The dollar **IS** the story; Gold confounds, A Brexit rabbit hole; EUR punished

March 28, 2019

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The dollar IS the story

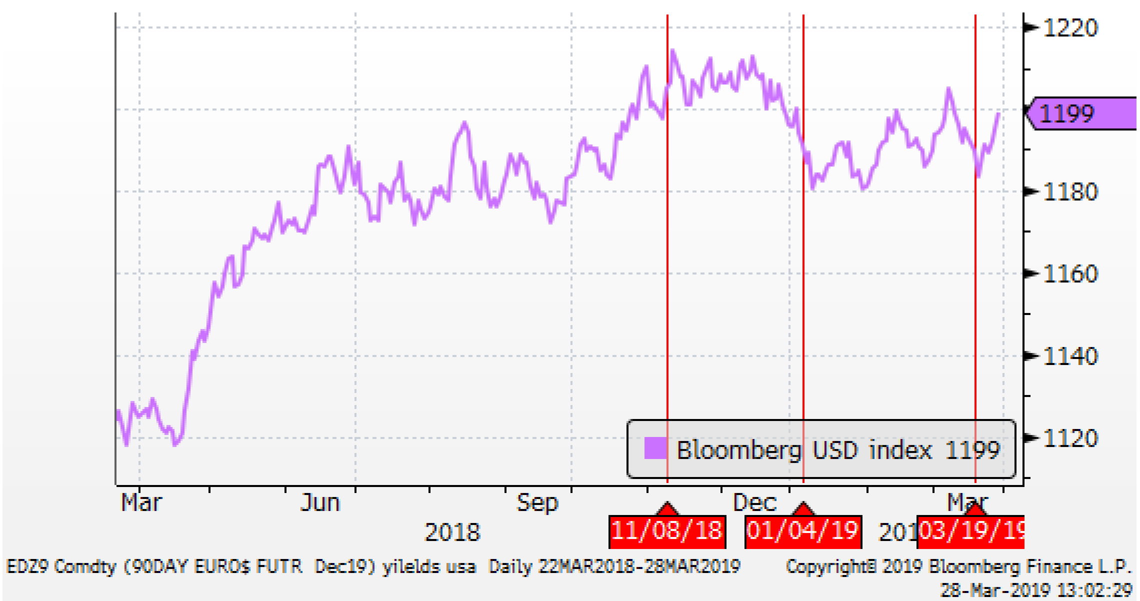
The story in global financial markets is dollar strength. We can come up with rationalisations, but the point is that dollar strength is driving developments in other markets. Dollar strength appears to be contributing to lower US and global bond yields, curve flattening, topping in global equities and commodity prices, and some recent widening in credit spreads.

Whereas we often turn to developments in global rates, equities and commodities to infer some direction in FX markets, in recent weeks the dollar appears to be in the driver's seat.

The fact that the dollar has strengthened despite the dovish turn at the Fed this year and the significant fall in US rates and bond yields has confounded many analysts.

US yields fall significant since November, and abruptly in the last two weeks

However, the USD response to lower yields is modest since Nov, and contrary to lower yields in recent weeks



Of course, it can be said that while the Fed has made a dovish turn, so have many other central banks, and this is weakening their currencies and supporting the USD. And this is true to a significant extent.

The broad fall in global yields is indicative of a weaker global economic outlook, and this weak global outlook has limited capital inflows to assets outside of the US, both developed and emerging markets.

EUR punished for negative yields

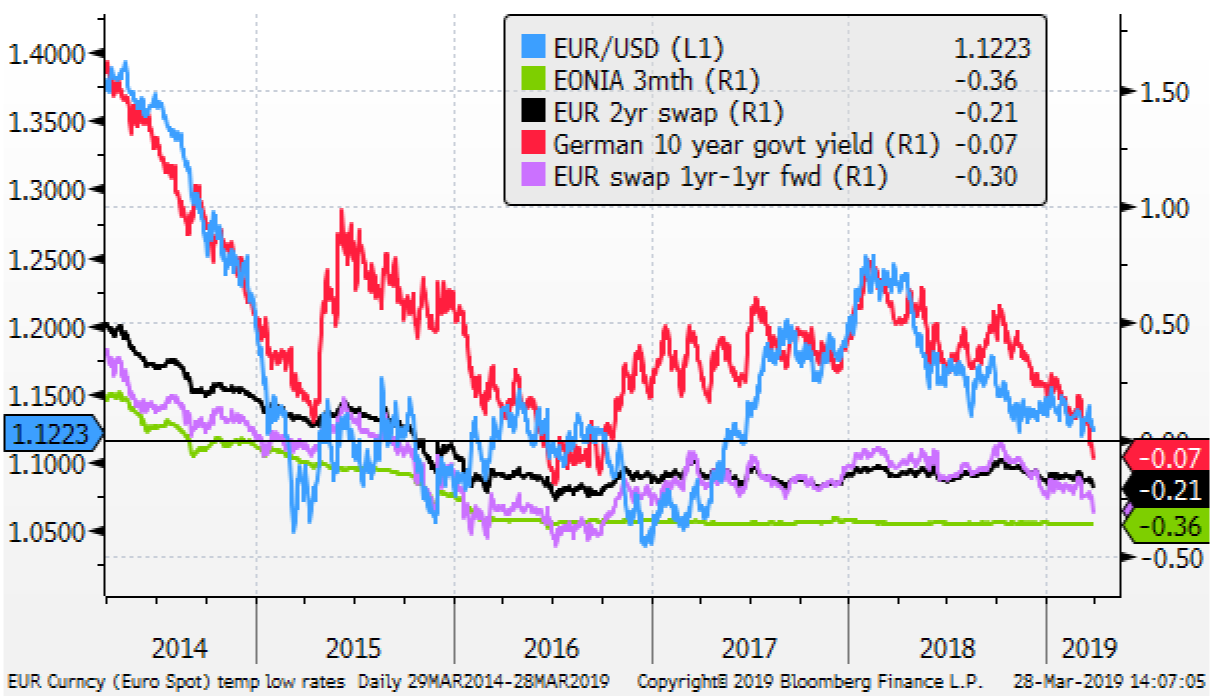
The EUR performance is particularly weak considering the significant narrowing in its yield disadvantage over recent months, as US yields have fallen much more than in the Eurozone. And there has been little obvious relative underperformance of Eurozone risk metrics; including credit spreads and equities, that might account for a weaker EUR.

It appears that after spending much of 2017, into Q1 2018, hardly caring about the negative Eurozone rates, the market is punishing the EUR for retreating into negative yields across the curve. The ECB has eased its policy guidance, and negative interest rates appear now more protracted.

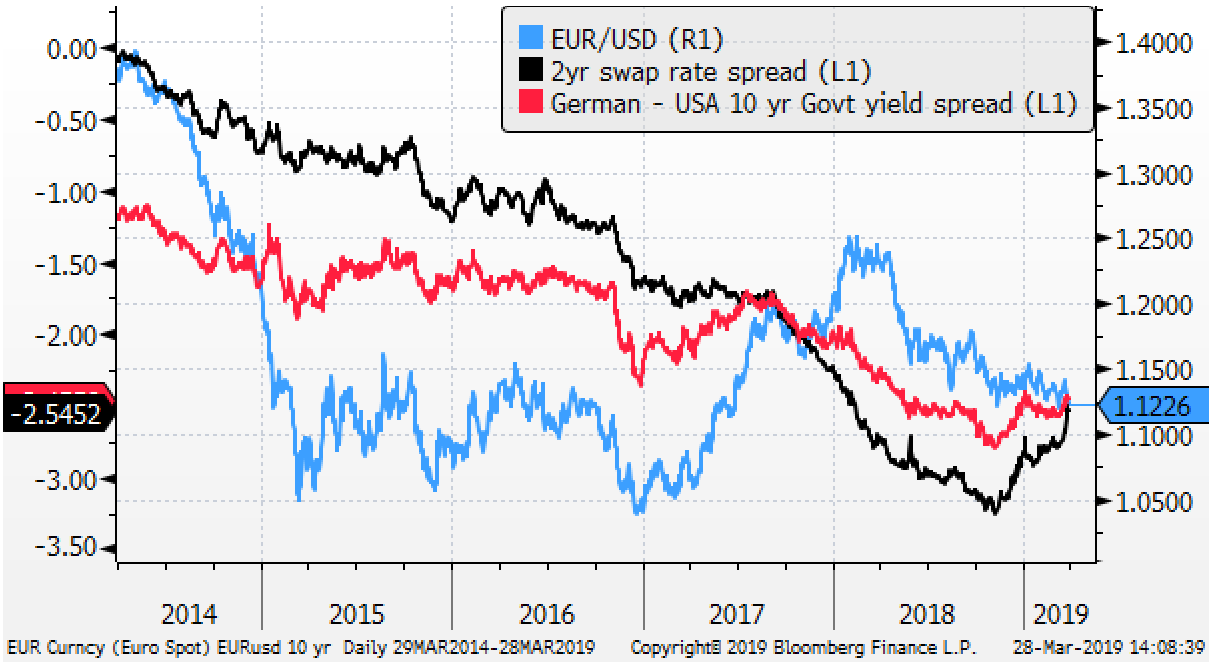
The ECB appears to be considering a tiered rate structure that might help relieve the strain on bank profitability from a negative rate and flat curve structure. While at the margin this may help bank equity prices, it also suggests that the ECB expects rates to stay low and negative for a long time. Therefore, perhaps contributing to a weaker outlook for the EUR.

It appears that the EUR, over recent months, has become more responsive to its own yields than yield spreads to other currencies.

EUR softens in line with its own retreat further into negative yields



EUR fails to recover with a rise in relative yields (albeit still wide and negative)



The EUR has unwound much of its strength in 2017/2018 in a period where the USD seemed surprisingly weak. A time when capital was seeking opportunity in European and global asset markets in the context of a synchronised global recovery. In 2017/2018, the market appeared to be unwinding EUR hedges taken during the tail end of the Eurozone crisis and moves towards negative rate QE policy in 2014/2016.

The ECB has emerged from adding to QE policy this year, but global economic growth momentum has fallen significantly, European equities are not attracting much inflow, and investors may again be increasing EUR hedges, worrying about protracted negative rate policy. While interest rate spreads have narrowed, there is still a significant yield pick-up from increasing EUR hedges or using EUR as a funding currency for carry trades.

It is not exactly clear what will arrest the EUR slide at this stage. It is possible that a US-China trade deal, Chinese policy stimulus, an easing in Brexit uncertainty, and global policy easing lift the European economy and trigger a EUR rebound. However, the market may need to see a significant and sustained rebound, which could take some time to develop.

EUR down-trend since early-2018; it has broken back into the 1.05/1.15 range it traded in during 2014/15. It's conceivable that it continues to drift lower for some time

Chasing Brexit down a rabbit hole

Brexit developments are churning rapidly as deadlines force the UK parliament to fix its deep divisions. It remains difficult to chase this rabbit down its burrow and figure out which tunnel it comes out. The failure of parliament, with almost a free vote, to find a majority for any of a range of alternatives to PM May's deal on Wednesday made it harder to see a path to solving the riddle.

May is still pushing for her deal, offering to resign soon after if it is passed. This may help bring some Eurosceptics in her party to fall behind it. The GBP appears to like any deal at this stage, even if May's deal gets up, and Eurosceptics take control of the Tory party and the trade negotiations that would then be required in the deal's transition period.

However, upside for the GBP would be limited by the prospect of lengthy contentious trade negotiations that would potentially further damage economic confidence and ultimately result in a deeper fall in GBP.

But if the Eurosceptics take control of the Tory party, Europhiles inside the Tory party might consider joining a no-confidence motion with the Labour Party and bring down their own government to force fresh elections.

PM May is thought to be considering to split her deal into two parts, and put only the divorce deal to a vote on Friday. The hope appears to be that MPs might vote for it just to allow the EU to agree to further extending the deadline on Brexit from 12 April to 22 May, allowing it more time to agree on a plan on trade relations. This might help GBP at the margin, but it does little to resolve uncertainty, so gains would be muted.

Further debate and another vote on a narrower set of alternatives to May's deal appears to be set for Monday. This perhaps raises more hope for the GBP. A deal involving a customs union, endorsed by the UK business sector, was close to a majority in the votes on Wednesday. If parliament can achieve a majority on Monday, it may seem to boost the chances of this kind of deal winning a meaningful vote and becoming policy, boosting then GBP.

However, the government is still run by the Conservatives and support for such a deal comes mainly from the Labour Party, so the rabbit would remain deep in the labyrinth of tunnels.

There was also significant, perhaps more than expected, support for putting any deal back to the people in a referendum, and this is now Labour Party policy.

Ultimately, it appears that an election with a possible referendum to follow would seem the best way forward to solving the riddle. But the Tories have the most to lose from an election, and thus are trying to avoid one.

The Tory Party is the most divided over Brexit, and its hardliners are arguably moving against the tide of public opinion. The nation remains divided, but many voters might opt to now Remain in light of the difficulties with Brexit that have been revealed in recent years.

As such, the path towards an election is not clear and rocky. It may require more divisive pressure up against the cliff edge to force one to happen. A very acrimonious split in the Tory Party might be required. Some splitting on both sides of politics has occurred already with 11 MPs resigning from both the Labour and Tory Parties to form the Independent Group.

The GBP remains beholden to the Brexit issue, and no one appears to have a good handle on the what path it is taking and how long it takes for a viable solution to emerge.

The GBP slid last year on the Ireland border problem; it has recovered this year on signs that parliament may avoid a no-deal cliff-edge; it is whip-sawing on hyper-political activity as the cliff-edge remains and no deal has been agreed

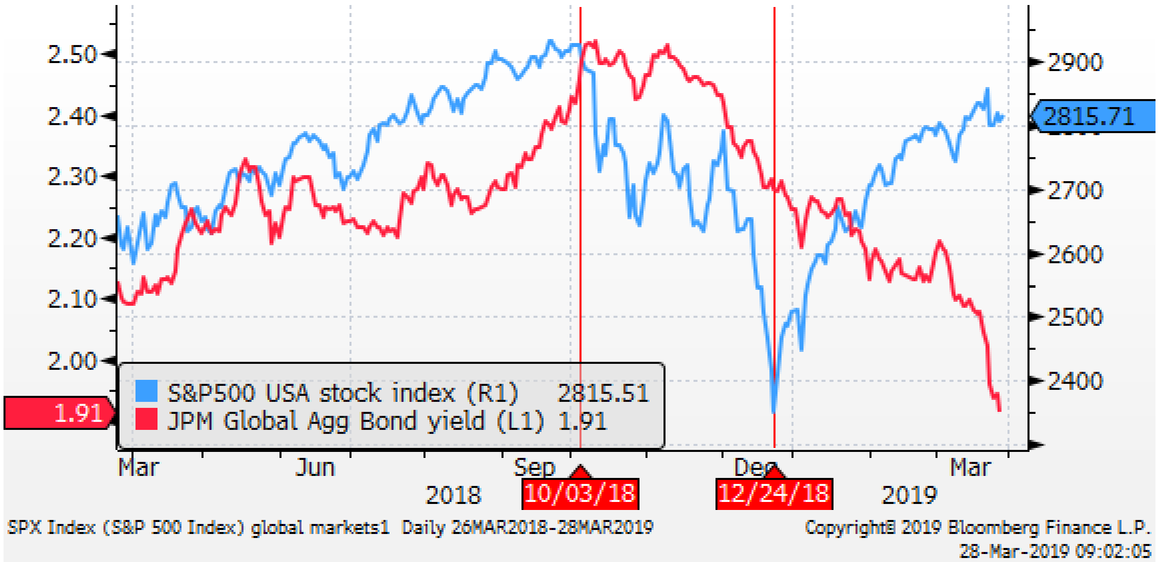
Gold confounds

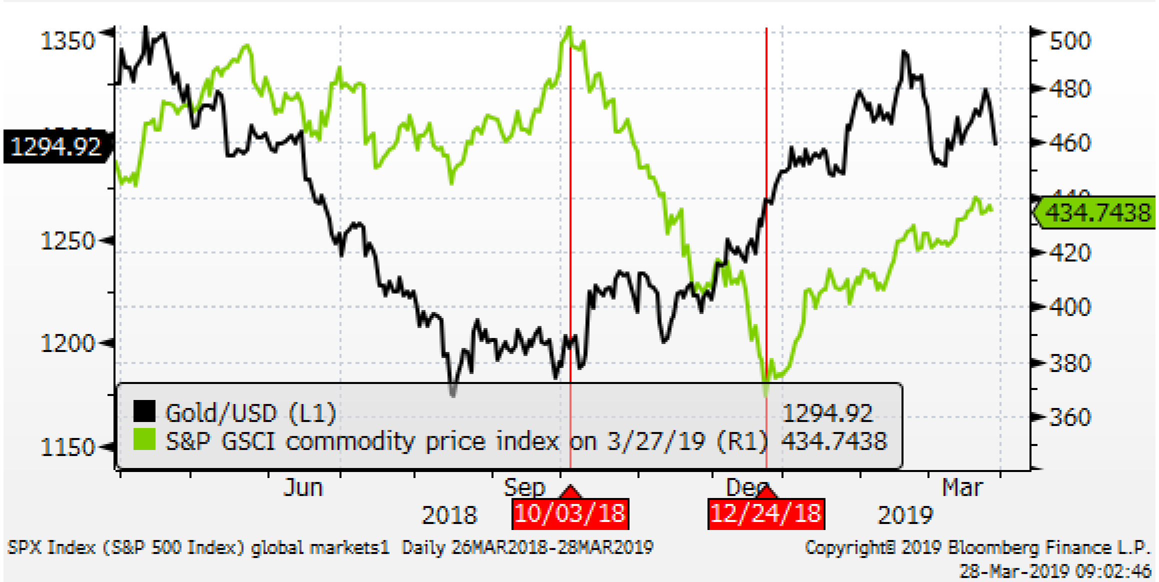
Gold has confounded me; I had thought lower US bond yields, weak pockets in emerging markets, and heightened uncertainty over a range of factors, would boost gold. Gold walked slowly up the stairs and has slumped in recent days.

The dollar is finding broad strength, and this may be weighing on gold, but its sharp fall is difficult to explain on fundamentals. The technicals are fighting the fundamentals and winning. I can only speculate where the selling may be coming from; perhaps central banks have stepped back from buying, perhaps troubled EM governments need hard currency and are selling gold reserves. Speculators are being forced by the price action to back out of long gold positions.

Gold chart – support around 1283; a break here might be seen as a head and shoulders top

Gold had risen since October last year, first on deep falls in global equities, and this year on falling global bond yields. However, it has stalled at previous highs around 1350





Bitcoin at an interesting juncture

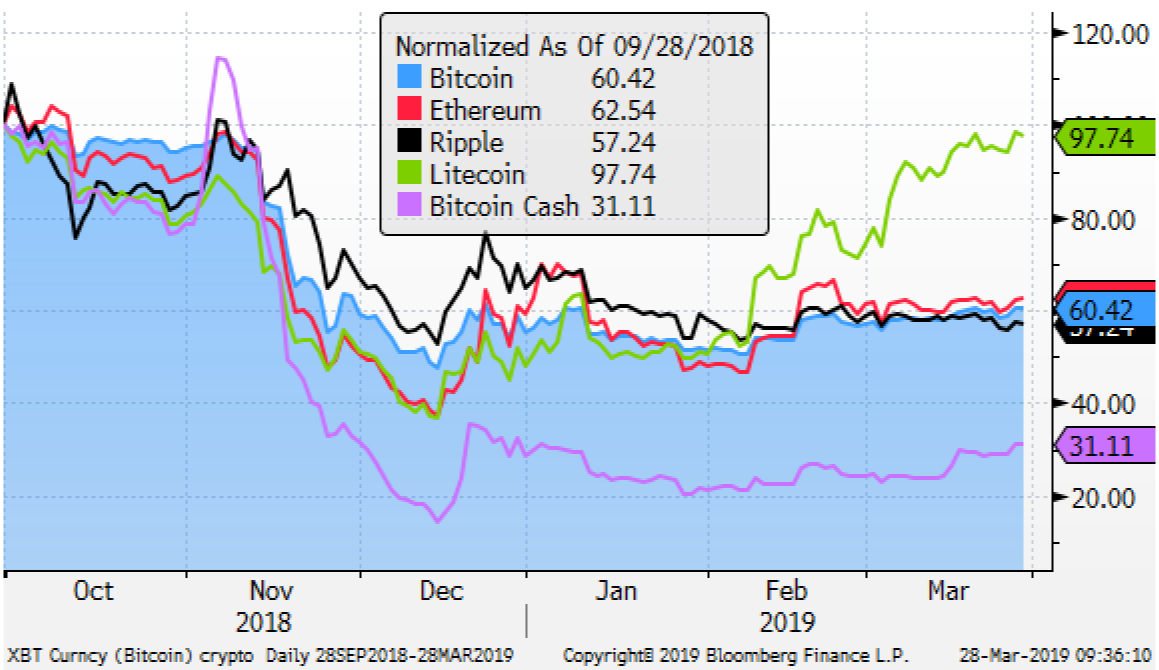
We once touted Bitcoin as potentially taking on the role of a safe haven alternative form of currency. However, it is far from clear that it has done so, and confidence in crypto-currencies have taken a massive beating since coming off a speculative bubble top in 2017.

Indeed my confidence in the bitcoin concept has been severely dented, and perhaps there are key fundamental problems associated with the cost of mining and verifying transactions. Its price may be highly manipulated by a relatively small number of large holders. Institutional investor interest may take longer to see the appeal. But I continue to watch its development and price action.

It has not clearly broken out of a downtrend since its peak in 2017. But its price has been creeping up this year, and it is testing highs in Dec/Jan. This is an interesting juncture. It could be bumping up against resistance before another severe price crash (as was seen in November last year). Or it could generate calls that the bottom is in if it can build upward momentum through 4110/4234.

Bitcoin creeping up to previous highs

Crypto performance over six months



Bitcoin lifetime in log scale – born out the GFC, its price has grown from next to nothing to a peak of 19,511, now around 4000 USD per Bitcoin. Its current correction has been underway for about 16 months; similar in length to that experienced in between 2013 and 2015. There are some technical analyst calls for it to fall back to around 1000, the previous long term peak in 2013.

Bitcoin lifetime in standard scale – it looks like a classic bubble that could eventually collapse to zero. A fall to around 1000 would certainly seem like quite a failure

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