. Contributions to changes in real GDP, actual amount in the first column.
2. Consumer price index excluding food and energy.
Source: OECD Economic Outlook 102 database.

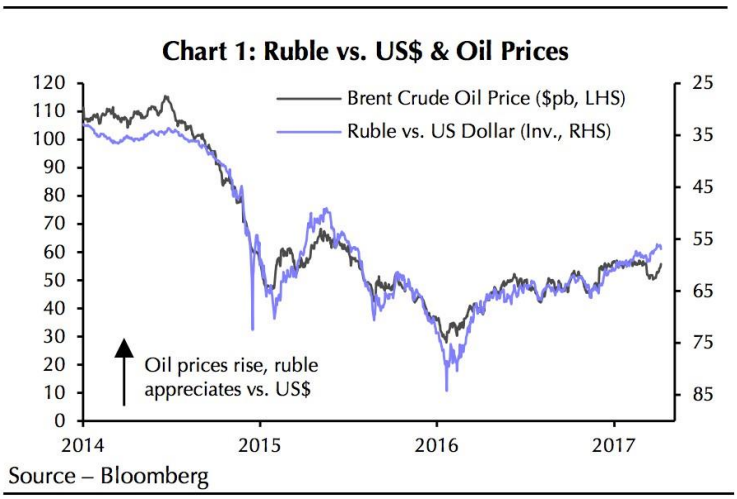
A report released by the OECD in November 2017 has revealed that economic growth should increase to over 3% in 2018-19, with stronger investments and exports driving this. Stronger investment will be required given the limited capacity currently in the economy, coupled with the high profitability and low financing costs within the economy. Agriculture makes up a significant sector of the economy and the recovery of this industry following adverse weather will boost exports further.

Inflation should increase through 2018, and by the end of 2019 it will have risen to 2.4%. The Central Bank is likely to move to an expansionary fiscal

policy, due to the governments new plans to increase government expenditure and investments principally. Monetary tightening is projected to have begun by the end 2018.

Central Bank of Russia

Russia is famous for its abundance in natural resources ($75tn worth) as being one of the largest exporters for natural gas and petroleum. Due to being heavily reliant on energy revenues to drive most of its growth, the Ruble fluctuations have been closely corelated to crude oil volatility, making the currency behave in an unpredictable way. This can be seen through the currency depreciating by 24% within a year of being on a free float and gaining its strength back as crude oil prices have risen by 20% (Q1-Q2). This, alongside the agreement made by oil exporting countries to cut oil supply, might have a positive impact on the Ruble in the next 6 months. Despite political tensions follow by trade sanctions, Russia has a potential to grow as an economy with strong physical and human capital base.



Recent Policy Decisions:

Reduction in inflation was shaped by Ruble appreciation and accumulation of high food stocks due to good harvests of 2015-2016. Today, inflation is close to its lowest for the post-Soviet period, coming in well below the Central Bank of Russia's (CBR) target of 4%, and consumers and companies alike are

benefiting from easier credit. The dynamics of inflation became one of the main drivers behind the key rate cut made by the CBR in October 2017 – by 25bps to 8.25%. As a result, commercial banks are increasing the quantity of credit given to private consumers, thus potentially boosting the aggregate consumption in the long-run. Despite that, the CBR will maintain a moderately tight monetary policy in order to keep in check the inflation risks caused by the inertia of inflation expectations and to maintain close to the 4% target.

Future Policy Path:

The CBR said it may consider buying foreign currency to restore its international reserves up to the threshold level of $500bn, taking an active participatory role in influencing the monetary funds rate of the Ruble. A lower currency valuation can help improve exports and drive economic growth, which have been named as 2 major economic goals mentioned in the 2016 Monetary Report.

People's Bank of China

Having slowed down in 2016, growth in China has accelerated through 2017 alongside strong domestic demand, substantial rises in non-financial debt and sustained high savings rates. Stimulus packages from 2014 to 2016 have enabled the growth in domestic demand – the benchmark lending rate was reduced by 165 basis points between 2014 and 2015, government net borrowing widened by nearly 3% of GDP between 2014 and 2016 and real-estate macro-prudential policies were eased. As well as this, significant supply side reforms like restructuring State Owned Enterprises (SOEs), reducing overcapacity in coal and steel sectors and numerous other reforms have boosted growth. One example of this is a 2014 reform that aimed to help business registration led to the number of new business created daily increasing from 6,000 to 15,000 per day. With concerns of medium turn financial and real estate risks, tightening measures have been introduced to slow real estate price growth and limit financial risks that have consequently significantly tightened financial conditions – interbank, corporate bonds and government bond yields have all risen since 2016.

Short-term prospects remain strong with medium-term concerns remaining the target of government and bank policy. Domestic demand is forecast to

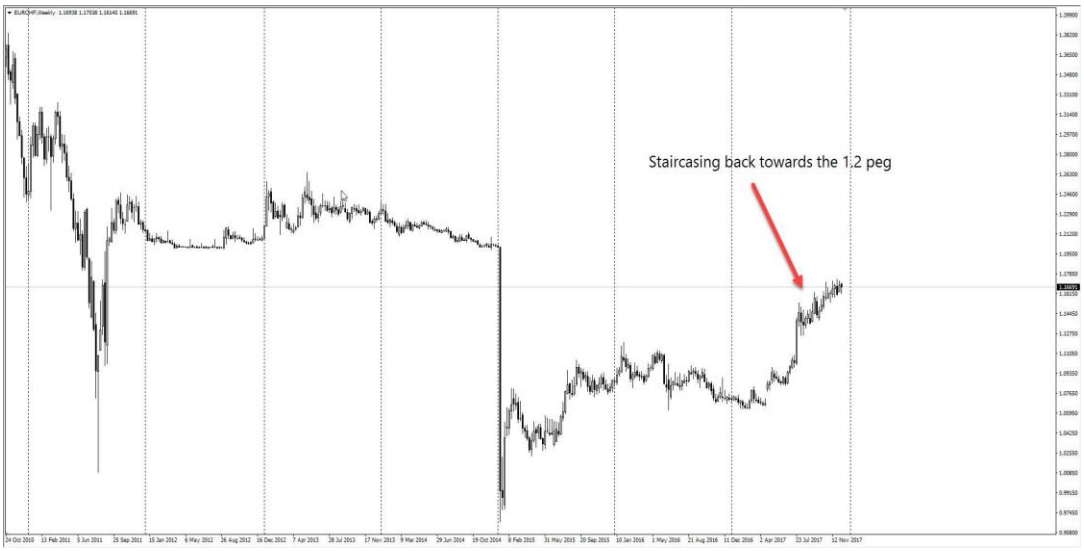
continue to grow and lead to a fall in the current account surplus. However, to meet 2020 output targets (like doubling 2010 real GDP) a continuation of current levels of public investment and private sector debt growth will be required. Non-financial debt is projected to rise from 235% in 2016 to 290% by 2022 and this is a major medium-term concern. China has an extremely high savings rate – 46% of GDP compared to the global average of 20% - and unless this decreases, private sector debt will continue to rise (relative to GDP it has already risen by 80 percentage points to 175% since 2008). This is likely to be a key factor in determining future PBOC interest rate changes. Currently interest rates are at historic lows with the benchmark lending rate at 4.35% - well below Taylor Rule suggested levels – and regulatory measures containing core inflation pressures. Exchange rate policy became more controlled over the last year with the Renminbi moving back towards its dollar peg, however China's foreign currency reserves of $3T allow it to move towards a floating exchange rate. Regardless, exchange rate policy is likely to be volatile over the short term.

Investment Suggestions

Given the factors discussed, our views which we have carefully developed and formulated are expressed via these key FX and Rates directional trade ideas for 2018:

FX:

- *LONG EUR/CHF*
  - Rationale/Fundamental – In January 2015 the SNB removed the EUR/CHF peg (SNB would not allow EUR/CHF to drop below 1.20), this was due to the ECB announcing QE which it was not feasible for the SNB to match, therefore, the 1.20 floor was abandoned. This led to the 'Francogeddon', with EUR/CHF dropping drastically. The SNB are now looking to reclaim this level due to the ECB tapering QE, and as mentioned earlier, the SNB's aggressive monetary policy should provide support for EUR/CHF. It is important to note, that ever since 'Francogeddon', the pair has been gradually staircasing back toward the 1.20 level. We are bullish EUR/CHF, expecting it to breach the 1.20 level in 2018.
  - Technical – Staircasing to 1.20 level; the Stochastic Indicator (STOCH) is 73.893 which indicates a strong upward trend; current price (1.1645) is well above the 50-day and 200-day Simple Moving Average (SMA50 and SMA200) (1.1121 and 1.1163 respectively); key support level at approximately 1.16 and key psychological level is 1.20. [2]
  - Risks – ECB have indicated their QE tapering is adaptable depending the outcome (could see an unexpected extension or ramp up of QE). Draghi is also highly skilled at regularly talking down the Euro to stop unwanted sudden appreciation. The Swiss Franc also suffers from significant safe-haven risk.
  - EUR/CHF @ 1.1645 [3]



- *LONG USD/RUB*
  - Rationale/Fundamental – There is some divergence on Central Bank Policy between the Fed and the CBR (Fed tightening vs CBR loosening). The U.S. economy continues to be upbeat (especially given that Trump's tax reform is looking ever-more likely to be passed). Although the OPEC deal will prove favourable for the Ruble, we must consider the U.S. shale industry production impact on crudes price providing significant downside risk (harming the Ruble). It was indicated that the CBR are considering bolstering their foreign currency reserves (most likely buying USD, giving upside to USD/RUB). As noted in the report, a weaker Ruble is a precursor for two of Russia's economic goals as mentioned in their Monetary Report.
  - Technical – Current price (58.8009) above SMA50 (58.2343) and well above SMA200 (57.1184), indicating upward trend; support levels at 58.38, 58.00, 57.50 and resistance levels at 59.00, 59.50, 59.90. [2]
  - Risks – If Trump's tax reform gets voted down this could have significant downside risk for USD. Also, given the Russian Ruble's correlation to crude oil, significant volatility is to be expected and any major event could force the Ruble to appreciate (such as a freak accident e.g. recent Austrian gas pipe explosion).
  - USD/RUB @ 58.8009 [3]

- *LONG USD/JPY*
  - Rationale/Fundamental – This was specifically mentioned in the BoJ section. The U.S. economy continues to be upbeat (especially given that Trump's tax reform is looking ever-more likely to be passed). The Fed are continuing to tighten monetary policy accordingly, whereas the BoJ are still continuing with quite experimental monetary policies, forcing significant amounts of Yen to remain in circulation.
  - Technical – STOCH is 68.343, beginning to indicate the strengthening of an upward trend; current price (112.75) is just below SMA50 (112.79) and SMA200 (112.98), but we expect this to reverse soon given our key fundamental factors; support levels at 112.00, 111.00, 110.25 and resistance levels at 113.50, 114.00, 115.00. [2]
  - Risks – Aforementioned risks with US economy e.g. failing to get tax reform voted through. Kuroda continuation as BoJ Governor (more hawkish than Honda) could give upside risk to JPY. JPY also suffers from safe-haven risk.
  - USD/JPY @ 112.75 [3]

Rates:

- *SHORT Canada 10-Year*
  - Rationale/Fundamental – Some expectation of rate hike for Q1 2018 which given the section on the BoC, would suggest this is not as priced in as it should be due to some key economic indicators lagging and potential NAFTA risks. However, these seem overemphasised in the grand scheme of things.
  - Technical – (In terms of Yield which moves inversely to price) Support levels at 1.821%, 1.80%, 1.75% and resistance levels at 1.90%, 1.98%, 2.05%. We believe that some of the other technical indicators have not priced in the probability of a Q1 2018 BoC rate hike which this trade depends on, displaying a trading opportunity. [2]
  - Risks – This trade is largely dependent on a hike within Q1 2018, so the main risk is if there is no interest rate hike from the BoC in Q1 2018.
  - Canada 10-Year @ 1.836% Yield, Price = 92.78 [3]

- *SHORT New Zealand 10-Year*
  - Rationale/Fundamental – The depreciation in the NZ Dollar will benefit the economy in the short-term (slightly more export-led than import-led), since NZ exports become more competitive. However, since imports still play a large part this could hurt the economy by forcing imports to become more expensive and thus stimulating inflation (consider that NZ has been known as low inflation and a stable economy). Economic forecasts are very strong. Agricultural recovery will boost exports. NZ is therefore highly likely to move to tightening monetary policy.
  - Technical – (In terms of Yield which moves inversely to price) Support at 2.61%, 2.51% and resistance levels at 2.82%, 2.90% and 3.00%. [3]
  - Risks – Sudden appreciation in NZ Dollar could derail the fundamental arguments behind this trade. Additionally, given New Zealand's predisposal to natural disasters, an unexpected event could cause the economy some short to medium-term harm.
  - New Zealand 10-Year @ 2.760% Yield, Price = 114.433[2]

[2] Technical Analysis taken from investing.com using the 'Weekly' option (since these are views for 2018)

[3] Prices quoted at 0100 18/12/17

Conclusion

The ideas presented advise how to best position oneself for 2018 based off analysis of some of the most important Central Banks, and their respective economies. As stated before, all the financial recommendations offered are for educational purposes only.