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2020: more raging politics and trade warcraft.

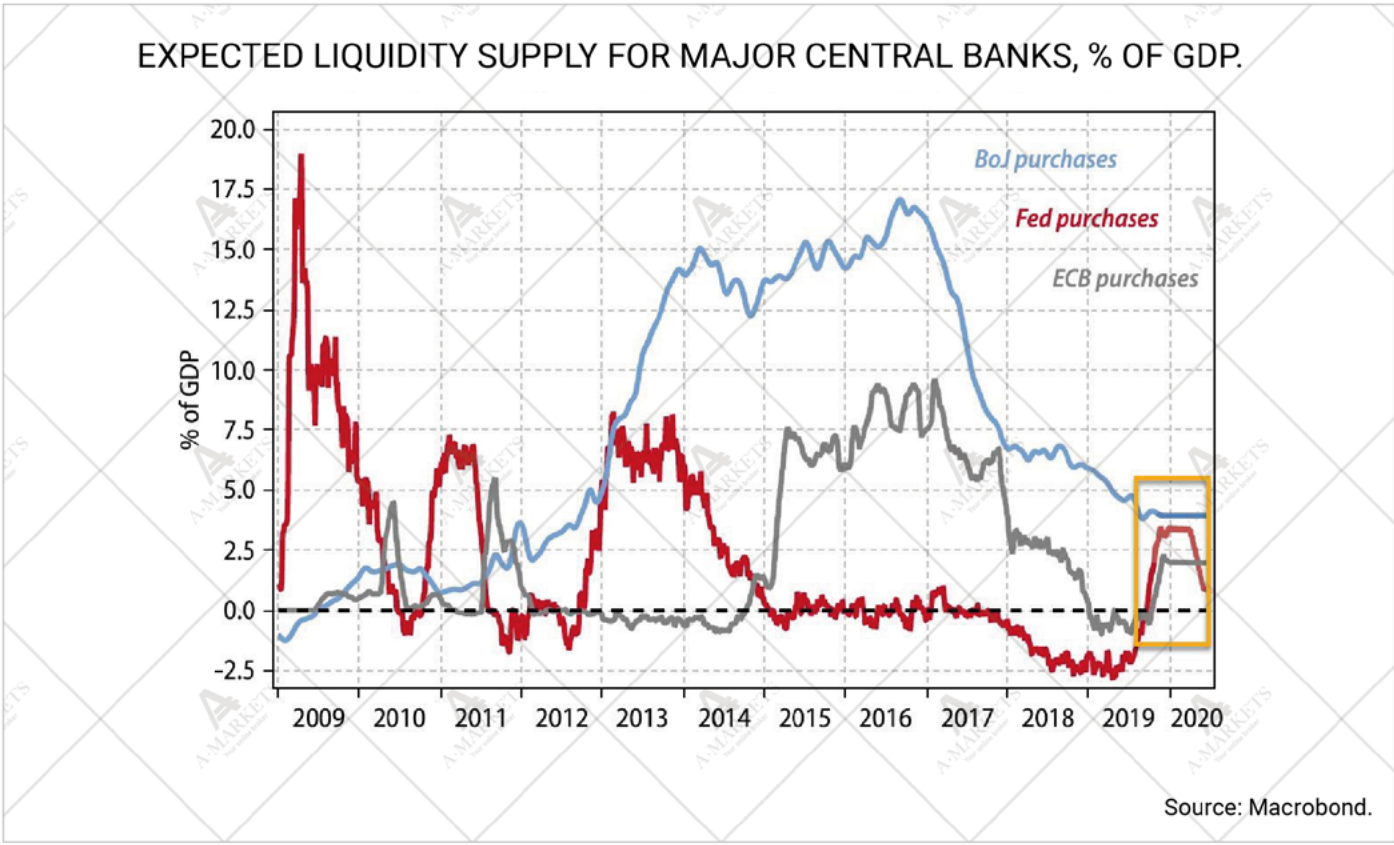
Author: Nick Korzhenevsky,
analyst with AMarkets Company. The anchorman of a TV program "Economics. Day rates"

Summary:

- The main themes for 2020 are the global growth slowdown on the back of yet diminishing tail risks, the tensions between the U.S. and China, and the fading monetary support.
- Volatility is largely underpriced, while risk-related assets are significantly overpriced.
- The impact of politics on the market has been rising throughout 2019 and will remain critical into 2020 as the U.S. presidential election approaches.
- Asian markets are showing signs of fragility and are susceptible to a potential crisis. The timing of such events, however, is always difficult to predict.
- A devaluation discount is starting to build in the US dollar. We can't rule out that a weaker USD will be present in the Republicans' 2020 campaign as an outright proposal.

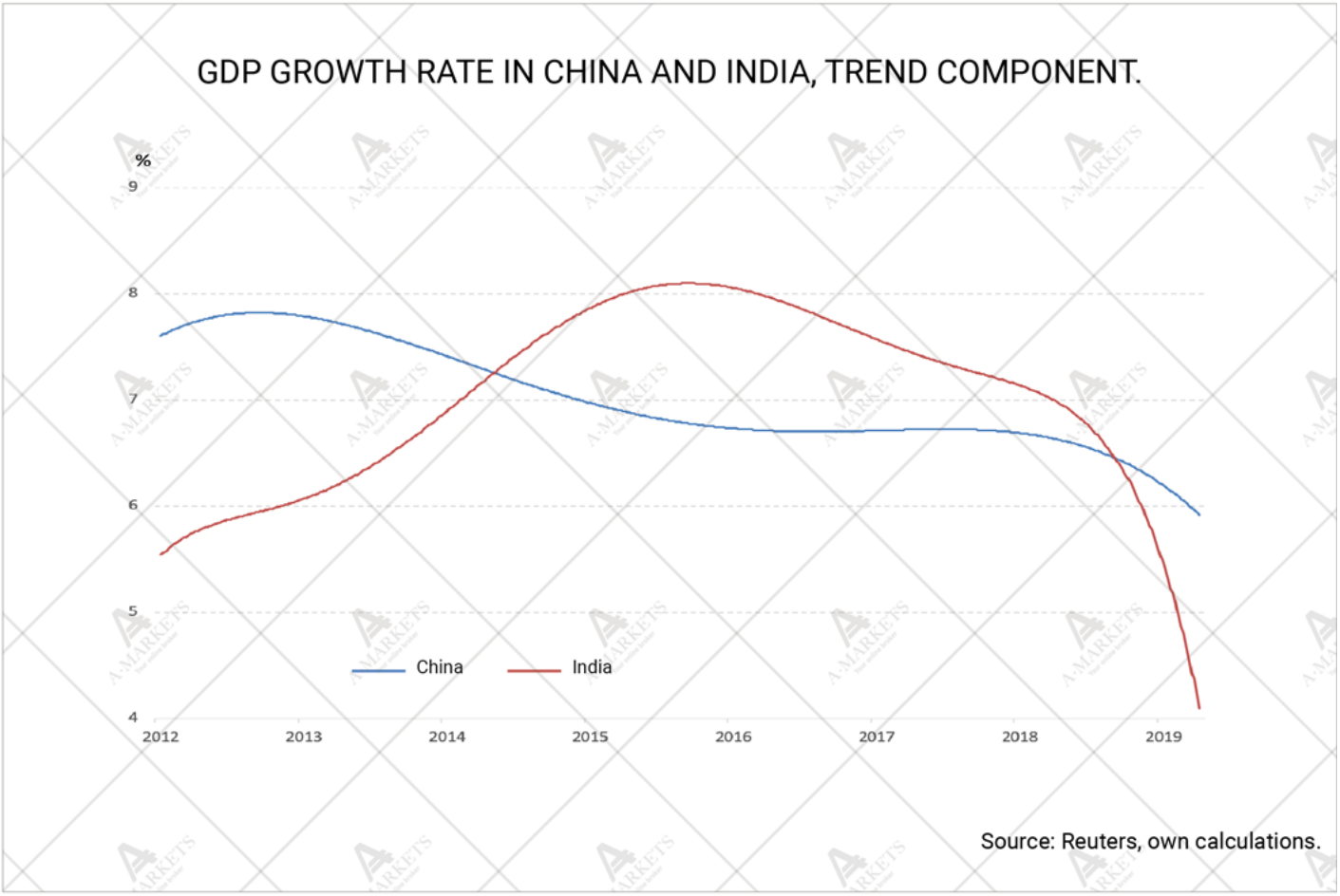
2019 proved to be a spectacular year for most asset markets. This is in contrast to the unusually tough 2018 when global risk aversion intensified unexpectedly in December. The party, however, seems to be coming to an end, as the factors fueling optimism are now fading. The first and most important of them is, of course, the Fed's policy. Nearly 12 months ago, when inflation expectations in the U.S. moved sharply down, the FOMC made a U-turn and announced it would cut rates instead of hiking for four times as announced previously. Then, in September, there was an emergency injection of liquidity in response to rising interbank rates. Now, that all of the above is done and seems to be working, the Fed is taking a wait-and-see approach.

The supply of central banks' liquidity is critical for asset markets. Expanding balance sheets is a green light of sorts for investors. And in 2020 there is more accommodation to come: about $10-20 bln/month from the Fed, €20 bln/month from the ECB, and ¥1.7 trillion/month from the BoJ. That should happen without any rate hikes. Having said that, we still see heightened systemic risks, stemming from rich valuations in both fixed income and equity markets. The other two significant considerations are rapidly falling marginal utility of balance sheet expansions, and the inability of the PBoC to join the printing party.



The second main theme is the lingering U.S.-China trade war. Donald Trump has basically confirmed that there hardly could be a deal in 2019. The American president, of course, assured that he's in total control of the situation, but we don't think that's quite the case. Communication between Beijing and Washington is clearly deteriorating. Trump has signed two new laws supporting Hong Kong protesters, which provides a framework for the U.S. to impose sanctions against China should there be a serious attempt to clamp down on the unrest.

On top of that, the Trump administration has considered adding Huawei to the SDN list, Reuters reports. The exact same thing happened to Russia's Rusal back in April 2018, which sent the company into a tailspin. The SDN list primarily includes individuals and entities from countries like Iran and North Korea, so being on the list is a financial death sentence of sorts. Sources say that while Huawei has so far got away with gentler measures, the idea is still kept as a back-up plan. If the U.S. does go through with it, relations between the two countries will complicate even further and make a trade deal virtually impossible. But even if this does not happen, the story is an excellent indication of just how fundamental the battle is. Right now the true state of things is not fully priced in.



Finally, for now, investors are just watching the economic slowdown in the Asian region, not yet acting on it. However, the deterioration is rapid, especially in China and India. In the former case, the slowdown is the direct result of the trade war with the U.S., which only exacerbated the underlying structural challenges. In India, there are issues with domestic economic policy. Both countries have started consolidating their banking sectors which is always the first sign of weakening fundamentals. Considering the links in the global production chains, we have little doubt that several European economies will slip into a technical recession in H1 2020. The Asian theme should also exacerbate the slowdown in the U.S.

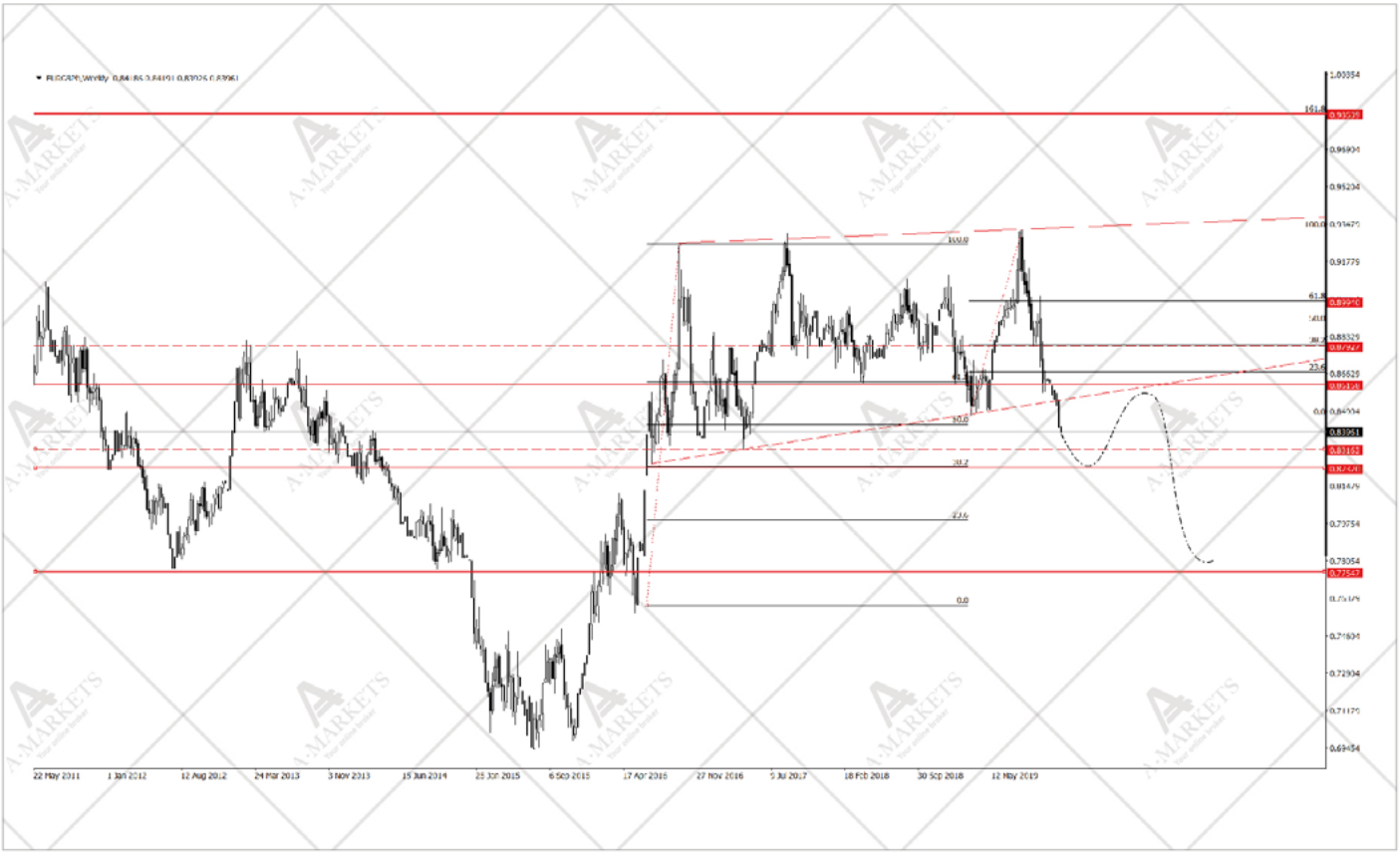
The combination of these three factors creates a more troubling environment for the market than what investors are used to. On the surface, the waters are smooth, but the cycle is in its later stage, which implies fragility. The lack of acute immediate stress allows for stable markets, and a slow grind higher in risk-related assets is possible for the entire 2020. The upside in many markets is nearly exhausted, but a downside move requires a trigger. Taking this as a given, our strategy for the next year is as follows:

1. Remain long in select risk assets, constantly on a hedged basis.
2. Actively using the euro as a funding currency.
3. Searching for relative-value trades in crosses.

With this in mind, here are our main trade ideas.

EUR/GBP: still a viable short.

We remain short EUR/GBP targeting 0.822/0.776, will add to the position at 0.858, stop-loss at 0.866.

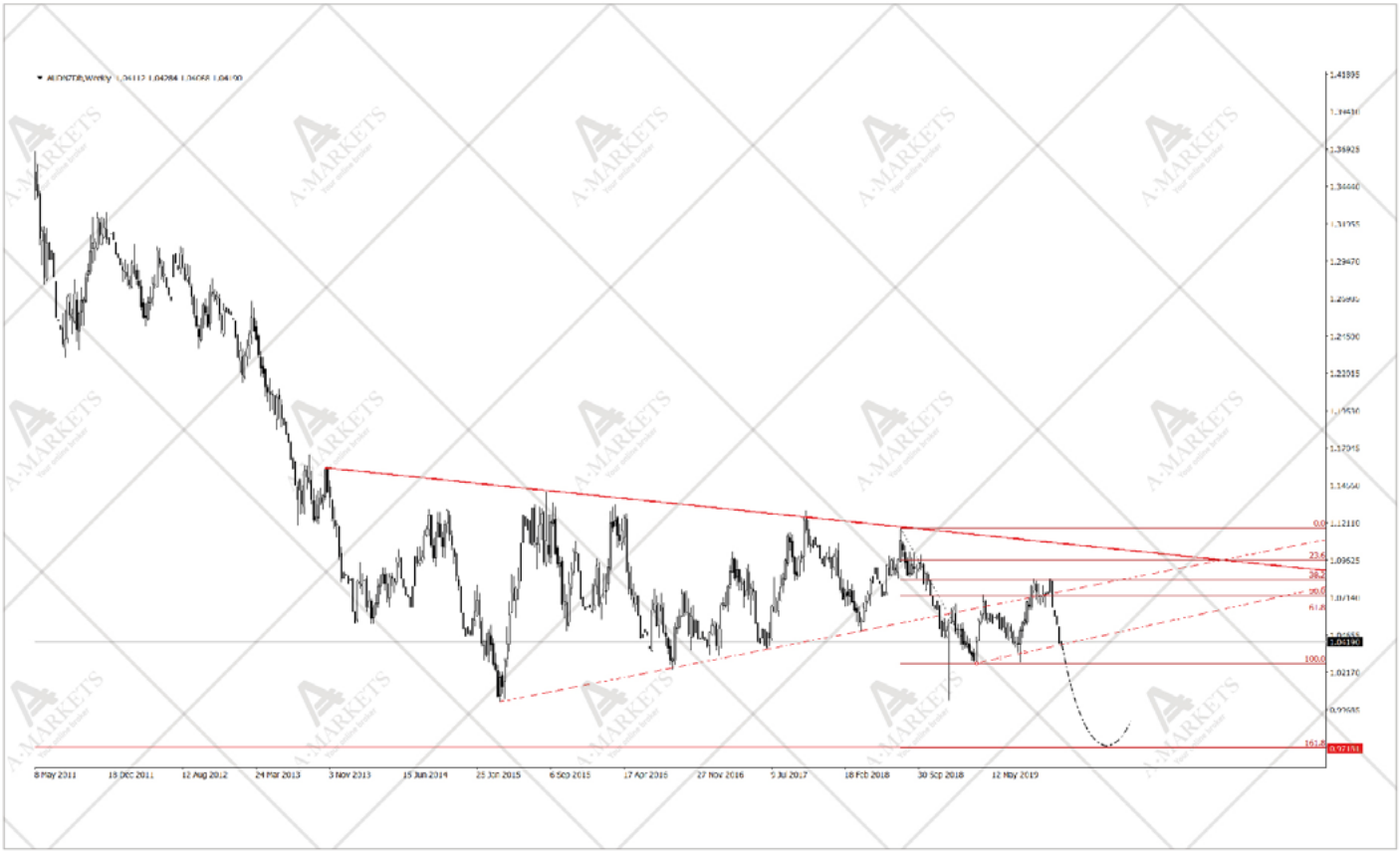


The British pound remains an exciting story, and it still cheap by many metrics, although it is hard to say which one would be a fair valuation approach. The current account indicates there's still plenty of downside. But the financial account may actually provide phenomenal support. Following the Brexit referendum in 2016, there was an exodus out of British assets. In fact, according to the IMM, all major types of investors except for market makers are net short GBP, which is a rare occurrence and clearly one-sided positioning. The derivatives tell us the same story (specifically, the persistently negative risk reversals).

The main show for the sterling is happening this year. The next U.K. general election is scheduled for December 12. Polling data shows a comfortable win for Boris Johnson's Tory Party, and, importantly, the prediction is mathematically more accurate and more reliable than that of 2016. We expect the incumbent Prime Minister to keep his seat and expand his grip of the Parliament. As a result, the Brexit deal in its fairly friendly version should be approved. With the uncertainty around Brexit vanishing, GBP/USD should return to at least 1.35, while EUR/GBP is likely to drop to 0.82. Of course, there's still a chance that the election produces a different outcome, which is one of the reasons keeping us from going aggressively long. The euro-pound cross should be a safer bet here, although the losses could still be very significant. We definitely favor staying short EUR/GBP over buying GBP/USD at present levels.

AUD/NZD: an option to play the trade war.

We sell AUD/NZD at market targeting 0.973, will add to the position at 1.083, stop loss at 1.107.



The AUD/NZD short is one of our main strategic ideas going into 2019. Cracks appeared in the middle of the year when central banks began loosening their policy. However, it is now clear this had no significant impact on the trend. Both Reserve Bank of Australia and Reserve Bank of New Zealand delivered 75 b.p. in total cuts, and the latter still looks relatively hawkish. AUD/NZD is, therefore, still headed south. From the technical point of view, the cross still maintains the super ambitious target of 0.972.

There are also fundamental drivers for this. First, the Australian dollar is by far more sensitive to the slowdown in China than its New Zealand counterpart. As relations between Beijing and Washington deteriorate, the AUD is quite vulnerable. We make no bets on the trade war resolution, but, having said that, both AUD and NZD reacted similarly to positive newsflow on the issue over the past year. Second, the relative monetary policy dynamics generally look more favorable for the NZD. We believe that the Reserve Bank of Australia will cut again, while New Zealand's central bank has completed its loosening.

XAG: looking for an escape out of negative rates.

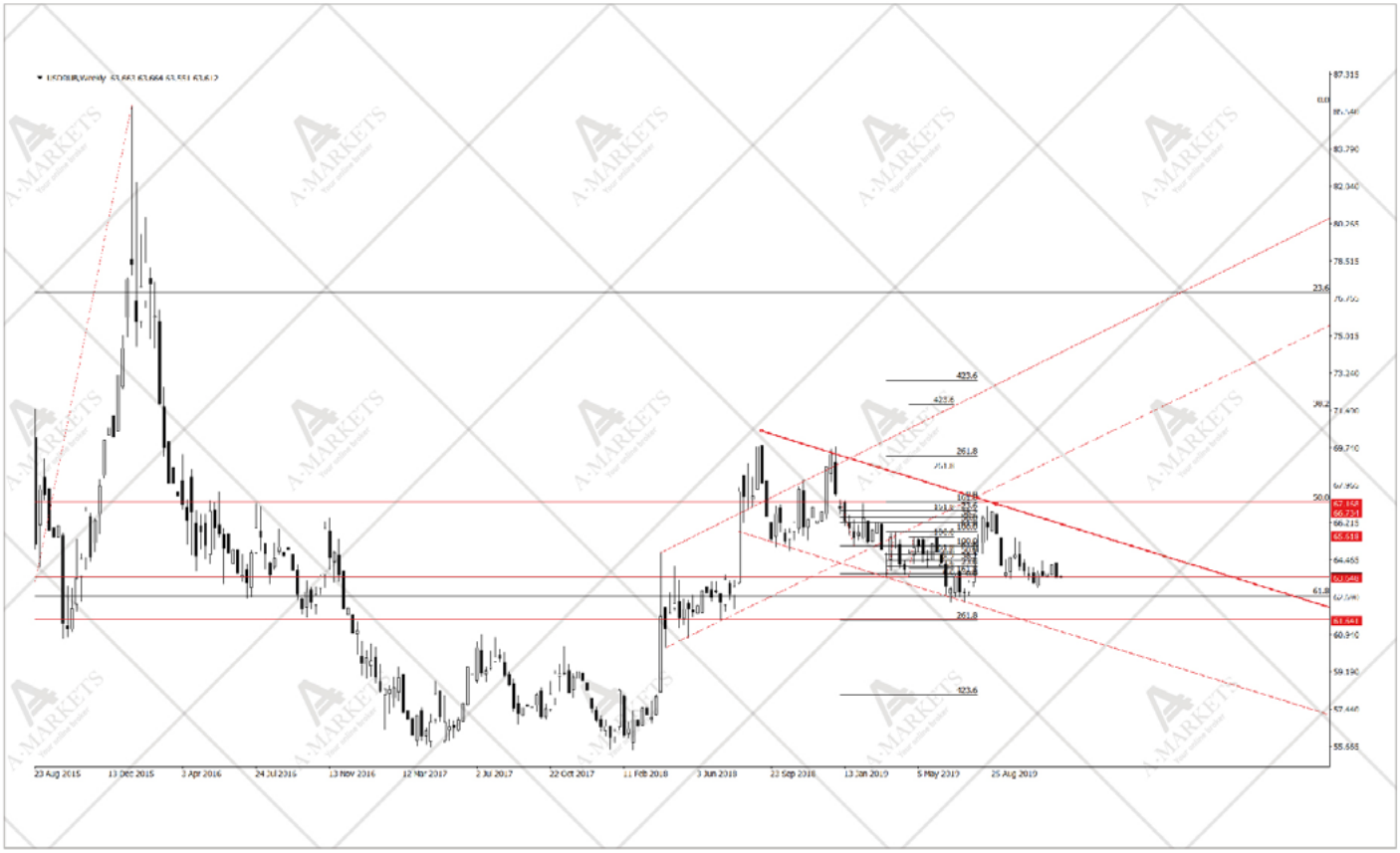
We buy XAG/USD at market targeting 19.7/20.5/22.8, stop-loss at 15.7.

As global central banks reversed their course in 2019, so did precious metal markets. Both gold and silver rallied impulsively this summer, and are now consolidating. The price activity, however, suggests that it is just a corrective move to an established upward trend. With falling global rates and looser monetary conditions, this asset class turns into a natural safe haven. As in the case of the pound, substantial amounts of money were taken out of this market over the past years. That money often went into fixed-income assets to benefit from QE programs.

By 2020, however, the picture is looking different. Bond yields have fallen to record lows. Buying at current levels would only make sense if you're either desperate or have to follow your investment mandate. Investment portfolios are overloaded with FI paper but are generally underinvested into precious metals. Out of the two main commodities here we favor silver. This market suffers from a chronic deficit which is only going to get worse over the next two years. Coupled with favorable speculative conditions, this creates excellent upside potential. We view $20.5 as the conservative target and do not rule out going as high as $23 per ounce.

RUB: Excellent carry with unusually low EM-risk.

We sell EUR/RUB, CAD/RUB, ZAR/RUB.



The Russian rouble has long been our favorite and we still see reasons to remain long. Foreign investors are actively buying into the OFZ market, which naturally creates demand for the local currency. Since the Central Bank of Russia is likely to continue its easing cycle for a while, the influx should go on for another 3-6 months. On top of that, the RUB has exhibited stable seasonality, which has been quite pronounced after the CBR adopted the free-floating regime.

The question for 2020 is what to finance the rouble longs with. Strategically, we find it reasonable to go short EUR, CAD, and ZAR, with equal weights. This basket allows maintaining higher nominal returns (specifically through negative rates in the Eurozone), while volatility is smoothed out by the Canadian dollar. And the South African rand is simply the weakest out of EM-currencies. It is a natural hedge for a rapid deterioration in the U.S.-China trade war. We estimate that the Russian currency is to appreciate by 4% against the basket, and the carry should run at around 4% per annum. USD/RUB, meanwhile, should be generally stable, with the downside less pronounced.