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Looser, lower, softer.

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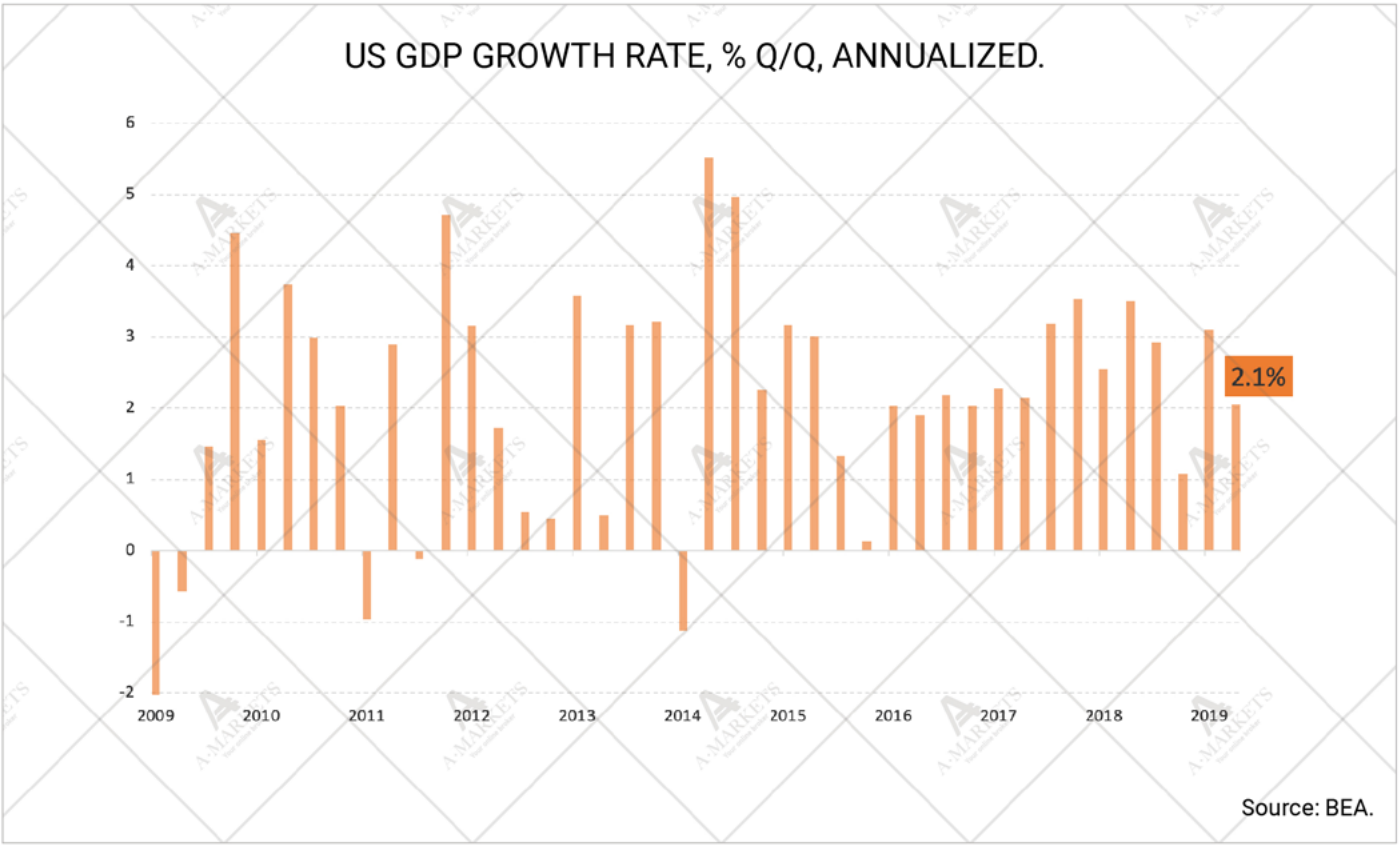
Summary:

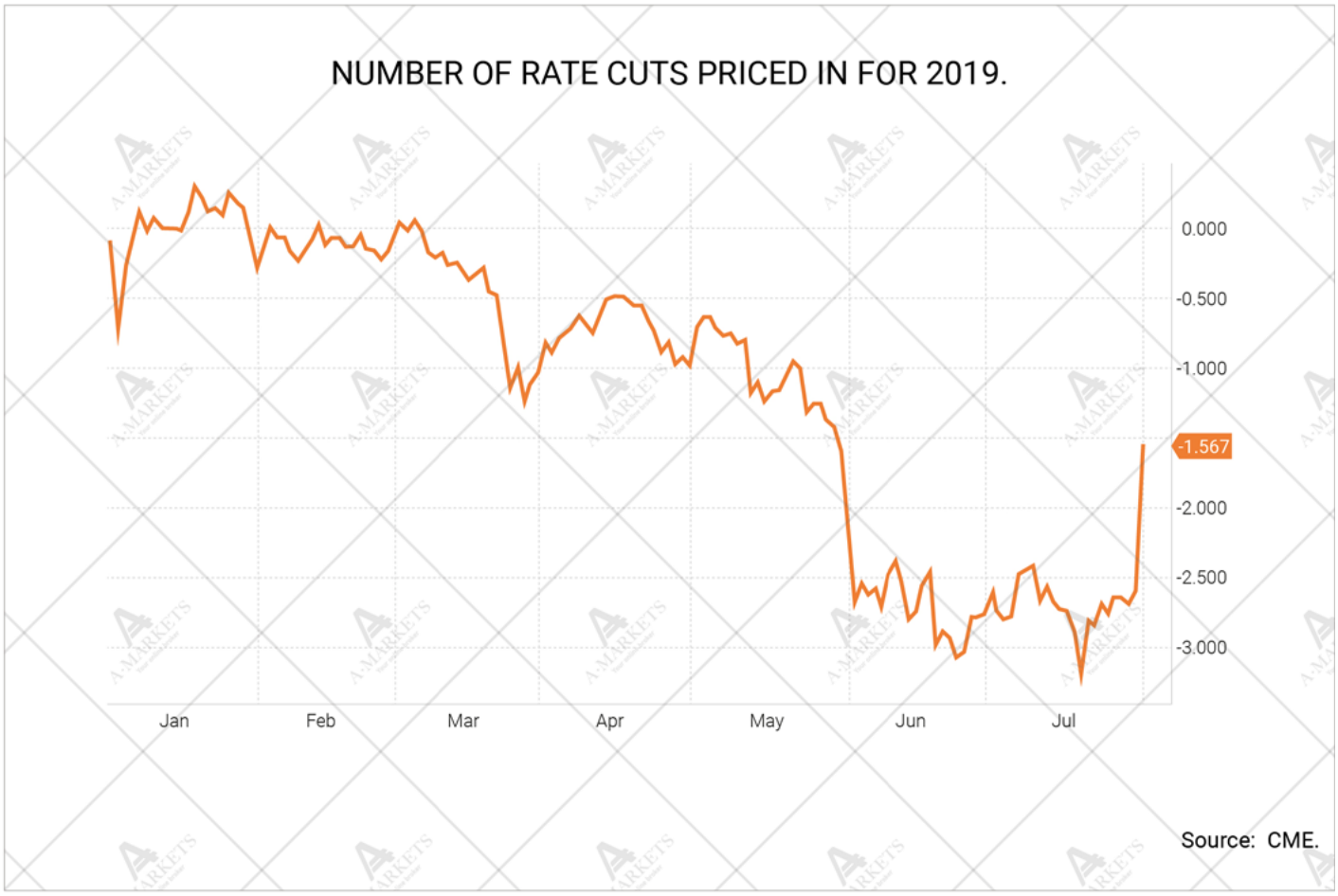
- Key central banks are starting to loosen their policies.
- This won't be highly effective given the later stage of the economic cycle and elevated asset valuations.
- Event risks are chiefly related to the approaching U.S. debt ceiling debate and the budget process in Italy.

The world's central banks have begun loosening their monetary policy. Leading the pack is, of course, the Fed. At the end of July, Jerome Powell delivered the first rate cut in 11 years. Fed funds target range was lowered by 25 b.p. Mr. chairman was careful as not to commit too much to the market, as he specifically stated that this was a mid-cycle adjustment, not a beginning of a cutting cycle (although another 1-2 notches down should not be ruled out). The initial reaction was a stronger dollar and broad risk selling, but in our judgement, this is just the disappointment of those who was expecting a 50 b.p. step.



It is perfectly clear that the Fed is going for a preemptive strike. The U.S. is, strictly speaking, the only large DM growing at a rate close to potential. Unemployment is around all-time lows and inflation is close to the target. There are, of course, nuances here. In particular, short-term real rates have turned positive by most metrics after the December hike. There is a theory that this serves as a meaningful change of environment for financial markets, and the unusual risk sell-off in the end of 2018 are a case in point.

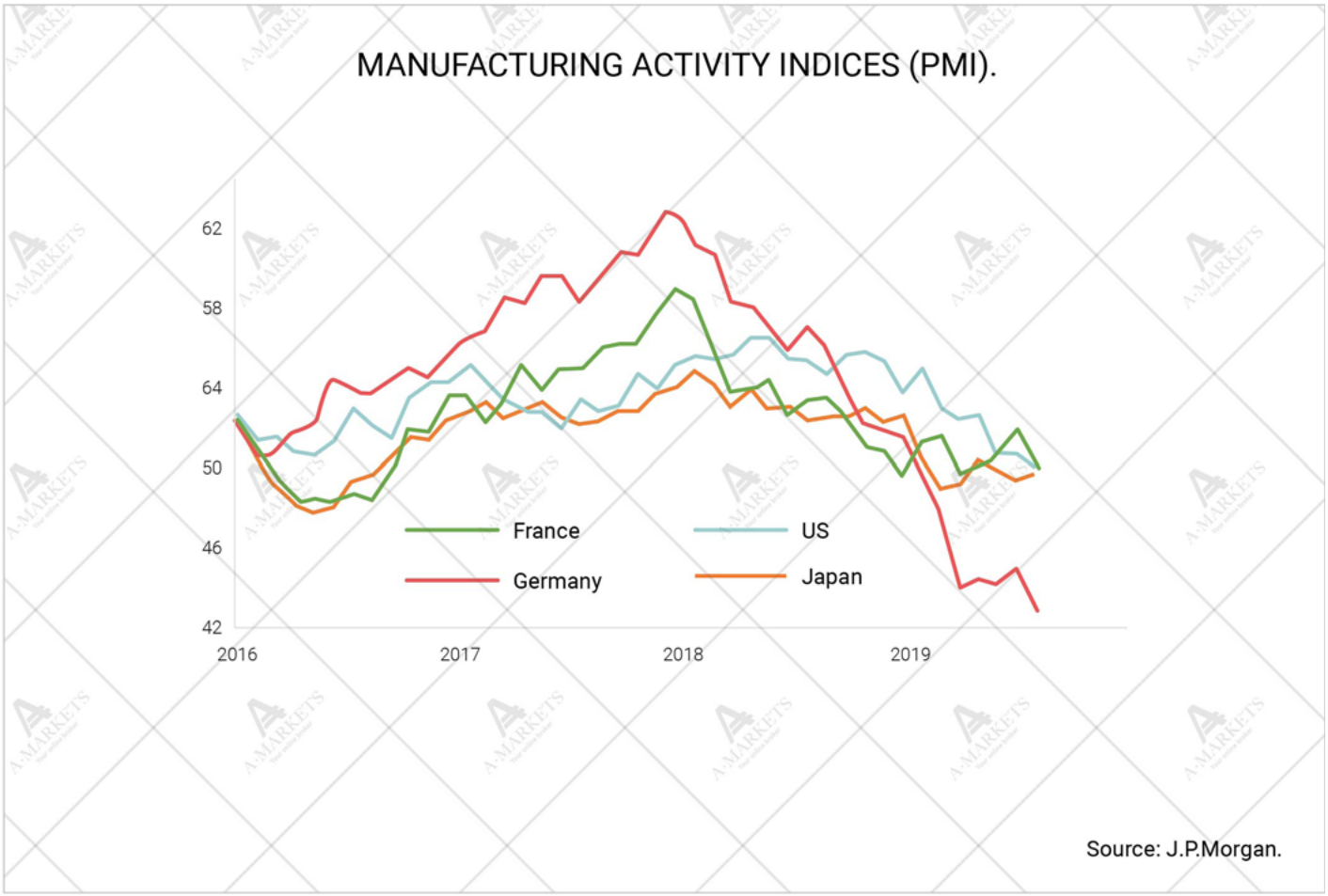
Market watchers have labeled the Fed's actions an "insurance cut," which is a fairly precise term to describe what is happening. The market is confident that after 3-4 cuts of 25 b.p. the Fed will stop and even reverse back to tightening. Some analysts believe that the FOMC will take a prolonged break after just two cuts, and we tend to find ourselves in this camp. What happens next is a big open question.



And while the U.S. is only headed towards slower growth, Europe is already there. To put it in a nutshell, the German and Italian economies have stalled and are surely to enter a technical recession. This implies some sort of stagnation for the entire eurozone. France and Spain are holding up bette, but they are unlikely to keep the region afloat (although they will, at least, make the general GDP data less horrid).

Now Mario Draghi will have to fire his big bazooka one last time. The ECB has already promised to consider every option to loosen their policy following the crash in economic activity across the largest industrial centers. We expect the change to happen during the next meeting, even before the new chair assumes office. The situation is urgent which Draghi can't just hand off to Christine Lagarde.

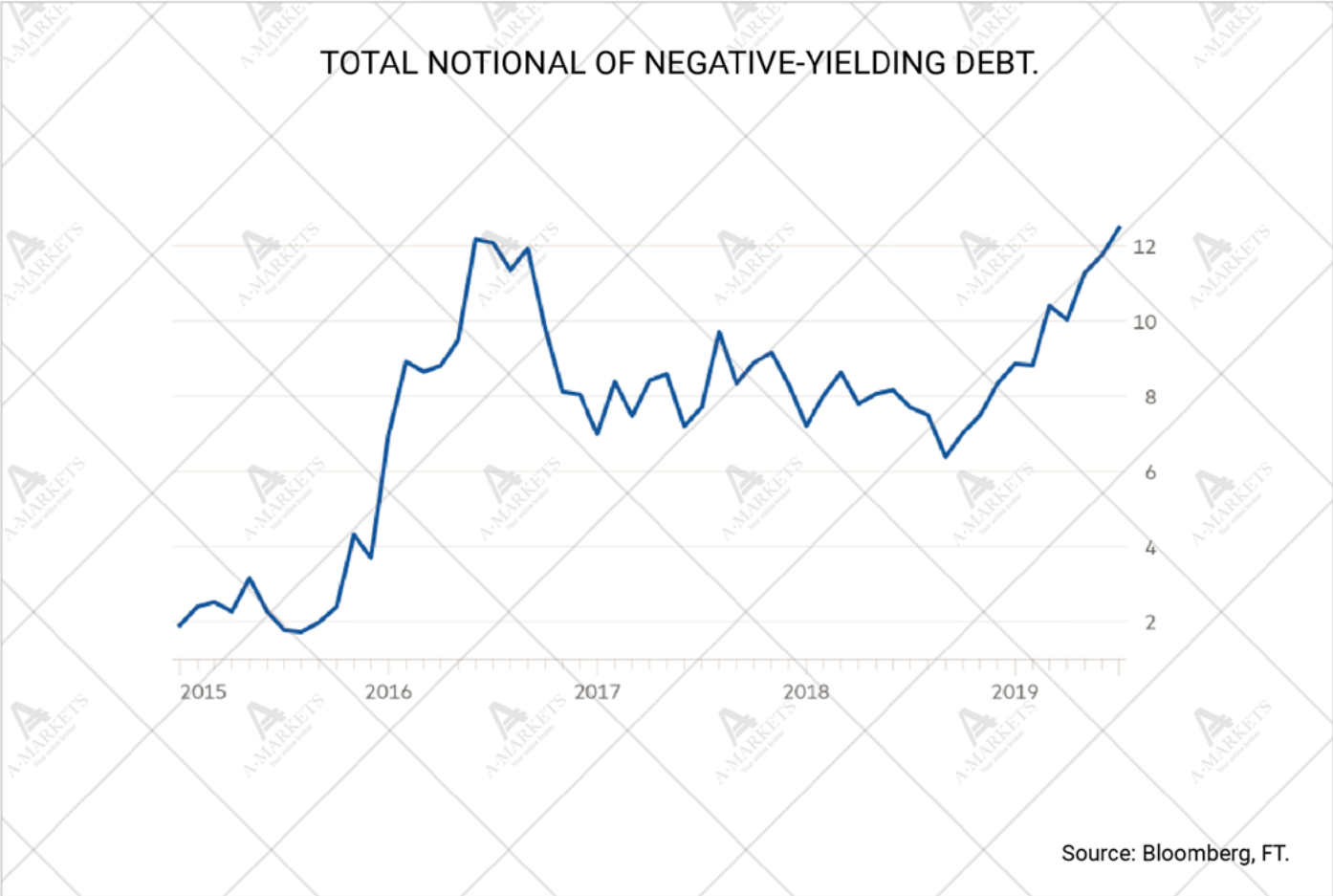
We expect that the ECB will cut the rates by 20 b.p. in September and launch a two-tiered reserve system. The latter means that negative rates won't affect the entire reserve base, but only a fraction of the excess reserves. One can only take an educated guess about the precise numerical setting of these, but one way or the other, Mario Draghi has already announced that the approach is being studied, i.e., modified in a way to best suite European banking system. Two-tiered system essentially compliments quantitative easing, as both appear when the zero-bound is hit. We also expect a new round of QE from the ECB, but in September the president may only announce the readiness to restart the program. The purchases are set to start before 2020 and to include both government and corporate debt; no assets outside of fixed income will be acquired at this stage.



This already-impressive list might be complemented by an enhancement in communication of sorts. For one, at the last press-conference, Draghi spoke about managing expectations more carefully. The governing council can introduce some tools that have proven efficient, for example, the Fed's dot-plot or BoE's fan charts, revealing central bank's own take on the future rate path. However, this type of measures are normally used to boost the effectiveness of negative rates and especially the QE, and should be viewed in this context.

So what does all of this mean for the FX space? Alas, not as much as the regulator would want. The ECB's policy loosening has been anticipated for a while now and is already priced in to a large extent. Of course, if Mario Draghi really goes all-in and rolls out this entire complex, it should keep the euro pressurized. But one can hardly expect a major move just based on what is actually expected – this is not how the market works. A leg lower is possible, but only if other factors weigh in (for example, a quick and negative Brexit development).

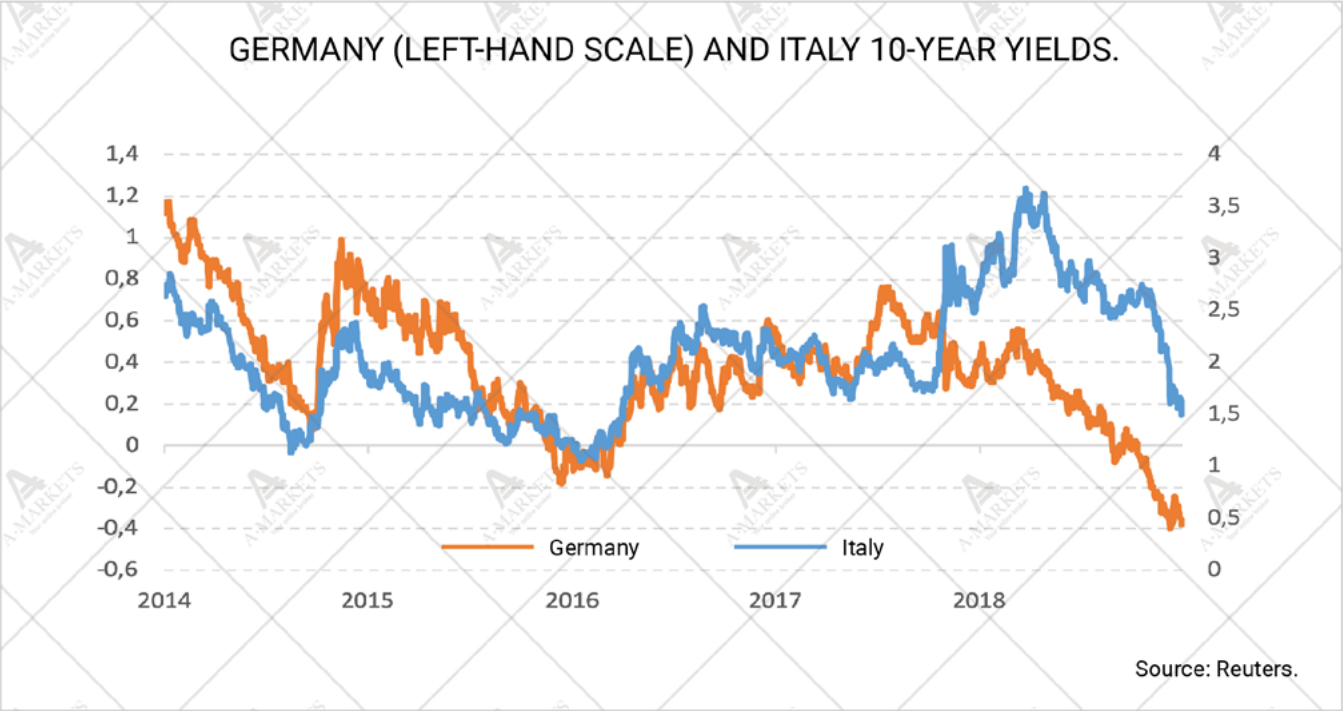
The turnaround in global monetary policy and sharp increase in amount of debt yielding sub-zero rates pushed investors to a somewheat forgotten asset-class: precious metals. Gold and silver, in particular, exhibited outstanding performance over the past two months, as the yellow metal spent nearly all of July at above $1400 per troy ounce. Just recently, zero yield was considered the main weakness of these assets (the yield here is actually slightly negative, due to storage expenses).



But in today's environment even a slightly negative yield is higher than what one gets when depositing money with a central bank, or buying the safest of the cash-equivalents. The zero yield is one of the few alternatives allowing to avoid losses from having excess money at hand. Of course, banks would be happy to issue loans yielding positive income, however, the economies are not growing fast enough to provide demand for credit.

Going back to the precious metals, their fate now mostly depends on what the Fed is ready to do. Should it really go for just 2-3 rate cuts, the savers will still enjoy the option of positive nominal dollar rates, and shouldn't exit money markets all at once. But if Jerome Powell ends up drastically loosening the policy, gold and silver may become one of the main market themes over the medium-term.

Over the short run, we are watching two stories outside of central banks. The first one is the upcoming U.S. debt ceiling debate. The financing of about a dozen of key programs expires on September 30th. The U.S. finance minister Steven Mnuchin has been asking politicians to take up this issue as soon as possible—but the message has yet to be heard. To complicate matters, congressmen are going back to their states for summer holidays, from August 5 to September 6. When they return, there will be just over three weeks to discuss all the details, which creates a risk for another government shutdown.



Secondly, in the context of the slowdown of Italy's economy, their budget process becomes a very important factor too. In July, Italian deputy prime minister Matteo Salvini said that the new budget is being drafted and should be mostly finished in August, which should allow time for public discussion. According to the EU rules, the final version of the budget must be submitted in mid-October, and it may not be to the liking of the bureaucrats again. For example, the ruling coalition has already refused to raise the sales tax even though that's something the two sides seemed to have agreed on. In the face of a weak economy and dropping budget revenues, Brussels will push for extra tax, but just like the last time, Rome will refuse to obey.

This budget conflict can prove a more meaningful negative for the euro than the ECB's policy change. Especially given that the Italy's 10-year government bond yields fell to about 1.5%. Even Greece's – obviously junk – 10-year bonds offer about 2% YTM, which is precisely where the ultra-safe 10-year U.S. treasury is quoted. This can trigger a fast, painful sell-off across the eurozone, which will affect the FX market as well. In this context it's important to remember the story of the Natixis funds which discussed in the previous release of this publication. It is not necessarily having an immediate follow-up, but serves as a good example of the potential domino effect.

EURUSD, EURCHF: still more direction in the crosses.

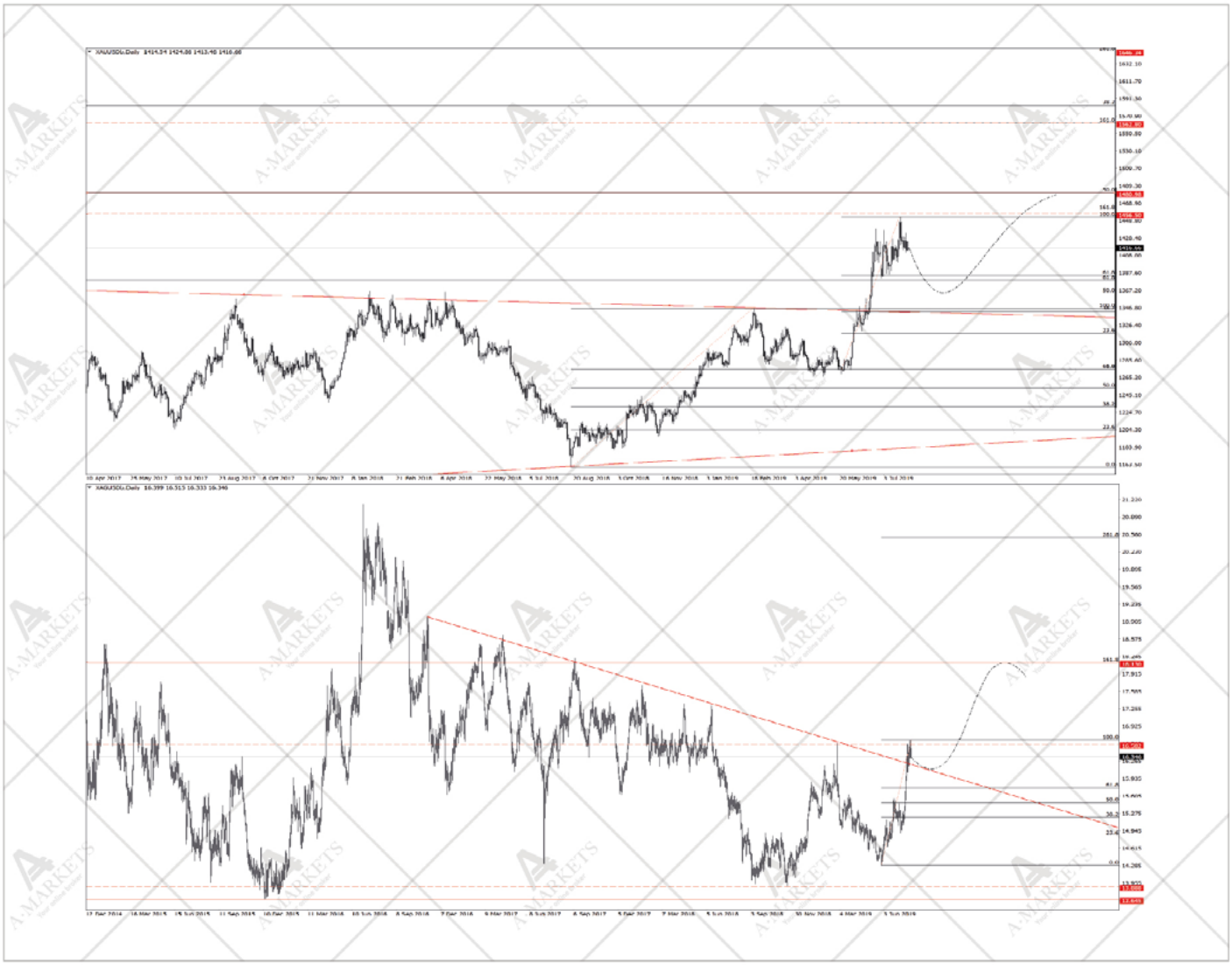
We sell EURCHF at 1.1085/1.116 targeting 1.067, stop-loss at 1.121.

EURUSD remains in a muted downtrend. We're still waiting for volatility to rise and for the unit to post a pronounced drop, but so far it has managed to spend months in narrow ranges. The technical pictures shows no new information. Wave count might be giving new information, but it changes the overall outlook only marginally. Fundamentally, the race is on to ease monetary policy—and the ECB is still trying to keep up with the Fed.

The EURCHF cross looks relatively clear. As we mentioned in our previous review, the franc is one of the most attractive currencies, given the current monetary environment. From the technical viewpoint, in July we saw the pair break through the 1.12 mark, which implies that the move is impulsive. Corrections towards 1.1085-1.116 should be a good opportunity to open a short position, especially considering the risk/profit ratio. Stop-loss can be placed just above 1.12, while the trade targets 1.065-1.07. Another candidate for a short position is GBPCHF: the respective levels here lie at 1.2505 and 1.172.

Gold and silver (XAUUSD, XAGUSD): a (very serious) matter of interpretation.

We will buy XAUUSD on dips to 1395 targeting 1600; stop-loss at 1332, will move to the entry point once 1452 reached.



An outstanding June was followed by a strong July for precious metals. Gold is consolidating near its 6-year highs, silver has even managed to continue its rally. The fundamental reason for this is, again, the abundance of negative yields in the fixed income space, which makes zero-yielding assets an interesting alternative, and somewhat a haven from negative rates. The technical picture looks quite intriguing as well.

At first glance, gold has formed a strong uptrend. The metal breached to the upside from a triangle, and that seems to be the consensus view. If this is the way to look at it, the next move should be a correction to $1340, enabling $1560-1600 target range. Wave analysis suggests that the downward move should halt in the $1385-1395 area, while the target for the move up is 1600.

But things aren't as simple. All the rally of the past three and a half years can still be considered a multi-month correction from the downward move. Just to recap, gold reached a high of 1920 in September 2011 and then crashed to 1046 in December 2015. The strong resistance level in this case should

lie between 1452-1480. If not taken out quickly and decisively, this should be interpreted as a risk of significant downside. We aren't going to lean towards either scenario, as a lot will depend on the fundamentals. But one can not rule out the second scenario just yet.