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Political twists and economic turns

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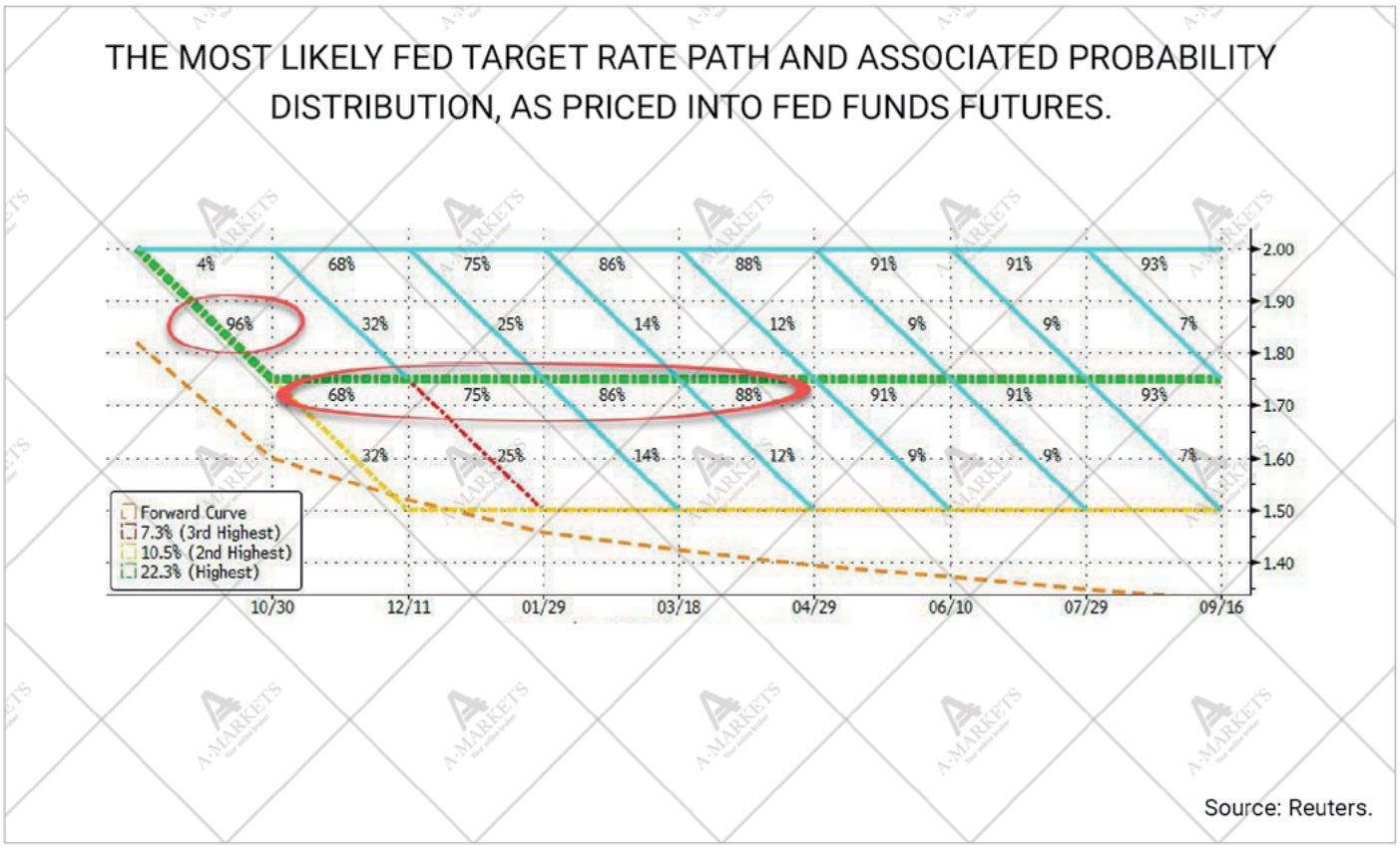
Summary:

- The FOMC is done cutting for the remainder of the year. The focus shifts to further guidance and the measures addressed to support the interbank market.
- The Brexit process has taken another twist, but is still shaping up as a clear positive for pound sterling.
- Major currencies are likely to trade sideways. The dollar rally that started in September should pause.

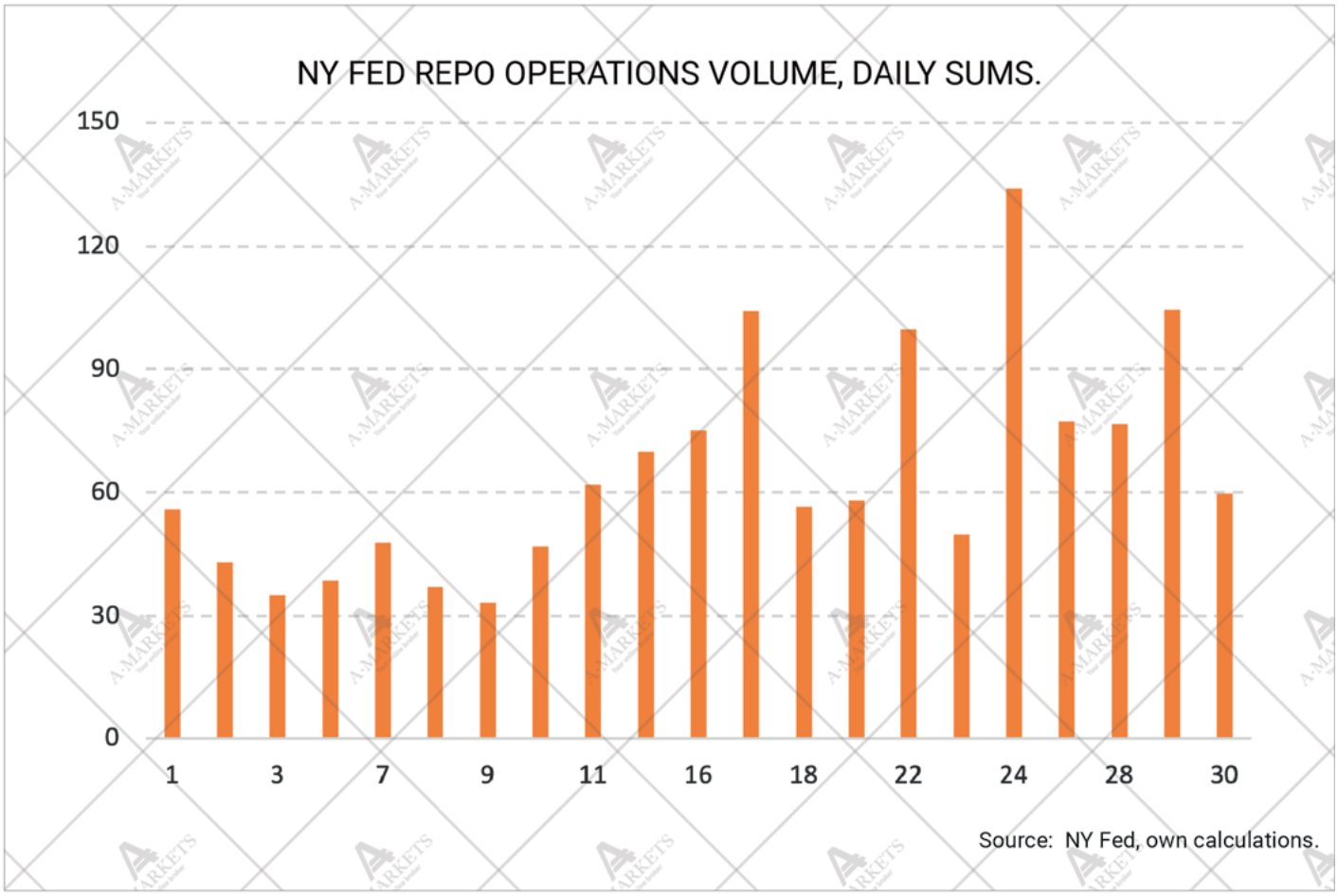
The newsflow remains heavy, yet the markets are not reacting much. Political developments are fast, but traders await conclusive outcomes, and that has become a clear prerequisite for another major move in currencies. US-China negotiations and the Brexit have proven so lengthy that there is actually little new information to digest, even as the headlines are coming in intensely. At this point both stories are viewed as a (very loud) noise, and only definitive clarity is capable of moving markets sharply.

Investors are also trying to gauge just how serious the slowdown in the US economy is. If it is indeed just a mid-cycle blip and growth reaccelerates next year, it could take risk-sensitive assets to new highs. This is also a crucial factor that will determine the Fed's policy. As per the Oct 30th meeting, there is a consensus in the FOMC that three cuts is enough under current economic circumstances. The 'act as appropriate' pledge was removed from the statement, signaling that the committee is likely staying on hold over the next several meetings.



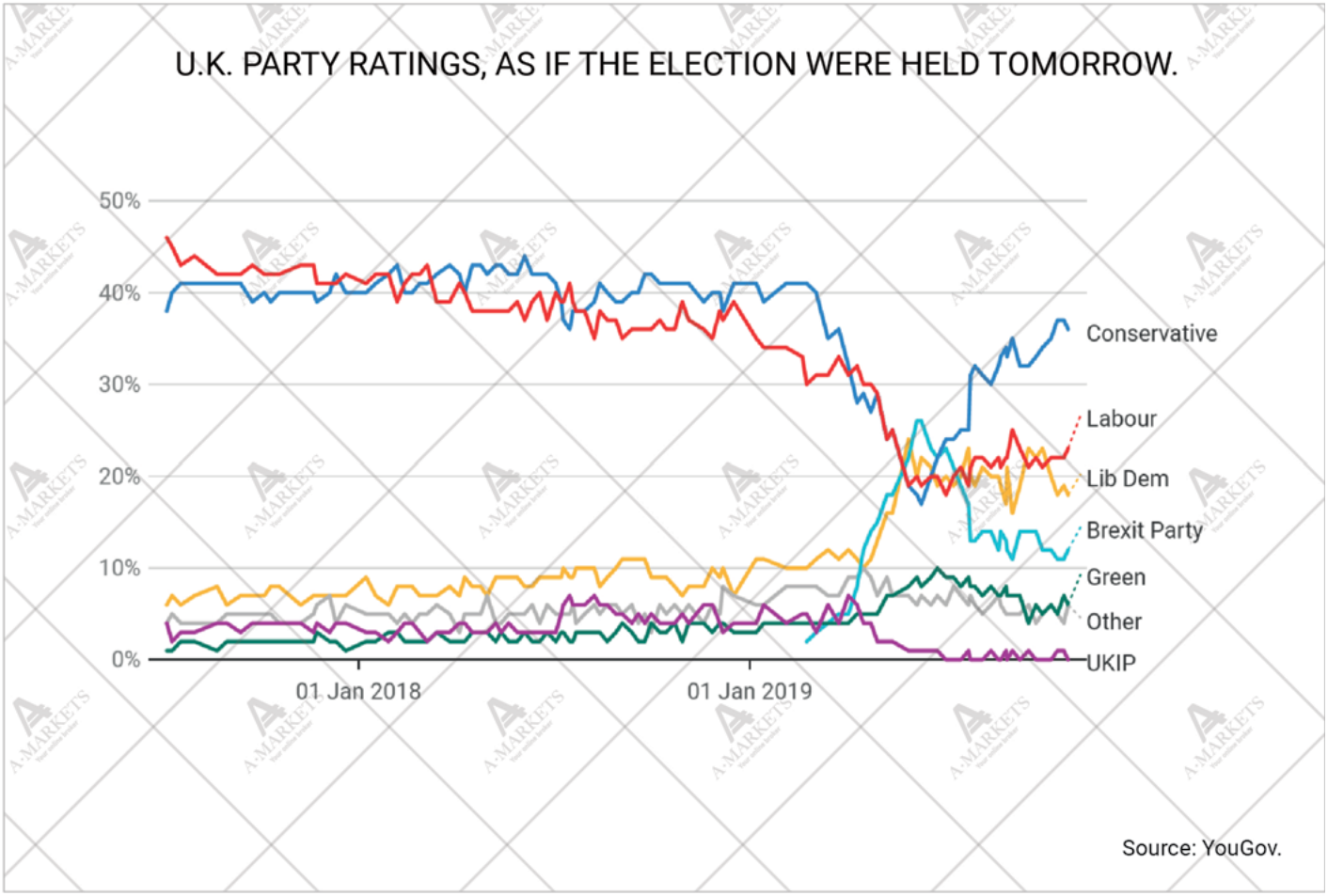
Jerome Powell set a fairly high bar for another cut, but he also explicitly stated that it would take a sustainable uptick in inflation for the FOMC to consider raising rates. All in all, we are back to the goldilocks, where the broad balance has been achieved. The attention is now firmly on the interbank market and the measures addressed to support it, arguably the most important development of October. The Fed launched a QE-like program, under which it buys $60 bln worth of bills each month. The program will run through the 2nd quarter of 2020. We expect it to be scaled down as early as March 2020. The idea behind the move is to supply additional reserves that were taken out by quantitative tightening, and that needs to be restored fairly quickly. The question remains as to what happens afterwards.

The NY Fed currently keeps on supplying liquidity through its repo operations in parallel to the outright purchases. In a perfect world, once the banking system returns to the state of ample reserves, the demand for repos should cease. Precisely this will be the reality check. The events of September have exposed the fact of scarce liquidity and high leverage that was built over the period of near-zero rates. It is now necessary to assess just how fragile the system is.



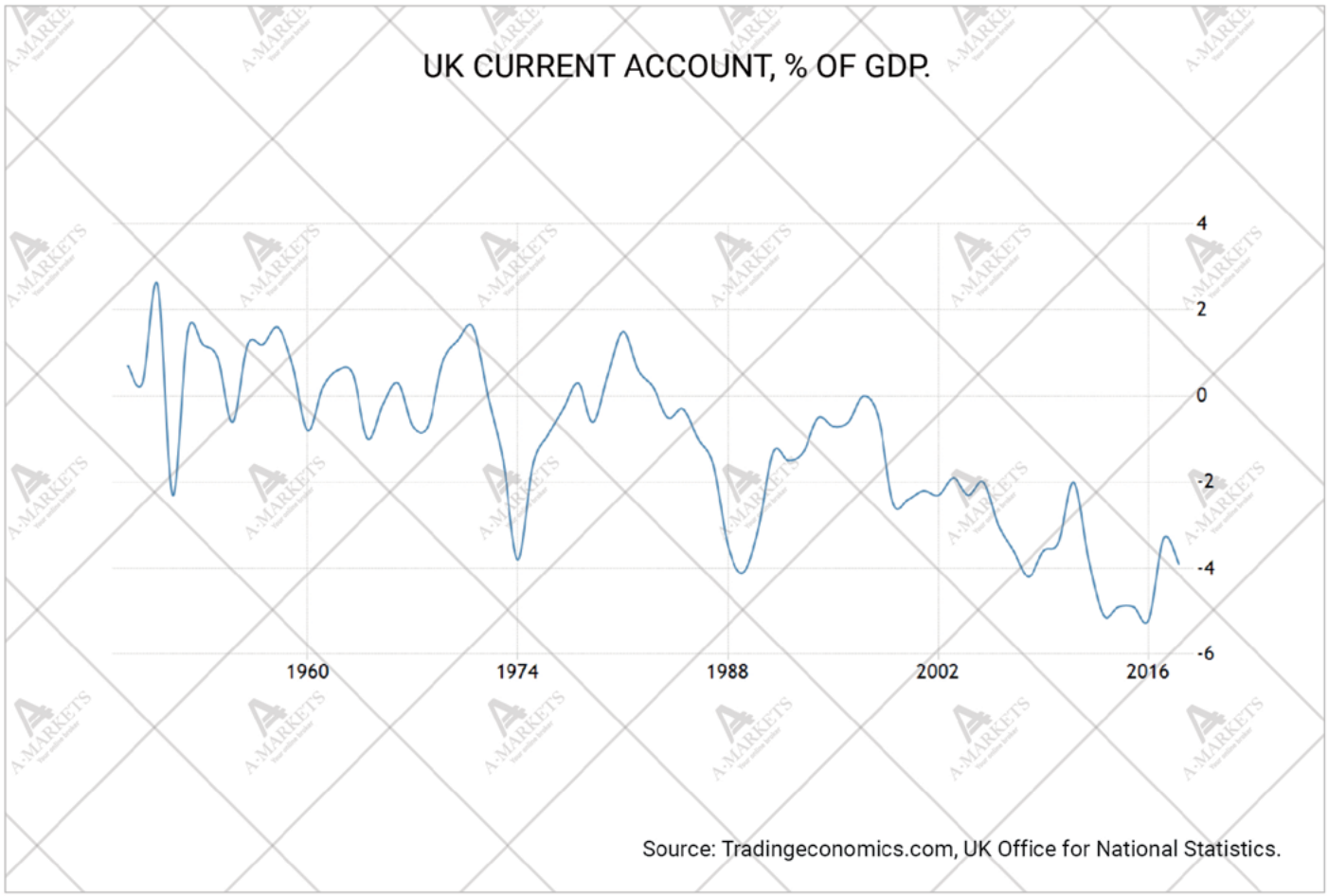
Some observers have pointed out the fact the heightened demand for liquidity could be related to seasonal factors (end of the fiscal year in the United States, and now the end of the calendar 2019 approaching). And that is certainly possible. However, if the interbank market remains strained going into the spring, it will be a clear sign that the stress is structural. This, in turn, implies that asset liquidations might occur, especially if market interest rates move higher. It would also signal a lack of trust between the largest market participants, which is always a sign of curtailed liquidity and upcoming financial deleveraging, i.e. sell-offs across markets.

The other big story is, déjà vu, Brexit. Things finally started moving ahead. For the first time since the referendum of 2016, the parliament voted in support of a Brexit agreement. There were 329 'ayes' against 299 'nays', a leap forward relative to all the political indecision of the past 3 years. MPs still supported a motion to introduce additional legislation before the UK leaves the EU, but this is merely a technical question. And the EU quickly agreed on a technical extension of the deadline for another 3 months, through January 31st.



What is a trickier twist is the snap election planned for December 12th. The two leading candidates for an outright victory are, of course, Boris Johnson and Jeremy Corbyn. The incumbent prime minister enjoys higher ratings, leading by 8-15 percentage point, depending on the poll. However, Theresa May enjoyed a similar advantage ahead of the 2017 vote. And the actual performance of her party was extremely disappointing. Keeping in mind that the whole Brexit referendum was a partly a political gamble from the very beginning, one should be mindful. Could Corbyn win by accident? This can not be ruled out.

Importantly, this does not change much in our fundamental approach to trading decisions. The worst-case scenario for the pound would be a no-deal Brexit, and it is now off the table. The Johnson agreement is net market friendly. While it is not a huge boost for the U.K. assets, it will certainly remove major tail risks, and provide additional support for the pound. Our estimates suggest that it is sufficient to take GBPUSD at least to 1.35.



But if suddenly Corbyn wins, this would dramatically change the landscape. Should Labour become the largest party, a second Brexit referendum can be expected. Markets would start pricing in a no-Brexit scenario (or an EU-friendly one). Over the short term this would trigger volatility, as a new agreement would need to be drafted and voted on. But from the medium-term perspective, it would shield the U.K. from any balance of payments shocks, as the country still runs a fairly large current account deficit, even after the pound's sharp depreciation. This, in turn, would ignite a meaningful rally across british markets. In particular, sterling would likely return to where it was just before the 2016 referendum, the 1.42-1.5 area against the dollar.

EURUSD: a short-term relief

We go long EURUSD at the market (1.116), will add to the position at 1.112 targeting 1.129, stop-loss at 1.106.

Now that the Fed is done cutting, but it flushing the system with dollar liquidity, we expect the USD to temporarily trade on the weaker side. GBP and EUR, on the other hand, are getting a boost from Brexit developments. The pound has long been our favorite, and we absolutely stick with sterling longs. But, as repeatedly mentioned, trading the British currency involves significant 'binary' risks that are difficult to hedge. Anyone going long GBPUSD has to realized they are getting exposure to extreme volatility, and, therefore, not only a large potential gain, but also a significant loss.

EURUSD, on the other hand, is stuck in a slow-motion downtrend. Lower lows and lower highs have been the pattern. However, the move in absolute terms is very mild. The euro is still trading at around $1.11-1.115. Now that the Fed meeting is behind us, and further Brexit headlines should only arrive in December, November should prove fairly quiet. Positioning and fundamentals both support EURUSD recovering towards 1.13. After that the British election and the first ECB meeting under Christine Lagard will be potential market moving events.

XAGUSD: another way to trade the 'QE4'.

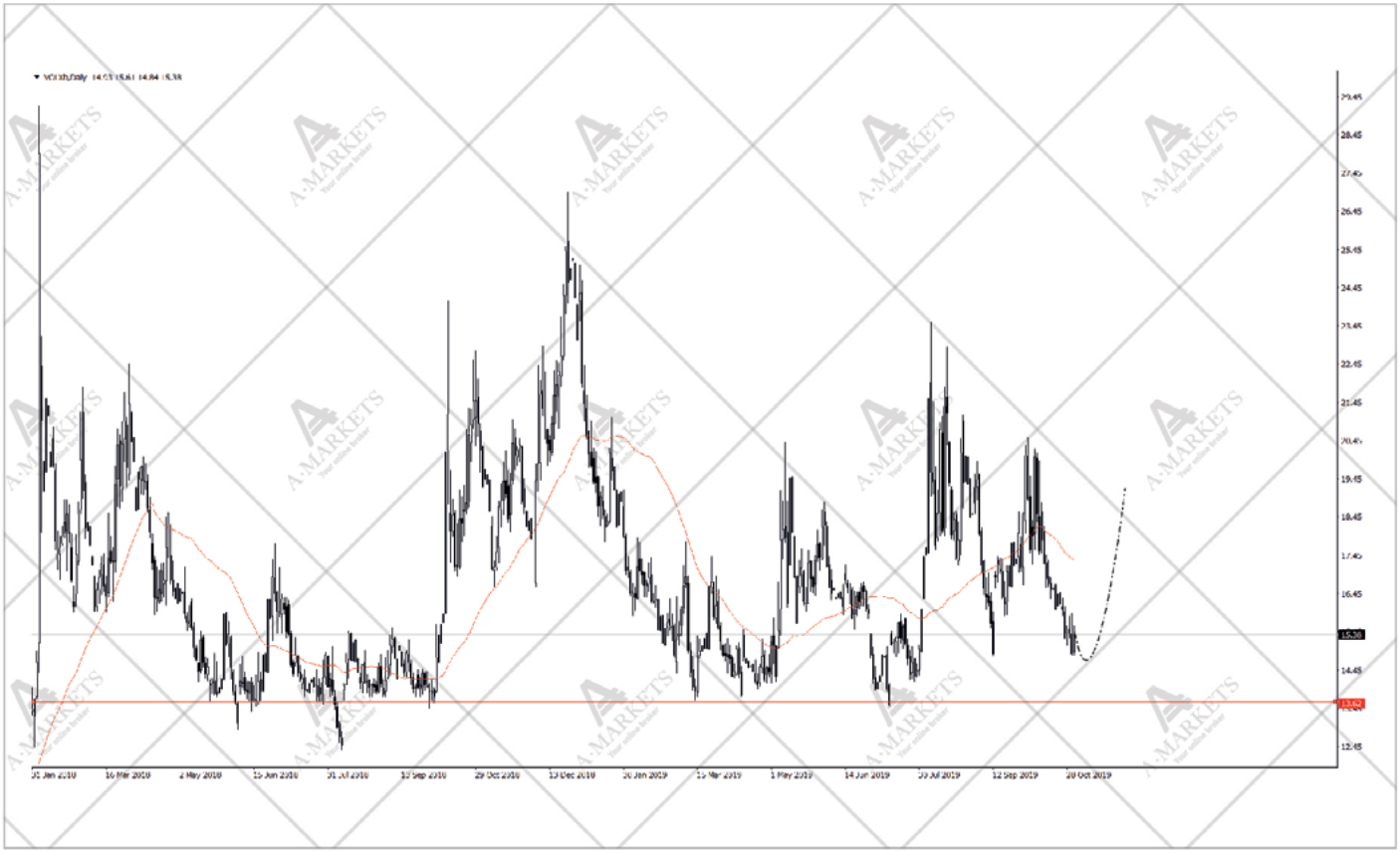
We will go long silver (XAGUSD) at 16.6 targeting 20.5, stop-loss at 15.4.

Precious metals have been consolidating after a sharp rally. The September 'repocalypse' episode has clearly put a lid on both gold and silver, as a shortage of dollars in the U.S. interbank market emerged. Now, with the Fed supplying liquidity via repo operations and bill purchases, the normal order of things should be restored, at least temporarily. Potentially tight dollar liquidity beyond March 2020 is a clear challenge, and a good reason to wait before buying into this market.

However, with silver supply-demand balance tight, we would view further price declines as a good entry point. The balance of risks is skewed towards higher precious metals, as QE4 is underway, and the Fed is not inclined to hike anytime soon. Neither is any other major central bank. The combination of fundamental and monetary factors makes silver a good buy in the $16.5-17 area. Conservative upside target lies slightly above $20. And we would hold on to the long position all the way to the $22.8-$23 area.

VIX: volatility is grossly underpriced.

We go long VIX at 15.3, targeting 18.2.



Again, the Fed extending liquidity supplies in October has triggered volatility compression across markets. Our models indicate that implied vols are now unreasonably low. They are priced as if the Fed was on the way of cutting rates to nearly zero, and launching a full-fledged QE. Neither is happening. Jerome Powell has indicated an extended pause, and runs large, but technical purchases to save the interbank market. Meanwhile, the economy is slowing down and global risks remain. This environment suggest there will be bouts of volatility, and current levels of VIX (and the likes) are fundamentally unjustified. According to our estimates, average value of the spot VIX index for the next 6 months will fall in between 18.8 and 19.2. We therefore view current pullback as an opportunity to go long.

We also hold our GBPUSD longs and EURGBP shorts.