

# 2016 PREVIEW: FULL VIDEO SERIES

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## **Does it matter that the CNY (Chinese Yuan Renminbi) is to be included in the IMF's Special Drawing Rights (SDR)?**

The inclusion of the Renminbi in the IMF's Special Drawing Rights basket does matter for the foreign exchange markets. Over the past few years one of the biggest drivers for fx markets has been what foreign exchange reserve managers are doing. And therefore, the fact that the Renminbi is being included within the SDR is likely to also encourage foreign exchange reserve managers to include the Renminbi in their reserve baskets as well. Question is how much of a weighting the Renminbi is likely to have. Looking at the numbers that have come out over the course of the last few days from the IMF, we know that the Renminbi is going to have roughly the same weighting as Sterling and Yen within the SDR – it's going to be about 11%. If we factor that through and we look at foreign exchange reserves I think it's probably fair to say that the Renminbi will end up over the course of the next 5 years hovering around somewhere in the region of about 5%. In FX reserves, to put that into hard numbers, given what we know about the size of global FX reserves today, ex-China, that's about \$390 billion of Renminbi that needs to be bought. The other thing that matters is the fact that actually the Euro and Sterling have been significantly downgraded within the SDR basket - a 6 percentage point reduction in the Euro's weighting, and a 3 percentage point reduction in Sterling's weighting. That might already be being reflected in what reserve managers are doing, but nevertheless, it says a lot about the reduced standing of both of those currencies in the eyes of the reserve management community. No doubt that will be reflected in their valuations over time as well.

## **What worries you the most about the current market environment?**

I think one of the things that has really struck me this year is how little the market has actually reacted to non-monetary policy risks. Relative to the movements that have been driven by monetary policy, I think one of the easiest ways of illustrating this is to look at the markets, largely indifferent response to the downing of a Russian plane in late November, close to the Turkish-Syrian border, and compare it to some of the extraordinary moves we saw earlier in the year on the back of monetary policy moves. Perhaps one of the most notable coming in March of this year where after an FOMC meeting the chairman of the federal reserve Janet Yellen gave a



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press conference and tweaked people's expectations a little bit about what might and might not happen with regards to monetary policy in the United States. In the immediate aftermath of that tweaking of perceptions about monetary policy, EUR-USD went up to around about 4 big figures and then over the course of the night came back off almost the exact same amount. The reading in overnight volatility for the dollar index that day was the 5<sup>th</sup> highest since the Plaza Accord meeting in 1985. It was only beaten by things like Sterling coming out of the exchange rate mechanism in 1992, the collapse of Long Term Capital Management in 1998, the collapse of Lehman Brothers in 2008, and another move in December of 2008 in the depths of the financial crisis. The fact that we're seeing far higher volatility on the back of a tweaking of expectations of monetary policy relative to what is quite a significant potentially geopolitical event tells me that this is a market that is focused on monetary policy to the exclusion of almost anything else. That therefore also tends to suggest that the real risk going into 2016 is that we have a market that's reaching for yield and perhaps ignoring a lot of other things that it should be looking at.

**The "Brexit" Debate in the UK seems to have disappeared off the radar for investors. Will it return as a theme next year?**

I think one of the things we've seen in UK politics and how it impacts the currency markets over the last few years is it tends to be a relatively short lived phenomenon in how it actually impacts sentiment. We can think back to the Scottish referendum, we can think back to the UK general election and in both cases the market certainly reacted in the immediate month ahead of the event itself. I think that's probably going to prove to be the case with the EU referendum itself. Nevertheless, given the fact that 2016 is currently the most likely date for the EU referendum in the United Kingdom it does seem fair to say that it is going to start to become rather a more significant factor in investors' thinking. The problem is that over the course of the last few years, the polling in the United Kingdom has proved rather more unreliable than perhaps one might have hoped. That certainly proved to be the case in Scotland and in the general election and therefore it's difficult to get an accurate read of how the UK public will vote. Nevertheless, at the moment the surveys are running incredibly closely and it looks as though it's going to be too close to call when it comes to saying how the vote will take place. Given that, and given the fact that we have Sterling that is more reasonably valued than it has been for a long time, given a lot of the forces have actually driven Sterling in terms of it being a safe haven are dissipating, and given the problems that the Bank Of England will have next year, I believe, in hiking rates aggressively, I think that Sterling actually may well start to suffer a little bit on the Brexit debate as people take a rather more cautious tone. Therefore yes, I do think the debate over the EU referendum will become an important decision in 2016 for investors.

**Oil price weakness has been a defining feature of the past eighteen months. What is driving this and will it continue next year?**

Clearly there are a variety of factors that can be pinpointed when talking about oil price weakness, not least of the continued weakness in the Chinese economy and of course the fact that OPEC continues to keep the taps fully on for oil supply. However, I've got to say I think for me, the key force over the course of the last 18 months has been actually the relationship between oil prices and Dollar demand. If we go back to the summer of 2014, where you started to see huge inflows into the Dollar from mid-June onwards, at the time of the ECB policy move and of course the dollar rallied exactly in line with those huge inflows. What's absolutely critical

to note is that the decline in the oil price comes from almost exactly the same point and there is almost exactly what happens to the dollar. It's not the first time we've seen this happen. You can go back to 2007 and look at the Dollar declines then, and compare it to the sharp rally seen in the oil price. Equally we can look in early 2009, the depths of the recession, and see the introduction of QE in the US, the decline of the dollar matches exactly to the rally in the oil price we've seen. Therefore I think the key issue going into 2016 for the oil prices is do we see another rise in demand for the Dollar? For me, the combination of a Fed that's tightening and an ECB that's going to reduce policy even further, seems to me that if anything demand for the dollar is going to build. And if that's the case, weak oil prices look to be effectively with us quite some time and certainly the opening months of 2016.

### **Will weak oil prices complicate the picture for central banks next year?**

I think that weak oil prices, if we're right that weak oil prices do kick in in 2016 once again, then yes it will complicate the picture substantially for central banks. One of the big problems that has been faced over the course of the last few of years is the persistence of disinflationary pressures. One of the reasons why the Bank of England, for example, found it so hard to hike rates was that energy prices continued to the downside. I therefore think that if we see a renewal of downward pressures on oil prices, then yes – central banks will struggle in 2016 to make aggressive moves. Certainly I think the Fed may well struggle to be particularly aggressive in 2016 if we're right about oil prices. Equally I think the Bank of England may find itself having to wait maybe as long as 2017 before making its first move. And I think the pressure on the ECB to keep policies easy as possible for as long as possible will only continue to grow. Therefore for me, 2016 the story is not necessarily about aggressive moves hiring policy but it's rather more about how people are going to be able to do anything to the upside and more about how people actually ease policy. That I think presents an astonishing picture for assets because quite clearly the key risk for 2016 becomes do we end up with investors reaching for yield. That's why I think the oil price story really matters, above and beyond the energy markets.

### **Why do you think 2015 felt so much like 1998 and why does that matter when we think about how events could play out in 2016?**

I think that comparison between the 2 years is absolutely fascinating. Both come after multi-year Dollar rallies. Both come on the back of a very very slightly hawkish Fed in years past and both come in the face of a series of emerging market crises. What really struck me about the comparison this year was the fact that actually we ended up with a rhythm through the summer this year that matched so closely to what we saw in 1998. A semi-annual testimony from the Fed chairperson, which was again slightly hawkish, a crisis in a major emerging market in August that sent mainstream equity markets and the Dollar into a tailspin (in 1998 it was Russia and the devaluation; this year it was China and the devaluation – or supposed devaluation – of the Renminbi). Most importantly, was the fact that actually in both cases the Fed reacted to market concerns. In 1998, the Fed cut rates in September, again in October and again in November to try and provide support for markets. And that worked. It ended up with a market that actually started to recover its confidence in the 4<sup>th</sup> quarter of that year and on the back of that Fed put to support them, rallied incredibly strongly in 1999. This year the Fed paused. It didn't go to hike rates in September. It held off. It held off in October and it was only in December that we finally went to make the move. That also had a positive impact on investor

sentiment. As we came into the 4<sup>th</sup> quarter of this year, we saw a huge surge in sentiment – positive risk sentiment. And it seems to me if there's a key story here, as much as in 1998 with the "Greenspan put" driving investor sentiment positively, I think this year the "Yellen put" equally provided investors with a positive base from which to build in terms of asset price appreciation.

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