

Episode 29: Global FX Outlook

GPS Capital Markets

- Intro: On this episode of the 2019 Outlook series, Crag Jeffery sits down with David Pierce, Managing Director of Global Hedging Products at GPS Capital Markets, to discuss the impact of foreign exchange exposures on the US economy and worldwide. Listen in as they share viable insights into the macro trends and developments taking place for the coming year.
- Craig Jeffery: I'm here with David Pierce from GPS, and let me give you a little background about GPS and David Pierce and then I'll welcome him to the podcast.
- Craig Jeffery: GPS is the largest FX broker in the US, they're licensed in the US, the European Union, they also have offices in Australia. David Pierce heads their Global Hedging Products team and is their lead economist, he's appeared on CNBC and he has over 30 years of FX experience. David, welcome to the podcast.
- David Pierce: Thank you so much. Glad to be here.
- Craig Jeffery: So, David, let's begin, as we look forward, let's start by looking back on 2018 maybe you could step through and review some of the biggest items that have impacted FX, particularly making larger FX movements, what are they and how we should we think about those?
- David Pierce: I think that's it's probably best to start with the tariff issue that we've had going on from a political standpoint here in the United States and how that has impacted countries around the world.
- David Pierce: Starting with China, the tariffs that Trump has put on goods with China have made a significant difference in the currency exchange rates between the United States and China. The reason for that is the Chinese, the way they have retaliated against these trade tariffs, has been to devalue their currency. They've been able to value their currency over 8% in a response to these tariffs. The problem that China has got, and this bleeds over into the rest of Asia, is that the United States is a huge importer of products. For instance, the United States only exports about \$130 billion a year to China, but their imports are about 500 billion, so almost four times as much, this gives the United States much more control and power to put tariffs on Chinese goods than they have to put tariffs on US goods. They recognize this and because of that they have chosen to devalue their currency in addition to the retaliatory tariffs that they have placed on US goods to preserve their mark position and the amount of product that they are selling internationally, and that has brought implications throughout all of Asia because China is the second largest economy in the world and it becomes extremely impactful.
- David Pierce: The second thing we need to look at is let's talk about what's happening in Europe and let's talk specifically about tariffs to begin with, then we'll get to other things like Brexit.

Craig Jeffery: Before we jump too much into Europe let's finish up with the renminbi if I could just ask a question on that, how does that fluctuate the price? I know it's been more than 5% but what's going on with the USD renminbi rates?

David Pierce: Yeah. The exchange rate, the dollar versus the renminbi, the US dollar has strengthened against the renminbi, almost 8% since April, and it doesn't sound horrible that the US dollar is stronger but the Chinese government does not allow the Chinese renminbi to freely float in the market place. Meaning they really control and manage what exchange rates their currency is going to be exchanged at versus other currencies, so it is a managed currency. It's not freely floating. What they have done is they have weakened their currency to make it so that it is less expensive for us in America to buy products from China. An 8% movement doesn't completely counteract the tariffs that has gone on but it goes a long way. When you look at the tariffs that they have put on US goods combined with the 8% depreciation in the Chinese renminbi, it makes a huge impact.

Craig Jeffery: Excellent. So that's great information. Moving from China and the far east I think the next area you wanted to cover was Europe, and I know you're talking about trade tariffs as well as ... Well, we talked about Brexit before this episode but maybe you'd cover Europe.

David Pierce: Yeah, let's talk about trade and tariffs where it relates to Europe right now because that's also really big news because, as we all know, Trump has been on a mission to try and make things, in his words, equal, and with Europe is a really difficult dynamic right now. I think that the best way to describe this is when Jean-Claude Juncker was over visiting with Trump a few months ago, they were talking specifically about automobiles and the tariffs on automobiles, the comment came up that any US cars that are exported into the European Union had a 12% tariff imposed on them by the European Union. Counter to that, any cars that came into the United States from the European Union only had a 2% tariff. Well, Trump said, why don't we both go to zero, and Juncker said, no we can't do that, and he says, well let's got 25%, and he said, no we can't do that, and then the explanation was really interesting.

David Pierce: He said that we can't do either one because if we lower the tariffs on US cars coming into Europe, because the dollar volume of automobiles coming into Europe is so high and with the 12% tariff the European Union specifically needs that money to run their government and without that money they will not be able to manage running their government because any tariffs on vehicles and any product that is imported into the EU, none of that money goes to the car manufacturers and people that are in the specific industries, all that money goes directly to the governments.

David Pierce: Counter to that, he said that if the United States raised tariffs on European cars, so your Mercedes, and your BMWs, and Portias, and FIATs and so forth, that that would devastate the European economy because it would reduce the

amount of cars that the Europeans were able to sell into the United States. And given the very tenuous nature of the European economy right now they could not afford to either reduce the tariffs that they charge on American products or allow the United States to increase tariffs that they currently have on European products because it would be devastating to the European economy.

David Pierce: Understanding that right now in Europe they are in a negative interest rate situation because they're trying so hard to stimulate their economy because they are struggling, and if you don't understand what a negative interest rate is that means if you take \$10,000, deposit it in your bank, your bank is actually going to charge you interests for keeping those funds sitting in a bank account. That's what negative interest is. Same thing goes along with borrowing, you can borrow funds there at very, very, very low rates, and they have done that to try to stimulate the economy in Europe. So from a tariff standpoint, Europe is in a really tough situation.

Craig Jeffery: Now, as we continue to look back on some of the big movements in FX maybe you could cover some of the other movers, whether it's related to Brexit, North American trading, maybe you could talk about a couple of those and then we'll focus fully on 2019.

David Pierce: Let me talk a little bit about what's been going on in some of the other countries in the world. The US dollar has been strong against almost every country in the world. There's a few currencies that have done pretty well, one of the main currencies that has strengthened this year is the Japanese yen. It has strengthened about 3 1/2% against the US dollar over the last year. The Japanese economy is finally starting to perform, and this is really significant because they've been in a really under-performing economy for over 20 years. So to see the Japanese yen finally starting to strengthen, finally starting to do well, and the Japanese economy coming around is really significant, especially compared to some of their neighbors like China and South Korea that has had more struggles than Japan has.

David Pierce: If we look at the US dollar against the euro, the US dollar strengthened 7.4% this year against the euro, that's in 2018, and so the euro continues to depreciate against the US dollar as the US economy is stronger than the European Union and they still continue to struggle throughout the EU. Neighboring the European Union is the British pound, and the British pound has also weakened, 6.7% against the US dollar, a lot of that is on the backs of Brexit and general weakness in the economy in Europe.

Craig Jeffery: Why would the US dollar strengthen more significantly against the euro than the GBP if Brexit was having an impact?

David Pierce: The economy in the United Kingdom is much, much stronger than in the mainland European continent, and so if we took Brexit out of the equation I would think that the British pound would have been flat to maybe even a little

bit stronger against the US dollar. But Brexit has really been weighing against the pound and it has been pulling it down because people are concerned that if Brexit goes through they're going to have more economic difficulties in England than they currently because it's going to be more difficult for them to trade with some of their European counterparts.

Craig Jeffery: Interesting. Okay. Makes sense.

David Pierce: Moving on to some of the other countries around the world, Canada, the US dollar has strengthened 7% against the Canadian dollar over the last year. This is really interesting because traditionally the US dollar and Canadian dollar exchange rates have really followed the commodity markets, and when we look at gold, and silver, and oil, the Canadian economy has really depended on those commodities and the US dollar kind of follows along that line between the price of commodities versus the exchange rate between the Canadian dollar. So we've seen Canada weakened about 7%. Some of that also has been and the backs of the North American Free Trade Agreement that has been up in the air and that Trump has renegotiated, and since they have come to an agreement we've actually seen a little bit of rebound in the Canadian dollar and a little more strengthening, so that is actually looking a little better than it did earlier in the year.

David Pierce: The next one to talk a little bit about is the Mexican peso. The Mexican peso has had a ton of volatility this year. It has moved 16 1/2 % this year. That being said, where we started out the year and where we are right now, we're only about 2% different. So the Mexican peso has weakened a little bit this year but it has had a tremendous amount of volatility. The volatility that we've seen in Mexico has been really surrounding the elections that they've had in Mexico and we saw a significant weakness with the presidential election down in Mexico, but their economy has been doing fairly well and so once all the rhetoric from the election died down we've actually seen the Mexican peso rebound quite a bit against the US dollar.

David Pierce: On a global basis, if we look at what's called the US dollar index where we compare the dollar against all the countries as a basket across the globe, the US dollar has strengthened 8% on a global basis. And if we look at the world economy, pretty much the US economy is doing very well compared to any other economy in the world. And this might be a good time to talk about NAFTA and some of the revisions of that because the US economy is extremely reliant on what goes on in both Canada and Mexico, and I think that a lot of people don't realize how interdependent those three markets are with one another. If we look at the United States' top trading partners, China is number one, followed by Canada and Mexico, so Canada and Mexico are the second and third largest trading partners of the United States. So Trump renegotiating trade terms with both of those countries makes a significant impact, not only on the US, but also Canada and Mexico, because there really is a lot of synergy.

Craig Jeffery: Let's try to look forward a little bit, into 2019. There are definitely a number of macro economic shifts taking place maybe you can comment on some of those in the context of investment decisions or risk management decisions that go on. Why don't we start with the Brexit, is there going to be a resolution on that?

David Pierce: Yeah. I mean, nobody can go anywhere without hearing the word Brexit right now because it seems like it's the top of the news in everything that you see. Every report has got something about Brexit. As you know, the last few days have been really interesting because Theresa May's proposal for Brexit was shut down in Parliament and it was voted against by over 200 votes, and that is the largest loss of any major vote that has ever happened in the British Parliament. So it was soundly defeated in the British Parliament. A couple days after that they actually had a no-confidence vote for Theresa May, whether or not they wanted to remove her from office and have another general election in the UK, and she won that by just 20 votes so she is going to continue as Prime Minister for now. The problem is Brexit is supposed to happen in just a few weeks, and they do not have a plan in place. What we really need to try to understand is what are the implications of either going forward with no deal, or trying to postpone the implementation of Brexit, or what are the odds of them being able to renegotiate a new deal.

David Pierce: So let me just talk about a couple of those different options. Number one, what happens if they go forward with no deal? Well, the biggest implication really on this has to do with Northern Ireland and Ireland because it's one continent ... Well, not a continent but an island, and there is no real border there, there's a lot of back and forth travel, and they're fairly homogenous people, and there has not been any agreement on how they're going to deal with the movement of people and goods in Ireland to Northern Ireland, and that seems to be the biggest sticking point in all of the Brexit negotiations. And what happens if they don't have a deal? What are they going to do? There is no checkpoints. There's nothing. So most likely there's going to be pre-movement of trade back and forth even if we go through with no deal.

David Pierce: The next thing that is a real big point of contention is how much the UK is going to pay in penalty, so to speak, to leave the European Union? The European Union has kind of been taking a hard line and basically wants a pound of flesh because the UK is leaving and they're trying to demand huge amounts of money for them to leave in return for continuing to be part of the European Union as it comes to trade. If they go forward with a no deal, the United Kingdom will still be able to trade with the European Union, but it will be under IMF regulations rather than negotiated trade within the EU. So they will have to worry a lot more customs duties and being able to get everything certified. It's going to be more work for anybody that's going to be importing or exporting anything within the European Union. So those are the big implications going forward. And so UK companies could have some significant impact, and especially exports.

David Pierce: What happens if they postpone this for another 8, 10, 12 months, kick the can down the road, so to speak? That just means that there's going to be more uncertainty in the market. I think that it's going to be more of the same and we'll not see a ton of implications right now and things will just go along as they currently are.

David Pierce: The third option really is if they're able to put together a last minute deal with the European Union and agree to a new plan, which Theresa May is trying to put together right now. I think the odds of that are very, very low. I think that the odds of a no deal seem to be the best right now, that that will happen, followed closely behind with them extending the time that it's going to take them to leave the European Union. So either one of those two are the most likely result of this. But anyway shape or form you look at it, there's going to be more uncertainty in the market place.

Craig Jeffery: Interesting. So let's move across the Atlantic to the US, let's talk about tax reform impacts, fed funds, I know you had mentioned a couple items there, so I wanted to hear what you thought about tax reform. What are the things that are impacting the economy, exposure to FX, even if it's just related to tax reform?

David Pierce: Yeah. From a tax reform standpoint, we've had a significant reduction in taxes here in the United States and we've seen two things that I think are significant as part of that, number one is that we have seen a lot of direct foreign investment coming into the United States. It's coming in in a way that we have not seen before because taxes are significantly lowered here and we see a struggling European economy, we're seeing a lot of big chunks of funds coming in and we see a lot of family offices and private individuals sending 50, 100, 200 million dollar chunks of funds into the United States to invest in different ventures. The rate of this has picked up dramatically from anything we have seen in the past, so that's one thing that I think has been a big change.

David Pierce: The second thing that companies need to think about from a financial and economic management standpoint is they have changed the way that leases are managed from an accounting standpoint. It used to be that your leases were an off-balance sheet item and they have changed it so that leases are now an on-balance sheet item. So if you've got leases of building, plants, equipment, anything like that that is denominated in a foreign currency, that is not going to have to be revalued on a monthly basis where you are going to have FX gains and losses to your financial statement if you're not doing anything to manage the exposure of those leases. And in the past, most companies completely ignored those, did no hedging because it was an off-balance sheet item, did not impact their financials from an FX gain or loss standpoint, or income statement standpoint, so that changes something that I know that we have a lot of clients right now that are really, really struggling with that because they have to change the way they're looking at all of their leases and they got into these leases

specifically so that they were off their balance sheet, and now it is being very impactful to them.

Craig Jeffery: Now it's back on.

David Pierce: Yeah, it is. You asked about fed funds and how that can be impactful to us, there is a really interesting correlation between long and short term interest rates and the St. Louis Federal Reserve has done this big study going back about 50 years, and what they look at is short term versus long term interest rates and they take the 10-year treasury versus the two-year treasury, and when the long term interest rates changed so that they are lower than short term interest rates, shortly following that, there has always been a recession. And if you look at the graph that they provide, there has been five instances of a recession happening and right now we are getting close to that line where the long term interest rates are almost the same as short term interest rates, and as the fed continues to raise short term interest rates we're in danger of those short term interest rates exceeding the long term interest rates, and typically between one year and 18 months after that happens there is always a recession in the market. So that's one of the things that we need to just watch, think about, worry about, and be prepared for.

David Pierce: And from a foreign exchange standpoint, when we look at interest rates, we are helping clients that are hedging and managing their exposure out into the future, and so we're always watching where these interest rates are because they impact the price of the derivatives that we use for helping people hedge. But I think that that's something that we need to watch for going forward because we're kind of getting close to that level where we could be having a recession in 18 months, 2 years, if we see some additional fed funds rate increases, which we're expecting two more of this year by the way.

Craig Jeffery: We look to the fed not necessarily being a complete autopilot with the rate raises and they made some noises in December about maybe less-

David Pierce: Yeah, they had originally planned to have three rate increases this year and they have come out and announced that they are now planning on having two rate increase. So they have backed off from there they were a few months ago but we're still at the point we're expecting a couple more rate increases this year.

Craig Jeffery: Maybe you can comment on this as well, I mean with moving from quantitative easing to quantitative tightening where they've been dumping about 50 billion back into the market every month, is that likely to continue and is that having an impact as well on the different rates we're seeing?

David Pierce: Yeah, I mean anytime you change the money flow we're going to see an impact on rates, we're going to see an impact on people's appetite for going into new business, expanding their current businesses, and as we see higher interest rates are making it tougher for people to go out and borrow funds, because it's

going to be more expensive ... So yeah, it definitely impacts the economy. What we don't want to see is the economy to slow down as much as the rest of the world. It's really kind of a juggling act where you want to a strong economy, you don't want it to be too strong, and I think that we're almost at that tipping point right now where we have accelerated the economy and then we're slowing it down by increasing interest rates and we're almost at the tipping point where if we raise rates much more than we currently have then we're going to turn the economy backwards and we're going to be slowing the economy back down again, and I don't think anybody really wants that to happen.

Craig Jeffery: Interesting, a number of factors moving in different directions. So this is a 2019 outlook podcast discussion and the audience is increasingly global as we're into our start of our second six months, maybe you can give us some projections on currency rates. Where do you see them moving and what are some any additional influencers on those rates that you foresee in this coming year?

David Pierce: Well, that's a very general question because we've got a lot of different currencies out there and a lot different rates-

Craig Jeffery: Okay. Maybe the majors.

David Pierce: Yeah. Let me address that on a region by region or currency by currency basis, I think that makes a lot to sense. When we look at currency movements there's really two main things that drive it, economic activity and speculation. And economic activity is just the idea of somebody in Germany making cars and shipping them to the United States, and the more cars Germany ships to the United States that means the more US companies are going to have to sell US dollars and buy euros which would tend to strengthen the euro, and that's the main driver behind changes in exchange rates is really economic activity. So if we look at where economies are going to go over the next year we really expect the European economy to not grow. We're expecting it to be flat and even negative growth, and so we're not expecting a lot of out of the euro this year. It'll go up and down a little bit, but we're expecting it to be flat to weakening against the US dollar. Same with the accompanying countries in the European area, the pound and the Swiss franc.

David Pierce: In Asia, if we look at China, I think that we're going to have a resolution of the trade war with China, and if that happens we should expect to see the Chinese renminbi strengthen again versus US dollar, and I'm expecting that to be concluded in the next few months. I cannot imagine that China would want to go into a prolonged trade war with the US just because, like I mentioned earlier, we have four times as many imports as they do and so they are the ones that would be on the big losing end of this. And so we have way more ammunition in the gun, so to speak, so they really need to get this solved. And once we come to a resolution on the tariffs with China, they will allow their currency to strengthen once again. So I think from the Chinese standpoint we should a

strengthening in their currency. Same thing with the Japanese yen, the Japanese economy is doing fairly well, expect to see that strengthen some.

David Pierce: One of the interesting currencies that we haven't talked about yet is the Australian dollar, and the Australian dollar has been weakening this last year and some of that has to do with what's been going on in China. As China struggles, Australia struggles because they provide a ton of food and raw materials to the Chinese economy, and as the Chinese economy has had some struggles this past year because a lot of it is due to the tariffs with the United States, it has really impacted the economy in Australia. So as we see the trade war ending with China I expect to see the Australian dollar rebound and strengthen against the US dollar once again.

David Pierce: Then if we look north and south of United States, Mexico and Canada, the Canadian dollar I think that is a little bit too weak right now and I expect that now we've got trade issues solved with them and if we see a strengthening in the price of gold and silver and oil, we should see a strengthening of the Canadian dollar this year. The Mexican peso, really interesting, it traditionally has been kind of a one-way street against the US dollar, the last four years it's depreciated 42% against the US dollar and it usually does that on a pretty regular basis, but following the election we saw a significant amount of strengthening in the Mexican peso so that one is kind of up in the air. We really need to see what happens with the change in administration down there, and I could see the Mexican peso being more flat against the US dollar than it has in the past, which for them would be a real big win. So that's where we're seeing currencies go in general around the world.

Craig Jeffery: Okay. I'm not sure we covered the pound this next year. You did talk a little bit about it with Brexit if there's resolution or not, what's your outlook on the sterling?

David Pierce: Years. With the British pound ... So goes Brexit so goes the British pound. And it's my personal opinion that if Brexit goes through, especially if it goes through with no deal, we will see an immediate devaluation of the British pound. I don't think it will be dramatic but I think that it'll be somewhere in the 8 to 10% range which is a good move. But I expect from that point on that the British pound is going to rebound because no matter what anyone says their economy is still doing very well over there, business is good, and businesses seem to be growing in the UK, and I think that once that knee-jerk reaction is done we're going to see a continued rebound and strengthening of the British pound. I really don't expect that a year from now we're going to see the exchange rates on the pound versus the dollar much worse than they are now, and if anything I could see a a little bit stronger pound at the end of the year if all goes well for them.

Craig Jeffery: You talked about the movement of flow of funds, I don't know if there's anything else that you wanted to mention about that in terms of access to

capital, rates that might be available for investments in the US, for example, versus Europe.

David Pierce: We look at currency rates ... One rule of thumb is you always chase the higher interest rates, and so the country with the higher interest rate is going to be the stronger currency and it will continue to do that. The reason being, people are always looking for a better return on their funds. So if you're somebody sitting in the European Union and you've got 50 million euros and you stick it in a bank account and your bank says, oh that's great, thank you for the 50 million euros we're going to charge you half a percent a year to keep your funds. Your money is losing every single day you've got it in there. So what a lot of people are going to do is say, well, guess what, I can send it to the US and I can get a return there in my funds, it might not be tremendous but I could get 3 or 4%, so I'm going to send those funds to the US, invest them over there. And they may invest them in treasuries, or just interest bearing funds, but most likely they're going to look for a greater return of funds than just 2, or 3, or 4%. And in an economy that's growing that's much simpler to do than in an economy that is shrinking.

David Pierce: So that's one of the things that we always see is ... Well, in general, if your interest rates go up there tends to be more demand for your currency.

David Pierce: Now, there's obviously exceptions to the rule when we get to some of the South American countries that have extremely high interest rates or hyper inflation, that kind of breaks the rule of thumb because the amount of inflation they have going on there really overruns the value of their currency going up, and Mexico is an example. They've got significantly higher interest rates than the United States, but yet their currency continues to devalue against the US.

Craig Jeffery: So, as we wrap up, David, what do you say to your clients or others about the opportunities or concerns that they should be monitoring throughout 2019? You've touched on a few of them, maybe you could talk about any course of action or advice, what should they be monitoring, when should they act, maybe just give a few pointers.

David Pierce: Well, I think people should always act now. If you've got exposure you need to look at it and you need to be proactive. A lot of people sit back and say, well, I've got exposure, I'm underwater, I'm just going to sit back and wait until it goes my way. Well, that's like flipping a coin, if you wait until you flip a coin until whether heads or tails you choose comes up, that's not really an investment strategy, that's not really a business strategy, that's gambling. And I always try to encourage people to look at any exposure they have now or any exposure they expect to have in the future, and really be proactive in managing that.

David Pierce: One thing that we have seen more and more over the last couple years is people willing to look at alternative products and alternative ways to manage their risk. It used to be that a forward contract was the only hedging option that people would do in the United States. It's more and more common for people to say,

you know what, I know I've got exposure, I know I'm going to have \$100 million in risk over the next 12 months, I'm not sure quite sure when it's going to be, but I want to protect by downside.

David Pierce: That being said, I'm a proactive CFO, I'm a proactive treasurer, I want to do what's best for my company, and so I am also willing to look at some products that give me some rate improvement and that have some rate upside on it and ways to get a better rate in the market place. And we're seeing more and more companies asking and wanting to look at products like that so that they can actually take advantage of some swings, upside in the market, especially given all the volatility we have, and with the volatility we've seen this last year a lot of companies have really come out on the losing end of that because they have not been really proactive. And that's what we try to do is help companies put together a plan to look at their exposure, identify what that exposure is, when it's going to occur, and look at a half a dozen different ways that we could manage that exposure and try to put together a plan that matches their risk profile and help them eliminate any downside, but hopefully get a little bit of upside in the market as well.

Craig Jeffery: That's not speculative like you had mentioned before, just waiting, it's looking to protect your range but giving yourself some leeway if it moves in a particular direction.

David Pierce: Yeah, and I'll give you an example. I mean, we had a client that sold off one of their businesses in Europe, and from the time that they started to sell to the time that they completed the sale was a number of months, it was six or eight months, and during that time frame they also changed treasury staff and CFO, and the previous treasury staff had done nothing to hedge this sale. They knew it was going to happen, they knew when it was going to happen, but they hadn't got the funds yet. But by the time they got the funds, and this was a large amount of money, the market had moved 6 or 7% against them. They had been sitting on these funds for months and months because they said they couldn't afford to bring the funds back, even though they wanted the funds back in the United States, because they were at such a discount at what they were supposed to have got for the company they sold and so they were just sitting there on the funds.

David Pierce: Well, if you're not doing anything to protect your downside there's some products out there where you can say, all right, I'm not protecting my downside but if the market moves one way or another I can get some upside from the market greater than what the market rates are, there are some leverage products, that way there's ... The market might move 2% in their direction, but the market moves 2% in their direction you can get 6% upside, and that's a way that they could leverage their exposure so that they could actually get the rate that they were looking for in the market place. And at the time, they weren't doing anything anyway, so if they put something, a revenue enhancement strategy in place, at least they're doing something to try to get a better rate, and

if the market goes that direction then it's a lot easier for them to get the funds back.

Craig Jeffery: Excellent. Thank you, David. I appreciate you joining me on The Treasury Update Podcast with this 2019 outlook.

David Pierce: Thank you so much. I appreciate being here.