
Weekly Market Summary

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Buy or Sell the US Dollar?! Better Wait for this Afternoon's Payroll Release!

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Foreign exchange markets are well known for overshooting – both on the upside and downside. A currency that starts moving in a particular direction as economic fundamentals improve/deteriorate will often end up at a rate that cannot be justified by the data. This occurrence can easily be explained by the importance of technical, momentum and herd mentality trading. The latter refers to the tendency for individuals to mimic the actions (whether rational or irrational) of the larger trading community - either due to a lack of strong personal convictions on markets, the social pressure of conformity (rather than be branded as an outcast) or the common rationale that it is unlikely that such a large group of smart traders/hedge fund managers could be wrong - and usually leads to catastrophic financial events (take for example the bursting of the internet bubble in early 2000, where a 235% rally in US tech stocks between late 1998 and early 2000 was quickly followed by a 68% drop from the highs over the next 12 months, effectively wiping out the whole up move!).

So trying to make sense of every move in the FX market (as well as all other asset classes), or even better trying to define fair values/ranges for particular currency pairs (an exercise I personally enjoyed performing in my early years of trading before realizing the futility of concluded forecasts and moving to a more stable Sales position!) is akin to world leaders attempting to solve the root of the Middle East conflict!

In early April, I released a weekly piece entitled *“When Global Markets No Longer Obey Economic Common Sense !”* where I referred to the Shanghai so-called *“secret”* meeting, a side meeting of a core group consisting of US, Europe, Japan, China and the IMF that took place in late February and discussed ways to support China and its ailing currency by allowing the USD to weaken against its major peers (in other words if the yen, sterling and euro could get stronger against the greenback, that would be the same as making the yuan weaker and hence stabilizing the Chinese economy, but without the shock of Chinese devaluation). Suspicions that Finance Ministers had reached such agreement seem now almost confirmed by the dollar index's decline of more than 5.7% from its February-end highs. China's recent efforts/moves to boost the yuan's daily reference rate to its highest levels this year also backed the impression of a suspension of hostilities.

But whilst Fed officials and U.S. manufacturers had long worried that a too-strong dollar would threaten US exports and profits and lead to lower GDP growth (partly confirmed by the +0.5% anemic US Q1 GDP recent data release), the recent FX trend reversal - powered by gains for the Japanese Yen and Euro – will surely pose bigger risks to the struggling economies of Europe, and Japan. The euro, for example, pierced \$1.16 on Tuesday reaching its highest level since August 2015, whilst the yen breached 106 to the dollar - down from a high of 121.87 in late January 2016! Those are also the kinds of moves that would surely make central banks uncomfortable - especially when, like the European Central Bank and the Bank of Japan, they are already

struggling to revive growth and avert deflation. Australia's surprise decision last Tuesday to cut interest rates (the RBA cash rate target was unexpectedly dropped to 1.75% from 2.00%. The RBA statement of monetary policy left the door open for further rate cuts) - driving its currency lower against all 31 of its major trading peers (AUD/USD down sharply from 0.7800 to 0.73600) - is a sign that skirmishes might soon be breaking out again.

For now the US remains the only economy that can absorb currency strength. As Morgan Stanley's research team puts it, the resilience of its domestic economy is rooted in an internal rebalancing that most of the rest of the world has not yet completed. US dollar strength has been a reflection of the relative improvement in the US compared to the rest of the world, as well as a conduit for the US assisting the rest of the world in its rebalancing by importing global deflationary pressures. Nonetheless, if the Chinese yuan/renminbi strengthens along with the dollar and against other currencies, disinflationary risks could intensify. This would in turn raise real rates, hurt domestic asset prices and create the risk of capital outflows again. Whether Chinese and world policymakers are now better positioned to work closely together and deliver a comprehensive strategy for addressing such concerns surely is the million dollar question (the unfortunate alternative would be a replay of the late January/early February market meltdown movie). Ominously, the U.S. Treasury recently produced a new "monitoring list" of activity in the foreign-exchange market as part of the Trade Facilitation and Trade Enforcement Act of 2015 (there are 3 criteria to qualify for special attention: A "significant" trade surpluses with the U.S., a "material" current account surplus and "persistent one-sided intervention in the foreign exchange market"). While five countries made the list by triggering two alarms -- China, Japan, Korea, Taiwan, and Germany -- the Treasury said no one "currently meets all three criteria." The report did, however, wag its finger at the currency policies of the first four countries.

Last, it does not help the US dollar that traders have been scaling back their expectations for whether the Federal Reserve will raise interest rates in June, or indeed later in the year. The futures market currently anticipates just a 5% chance of a move next month (June 15th meeting), down from 40% a month ago. Economists have lately extended their deviation from the Federal Reserve in forecasting the path of US policy tightening as they have lowered predictions for when and how high the US central bank will be able to lift interest rates. Analysts responding to a recent Bloomberg survey cut their expectations for the Fed's peak policy rate at the end of this tightening cycle, known as the terminal rate, to a median of 2.5%, from 2.875% in February and 3.375%. That compares with the Fed's median forecast of a 3.25% terminal rate, which it revised in March from 3.5 % in December and 3.75% in June. Futures traders have also pared bets on the Fed's policy path and now assign coin-flip odds to a rate increase in 2016, down from a 95% probability assigned at the start of the year (by contrast, Fed officials in March lowered their forecasts for 2016 increases to two from four). That is totally at odds with recent speeches made by four regional Federal Reserve presidents (St. Louis chief James Bullard, San Francisco's John Williams, Robert Kaplan of Dallas and Atlanta's Dennis Lockhart) who are very positive on US fundamentals and remain open to considering 2-3 rate hikes for 2016, with the first one coming as early as the June 14-15 FOMC meeting. *"My attitude about June is that it is a live meeting, in which we will have plenty of new data compared to March,"* Bullard, a FOMC voter this year, told reporters in Santa Barbara yesterday. *"Our options are open at this point."*

Talking about new and sensitive data, market focus is fast shifting to this afternoon US April job release (3:30 pm Bahrain time). As always, welcome to random number generator, also known as US Non-Farm payrolls: Bloomberg's consensus is for a 200,000 increase in jobs on the month (although the whisper number is possibly lower at 175,000 following the weaker-than-expected US ADP Employment release on Wednesday), a slightly lower/improved unemployment rate (4.9% versus 5.0% in March), and a small increase in the average

workweek (34.5 versus 34.4 hours in March) and wages component (+2.4% YoY expected for April versus +2.3% yearly increase in March).

**Non-farm Payroll (NFP) employment was later released: It increased by 160k in April, less than the 200k expected by consensus forecasts. However, despite the shortfall in the headline number and lower revisions to the past two months (-19k), the job report was not a complete bust. Payrolls are still rising above the level that would see the unemployment tick up (Fed estimates put it below 140k per month). Despite the participation rate falling two-ticks, there was a large drop in the household survey of employment that allowed the unemployment rate to remain at 5.0%. That said average hourly earnings showed signs of life again in April, gaining 0.3% and taking the annual rate to 2.5%, one-tick above expectations but still not higher than the levels reached at the end of last year. Also the average workweek expanded by 0.1, rising to 34.5 hours. All told, the report should be slightly negative for the US dollar and positive for fixed income (US Treasuries), given that it is likely to confirm that the Fed won't hike in June but rather wait till the September 21st FOMC meeting (GS view after the data release). We caution against such rushed conclusions, noting that there is plenty more data to come between now and June 15th (including the May payroll data that will be released on June 3rd).*

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