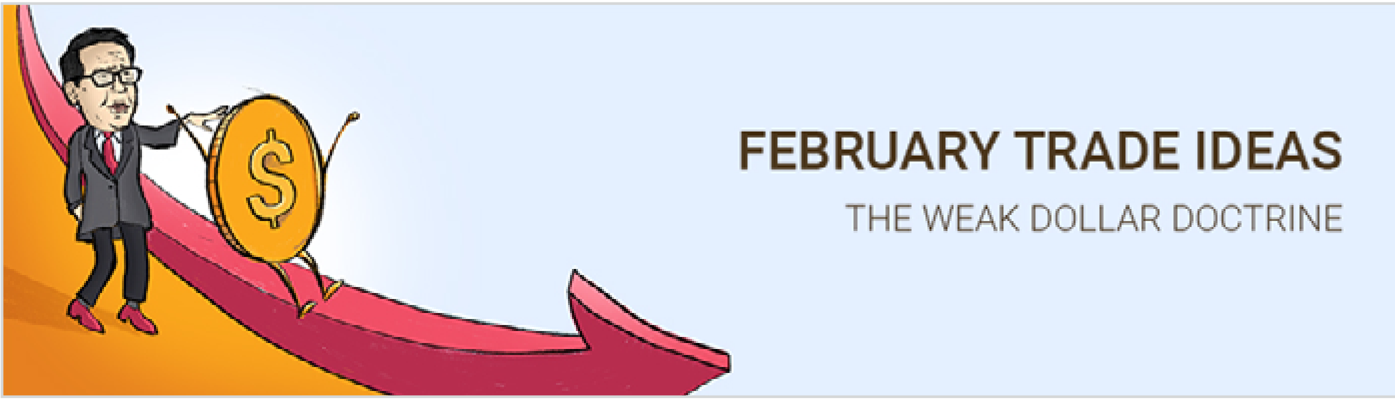
The Weak Dollar Doctrine

**Author: Nick Korzhenevsky,
analyst with AMarkets Company. The anchorman
of a TV program "Economics. Day rates"**

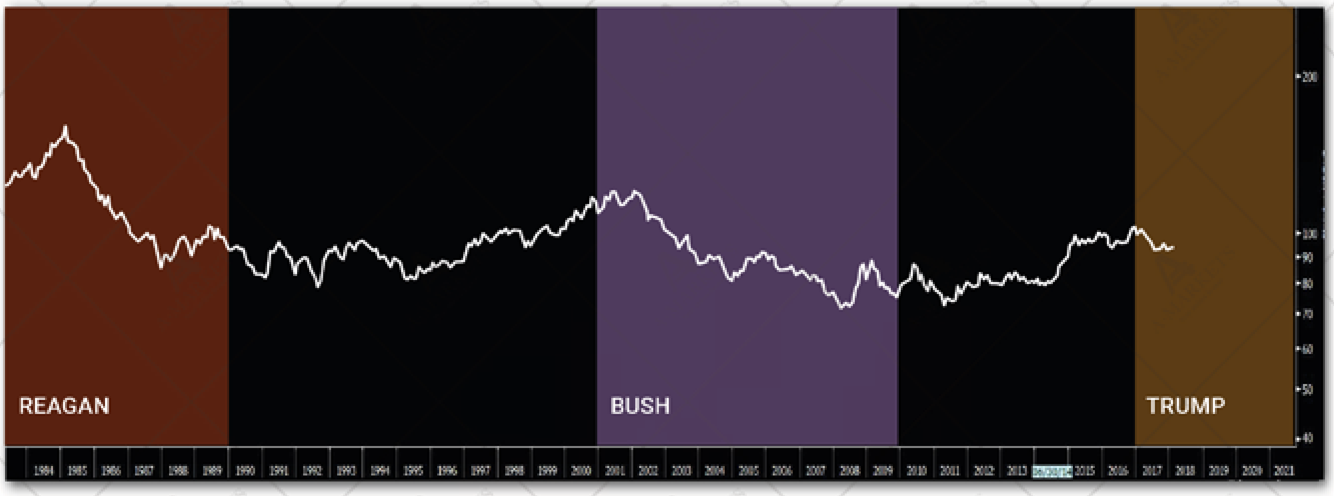


Summary:

- The dollar is now firmly in a downward trend. Any USD strengthening should be viewed as a corrective move.
- Treasury Secretary Steven Mnuchin welcoming a weaker dollar is a shift to a new stance. Yet another round of currency wars is under way and the winner is clear from the very beginning.
- The commodities sector is signaling an increase in inflation pressure. Major central banks are likely to tighten their policies sooner and faster.

The year is off to a good start. Markets are very active, and the news flow is intense. January's main newsmaker is undoubtedly the U.S. Treasury Secretary Steven Mnuchin. Speaking at the WEF in Davos, he literally said that a weaker U.S. dollar is beneficial for the country's economy. To quote: "Obviously a weaker dollar is good for us as it relates to trade and opportunities." Mnuchin backtracked the following day, trying to clarify that he only spoke of the short-term, and generally meant something completely different, but investors had heard enough.

THE DXY INDEX AND TAX REFORMS IN THE U.S.



Source: Bloomberg.

Although very rare for a treasury secretary, Mr. Mnuchin's words should come as no surprise as they are perfectly in line with the current administration's economic policies. It's a whole new doctrine which calls for fundamental changes in foreign trade, fiscal policy, and, apparently, exchange rates. In one of the previous editions of this publication we spoke about Donald Trump having a historic chance to hire not only the new head of FOMC, but also the majority of the committee. Initially, there was some doubt as to whom Mr. Trump would like to fill the vacancies with. And while only two months ago we assumed that he might favor "hawks," we now do not rule out "doves" joining the Fed committee.

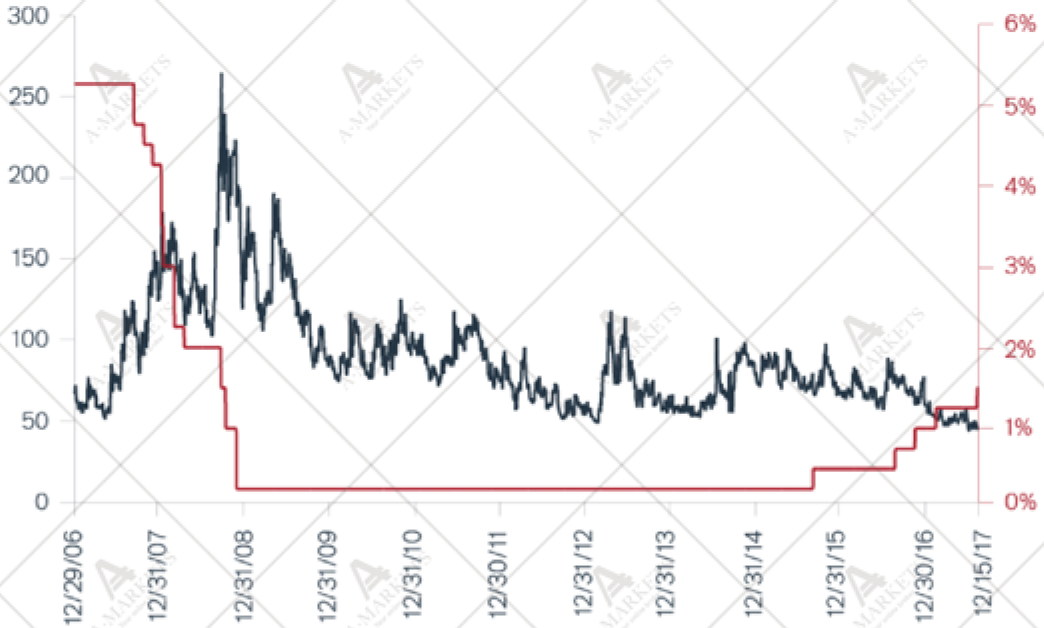
The dollar is falling fast along with U.S. treasuries; 10-year yields are at their highest since 2014. This is quite unusual as FOMC policy tightening combined with higher market rates should, c. p., strengthen the greenback. What we're seeing here is more of an EM market type of behavior. As soon as investors become anxious about some emerging trend, they usually sell securities and convert the proceeds from the local currency into a stronger one (that very dollar, for instance). But that's not how it works in a developed economy. In particular, the currency factor should be absent: what investors normally do is simply sell the risk, and move to the safe-haven assets.

10-YEAR TREASURY YIELDS.

Source: StockCharts.com

Just to make it clear, we are not worried about the rise in treasury yields. Rather, considering the U.S. GDP dynamics, as well as the magnitude of the tax reform and inflation pressures stemming for the commodity block, the fixed income market is just in a process of normalization. Rates are headed where they should be, departing from unusually low levels. What is counterintuitive is that simultaneously the dollar is weakening fast.

FED FUNDS TARGET RATE AND THE BOND VOLATILITY INDEX (MOVE).

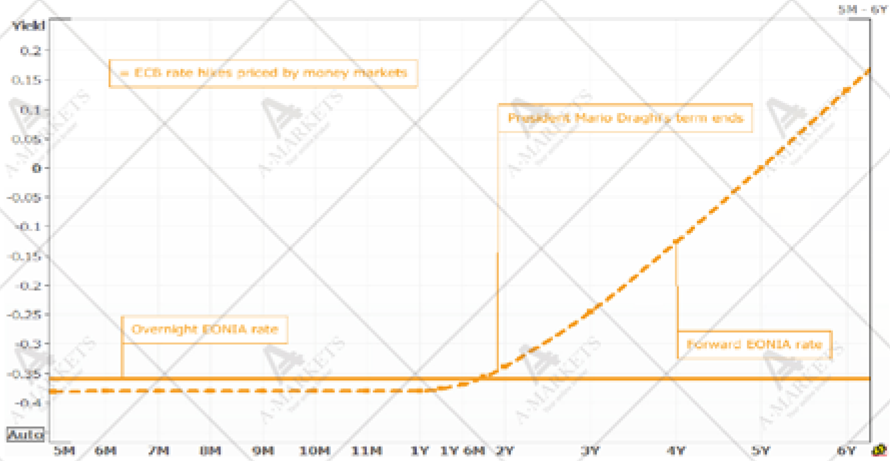


Source: Janus Henderson, Bloomberg.

So, what's next? We still believe that the Davos incident will prompt global regulators to intensify coordination and trigger some market rebalancing. Once that happens, the currency market should finally see a correction. The euro, the pound, and nearly every liquid currency is now trading rich relative to the USD. This is not to say there's no upside left, but the move higher has been too fast over the past few weeks.

Another prominent theme is the ECB running out of space to maneuver. The ECB's Governing Council is currently doing its best to get through to investors and communicate that the balance sheet unwinding may continue up until the end of the year. But that doesn't mean much for anyone anymore – it is evident that QE is over and tightening is to come next. The printing press can't help the euro anymore; moreover, word on the street is that the rate hike may come even before the QE program is fully wound down, which is a much more important factor as it's clearly hasn't been priced in.

THE EONIA FORWARD RATE CURVE.

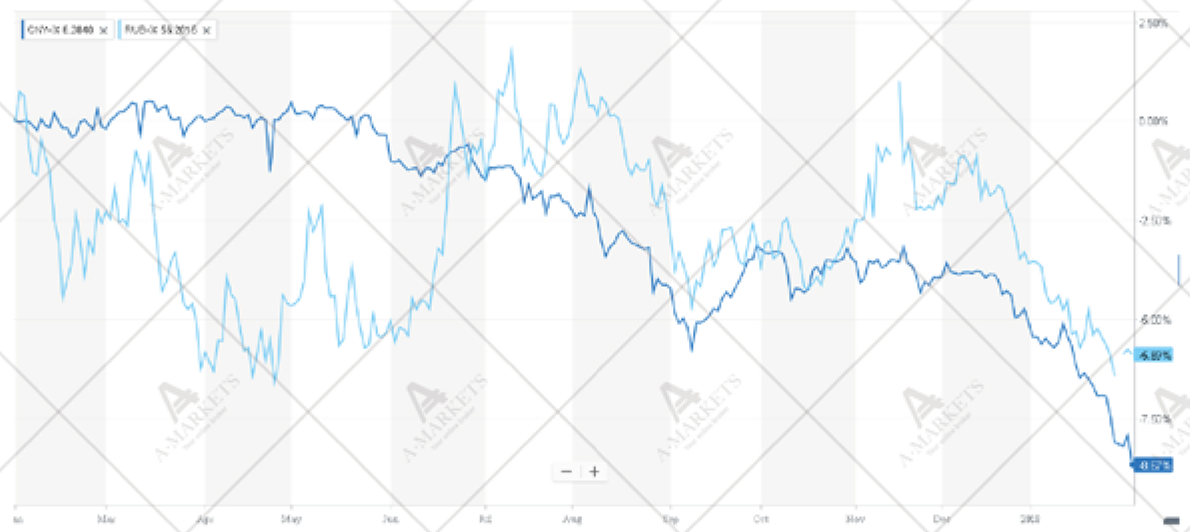


Source: Reuters.

The situation is also very positive across the EM economies. They are riding the global growth momentum and amid the still-low inflation. While advanced economies are slowly moving out of the goldilocks, the emerging world is just entering that stage. As a result, EM currencies are making strong gains. For instance, the Chinese yuan strengthened so much that the PBoC had to relax recent controls aimed at stabilizing the FX market. The perception here is clearly that the move up might have happened too fast.

The Russian rouble remains strong as well, shrugging off the risks of possible new U.S. sanctions. Judging by the so-called “Kremlin Report,” as well as Trump’s State of Union speech, the U.S. President has no plans for any aggressive moves against Russia. Specifically, we don’t expect sanctions to affect sovereign rouble bonds. As soon as investors see that they’re out of the woods, the rouble might enjoy an even stronger appetite for high-yielding assets.

USDCNY AND USDRUB OVER THE PAST YEAR.



Source: Yahoo! Finance.

The commodities sector also looks fairly strong. While copper technically was the weakest liquid asset in January, it went down by only 4%. Generally oil and industrial metals are making fresh highs. While a corrective move is long overdue, from a fundamental viewpoint there's still some upside potential for copper and nickel. Should the Congress pass Trump's $1.5 trillion infrastructure plan, another rally in industrial metals can happen. Again, broad dollar weakness has naturally boosted the demand for commodities. Gold, in particular, glitters in a newly-resumed uptrend after a multi-year hiatus.

Finally, January brought changes to the crypto world as well. And while violent volatility is still what defines the general picture here, one could say that crypto prices have somewhat stabilized. BTC has fallen to below $10000 and is quoted close to that mark. There is a chance that a weaker dollar and ample liquidity in H1 2018 can push the entire crypto segment higher, taking it to new highs. And yet, the bubble is close to bursting. We remain confident that the Bit will eventually fall to as low as $300 — which, by the way, wouldn't make investing in this cryptocurrency any less futile.

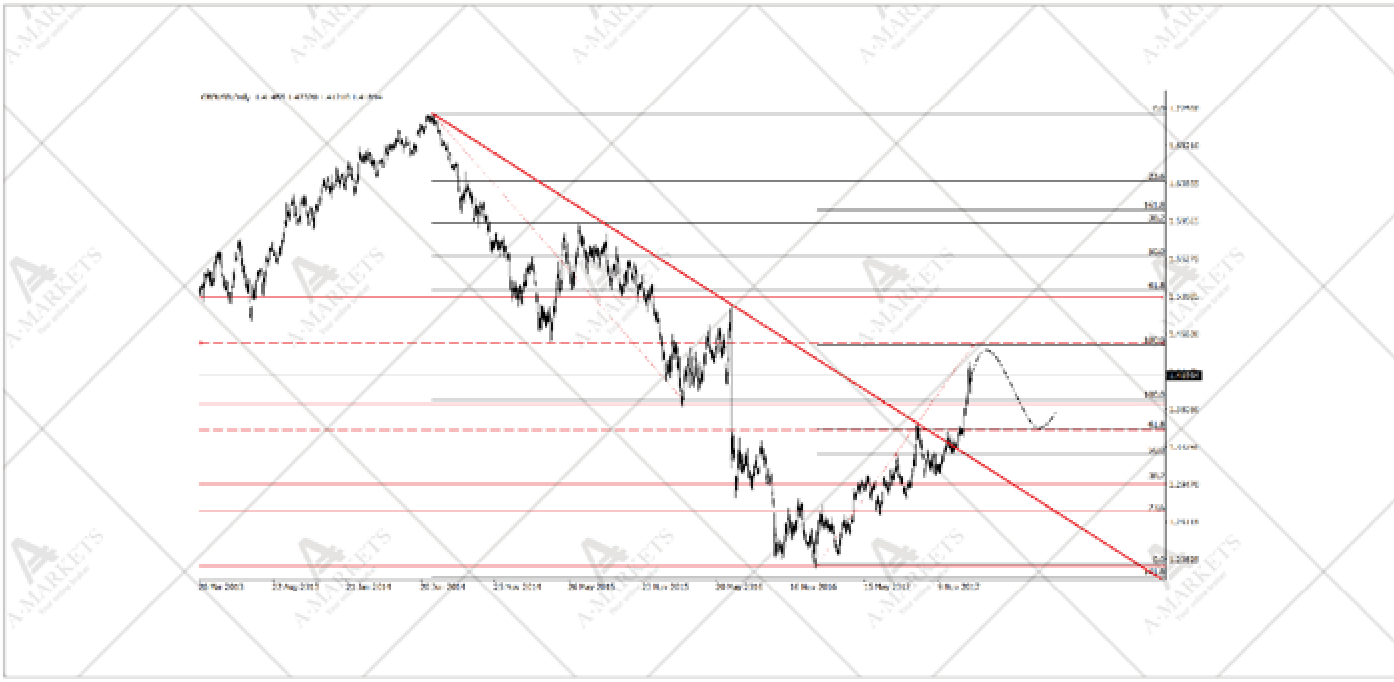
EURUSD: Mid-term uptrend now in place, short-term correction needed.

The American dollar has technically broken its upward trend. In January, the dollar index (DXY) has overlapped with its 2009 high of 89.62 which fundamentally alters the way every USD graph is to be interpreted. The key is now to generally expect a multi-year trend for a weaker dollar, and assume any move up as corrective. The long-term target for the index is now the 82.3 level, but it is unlikely to be reached before H2 2019. In the short term, we expect DXY to correct back to the 94-95 area.

We're now looking at the entire market thru this lens. Short-term EURUSD has clearly overshot and the upward momentum should wane. There's a significant trend resistance ahead, and it will be probably get tested several times before a clean break. An intraday bounce into the 1.26 which we mentioned in our previous review is still possible. But a corrective move should follow with the main target of 1.175. Strategically speaking, it would be wise to take a step back and remain on the sidelines, as corrections often occur in a “whipsaw” manner, and that is always a difficult environment for trading. Once 1.175 is reached the uptrend should resume.

GBPUSD: same tactical story as the euro.

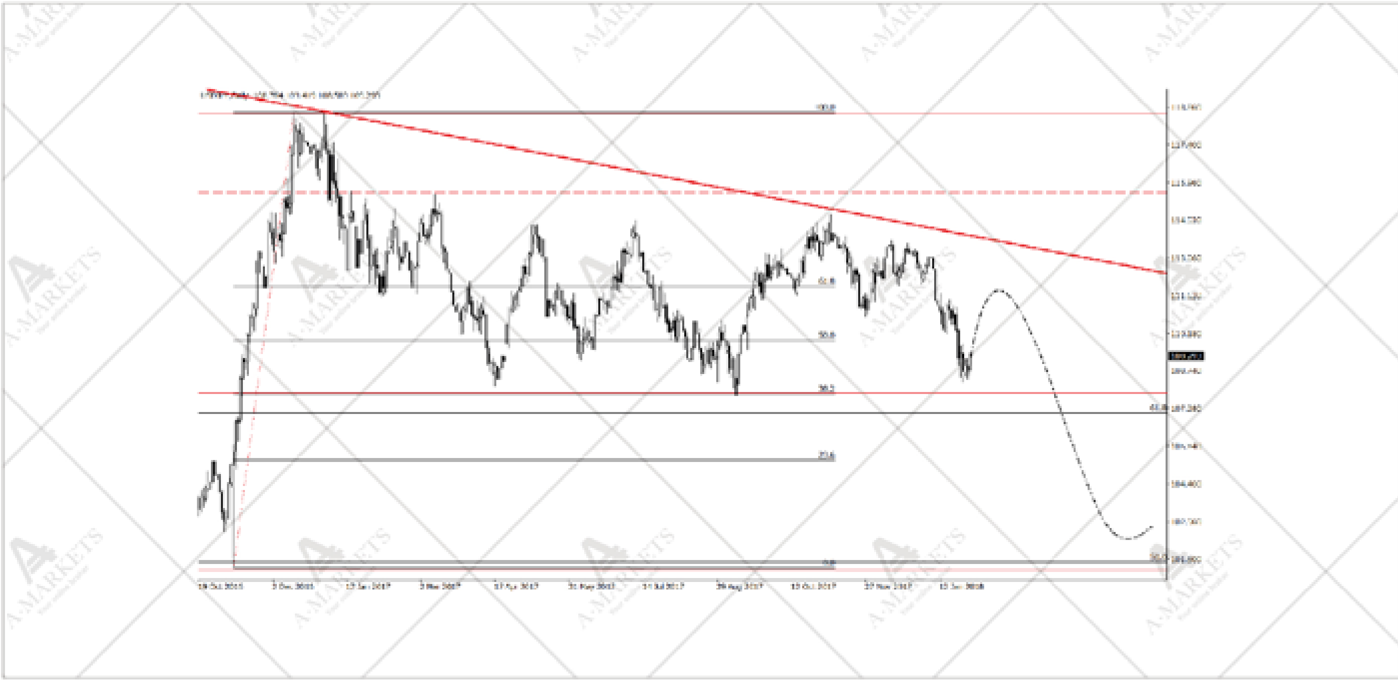
We will buy GBPUSD once it drops to 1.359, stop-loss at 1.325, take-profit at 1.51.



The technical picture in the sterling is nearly identical to that of the euro. In fact, the pound is even stronger in some respect: the currency has already managed to break out of the downtrend and it now needs to retest the same level as a support. That would be a classic textbook move.

Strategically we also prefer to wait for the cross to correct to lower levels that would be attractive for going long. The long-term picture is rarely as clear as it is now, so remember: patience is a trader's virtue. The most likely scenario is for the pound to retreat to the 1.35-1.36 area, although a short-term overshoot here is possible as well. Once the pair corrects, the 1.51 and even 1.6 targets would become relevant. Keep in mind that sterling often exhibits high intraday volatility, more typical for EM currencies.

USDJPY: a litmus test for the dollar.



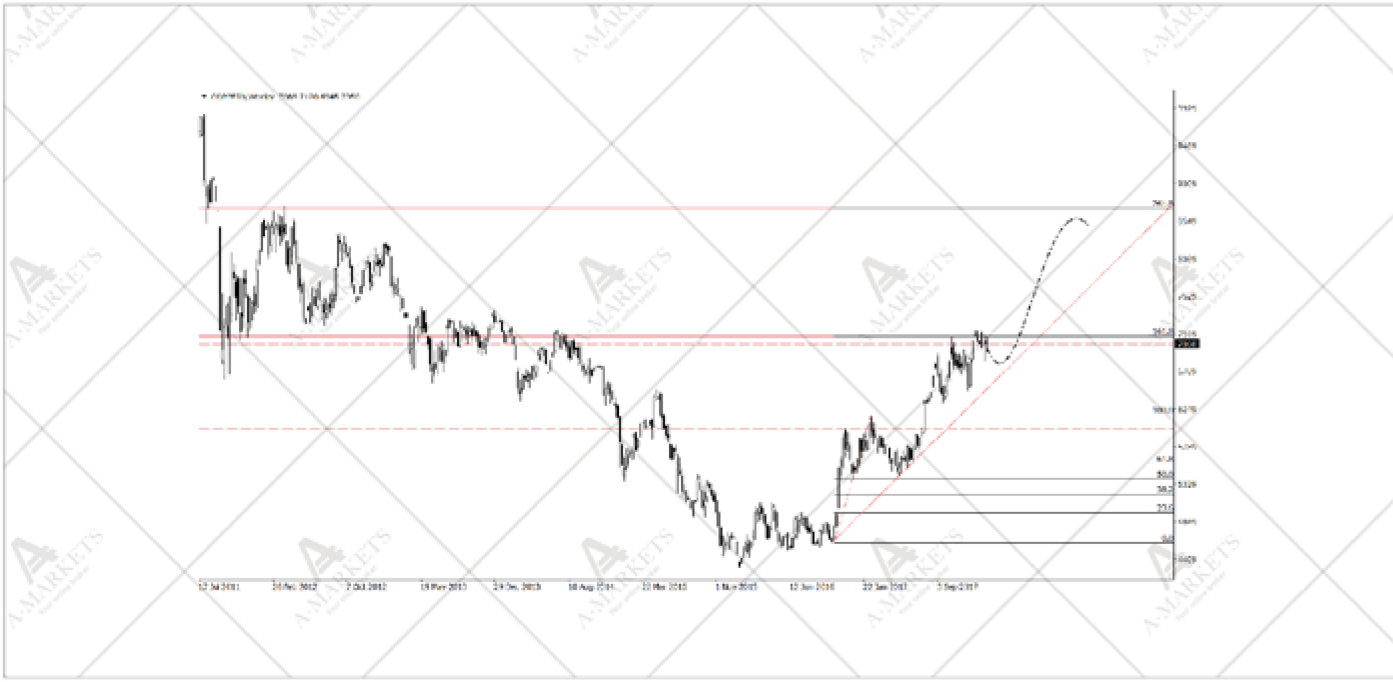
The yen has been one of the first currencies to hint at general dollar weakness. The pair spent the entire 2017 within a broad range, even though it would seem that all factors were in favor of a rally. And yet, even in the face of the widening yield differential between the U.S. and Japan, there has not been even a remote sign of upside. The pair is currently at the lower end of its trading range at 107.8 and the only thing keeping it afloat is the generally oversold dollar. Nevertheless, here too, the corrective rebound should be followed by a sharp sell-off. Short-term upside target is the 112-113 region, and the long-term aim lies at 101.2.

XAUUSD: the king is dead, long live the king.

Just half a year ago it would seem that gold had lost its speculative shine. Both the Fed rates and market yields had gone up. Those are the conditions that have historically put gold under serious pressure, making it completely unattractive to investors. But now the focus is on the weak dollar story with nobody knowing how weak the American administration would actually like the currency to become. That factor has created some serious uncertainty for investors who were quick to turn turn to the good old inflation/deflation hedge. Not only has the metal managed to break the downward trend, but it also touched the first target of $1350/ounce on its way up. And again, we are looking for a correction to the 1260 area. Technically speaking though, the gold is now also in a bullish phase.

COPPER: diagnosed as healthy by Dr. Copper.

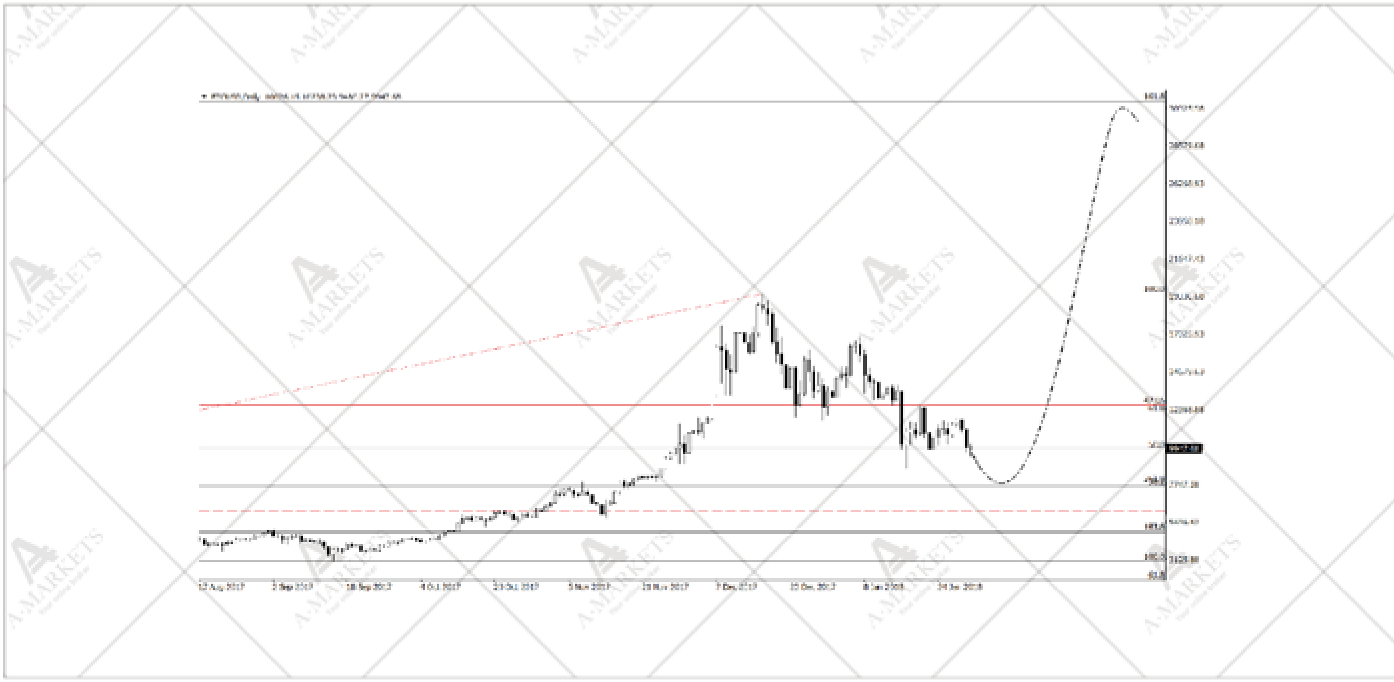
We will buy copper at 6800, stop-loss at 6650, take-profit at 8550.



Copper remains strong, much like the entire industrial metal sector. Taking into consideration Trump's plan to invest $1.5 trillion in U.S. infrastructure, there might not even be a significant correction. Global economy is enjoying rapid growth which is clearly led by the U.S. And if the demand for commodities grows even bigger, the current prices will be too low. As long as there are no sings of a slowdown, we believe it wise to reestablish the long in coper with a very narrow stop. Should copper move onto a full-fledged corrective move, the next level favorable for buying would be 6190.

Bitcoin: where did the party go?

We strictly refrain from any investments in cryptocurrenceis.



Turmoil in the crypto market and heavy news flow caused a heavy drop in Bitcoin and its cousins. However, to say that the bubble that is Bitcoin (which is currently valued around $10000/BTC) has already bursted would be premature. Sure there might not be much space or time left for it, but one more rally cannot be ruled out just yet. That is by no means an estimate: a market like this can always sway either way. Still, the patterns of the asset's past price dynamics lend some hope to those involved in the crypto market. The key here is to get out on time. But of course, on no account do we recommend buying or shorting this asset.