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| **ENGLISH** | **TRANSLATION** |
| **Headline**: Dollar bulls waiting |  |
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| **Intro**: September’s FOMC policy statement saw the Fed recognising that its monetary policy is global policy, and particularly so for emerging markets. For Q4, we look for a thaw in some emerging market currencies, taking a conservative approach and finding value in Mexico. |  |
| **Pull Quote:** “We will shine the spotlight on the Mexican peso and Polish zloty as our choices for a comeback in Q4.” |  |
| The extremely dovish September Federal Open Market Committee meeting saw chair Janet Yellen’s Federal Reserve acceding that Fed policy is global – and particularly emerging market – monetary policy, not just US monetary policy. |  |
| Extreme market volatility in late August and developments in commodities and Chinese exchange rate policy distracted and alarmed the Fed sufficiently to ignore very strong US activity and employment data and tilt their preference to sitting on their hands for just a little longer. That most likely means a move to hike rates at the mid-December FOMC meeting, by which we should have a sense of whether the Fed is risking getting dangerously behind the curve on starting its withdrawal of accommodation or will it sit on its hands until well into 2016. |  |
| The further delay to the Fed’s first rate hike together with the potential for more QE from the ECB could see a significant bounce in emerging market currency prospects during Q4 and delay the return of the USD bull market, though we could see a quarter in which the USD starts weak but finishes strong. |  |
| There is a significant risk in Q4 that we see another disorderly move in risk sentiment whose result would be a spike higher in the Japanese yen in particular, if not also the euro, as was seen in the August market meltdown. |  |
| Any marked appreciation in the euro or the yen from here, however, will likely be met with new easing measures from the European Central Bank and the Bank of Japan, eventually helping to turn the USD back to the strong side and possibly also bringing further relief to emerging markets. |  |
| The wildcard for Q4 could be the pace that China allows its currency to devalue after fighting pressure on the currency to weaken with extensive reserves after its August devaluation and exchange rate regime change to a managed float (with double emphasis so far on the “managed”.) |  |
| **Spotlight on emerging market currencies** |  |
| Emerging market currencies were under massive further strain in Q3 in an extension of the move lower that started almost perfectly in synch with the end of the Fed’s tapering process in late 2014 until the lead-up to the September FOMC meeting. |  |
| In Q3, the renewed commodities meltdown and then the China devaluation and global market turmoil in late August provided a further pummelling of already down-and-out exchange rates. The emerging market currencies with the worst structural setups – including the likes of commodity-dependent Brazil and Russia, as well as Turkey and South Africa – may have become so cheap after this latest bout of selling that it will only take a modest return of market risk willingness to see a significant bounce in their prospects in Q4, even as significant questions remain on whether (carry-adjusted) lows are in for the longer haul as these countries continue to face steep structural challenges from USD-denominated debt. |  |
| But rather than focus on the higher beta/higher risk currencies to pick interesting emerging prospects for Q4, we would prefer a conservative approach of finding the emerging market currencies that may have been excessively beat down by the latest across the board pressure and where the structural situation looks healthier. As such, we will shine the spotlight on the Mexican peso and Polish zloty as our choices for a comeback in Q4. |  |
| *MXN*: The Mexican peso is the baby that has been thrown out with the bathwater among EM currencies. As it is one of the most liquid EM currencies, it is likely often traded as an EM proxy has been excessively beaten down among its EM peers, and is primed for #SaxoStrats. |  |
| If we see any comeback in EM in Q4, MXN will likely participate strongly. Among the positives for Mexico is the structural situation, as the current account has not deteriorated beyond a modest deficit despite the oil price drop. As well, 67% of Mexican exports are into the strengthening US economy, Mexican real rates are edging into positive territory as inflation eases despite the weak currency of late, and the central bank may eventually hike rates in line with the Fed to support further MXN strength. |  |
| *PLN*: The last few years have shown us that the link between CEE currency performance and general EM performance is far weaker than it used to be, as the world sees the “big three” among the CEE currencies – PLN, CZK and HUF – to one degree or another as a convergence trade with the euro. |  |
| Poland’s economic fundamentals look solid heading into Q4, the country maintains a large and unthreatened pile of reserves, and Poland offers positive real rates with a 1.50% central bank rate and slightly negative inflation. EURPLN could return back to the 4.00 level over the next few months as the euro carry trade makes a comeback after a possible hiccup or two. |  |
| The one risk is a political one in Poland, as a possible new law-and-justice government after the October 25 general election could force Polish banks to take a loss on remaining CHF-denominated mortgages, though this should prove a one-off, modest adjustment. |  |
| **EM currencies with a twist: trading EM against what?** |  |
| Most trade flows in MXN are against the USD and most PLN trading is against the euro, so short USDMXN and short EURPLN are certainly one way to look for MXN and PLN appreciation going forward. However, there are two possible twists we can add to any long EM trades by pairing both of these trades against the euro and the Chinese offshore yuan (CNH)… |  |
| First and foremost, an environment of strengthening emerging markets is likely also a positive environment for carry trades, with the euro in the crosshairs if risk appetite makes a comeback in Q4 (as we have the argument that the Fed will remain extremely cautious in withdrawing accommodation, while the ECB will stay the course or even signal more easing if inflation doesn’t pick up soon). |  |
| As well, while China has mobilised significant firepower to counter a rapid weakening of the yuan in the wake of its steep devaluation on August 11. That and the move to a theoretical managed float regime points to a weaker currency that should see China’s currency mean reverting with its EM peers to a significant degree in coming quarters. |  |
| So pairing long EM trades against the euro and especially the offshore yuan (CNH) are one way to trade an emerging market resurgence, though it could be one of relatively short duration. |  |
| G-10 rundown for Q3 TABLE 1 |  |

TABLE 1:

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| Currency | Q3 outlook |
| USD | USD bulls will have to wait – though strong US data could suggest the Fed risks getting behind the curve, so a mid-quarter revival in the USD’s prospects is possible. |
| EUR | Should only thrive if risk sentiment is weak – look for aggressively dovish ECB on any strong resurgence in the euro and traders may look to trade accordingly (fading strength) |
| JPY | Could the Bank of Japan return to the QE trough once again on admission that inflation forecasts have been hopelessly optimistic and low commodities ease the risks of a weaker JPY on wages? |
| GBP | Defaulting to a “low beta version of the USD” outlook – more downside than upside potential in GBPUSD as the quarter wears on. |
| CHF | The Q3 experience proved that CHF is no longer a safe haven – expecting further weakness against both EUR and eventually against the USD. |
| AUD | Exposure to China likely to remain a focus, so expect a relatively low ceiling for any rally attempts. |
| CAD | Canada will hope that the US economic resurgence is sufficiently strong to keep Canada’s recession risk at bay. Looking for outperformance among the commodity dollars. |
| NZD | More downside risks ahead as rates have pushed to new lows for the cycle and the previous years of NZD strength have only been partially unwound. |
| SEK | Double top in EURSEK as SEK made a comeback from the lows, but any further SEK strengthening will be leaned on by the Riksbank, so no fireworks expected. |
| NOK | Has been excessively beaten down in places – especially against commodity currency peers, but comeback process could prove slow as oil is unlikely to launch a major new rally unless there is an unanticipated geopolitical disruption. |