

## July Trade Ideas: An Election Gone Wrong



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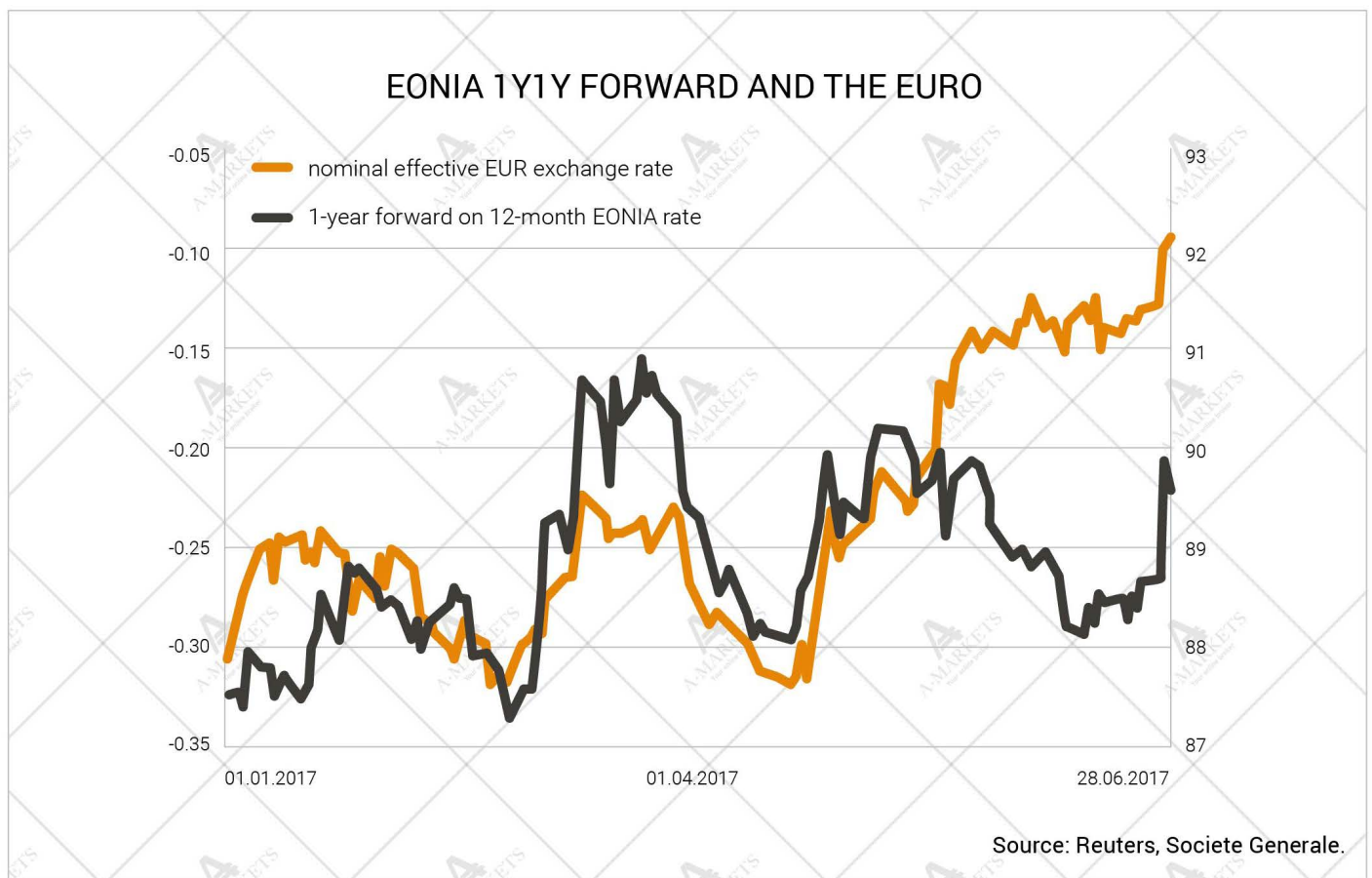


### JULY TRADE IDEAS AN ELECTION GONE WRONG

#### Summary:

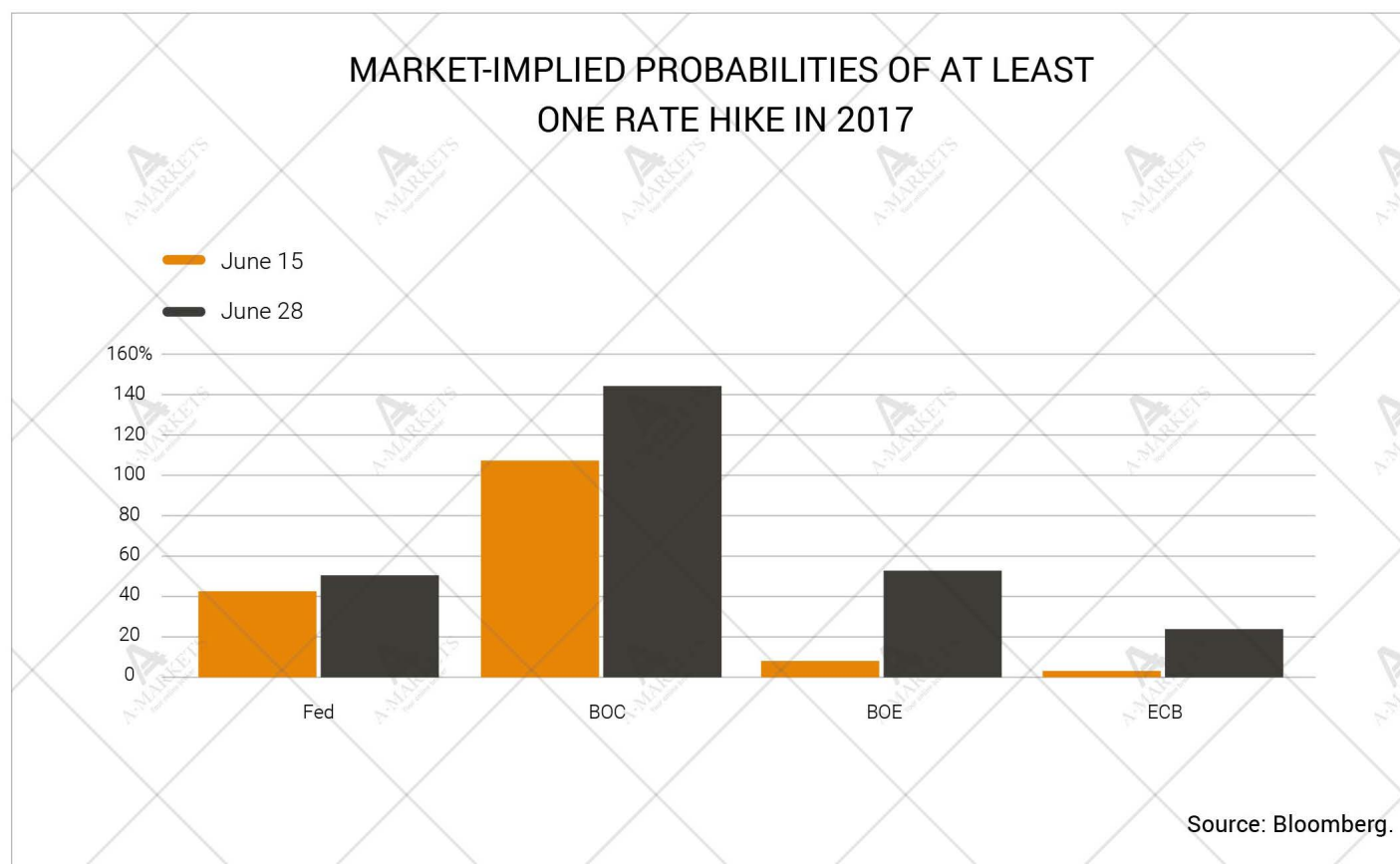
- World's largest central banks are signaling they're ready to start tightening monetary policy.
- The British government's attempt to secure more seats through a referendum has backfired yet again. The pound, however, has been resistant to political noise.
- The Fed seems to be worried about the market's tepid reaction to the latest rate hike. The regulator is likely to start exiting QE in October.
- High-yielding currencies have finally come under pressure, but for now that's a preemptive correction.

June made it very apparent that the markets have grown more responsive to signals from central banks and less sensitive to political issues. For the first time in a while, bouts of intraday volatility across main currencies were all related to comments coming from monetary authorities. And June's main winner is the euro. The currency had already been performing quite well but grew even stronger following Mario Draghi's recent comments. Speaking at the European Central Bank Forum in Sintra, Portugal, Draghi stated that the Eurozone's "deflationary forces have been replaced by reflationary ones." The statement sent the euro to a high of around \$1.14 at the end of the month. There's also a strong potential for the euro to strengthen on further expectations the ECB's policy tightening.



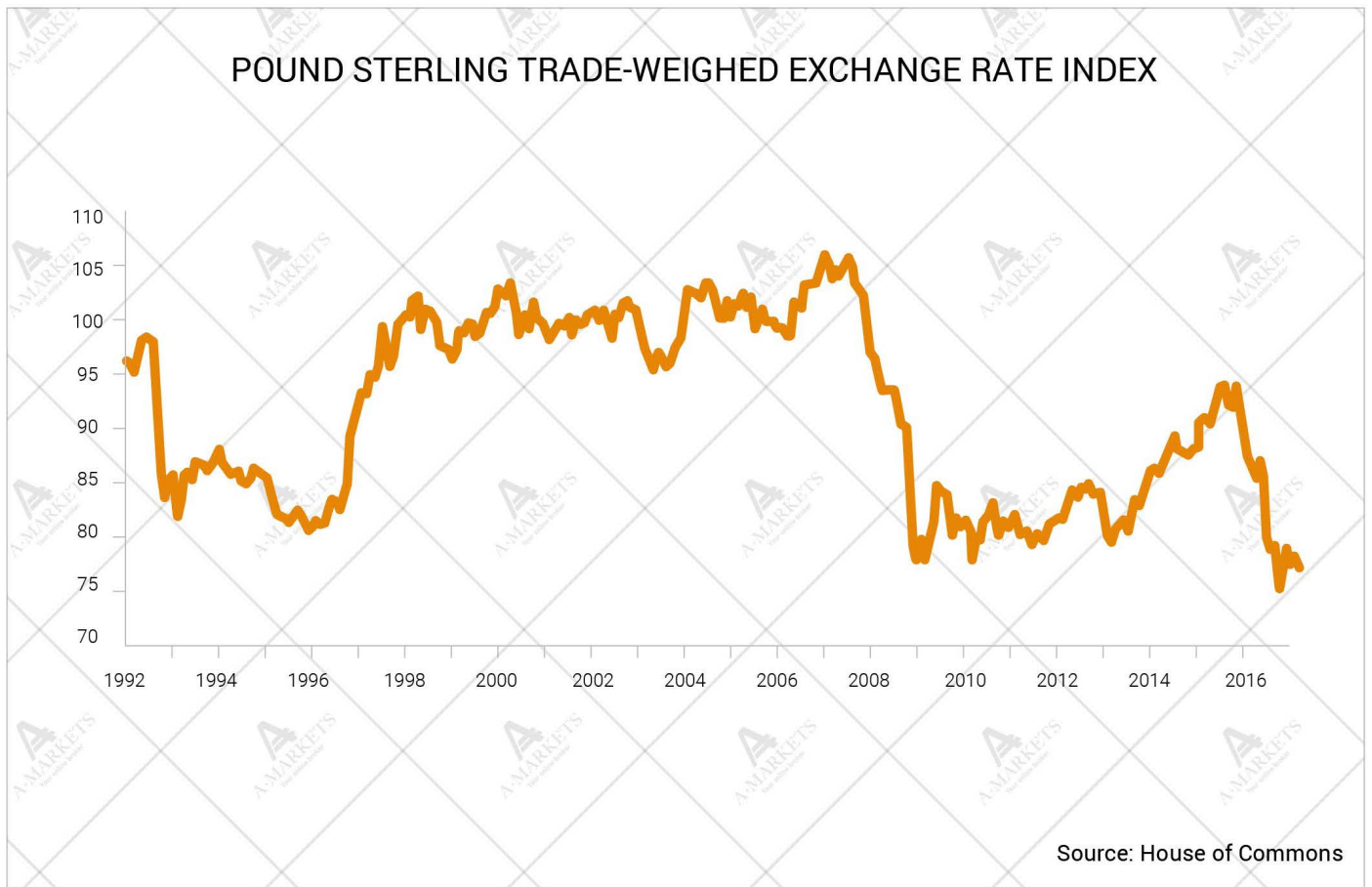
Speaking of the ECB, its officials seem to be having trouble communicating. In June, Mario Draghi made two explicitly hawkish comments. But some colleagues of his, however, were quick to play down the remarks, suggesting that Mr. Draghi's words had been misinterpreted. Those contradictory comments can only mean one thing: the central bank's officials have begun discussing their first rate hike. Policymakers are also readying to reveal the technicalities around the end to their QE program. The fact that their consolidated position has not been stated publicly is precisely the reason investors are getting these mixed signals. But the only thing that matters is that the bank's next step is policy tightening. Importantly, that has not been fully discounted yet.

There's a similar story with the Bank of England. During that same conference Mark Carney hinted at a rate hike ahead, stating that "a removal of monetary stimulus is likely to become necessary." We are confident that the regulator would already be tightening if not for the political struggles that once again struck Britain in June.



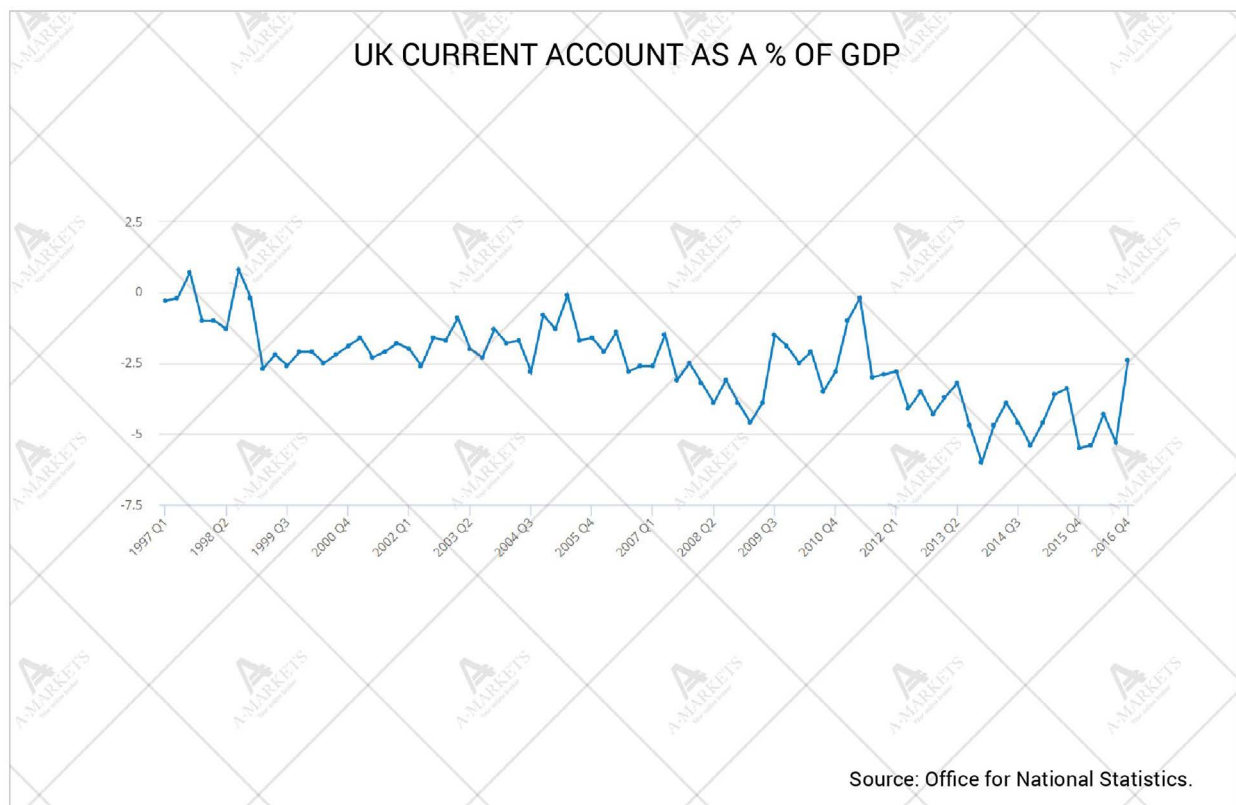
British officials should stop trying to legitimize a governing party through national voting because it just isn't working. A couple of years ago they arrived at the idea to hold a referendum on the country's membership in the European Union. But, instead of receiving the unanimous support for the union the government might have expected, they ended up with Brexit. Fast-forward to June 2018, and Theresa May is suffering a major blow to her attempt to show the entire country what the Brexit process should look like. May's election gamble cost her Conservative Party's absolute majority in parliament and they will now have to reckon with minority parties. And if the politicians don't stop pushing their views this hard, Britain may have to deal with all the challenges of a "hung parliament."

The outcome of the snap general election should be weighing negatively on the pound. Had May's election risk been a success, it would have taken a chunk of uncertainty surrounding the Brexit process off the markets. The PM's stance is relatively soft and it would be prevalent in the parliament. On top of that, the next election could easily be scheduled for 2021-2022 and Mrs. May could manage to single-handedly steer the country through Brexit. But something's gone wrong and the uncertainty did not decrease, but rather increased.



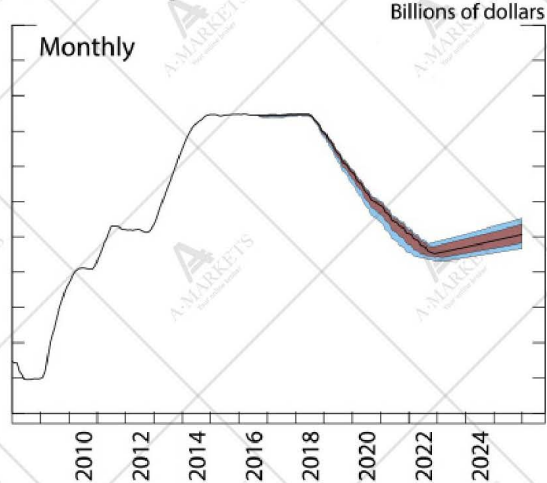
And yet sterling is hesitant to go lower. We judge this to be a highly important signal for markets in general and the pound in particular. Supportive GBP fundamentals are becoming increasingly evident. Politics is retreating to the background, and economic considerations are moving to the forefront. Pound's trade-weighted exchange rate index is currently at the 1994 lows, and it's actually slightly below where it was when George Soros launched its attack on the Bank of England. Yet it's obvious that the quality of life in Britain has not dropped that much after Brexit, and so external demand for goods and services is recovering.

Simultaneously there's decreasing dependence on foreign investments. In Q4 2016 the current account deficit stood at only 2.4% of GDP, which was a substantial improvement over the previous quarter's 5%. The year-end number is still alarmingly high – 4.4% of the GDP. Nonetheless, one should keep in mind that the effect of the pound's devaluation didn't manifest itself until the end of the year and we have every reason to believe that the improvement in the balance of payments is there to remain. As more investors focus on value, pound bears are having some difficult times. Sure, we still expect sterling to go lower (eventually), but the sellers do need to be very patient. And maybe even consider going bullish after the next leg down arrives.

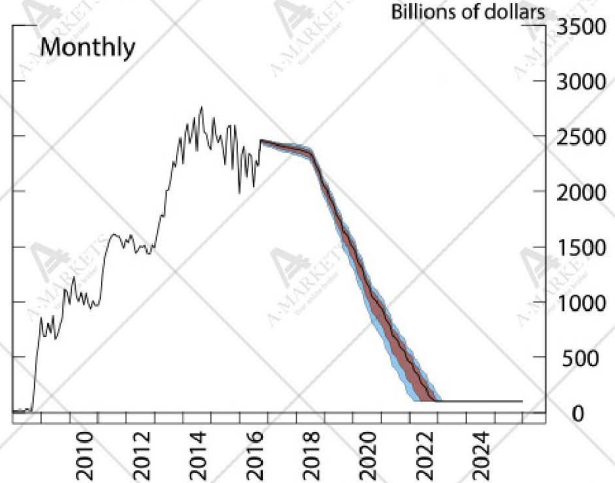


## CONFIDENCE INTERVAL PROJECTIONS OF THE FEDERAL RESERVE BALANCE SHEET AND RESERVE BALANCES

SOMA Holdings



Reserve Balances



Source: Board of Governors of the FRS

Now, of course, a few words on the Fed. On June 19th, Janet Yellen & Co. expectedly raised interest rates to a target range of 1 to 1.25 per cent. What is still surprising to us is how strongly the regulator is pushing its plan to roll back its balance sheet. Some very specific details were unveiled during the latest FOMC meeting.

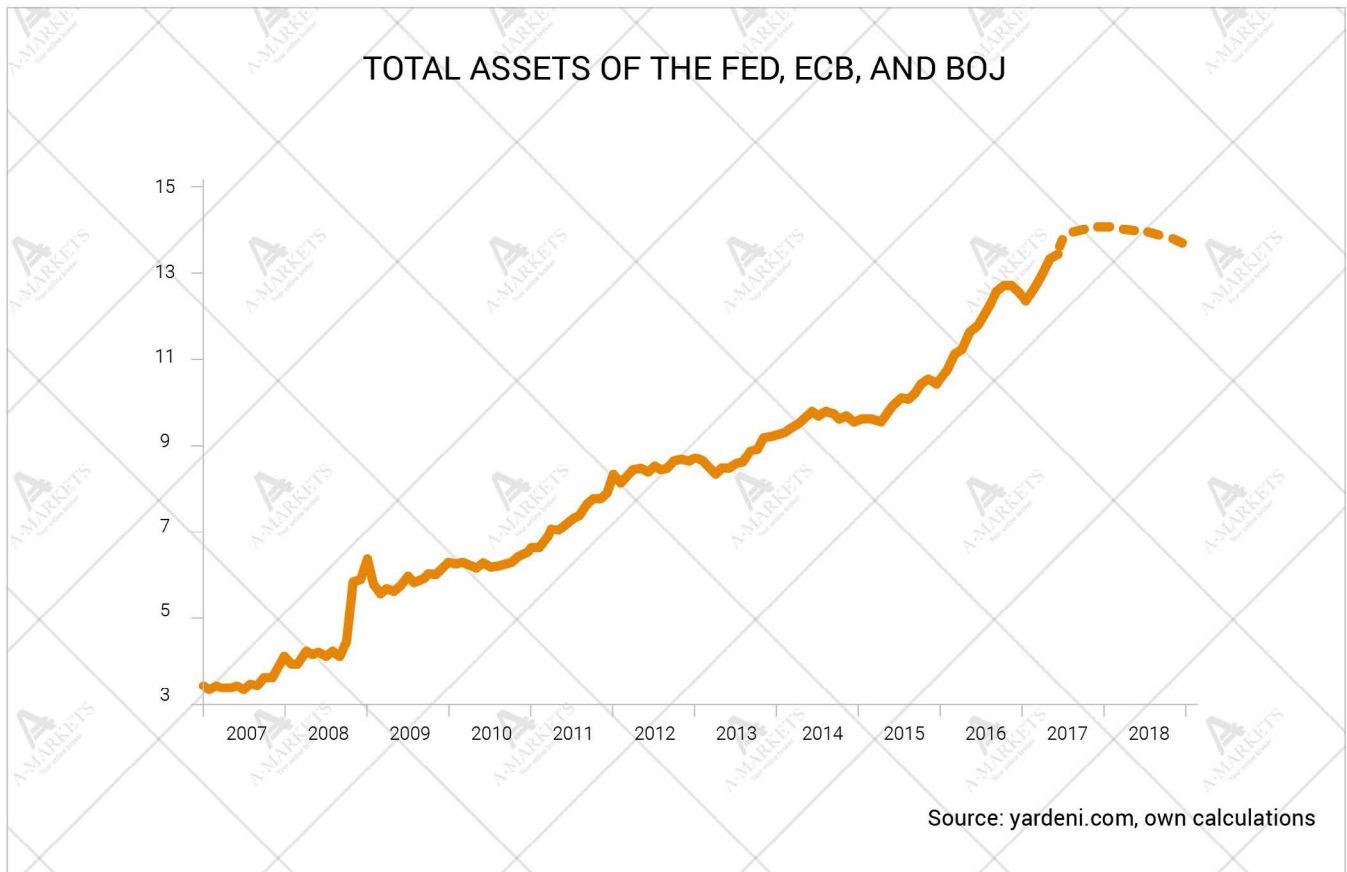
The date The Fed starts exiting QE is expected to be announced “shortly,” and we already know how the process is going to work. Reinvestment reductions will be initially capped at \$10 billion a month, with \$6 billion in Treasury bonds and \$4 billion in agency bonds. Suppose the assets yield the Fed a total of \$100 billion in a given month. This means that \$10 billion will roll off while \$90 billion will be returned to the market. The Fed will then raise the cap by another \$10 billion each quarter until it reaches \$50 billion. In that figure \$30 bln are divested from treasuries and \$20 – out of mortgages.



As a matter of fact, the only thing that the markets are yet to know is when exactly the procedure will start. We suspect that the officials already have a date but are choosing to give out information in bits. That allows them to have the benefit of receiving market feedback on each step they make. We expect the balance sheet roll-off to begin in October (with a formal announcement at the September meeting). And if things run smoothly through the months of October and November, there will be another rate hike—this year's third—in December.

So what are the practical implications here? In the April edition of this publication we gave our calculation of the size of the Fed's balance sheet that would be critical for the markets. Here's a quick catch-up: according to our estimates, a situation similar to the 2008 crisis is only possible with a balance sheet lower than \$3 trillion—or rather, in the \$2-2.5 trillion range. The dollar will not be affected as long as total assets exceed \$4 trillion. Only when the balance sheet drops below that mark will the greenback find support from the monetary policy.

Some quick math shows that under the announced plan the Fed's balance sheet will remain above \$4 trillion until the end of 2018. That, of course, doesn't mean that the dollar will be dropping the entire time as the other central banks are a factor as well. Yet the bottom line is clear: there shouldn't be any significant market movements. There might be some initial increase in general volatility but that's about it.



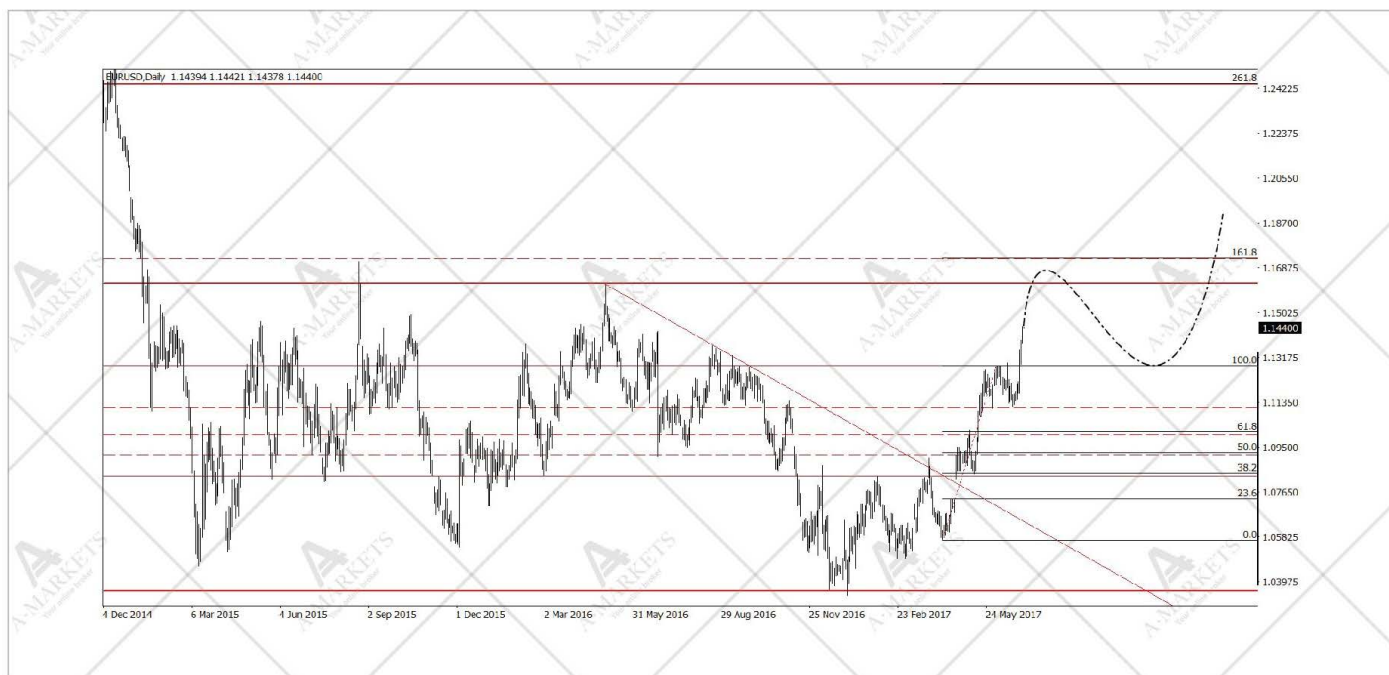
We note that the Fed's first steps in shrinking its balance sheet are unlikely to cause any major sell-off across risk assets. Investors are well aware of the process and it's pretty much already priced in. Now, the hawkish rhetoric from the ECB and the Bank of England—along with several others like the RBA, RBNZ and BoC—is what's new and what the markets will really be reacting to in the coming weeks.

One necessary condition for that trade to run is consistently strong macroeconomic data. That is a must to keep the market's expectations for a tightening in monetary policy. Inflation (or lack thereof) is a factor of special importance here as it keeps regulators sidelined and blocks the exits out of QE programs. And yet the market is wide awake and ready. A couple of high numbers in price dynamics are enough to trigger a new leg higher in both EUR and GBP growth. Conversely, a string of disappointing inflation data can dampen current rally.



## EURUSD: overbought in the short term, but has a strong mid-term growth potential

*We don't take speculative positions in EURUSD just yet. Preferred strategy is buying the dips.*

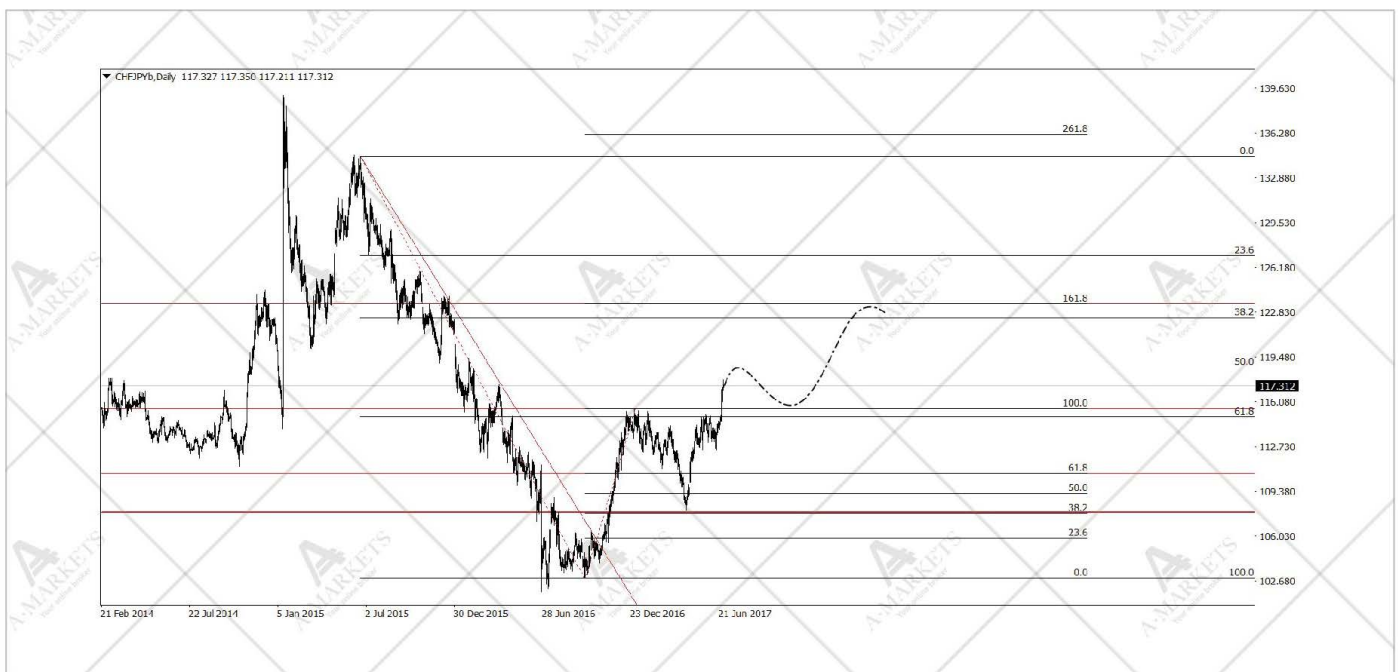
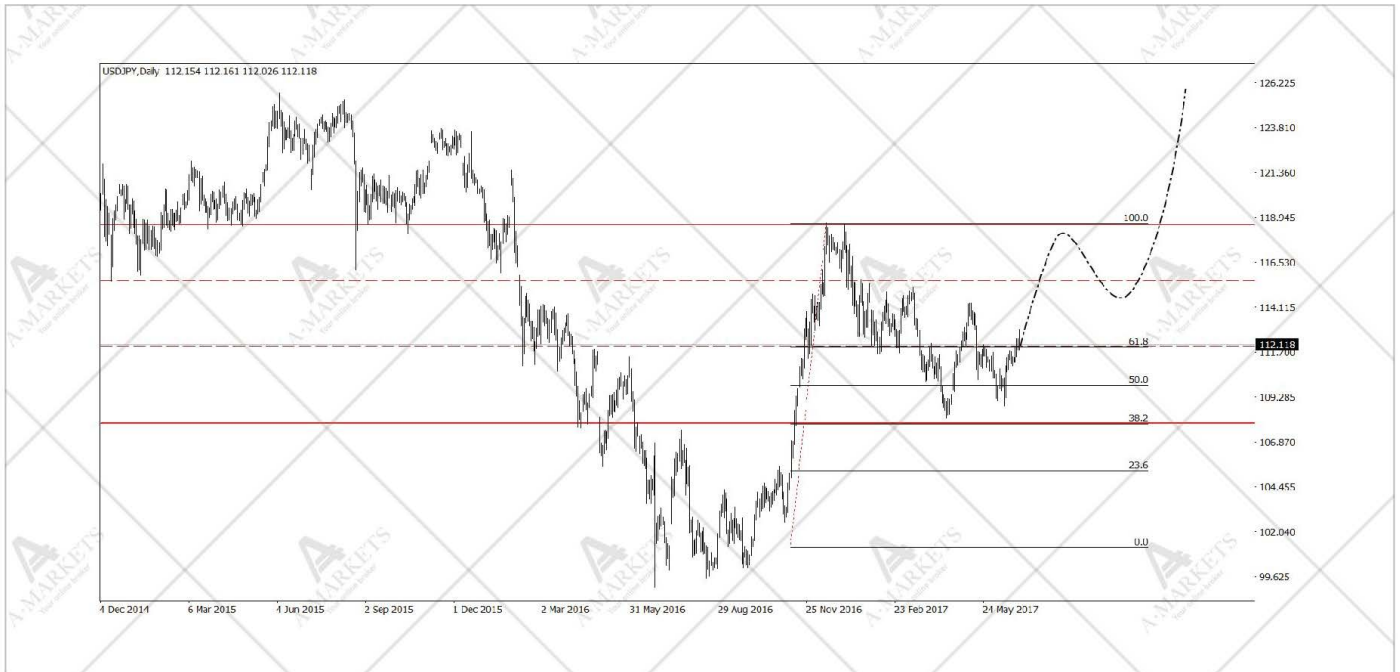


Just six months ago the euro was testing the lower end of its two-year range. Parity seemed close and 0.82 looked like an achievable target. And yet the European currency, fueled by the U-turn in ECB's rhetoric and general speculative positioning, bounced off from the lows. The short positioning is still lending support to EUR/USD to this day, and it has not been wiped out even as the unit soared above 1.14. As long the market remains bearish, nothing stands in the way of the uptrend, as there's support from the fundamental factors as well (see the first part of this publication).

Any rally to targets around 1.165 is seen as a quite ordinary technical correction to a two-year-old downtrend that started near the 1.4 mark. The minimum target for the current leg up is 1.153, the maximum — 1.174. A speculative long could be reconsidered if the pair drops to 1.131. Buying at the current levels (at time of writing EURUSD rate is quoted at 1.144) is just too late as the risk of an intraday correction is significant. Bottom line: we believe that 1.153 looks perfectly plausible as the next target, but the tactics are challenging. Once that level is taken out, one will need to reevaluate if the momentum is still present. That will mostly depend on those same positioning and the ECB rhetoric. The technical picture suggests that the euro is aiming at 1.216 over the next 6-9 months.

## USDJPY, EURJPY, CHFJPY: drop the idea and it'll work just right.

We buy USDJPY at 112.3 with a stop-loss at 111.4 targeting 118.5, CHFJPY at 116.5 with a stop-loss at 114.8 targeting 122.99, waiting for an entry point in EURJPY.

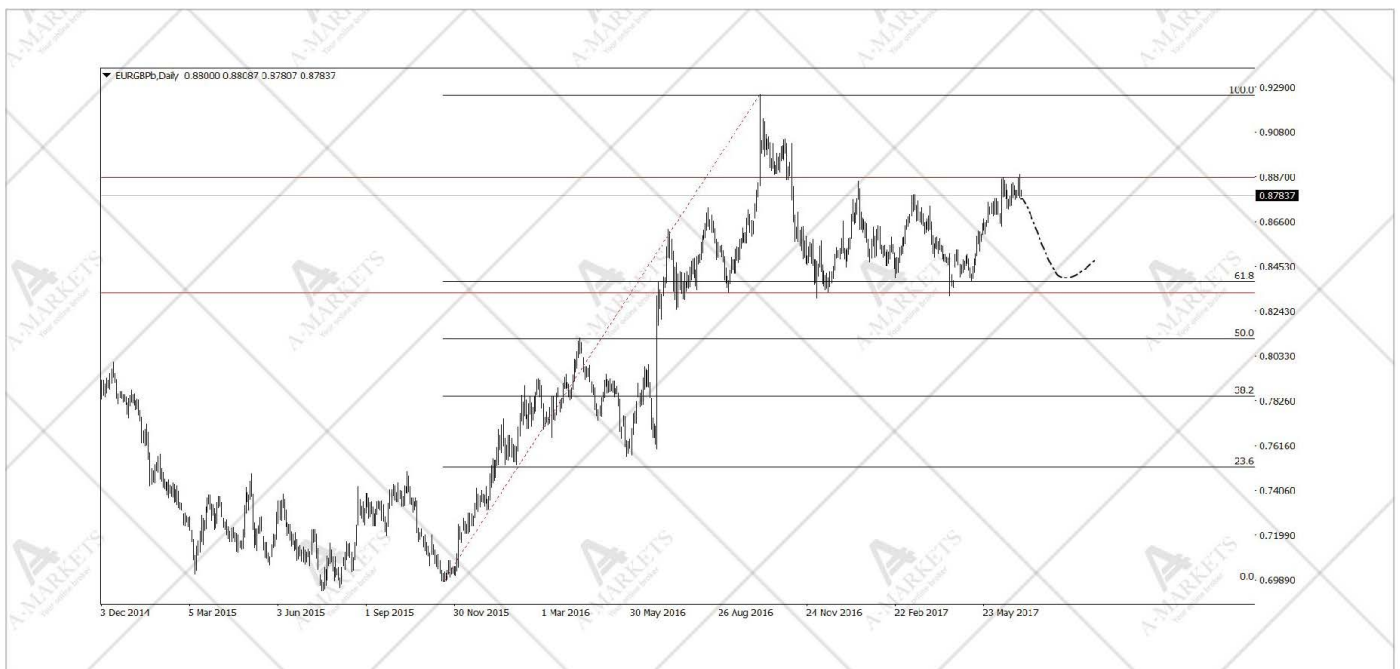
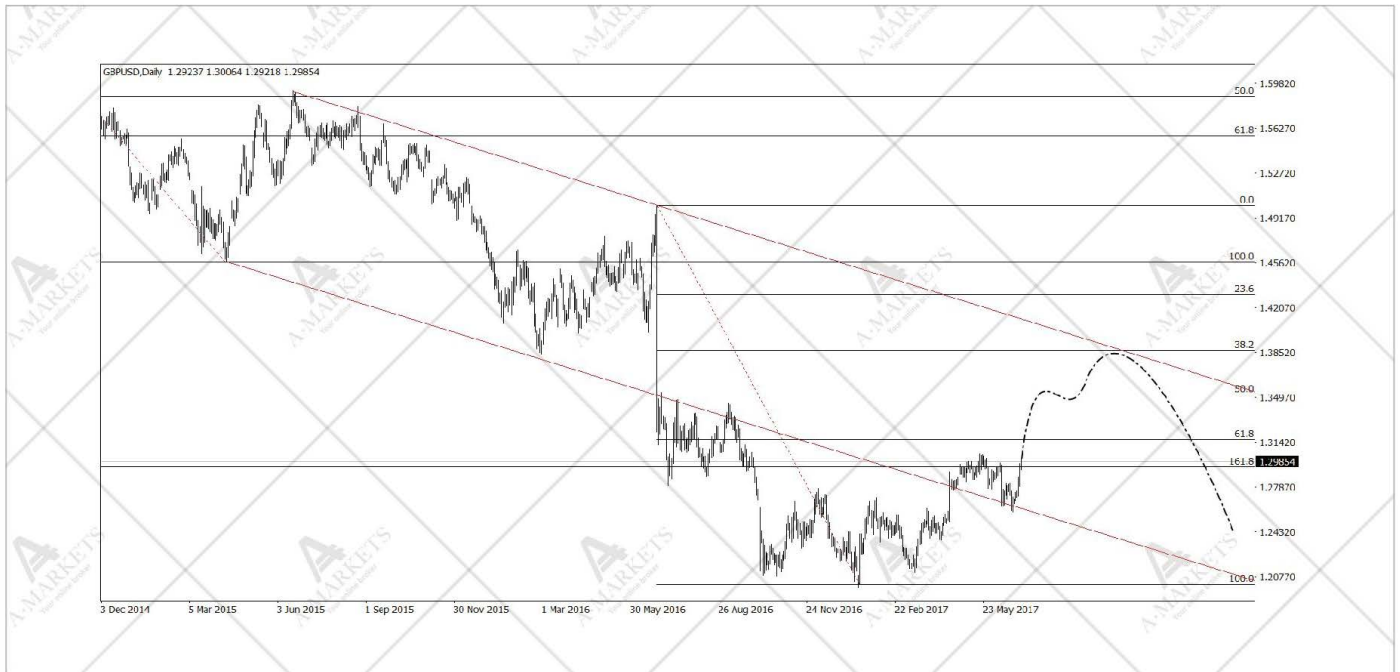


The Bank of Japan is the only major central bank not to drop any hawkish comments in June. The bank's next meeting isn't scheduled until July 19-20 and it's unlikely that the markets hear anything new before that. Then again, the meeting isn't likely to bring any changes either. Given policy changes occurring in nearly every other region, triggering a global increase in yields, create a perfect environment for a weaker yen.

Every JPY cross managed to enter a pronounced uptrend. EURJPY, GBPJPY, in particular, posted explosive rallies, but now both risk correction. As a matter of fact, the same applies to USDJPY and CHFJPY, but these two are way more fairly priced both short-term and long-term. Dollar-yen fell behind due to the relatively weak greenback but now has every chance to catch up to its counterparts. We expect the pair to reach the 115.2 mark in July. CHFJPY is looking very healthy technically as well. The pair has broken through every resistance level on a monthly closing basis and is headed towards the first target of 119.4. The main target for Q3 is the 122-123 area.

## GBPUSD, EURGBP: the pound is unbothered by political uncertainty.

We sell EURGBP at 0.88 with a stop-loss at 0.891 targeting 0.842, looking for entry points on GBPUSD.

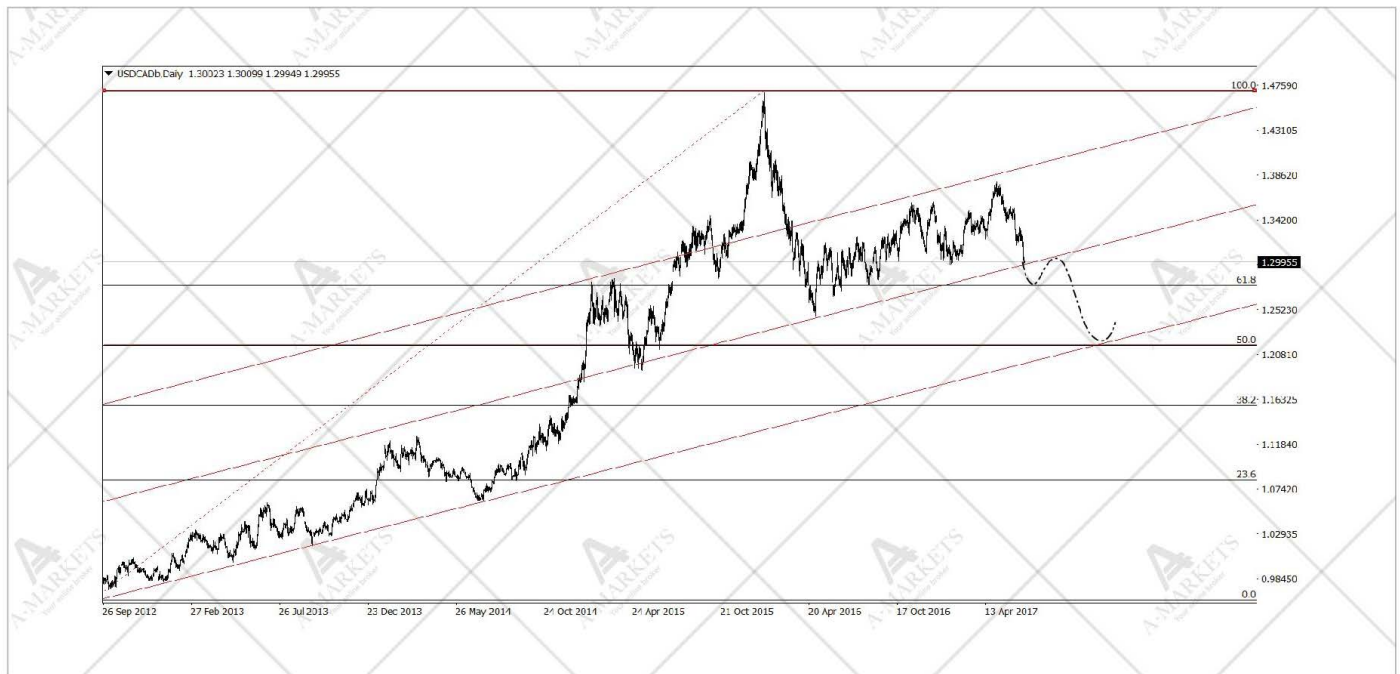


As stated earlier, the sterling has become somewhat immune to political upheavals. We believe that the reason is general economic rebalancing and the changes to the balance of payments that were discussed in the opening part of this review. Here we'd like to point out the local base formed around the 1.20 mark. The pound was trading in the 1.20-1.27 range for well over six months and the area can now be seen as a good (albeit inappropriately wide) support level.

The pound's future is now in the hands of the Bank of England. Should Mark Carney go for a rate hike and wind down QE, the bears will find themselves trapped. The market is poorly prepared for such a turn of events. EURGPB is stuck at the higher end of its year-long range—near the 0.88 mark—and it doesn't look like it will be breaking out anytime soon. We believe that continuing trading in this area is reasonable and expect the cross to go back to 0.84. There's a ton of potential in GBPUSD as well, but trading the Brexit-dependent pairs requires nerves of steel and ultra-conservative risk-management. Nonetheless, if EURUSD gets close to 1.22, then GBPUSD may move up to 1.385 proportionally.

## USDCAD: USDCAD: an opportunistic macro idea

*We will sell the pair at 1.293 with a stop at 1.3055 targeting 1.222, closing the long in EURCAD.*



Yes, you read it right: we're going to sell the pair at below current quotes. The logic here is very simple: USDCAD is testing a strong upward-sloping support level and might not break it. Therefore, it is preferable to wait for the pair to make a clean break down, into the lower channel, then reverse and re-test to this current support, which under the scenario would become a resistance level. The target would then be the symmetric 1.218 mark which also happens to be the 50% correction of a 5-year growth trend.

There are several reasons why we are tracing this story. While the Bank of Canada didn't get its deserved mention in the introduction to this review, it's one of the most prominent hawks. Not only has the BoC signaled a policy tightening soon, but the rate hike here is also much more likely, and can happen as soon as July 12, when the Bank's officials gather for their next meeting. Second, Canada benefits enormously from the growth in the U.S. economy. The loonie is supported by recovering oil prices as well. Third, the central bank managed to avert a mortgage crisis (see our May publication) with the help from none other than Warren Buffett, who made a major investment in troubled Home Capital Group, much to the satisfaction of investors. And finally, selling USDCAD goes very well with the likely weaker dollar ahead.