A·MARKETS
Your online broker

Just sell and go away.

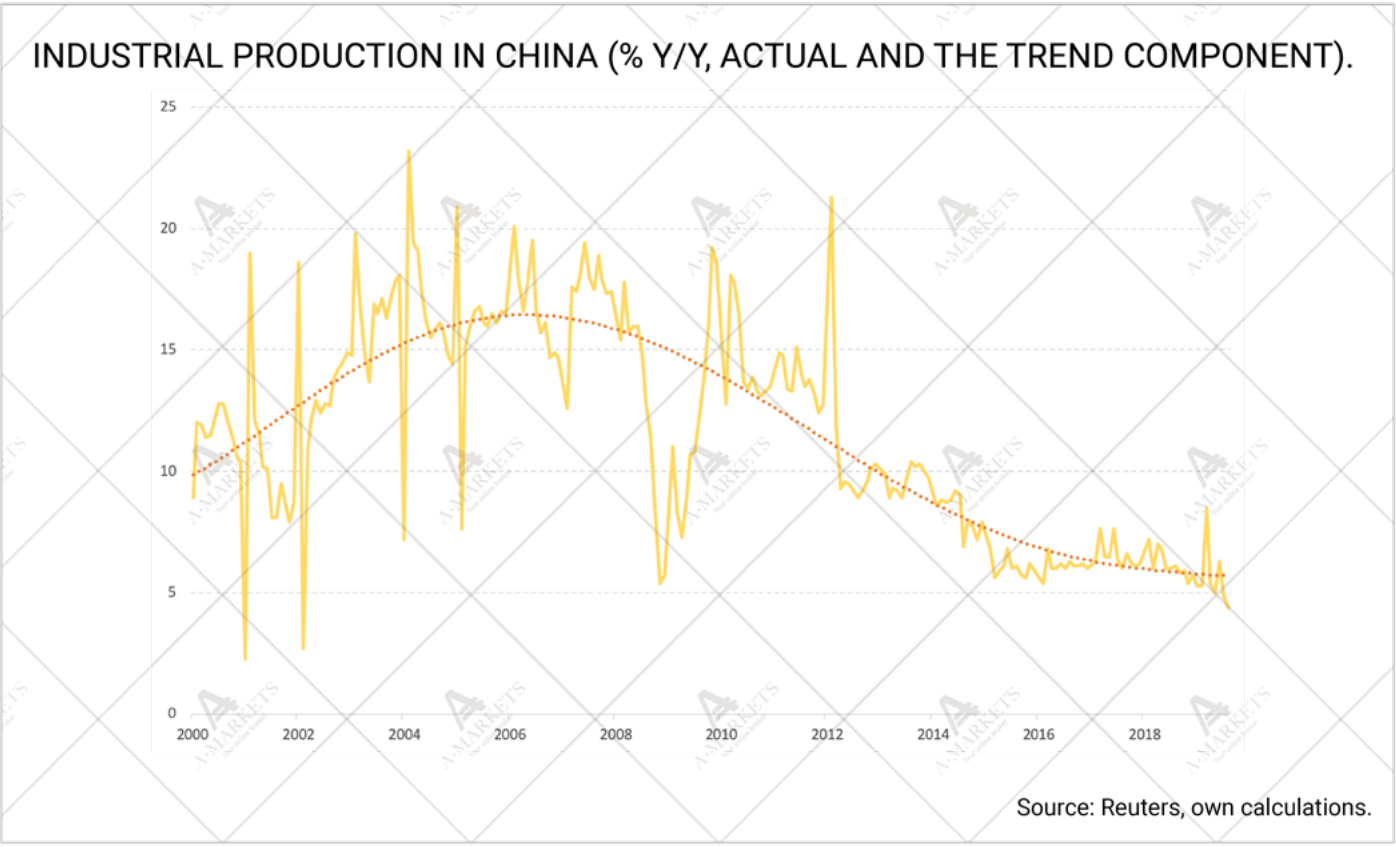
Author: Nick Korzhenevsky,
analyst with AMarkets Company. The anchorman of a TV program "Economics. Day rates"

Summary:

- Tremendous risks have been accumulated within the financial markets. We're moving to outright shorting risk.
- Trump's impeachment is likely to play out under the "Bill Clinton 2.0" scenario, where the House votes to impeach, but the Senate does not remove the president from the office.
- Credit risks are materializing at an alarming pace. The U.S. interbank market is the key issue and deserves particular attention.
- The fundamental economic narrative remains weak. The surge in oil prices amid geopolitical tensions is still a good opportunity to sell.

The risks are rapidly building up. The fact that stock indices are still close to their all-time highs and credit spreads are tightening is outright surprising. To be fair, though, crises rarely happen when the crowd is prepared for them. Instead, the analyst community first goes from ultra defensive to balanced. And only after the risk assessments are lowered, the trouble strikes.

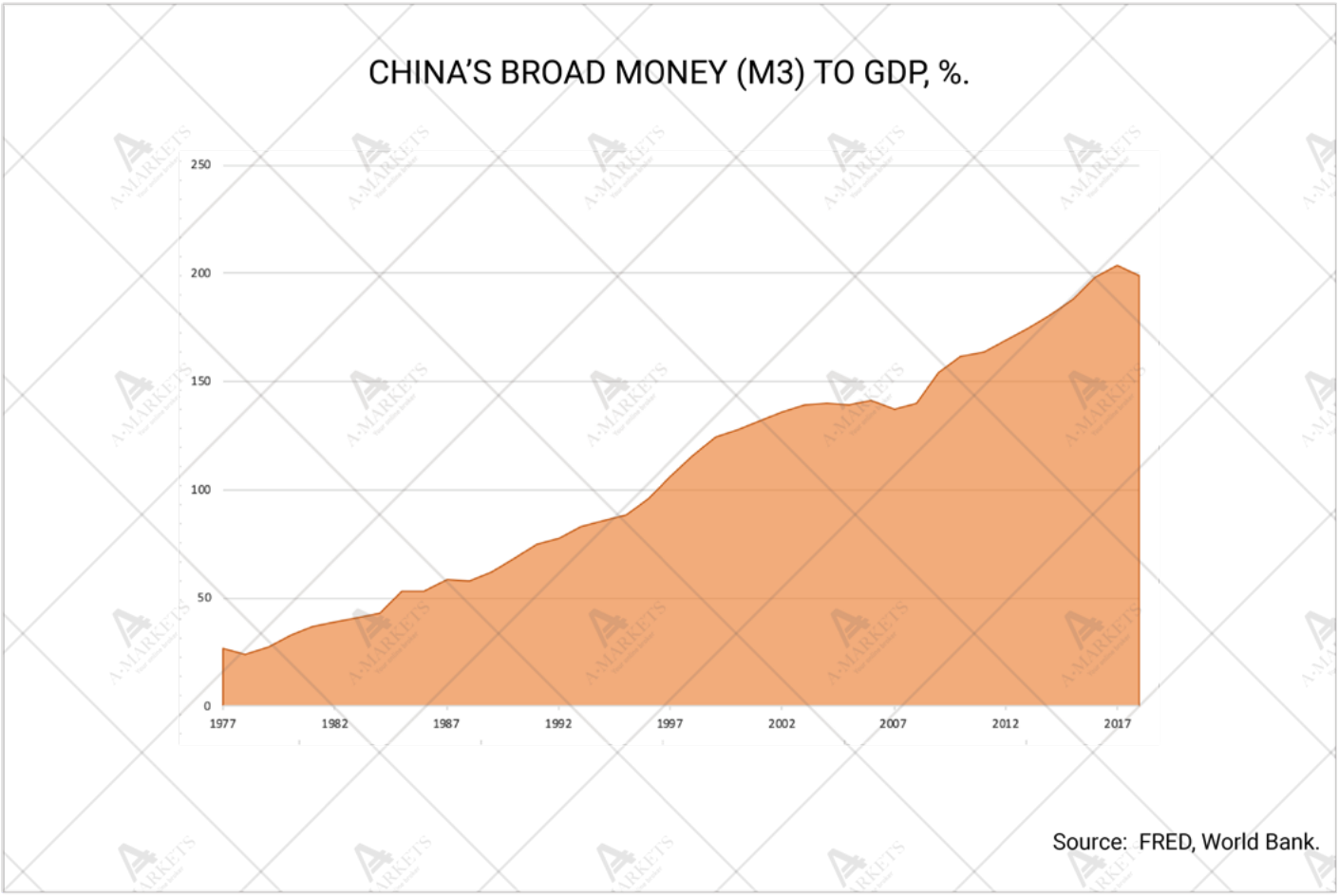
What kind of risks are we talking about? For the most part, the economic ones. Global economy continues to slow, dragged down by China. The country's industrial output growth weakened to 4.4% y/y in August, the slowest pace since February of 2002. The reader is likely familiar with the number, but it's crucial to fully understand its significance. Just like the market was late to recognize the scale of China's growth and its consequences, it is now failing to grasp the magnitude of the slowdown. It is by no means priced in.



There's no reason to expect an improvement either. As the U.S. presidential primaries get underway, it becomes clear that the Democrats' stance on China isn't much different than that of Trump's. Virtually everyone favors a stricter policy towards China—the U.S. political elites haven't been this united since the Russia episode not so long ago. Donald Trump himself has already promised a much tougher stance on Beijing when re-elected. And even if, hypothetically, the next American president is a Democrat, the chances for a softer policy are slim to none.

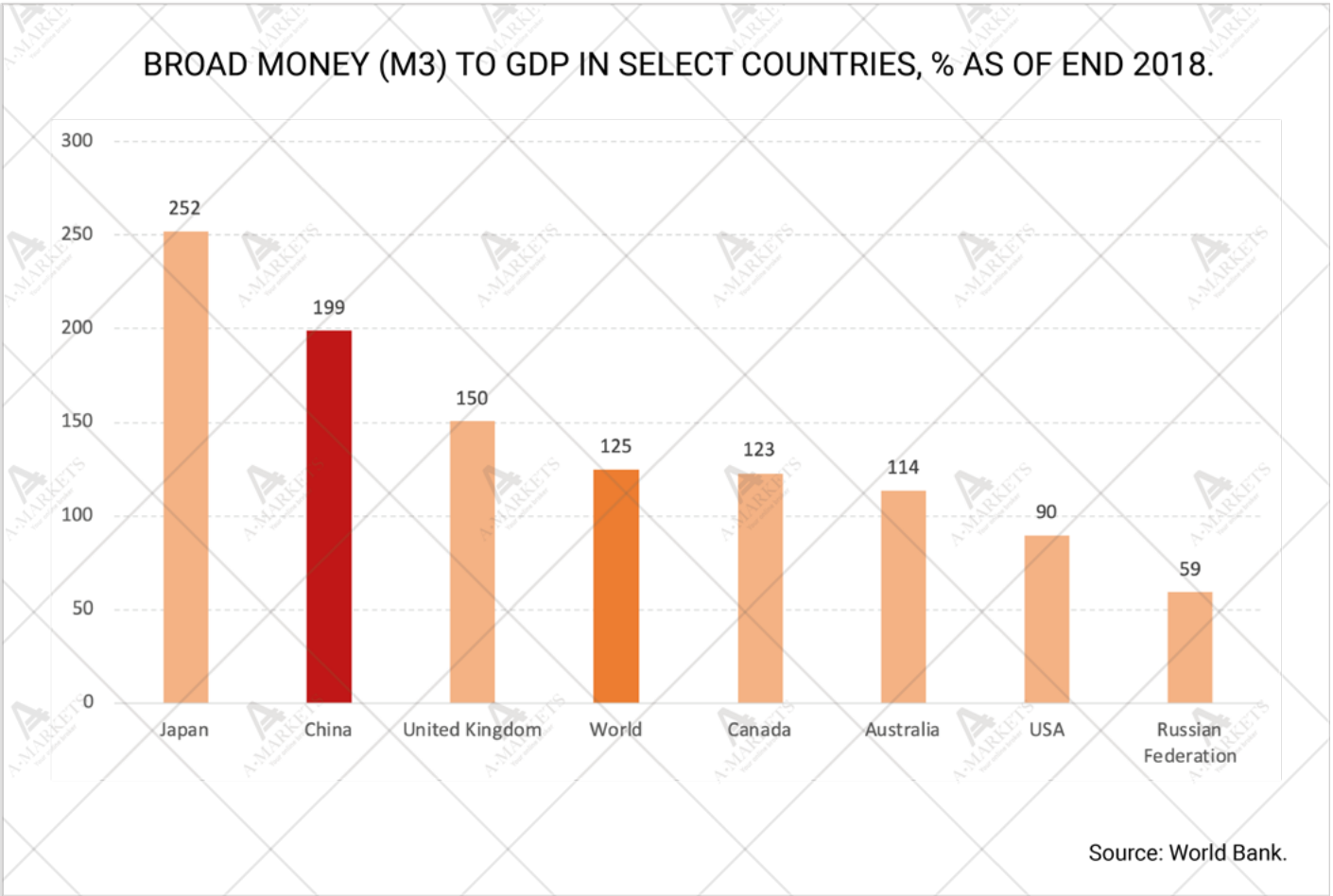
China's response to the external challenges has been largely muted. It's almost as if the officials have decided that if the economy goes down, it should take everyone with it (in our previous review we wrote about Germany being in a recession, which is a direct result of China's problems). The government's tax incentives primarily compensate for trade war losses. The PBoC is just keeping monetary conditions unchanged, but is not softening them. And both institutions are making sure that the real estate bubble doesn't inflate.

Perhaps things could've simply stayed this way for a while, but the U.S. is ramping up pressure on China. In late September, it was reported that Trump's administration considered limiting Chinese firms' access to USD funding (both debt and equity). Treasury officials played down the reports, specifically saying they were "not contemplating blocking Chinese companies from listing shares on U.S. stock exchanges at this time." But the key words here are "at this time." If this does eventually happen, Chinese investors will be shut out of the U.S. markets.



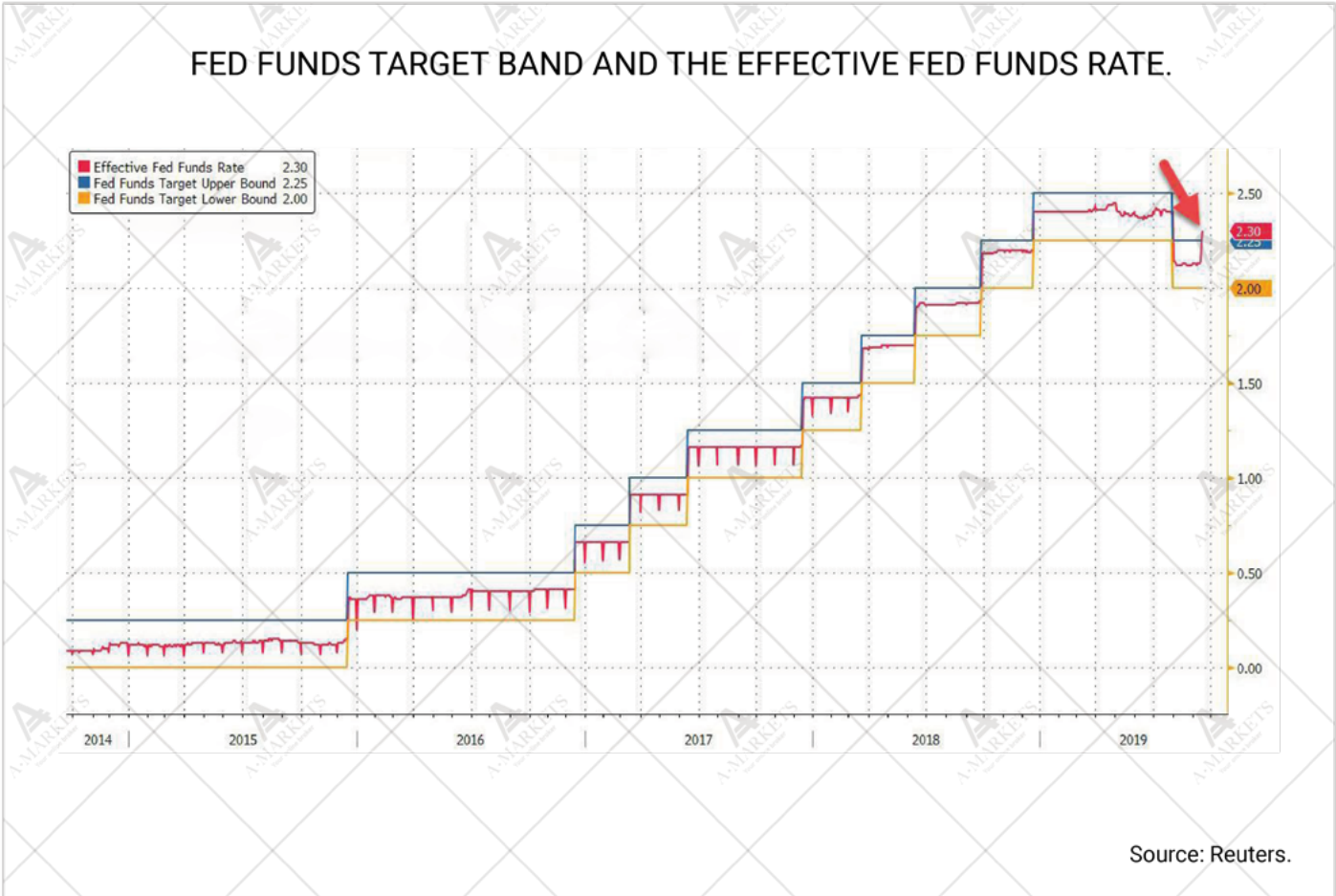
Such a step can be very damaging to China's financial system and economy. The country's corporate debt stands at 165 of GDP, the broad money supply is 200% of GDP. This is 2-2.5 times higher than that of developed countries and is a sign of enormous risks. In fact, China is long overdue for a credit crisis, but has managed to avoid it, chiefly due to its closed capital account. But the Trump administration seems to have found a creative way to trigger fundamental repricing of Chinese assets that also serve as collateral for the country's banking system. Should the U.S. proceed with this idea, it is highly likely to trigger extreme risk aversion across global markets.

Another key story of the month was the liquidity crisis in the U.S. interbank market. The fed funds rate broke out of the Fed's target corridor, which, in theory, shouldn't be happening. Even worse, it seems like the Federal Reserve doesn't have a clear understanding of why exactly that happened. So far there are two working hypotheses. One is that there is still liquidity surplus in the system, but it is unevenly distributed across banks. The other boils down to reaching a certain "terminal" reserve level, i.e. the lower limit of the Fed's balance sheet has been empirically established.



Of course, the Fed needs to determine the source of market stress. For traders, however, the picture tells only one thing: any positioning should account for an episode of sharp risk aversion. If the first hypothesis proves correct, it would imply that on the financial institutions is experiencing difficulties obtaining a loan. Because if the whole theory is based on the assumption that the system is still operating under liquidity surplus, then someone must be hoarding that liquidity. This is called lack of trust, and it can quickly turn into a full-fledged crisis. If the second hypothesis is to be accepted, the U.S. financial system has reached the point when there's simply no natural supply of fresh liquidity anymore.

Perhaps the only significant takeaway from this discussion is when to expect a crash-type episode. If what we're seeing is loss of trust between interbank players, 2019 could end much worse than 2018. If the system has hit a structural bound, the Fed's repo purchases can buy another 3-6 months. Unlike most of the market, we do not expect recent events to push the Fed back into QE as such operations are not flexible and do not adjust to fluctuations of demand for reserves. The beginning of the U.S. fiscal year should also be very telling (it is known that the Treasury's expenses were one of the factors that led to a surge in interest rates).



Finally, a few words on the U.S. political landscape. Democratic leader Nancy Pelosi announced that Congress officially opened an impeachment investigation against Donald Trump. We're not political analysts, so will not delve too deep into the issue. But the impeachment is likely to play out under the "Bill Clinton 2.0" scenario, where the House votes to impeach, but the Senate does not convict. A different outcome is very unlikely as the upper chamber is controlled by the Republicans, and the evidence for Trump's impeachment is too weak. So far, at least.

However, if the Democrats somehow manage to succeed in removing Trump from office, the immediate effect on risk appetite will be negative. Donald Trump has proven to be an investor-friendly president. His policies have been directly beneficial for those holding higher-risk assets, and are still indirectly supporting the dollar. We also note that back in the Clinton impeachment days, the main market stories were the Asian financial crisis and the Fed's response to that external shock. Which is why we're putting politics third among our key trends and keeping a closer eye on credit markets and developments in China.

XAUUSD, XAGUSD: a litmus test for interbank stress.

We remain long XAUUSD, XAUEUR. If stop-loss is reached, will again buy XAUUSD at 1390 targeting 1562, stop-loss at 1335.

The stress in the U.S. interbank market has surprisingly had no initial effect on the dollar. Even as rates were skyrocketing, USD strengthened only moderately. This is interesting for the simple reason that if someone needed liquidity (and could not borrow it), that could be done by selling some assets. And if the bank settled the transaction in a foreign currency, the next step would be to convert it into dollars. In turn, the demand for the USD would cause the currency to appreciate.

But the greenback only rallied at the very end of the month. EM-currencies and commodities took a hit, and gold was no exception. The yellow metal plunged more than 5% from its recent highs. We did expect the move (see our previous review), even though this severe shortage of dollar liquidity wasn't a factor a month ago. From the technical viewpoint, the 1480 mark, as well as the critical support at 1435 are now important for XAUUSD. A break through these levels would mean bad news for gold in the long-term, while a return to the 1300 area could even make the old targets below $1000 per troy ounce possible.

Actual trading isn't the only reason we are carefully monitoring precious metals (as well as cryptocurrencies). In the current environment both gold and silver help gauge the degree of the dollar-funding stress. If XAUUSD drops below the mentioned levels, but, say, EM-currencies don't go down with it, it would be a good reason to go short on them. This strategy works for risk-related assets in general, but of course, requires thorough quantitative modelling.

A·MARKETS
Your online broker

EURGBP: the euro is endogenously weak, while the pound gains ground.

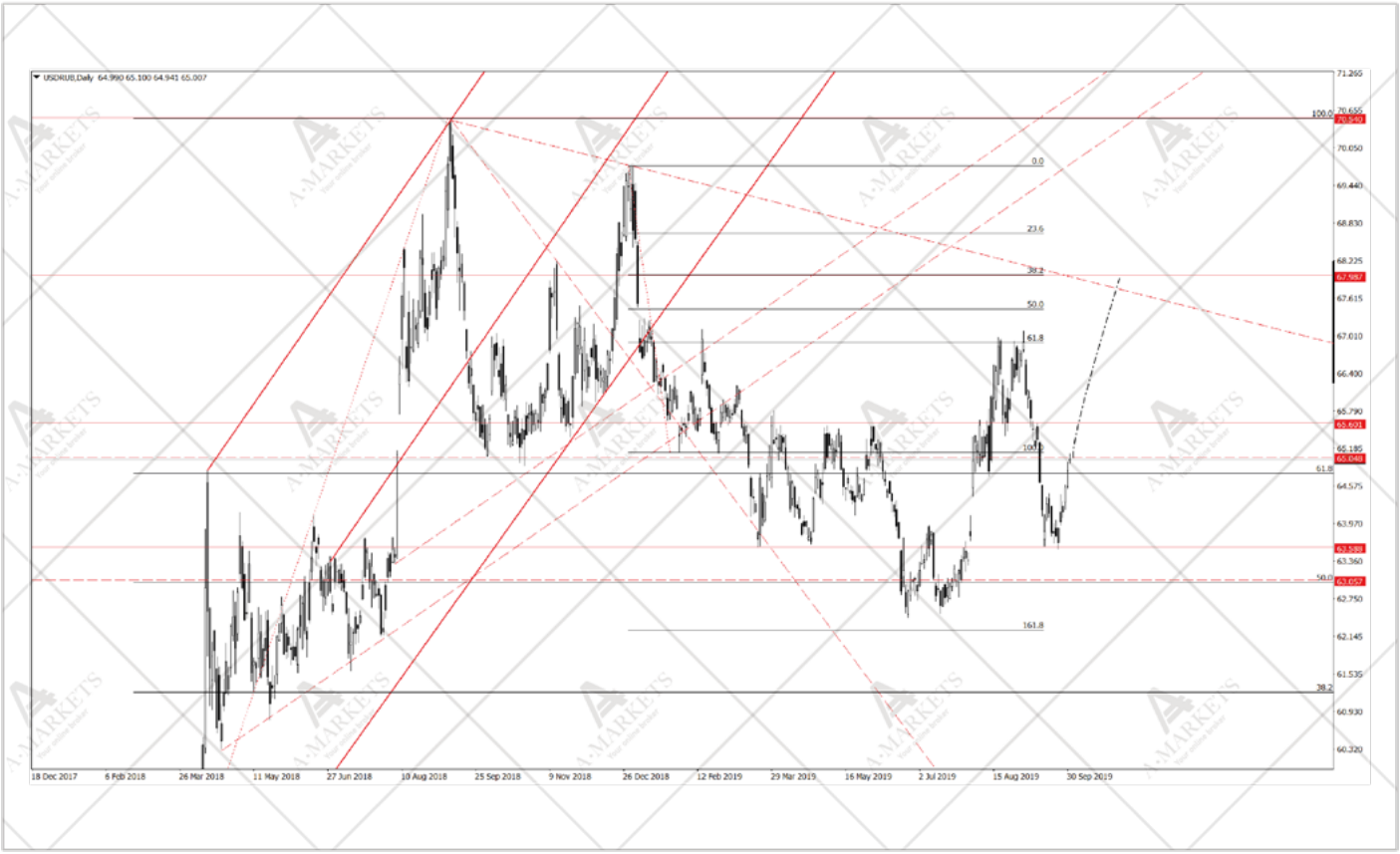
We remain short EURGBP, looking for EURUSD rebounds to 1.118 or a breach of the 1.086 to enter shorts targeting 1.0325, stop-loss at 1.131/1.093 respectively.

While the dollar has been gaining broad-based strength, the euro has been just as broadly weak. In our last report we stressed the very low probability for the EURGBP parity. While this scenario still can not be ruled out, the chances are getting slimmer. However, shorting the pair at the current levels is tactically impractical: the rate has gone down significantly, thanks to both the Brexit drama and the general weakness of the European currency.

But it is not about the EURGBP anymore. EURUSD has been showing signs of life, with a shallow, but consistent downtrend emerging. The unit closed September at 1.09, which is just above the critical support at 1.086. This is of an equivalent importance to the 1435 level in gold. If things worsen in the U.S. interbank market, the euro and gold can become highly correlated and tank simultaneously. For the euro, the first intermediate target lies at 1.064, and then the move could extend towards 1.032-1.046.

USDRUB: from testing lows to testing highs.

We buy USDRUB at 65.00 targeting 68/69.7, stop-loss at 64.00.



EM-currencies in general and the rouble in particular were also late to react to surging dollar rates. Over the past 3 trading sessions, however, they did all the catching up. USDRUB is trading by a full figure higher, and it's very likely that it's only the beginning. From the technical point of view, the conservative target is 68. But it is very well possible that it will reach levels closer to 70 before 2020 (or at the very beginning of the year). Our models suggest that the next year is to be challenging for the entire EM universe. In the worst-case, but still realistic scenario, the rouble could depreciate by another 15% by the end of 2020.

In our previous review we also pointed out USDMXN as another candidate to go long. The unit still trades at levels where longer-term investors can enter. Among the potential losers are also ZAR and TRY. No one is immune to the U.S. interbank stress and it will first affect crosses with the dollar itself. The entire EM-sector still has a long way to fall.