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Roaring US, hidden China.

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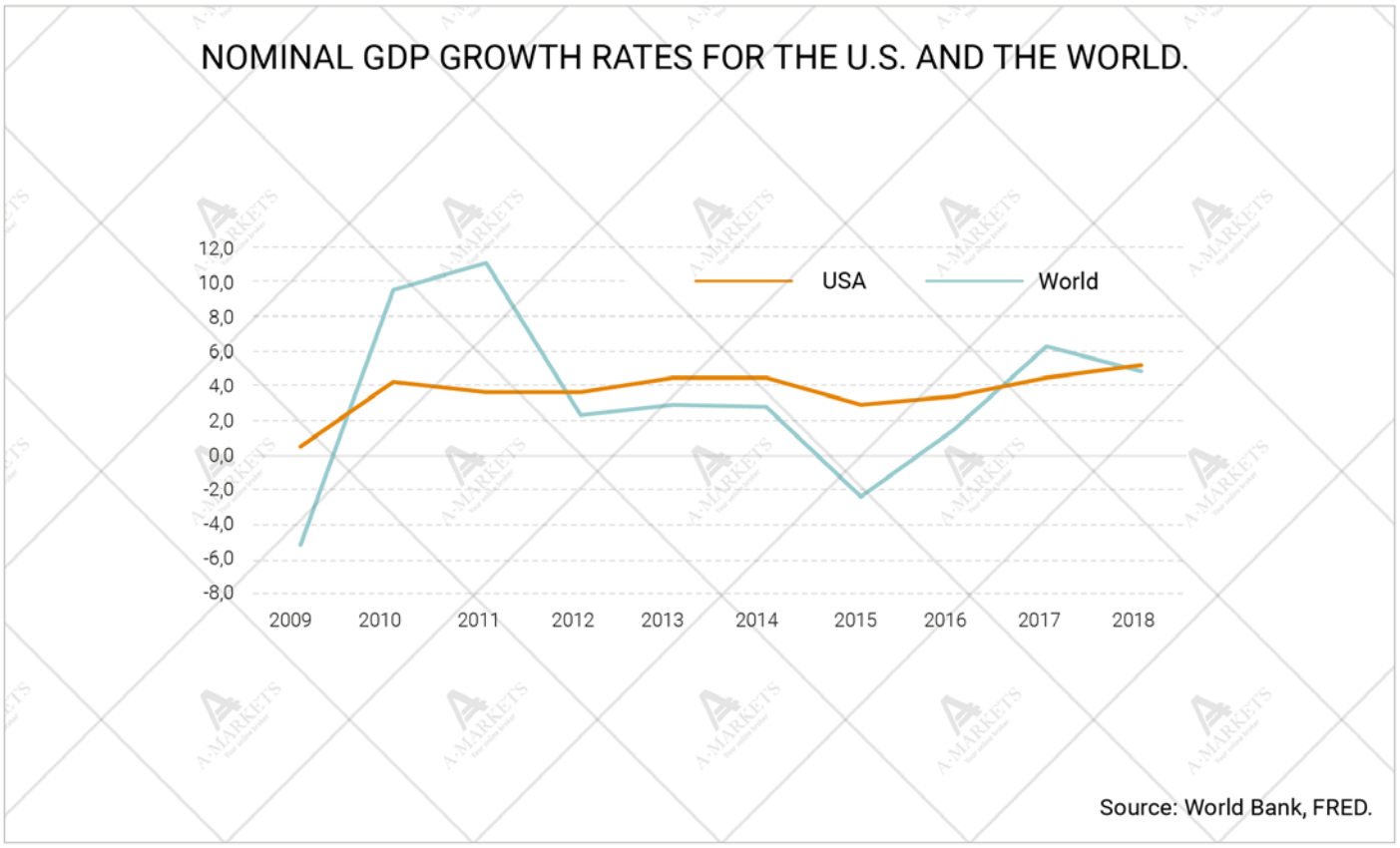
Summary:

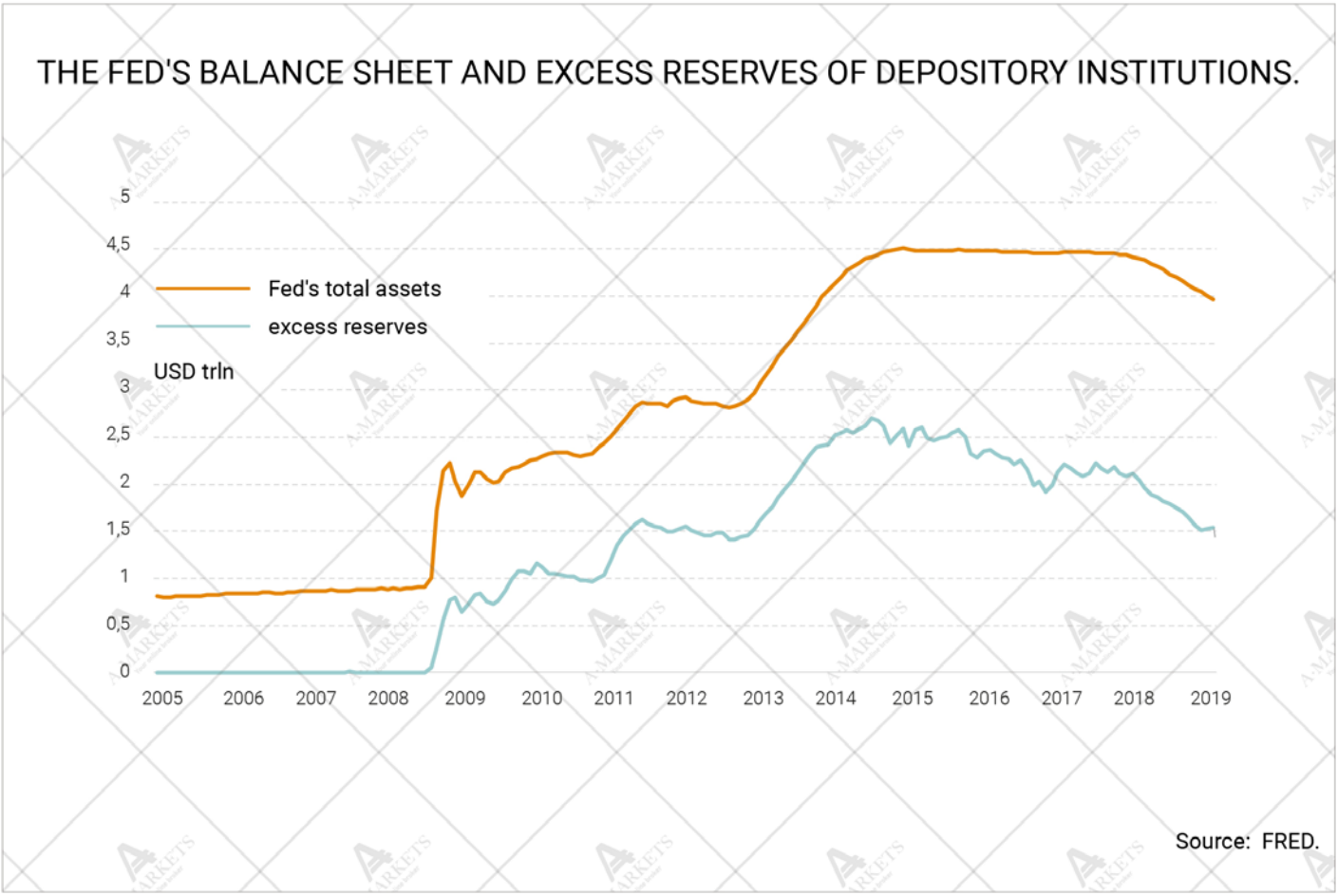
- Central banks turn dovish in attempt to prolong the economic cycle.
- The Fed is considering launching a repo facility, which would be a landmark tool for the central bank.
- Global growth continues to slow down, yet China has stabilized at low levels.

Another month has come and gone, but there's still no certainty in the main currencies. In fact, the outlook for the U.S. dollar itself remains unclear. On the one hand, it is supported by high nominal rates and relatively strong economic performance. The U.S. economy grew by 3.2% in the first quarter, which, by today's standards, is an outstanding number not only for developed countries, but for the developing ones as well. On the other hand, the Fed is readying major changes in its monetary policy, and its implications for the greenback are unclear, to say the least.



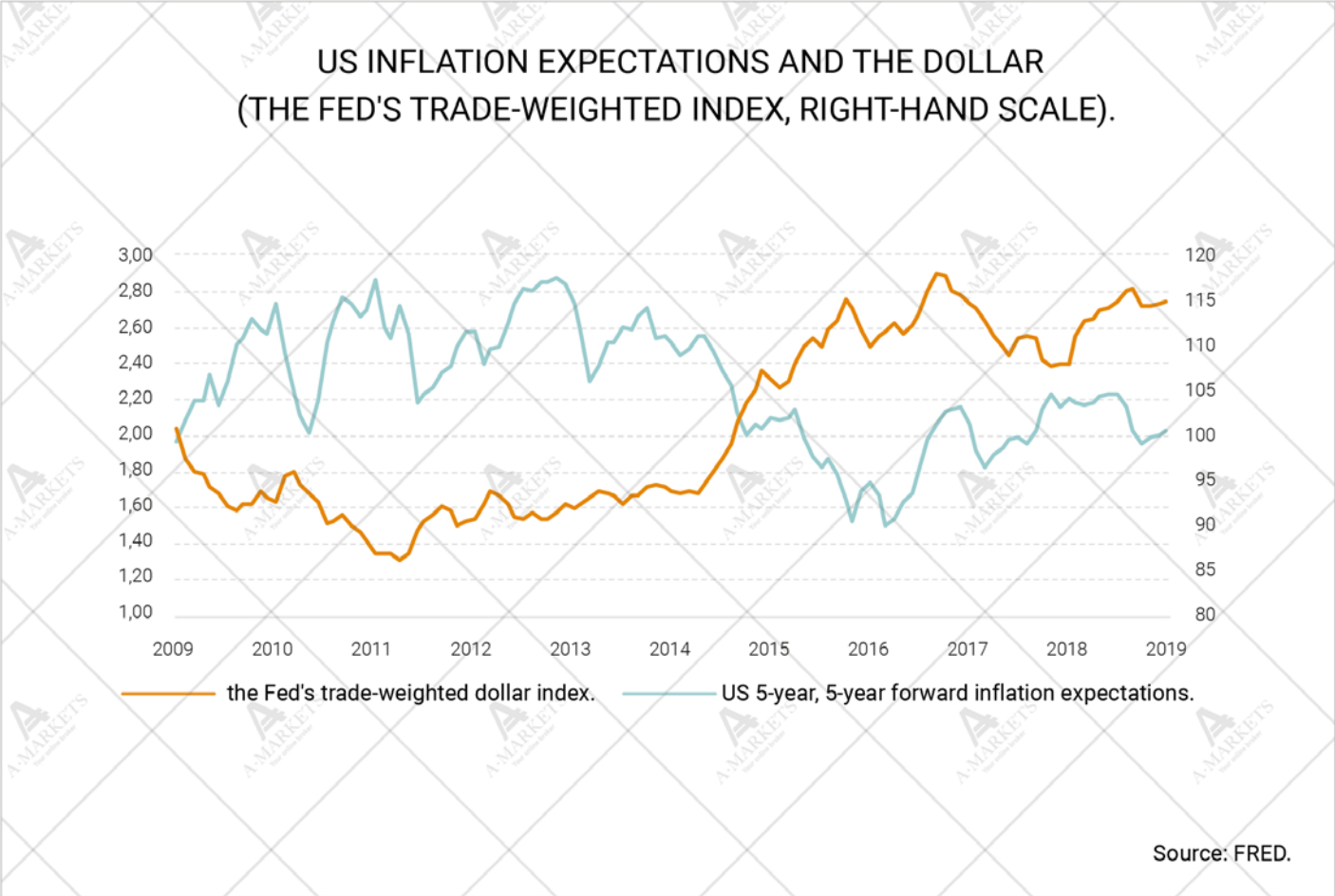
We covered this in our previous research. To recap, the Fed is holding a conference on the setup and targets of its monetary policy. Currently it is a dual mandate of the 2% annual inflation rate and maximum employment. The post-2008 era, however, has shown that prices may not necessarily rise fast even with on the back of large monetary stimulus. The reason why that happens is a different story, but for central bankers it constitutes a risk of inflation expectations re-anchoring at dangerously low levels. The officials certainly want to try to avoid that, and for that they are considering switching to either price level targeting or average inflation rate targeting (for example, 2% annual inflation over a full economic cycle). Ceteris paribus both options imply a looser monetary policy, and thus, less support for the dollar.

Another interesting idea to be discussed at the summer conference was brought up in an article called "Why the Fed Should Create a Standing Repo Facility," written by economists at the Federal Reserve Bank of St. Louis. It suggests creating a mechanism that would allow on-demand conversions of treasuries to reserves. In other words, it would permit banks to keep less cash and invest more in bonds as they would be able to exchange them for reserves at any time.



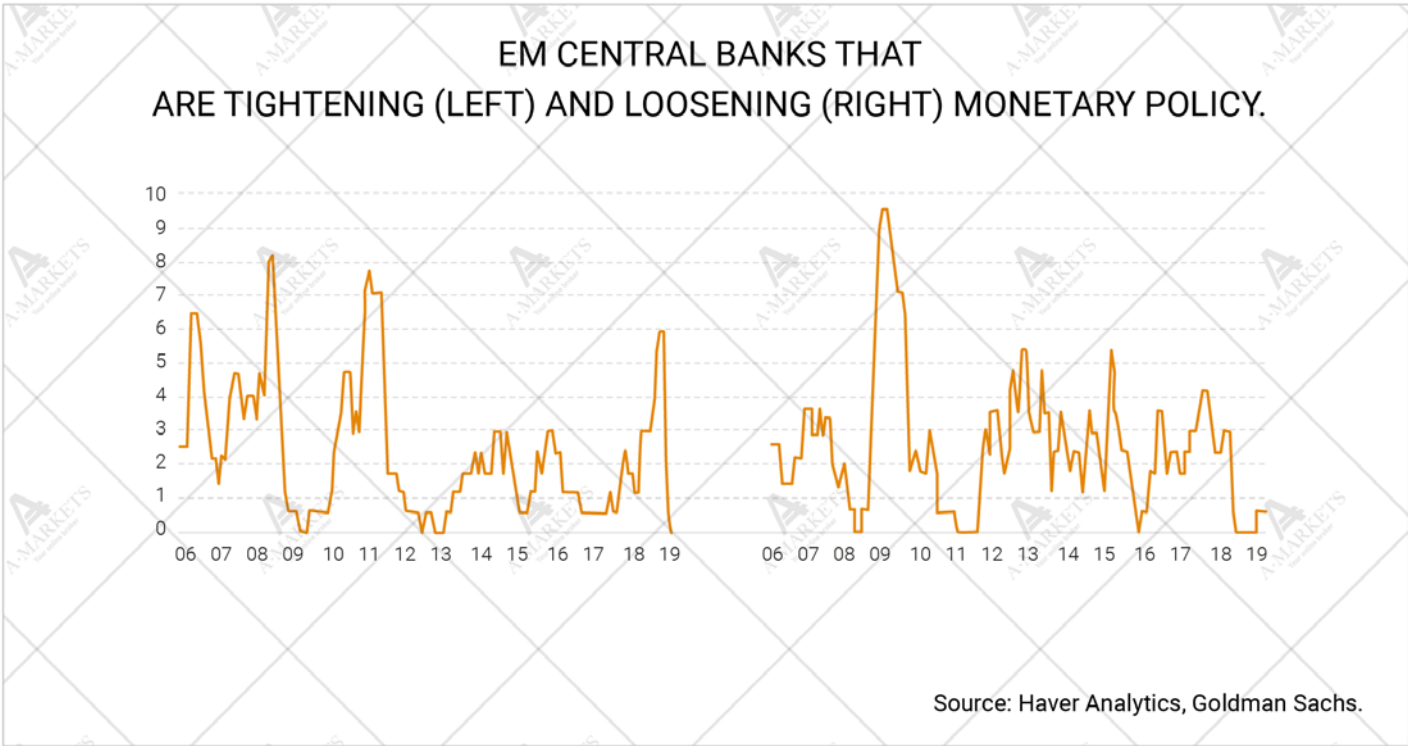
It seems that the Fed has decided to pro-actively manage excess reserves, and is now working out the details. It is notable that at the last FOMC meeting the rate on excess reserves was lowered by 5 b.p., from 2.4% to 2.35%, while all other rates remain unchanged. One possibility is that governors actually want to force banks into the treasury market. Because even if the Fed does create a repo facility, it doesn't mean that banks will be using it, unless there's a clear rate advantage of holding bonds. That said, there are some positive implications for the U.S. debt market that aren't as obvious.

U.S. banks are currently holdin0067 excess reserves of $1.5 trillion. St.-Louis Fed economists estimate that a half of this sum would be invested in sovereign debt, if there is a standing repo facility to offload paper when necessary. And there we suddenly have a funding source for the U.S. budget deficit for at least a couple of years. And if the treasury isn't in dire need for such a source, the Fed might as well carefully reduce its own balance sheet while de facto not tightening its monetary policy. This would alleviate much of the concerns about the twin deficits for some time — thus removing tail risks for the dollar. On top of that, a bonus, as the move could make Donald Trump happy. His tweets calling for looser policy are making the headlines every week.



The bottom line is: the Fed has decided to toy with inflation and it's unclear how the market is going to react. In the extreme scenario, changing the monetary policy target could potentially lead to the central bank losing control over inflation expectations, which poses obvious challenge for the dollar. With that, the idea of creating a repo facility to push reserves out into the market is de-facto a policy loosening (i.e. lower rates) without adding new dollar liquidity. Yet it removes tail risks, can reduce interest rate volatility, which, all things being equal, would be beneficial for the American currency. Which factor proves to be key? We'll know the answer soon enough: the conference on the Fed's monetary policy is scheduled for June 4-5 in Chicago.

Another major story in April was the string of dovish comments and moves from central banks around the globe. In the recent weeks alone, the Bank of Canada, the Riksbank (Sweden), the Reserve Bank of New Zealand, and the Reserve Bank of Australia all have softened their policy stance (we expect the latter two to cut rates at the upcoming meetings). In developing countries there aren't any hawks left at all. April saw Russia, India, and even Turkey move to neutral or looser policies (although it does seem a bit premature for the latter). The reasons are the generally weak global data, as well as the Fed doing a 180 back in December, which took a lot of pressure off other central banks.



Then there's China. The outcome of its trade conflict with the United States will be critical for the markets. The news flow regarding the war is mixed. On the one hand, the pressure on Beijing on the political front is evident. There's now all sorts of news about China-made devices being dangerous, and there were even attempts to directly prevent China from supplying 5G chips to U.S. brands. On top of that, U.S. authorities continue to charge Chinese employees with economic espionage. Conversely, the United States and China have reportedly reached a deal on exchange rates. There are even reports that Donald Trump is ready to soften his demands to Chinese tech, which could finally open the door to a deal with Beijing.

What are the risks? We believe it is probable that a U.S.-China trade deal is not signed in May. Should it become clear that it might not be happening in June either, the markets can expect a sharp rise in risk aversion. We will also note that if the U.S.-China deal involves any explicit commitment related to the yuan rate, this is extremely likely to find a way to materialize in other currencies as well. For example, if CNY is to appreciate by 5%, most EM-currencies will strengthen proportionally. Moreover, major currencies will see the same trends, although not as pronounced. We don't view this as the main scenario, but it can not be ruled out.

Dollar index (DXY): a prolonged consolidation.

We refrain from any positions in USD pairs.

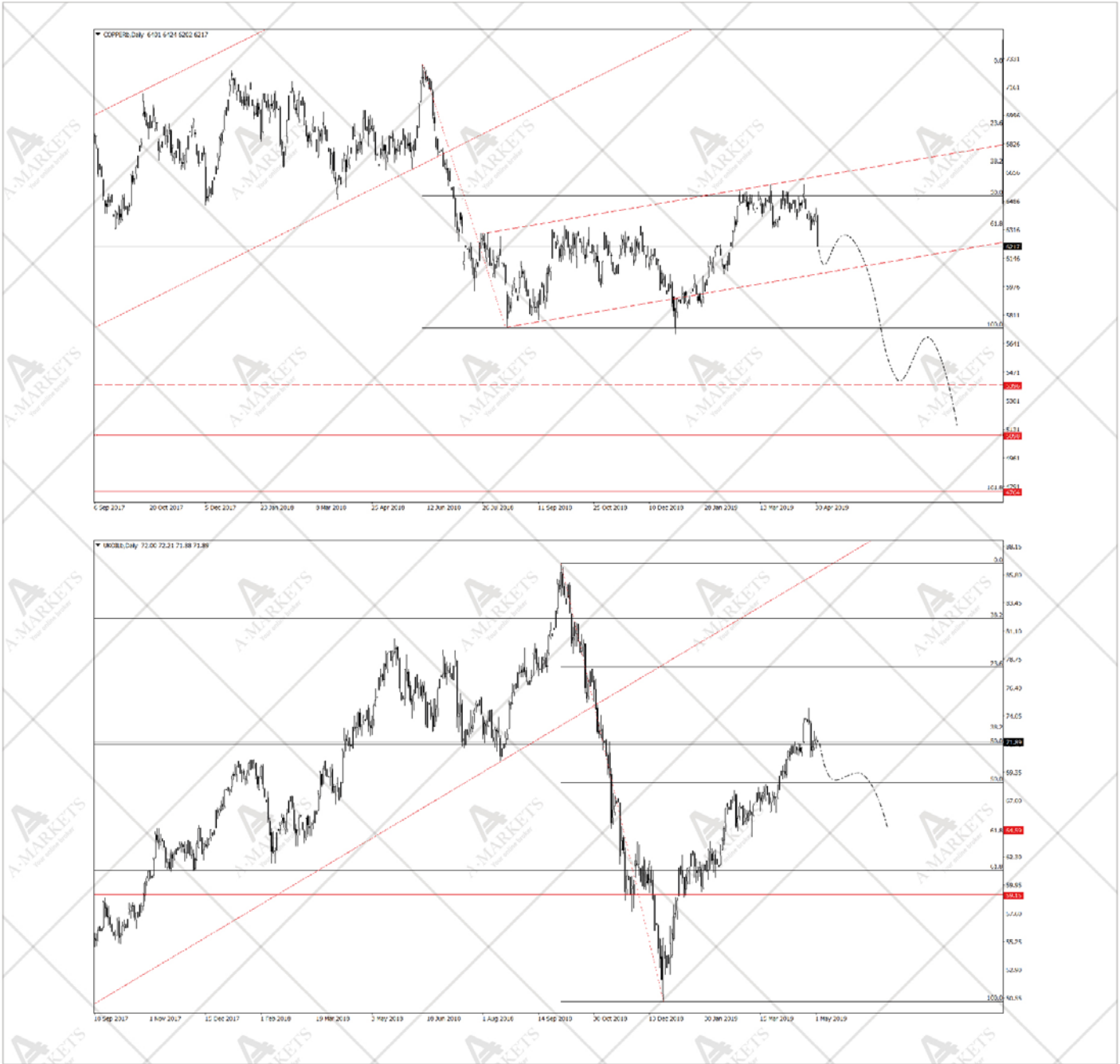
The multi-month consolidation in EURUSD remains intact. The pair's attempts to move to a downward trend have become more frequent, albeit still technically unsuccessful. The episodes of the dollar's strengths prove to be short-term and are not turning into anything sustainable. The jump observed in April falls well in line with this pattern. Yet, the fact that the greenback is showing attempts to strengthen does constitute somewhat a signal for a future trend. But again, no clear direction just yet.

This time we're looking at DXY instead of EURUSD (which hasn't been doing anything for months). It tested the 98 mark in April, but didn't break it. Now it's likely to roll back to 96.1. One can try to trade this via USDCHF. The unit traditionally moves in line with the dollar basket, and the franc has a short-term target at 1.01. It's important to note that this is only a figure below the current levels, meaning that it's basically the magnitude of intraweek noise. We prefer to wait until the main pair breaks out of its current range. For that the EURUSD has to take out 1.111. And the euro going higher than 1.127 would completely erase all the recent technical signs of an upcoming downtrend.

Copper and oil (COPPER, Brent): fresh proof of global slowdown.

We sell Brent oil at 71.9 targeting 65.5, stop-loss at 75.15.

We will enter a short position in copper once 6150 is taken out targeting 5410, stop-loss at 6360.



In the previous edition of this publication we focused on undoubtedly one of the main events of the year: the U.S. yield curve inversion. It is, perhaps, the sole most reliable indicator of an upcoming recession, and, in turn, a global slowdown. While the macro data somewhat stabilized over April, commodities now give the same signal: global economy is slowing down.

Copper is traditionally the asset most sensitive to the economic cycle. Yes, it is technically still in a corrective uptrend. But over the last two weeks the metal saw some heavy selling, and the volumes were notable. Should prices drop below 6150, it would mean that a long-term downtrend is back.

Its first leg manifested itself in mid 2018, and everything after that should be viewed as a corrective move. A break through 6150 would halt that move and revive the downtrend. The farthest target lies in the 4750-4800 area, and the first meaningful support is found at the 5400 mark.

The technical setup in oil is slightly different. The asset just registered as multi-month high and there are early signs that the run up is finally exhausted. Just like it is the case with copper, there was a batch of selling on heavy volumes here at the end of April. One has to be mindful of geopolitical factors that can lead to sharp reversals in oil prices. But absent these, Brent should at least give up some of the recent rally (that actually would be rather healthy for the market). We go short the front-month futures targeting 65 over a two-month horizon.

NZDCAD: battle of the weak.

We buy NZDCAD at 0.892 targeting 0.925, stop-loss at 0.885; will restore the position at 0.868 with the same target, stop-loss at 0.8635.

While the dollar is deciding where to go next, many crosses are seeing heavier volumes. One of the interesting units is the NZDCAD. Basically, it's two weak currencies fighting. Let us remind that both of the central banks have suddenly gone dovish. Last month we even closed our strategic short in AUDNZD due to that. However, in April the market discounted all of the kiwi bank's policy loosening, and we now see some potential in the NZD again.

However, our judgement is that going long NZDCAD is a better trade that restoring the AUDNZD short. First of all, the Bank of Canada has also capitulated, and the market is still repricing the shift. Second, this position would also partly constitutes a bet on cheaper oil, just discussed above. And last but not least, if we look at the major pairs separately, there's a local target of about 0.69 for NZDUSD and a series of targets between 1.37 and 1.4 for USDCAD. As mentioned above, we refrain from taking an outright position in the dollar, and NZDCAD looks like a good substitute.

We also remain short EURGBP.