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A correction long-awaited

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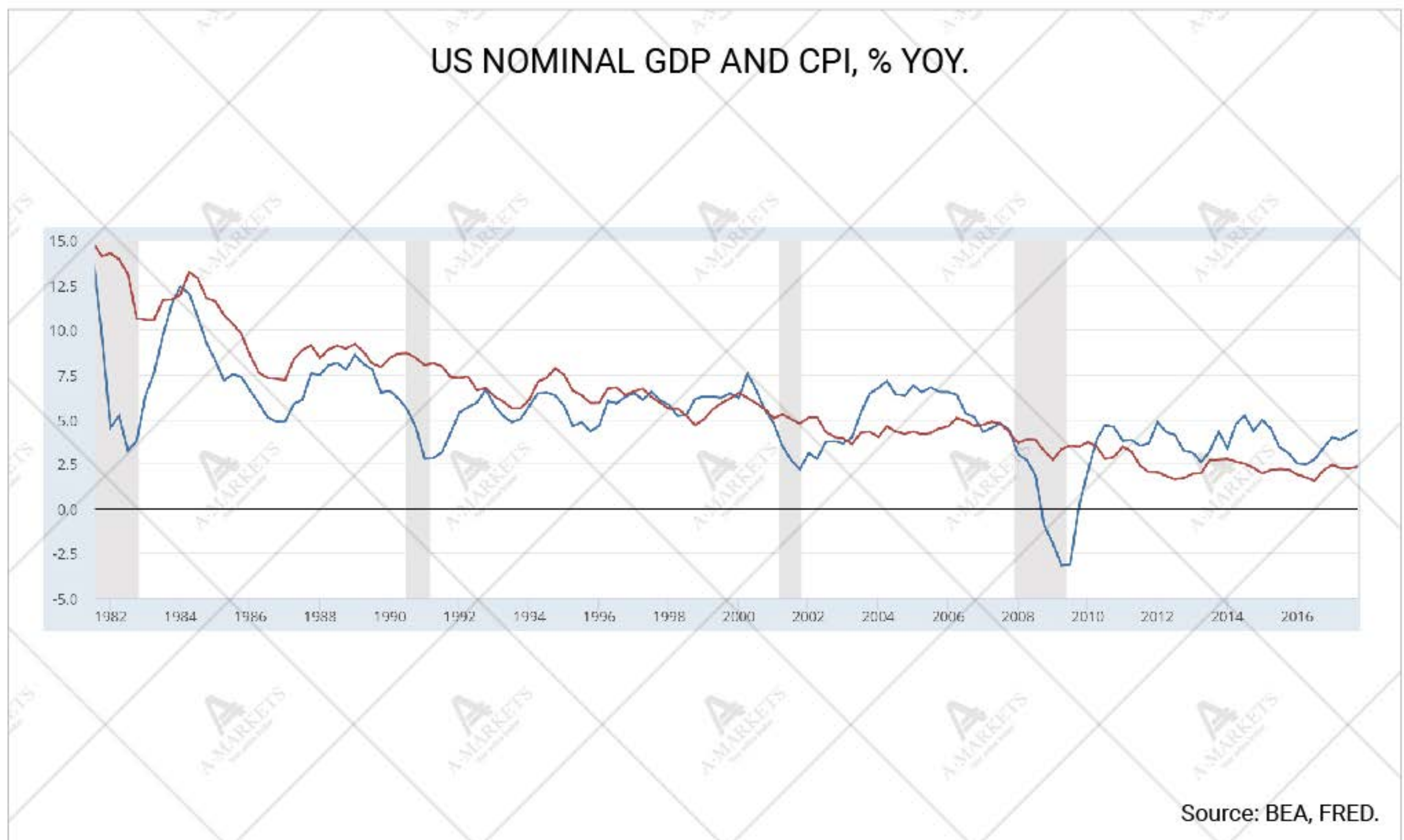
Summary:

- After a record-breaking rally, markets have finally seen a correction. Higher volatility is to persist for some time.
- The dollar, meanwhile, has failed to post any meaningful gains. The issue of a rapidly widening U.S. deficit is a serious threat to the greenback.
- Emerging markets are in the mid-cycle, still clear potential for FX gains in many countries.
- Cryptocurrencies (or, rather, "cryptoassets") are stuck in ranges. It remains to be seen if these can be broken to the upside.

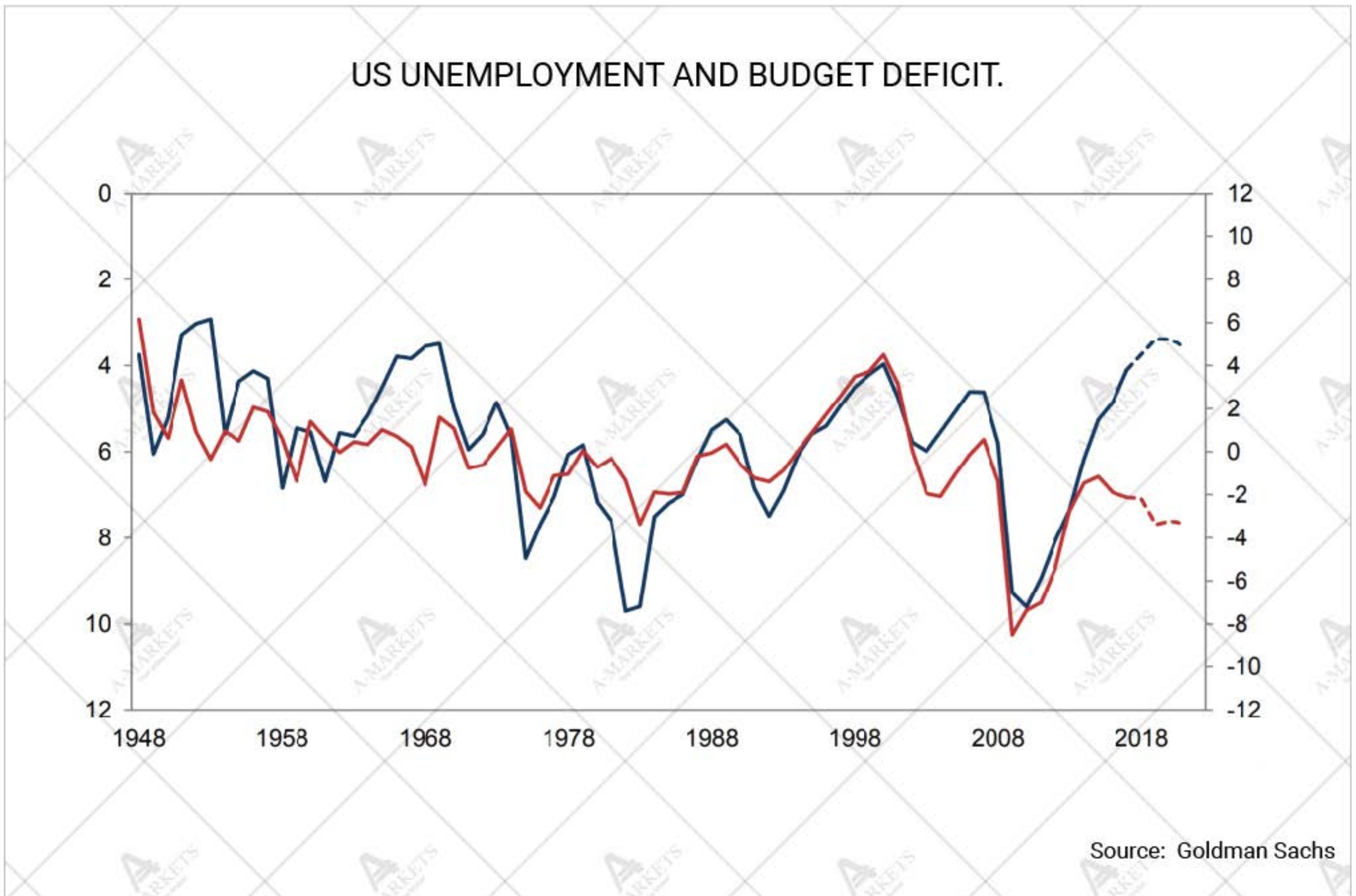
A few months late, but a correction has finally arrived. Assets have been repriced across the board, but the ultimate source of the move was the U.S. bond market. That's where it all started. The trigger arrived when the U.S. inflation data surprised to the upside. Just to recap: in January prices in the U.S. rose at a 2.1% y/y pace, compared to 1.9% expected. That was just enough to trigger panic selling in the treasuries.

To note, that development has been long overdue. Even the most conservative estimates suggest that the nominal GDP in the U.S. has been growing at above 5% over the first two months of the year. With yields half of that, the market was absolutely underpricing inflation risks. To the analysts, it's been long obvious that the economy has gone into overdrive. Importantly, historical economic patterns are finally manifesting themselves. A very tight labor market seems to be pushing up wages, and strong final demand will allow this to eventually translate into consumer prices.



But this is just part of the story. There is another major theme that will be much more difficult to deal with. And that's the government finance. Launching a tax reform during a strong economic upturn is historically uncommon. Politicians usually resort to looser fiscal policy during recessions, when there is a need to return to growth. Today we have a whole different story at hands. The Trump administration is likely headed for a budget deficit of 5-5.3% of the GDP in 2019. But who's going to fund that gap?

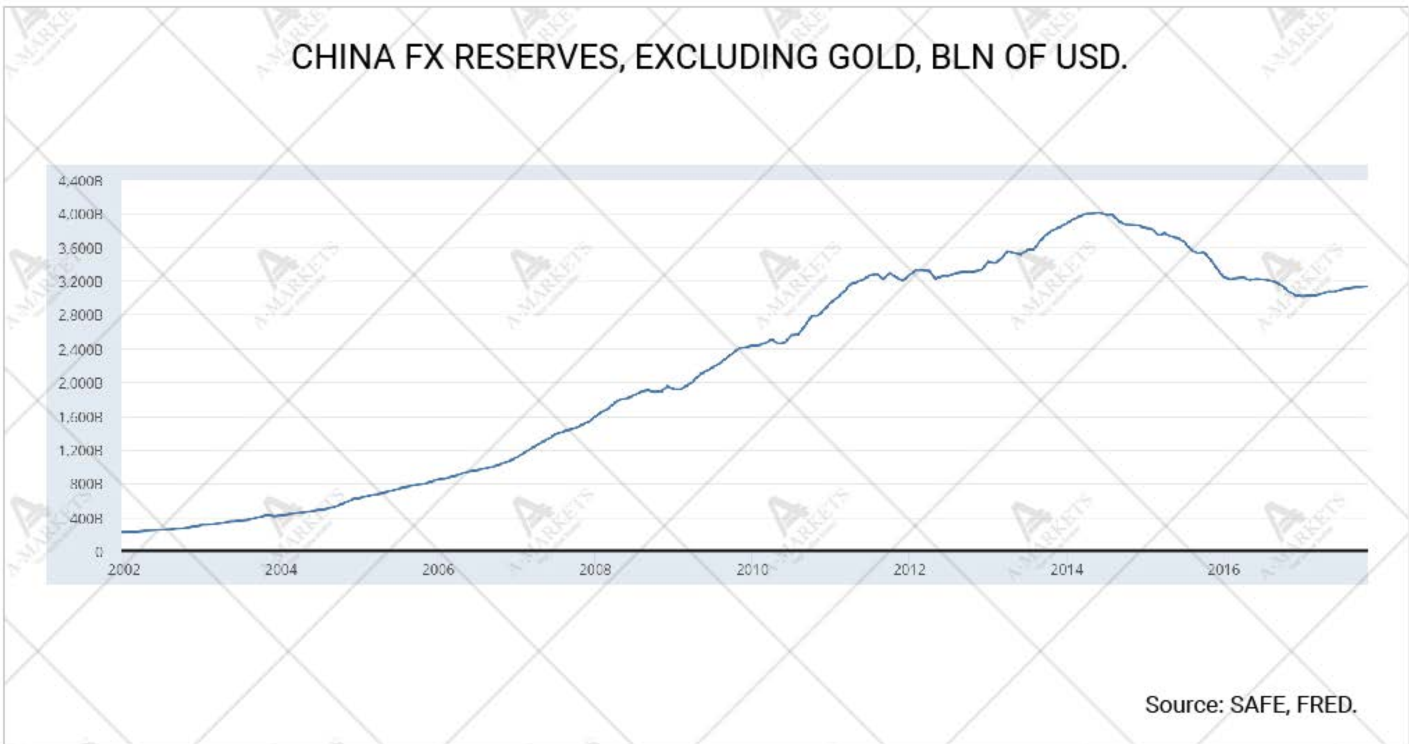
Emerging markets are not that source of investment they used to be. Faced with structural headwinds and lower export revenues, they are mostly inward-oriented, and are unlikely to supply any meaningful capital. The developed world is growing quite fast, but that means the U.S. will be competing for capital with Europe and Japan, and the two won't be exporting it outright. Furthermore, with capital account surpluses already at 4% and 5% of their respective GDPs, it is difficult to imagine these regions amassing any savings on top of that.



And then there's China, realistically the only country that could plug the hole in the U.S. public finances. But the U.S.-China relations are deteriorating rapidly. The department of commerce has recommended imposing protectionist measures against imports of steel and aluminum. The administration is due to make a decision on the in mid-April, and we'll cover this extensively in the next edition of this publication. For now we strongly recommend watching how the U.S.-China story develops.

Basically, there are two scenarios. First, a friendly one for the global economy and markets. The two countries suddenly find a way to settle their issues and avoid a trade war. This will likely boost China's appetite for the treasuries, which will keep yields contained. The dollar shouldn't suffer much, as this setting implies that the U.S. external flows will balance out nicely without much FX adjustment.

Second, a more violent and turbulent path. The U.S. proceeds with imposing restrictions on external trade, and these are mainly aimed at China. This does look very likely as, on the one hand, it perfectly fits the general political stance of the current administration, and, on the other hand, simultaneously helps a worsening current account. Beijing then will have little appetite for treasuries (after all, the government already holds a lot of paper). And in this case, the U.S. will need to obtain capital elsewhere. Higher rates and a weaker dollar are the necessary prerequisites for that.



Of course, going forward we'll observe episodes of both cooperation and confrontation. Yet unfortunately, the second scenario looks much more probable. One can easily "read" the position of the Chinese government by watching the USDCNY exchange rate. In a world where China slows down its investment into treasuries, the yuan would inevitably have to strengthen. This will likely be gradual, but still very telling of the general dollar trend.

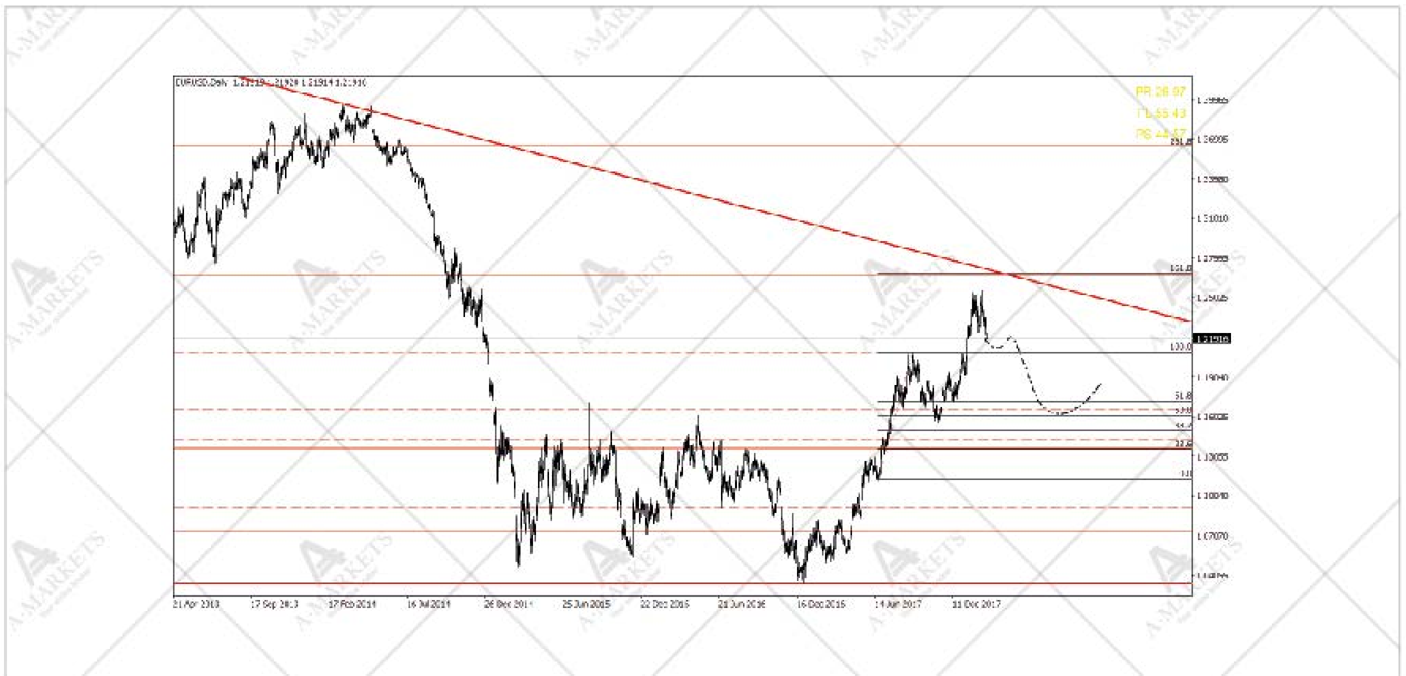
Short-term, there are risks to watch in Europe too. Much like it has been over the past two years, the risks are purely political. On March 4th Italy and Germany will get (or not) their new governments. Much has already been written on the former, and things are highly likely to go smoothly in Rome. The situation is much more nuanced for Berlin. The SPD will hold a vote on whether the party is ready to form a grand-coalition with Merkel, and the probability of a "no" has increased significantly. A failure to form a majority government is potentially a very negative event for the risk appetite in general, and the euro in particular.

There are also clear beneficiaries in case of a "yes" vote. It is not only the euro, but also the Russian rouble. The German minister of foreign affairs Sigmar Gabriel has officially stated that there is a potential to start lifting sanctions if the plans to put a UN mission to Donbass are a success. The idea seems to be realistic, but there has to be no major changes in the German government for this to work out. Therefore, forming a grand-coalition on the 4th might have a positive spill-over effect for the RUB. We generally expect the currency to perform well, given the rating upgrade from the S&P. With that, Russia is now officially back to the investment-grade camp.

And, the last word is, of course, on the crypto- story. The prices stopped going up – and the euphoria has vanished promptly. Suddenly these are not the currencies of the future, the killers of the dollar, etc. As it is always the case with casinos, the chance of another leg up here remains at 50%. But it is now clear that as global liquidity tightens, this balloon will suffer most. We heartily agree with Goldman Sachs' research that states: "Prepare for most the cryptos to go down to zero in value". Couldn't have said it better.

EURUSD: surprised it's still flying so high.

We sell EURUSD at 1.22, stop-loss at 1.233, take-profit at 1.174.



Despite the general rise in volatility and the jump in U.S. rates, the dollar failed to gain meaningfully. And while the upward trend in EURUSD had already been exhausted by the beginning of the year, the unit is holding up pretty well. Yes, the euro is under pressure, but the common currency is not willing to give up its gains easily. At the time of writing this piece, the EUR is quoted around $1.22. This has proven to be some sort of a support, which we believe is going to be broken shortly. We note the slow pace of the fall, though, as it is usually a good sign of a corrective move.

There are two ways to trade the current set-up in March, and both of these are, of course, a short position in EURUSD. A very conservative short with a very tight take-profit and stop-loss orders would be one option. If you suspect there's something wrong going on with the dollar (like we do), a take-profit at 1.202 and a stop-loss at 1.226 are one trade to consider. If you are slightly more hawkish on the dollar, then you could expect a full-fledged corrective move to take EURUSD 5 full figures lower, aiming slightly below 1.17 area.

GBPUSD: a correction to the broad recovery.

The pound also looks heavy, primarily due to the general stronger dollar theme. Out of all the European currencies, though, it is the sterling that is just in the early stages of its move up. Fundamentally, we are very eager to see the developments in the U.K.'s monetary policy. In the beginning of February, Mark Carney warned that the pace of policy normalization can be much more rapid than it is currently priced in.

While tightening too fast would be a clear mistake, it is a fair statement that the markets have been too sanguine. The Federal Reserve is already on the path of taking rates higher, and all other core markets will follow suit. That clearly has not been fully discounted. We believe that sterling should bottom out around 1.297 in about 3-5 months' time. From the technical viewpoint, it makes sense to seek entry for short positions here as well, but trading against fundamentals often proves reckless.

JPY: the strength is evident is in the crosses.

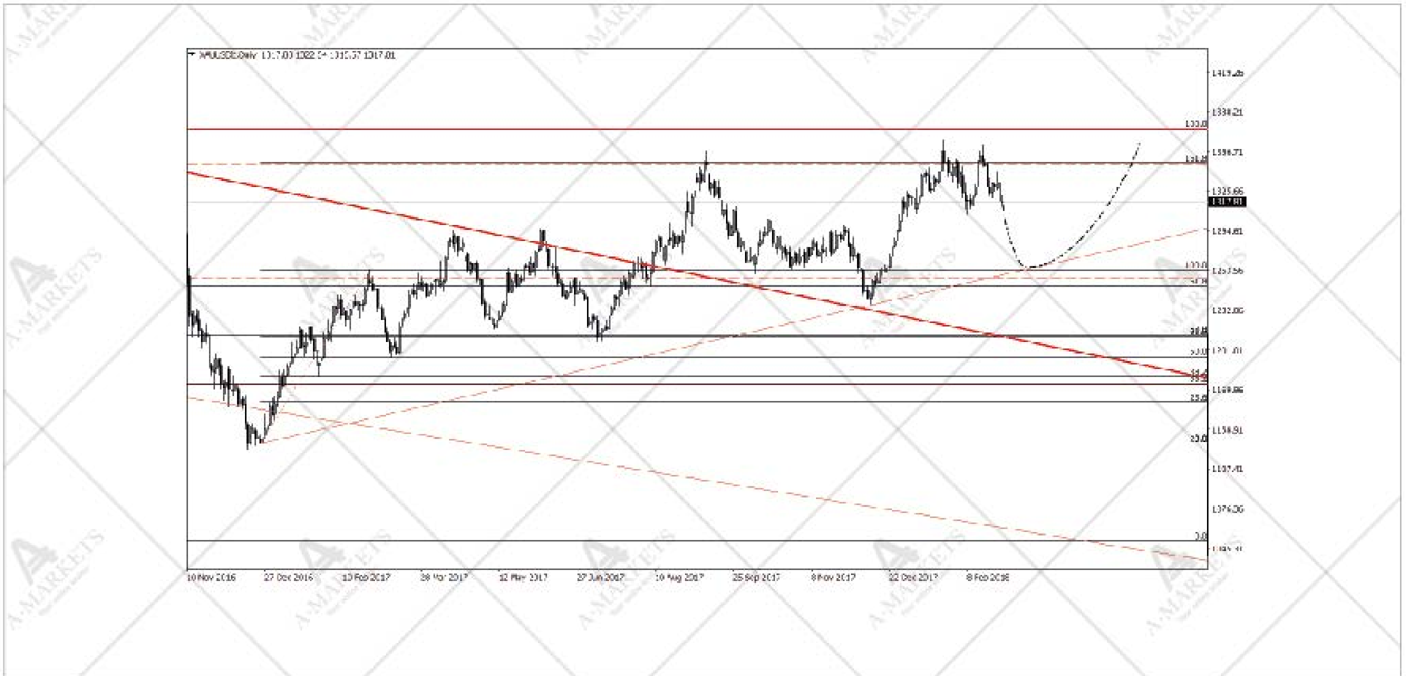
We sell CHFJPY at 112.7, stop-loss at 115.1, take-profit at 103.75.

Bank of Japan's decision to start 'policy normalization' in January put a solid floor under the yen. Now, the general risk-off mood has revived demand for the safe haven. Admittedly, USDJPY is managing to hold onto the lower boundary of the recent trading channel, thanks to the dollar strengthening simultaneously. But the yen clearly has been gaining momentum elsewhere.

We would like to point out two crosses in this respect: EURJPY and CHFJPY. The former can be viewed as a good option for those avoiding long dollar positions. As mentioned above, the technical set-up in EURUSD is absolutely bearish, which has already translated into the euro-yen. The latter does not look much stronger either. At the time of a true risk-aversion the Japanese currency usually outperforms its Swiss counterpart, and we believe that March is going to be just that case.

XAUUSD: has to go lower, like all the other anti-USDs

We will consider going long at 1270, staying out of the market for now.



As we noted previously, the surge in gold prices in January took us by surprise. The rally does not bring any good news for the economy. It is now clear that higher gold prices are a consequence of fiscal risks building in the U.S. Investors slowly realize that there can be significant challenges when the treasury is trying to borrow nearly $1 trln a year on the net basis. This translates into higher market rates, but simultaneously a weaker dollar.

Usually one would expect some selling in precious metals when yields go up. This is so simply because gold, silver, etc. do not bear any interest. And normally as USD money market rates move up, there is a flow of money leaving the hard commodities and going into deposits. However, this has not been the case this time around. The weaker dollar factor has proven to carry more significance, as investors seek protection from fiat currency problems.

Much like it is currently the case with EURUSD, GBPUSD, and many others, XAUUSD begs for a healthy corrective move. It is likely to be quite shallow. The prices are likely to find meaningful support around the $1256 area. That is where we will consider going long with targets around $1480 per ounce. Basically, the dollar is highly likely to regain some ground against all its counterparts, but we would use the move to buy anything “anti-USD”, with gold being one obvious option.

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COPPER: confirming we're observing just a corrective move across major asset classes.

We will go long at 6270, stop-loss at 5920, take-profit at 8200.

Dr. Copper has been quite firm in the face of general risk-off mood. A ton of the metal is still quoted around 6900, and we still believe there is medium-term upside for the commodity. Short-term one could expect more selling as the dollar strengthens, but, again, it is a healthy corrective move. Furthermore, copper is not seeing as much pressure as, for example, oil does.

The absence of sellers here tells us that the world economy is not in any fundamental trouble. Yes, there's gradual tightening of global liquidity and the rise in volatility, but these are not yet dangerous. Growth will likely deliver in 2018 much like it did last year, and therefore the final demand is likely to remain strong. Levels just above $6000, in our opinion, would be a great opportunity to re-establish long positions in the metal, with a very tight stop.