FX Weekly
Foreign Exchange Strategy

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Central banks to (temporarily) distract markets from politics

Last week was a flat week for the USD, but a volatile one for BRL, GBP and MXN due to elections and other political factors. Geopolitical risk seems to be the never-ending theme of 2017, but this week monetary policy brings a bit of relief from the theme of politics outweighing economics. The Fed is expected to tighten on Wednesday, while the BoE (Thursday), SNB (Thursday) and the BoJ (Friday) are expected to stand pat. Markets are so much less long of USD's heading into this hike compared to other hikes that the USD may experience a minor 'relief rally' if it meets expectations.

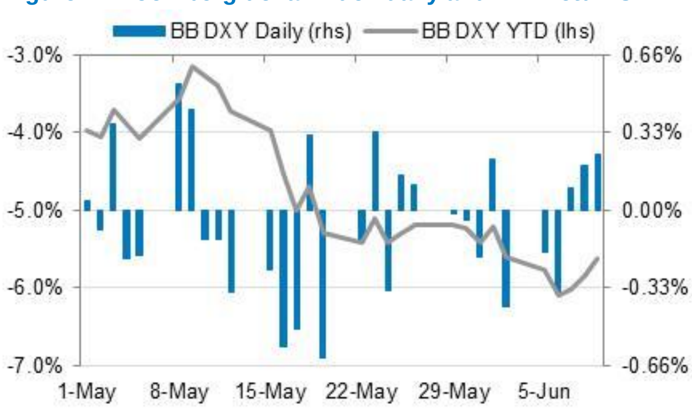
Brief summary of last week

Global political uncertainty and the approach of this week's FOMC caused a minor spell of risk aversion last week. The MSCI World equity index fell by 0.6%, which reduced its year-to-date return to 9.8%. The **CRB commodity index fell by 0.7% last week,** which brought its YTD return down to -7.6%. Oil had a particularly bad week; **West Texas Intermediate fell by 3.8%,** which brought its YTD return down to -5.7% YTD. There was a divergence in the movement of interest rates. The EUR-denominated 2Y swap rate fell by 2bps in the wake of the ECB meeting while the USD-denominated 2Y swap rate rose by 3bps in anticipation of this week's FOMC.

In FX, Bloomberg's liquidity-weighted **USD index (BBDXY) was flat last week,** so its YTD return remained at -5.6%, as shown in **Figure 1**. The lack of USD movement belies the variation across the spectrum of currencies, which was fairly dramatic, as shown in **Figure 2**. Among **developed currencies**, the **GBP was the worst performer** with a -1.1% return week-on-week return in the wake of the election (see page 3 for more). **AUD was the best performing G10 currency** with a 1.1% return due primarily to short covering.

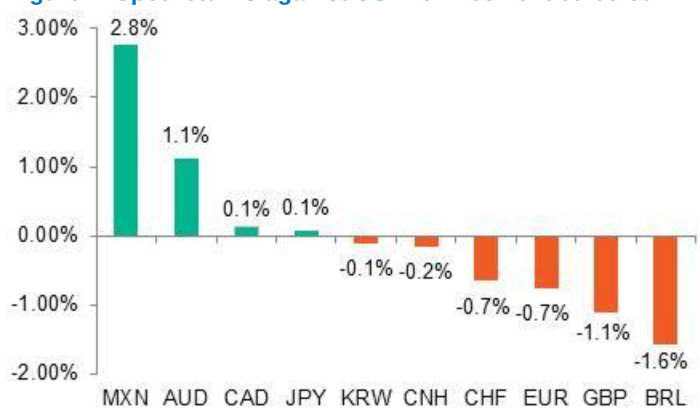
Among local market currencies, **BRL was the worst performer** due to political uncertainty (although that **move is likely to reverse this week because the Supreme Court ruled in favor of President Temer** in a case that threatened to remove him). **MXN had a 2.8% positive return** after the ruling PRI party survived an election against a far-left challenger to the governor of the country's most populous state.

Figure 1. Bloomberg dollar index daily and YTD returns



Sources: Bloomberg, BMO FX Strategy

Figure 2. Spot returns against USD for week ended 09-Jun



Sources: Bloomberg, BMO FX Strategy

FX market positioning

According to the most recent Commitment of Traders report by the CFTC (for the close of Tuesday 06-June), the biggest currency position in notional terms was the long side of EUR, which was worth USD 9.1bn. It is normal for EUR to have the most activity and biggest positions. We like to scale positions by comparing each currency side to its

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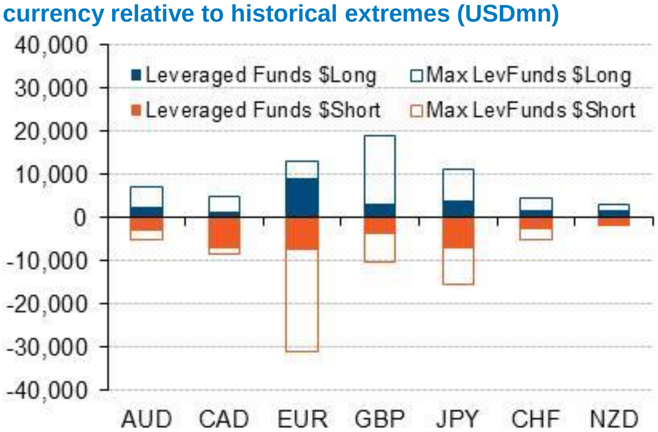
respective 3Y maximum. By this metric, **this week's EUR long stood at 70% of its 3Y max**. However, that is down slightly from the prior week's 77%. As shown in **Figure 3**, other currency sides can also be compared to their 3Y extremes. Although the **short-CAD side** (worth USD 7.7bn) isn't as big as the long-EUR side in USD notional terms, it is bigger **in percent-of-max terms at 87%**. However, **the biggest currency side as a share of its 3Y max is short-NZD at 89%**. Other noteworthy currency sides are **short-AUD (60%), long-NZD (54%) and short-CHF (52%).** Every other individual currency side is smaller than 50% of its 3Y extreme.

To gauge broad positioning in the USD, we look at the aggregate of {AUD,EUR,CAD,CHF,GBP,JPY,NZD}. For that aggregate, the **long-USD side was worth USD 33.7bn, which is 56% of the 3Y max.** That puts long-USD in 5th place on the list of noteworthy positions. The aggregate short-USD position is worth 23.3bn, which is 54% of its 3Y max (7th place on the list of biggest positions).

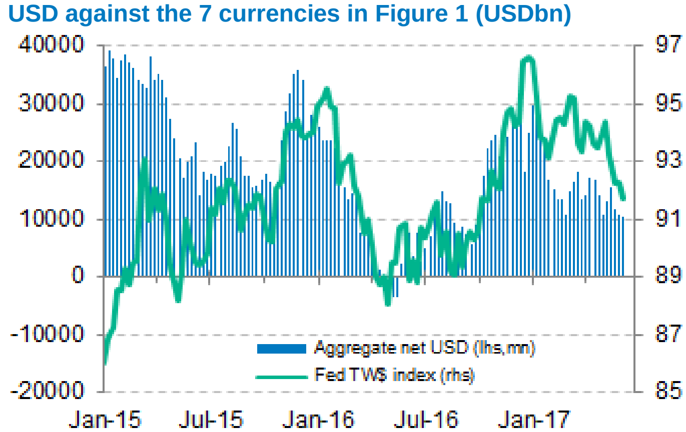
The net position in the USD against the aggregate was long-USD by 10.4bn—down 0.3bn from the previous week. That puts the **aggregate net USD long** at **about 35% of what it was at the start of 2017**, as shown in **Figure 4**. **Leveraged funds' open interest** (sum of shorts and longs) in the aforementioned currency futures stood at 57.0bn, which was down 3.7bn from the previous week. Leveraged funds' FX open interest registered at **88% of its 3Y average**. FX open interest for all categories of CME participants (including asset managers, corporate hedgers and dealers) stood at 112.9bn (100% of its 3Y average).

Figure 3. IMM leveraged funds' positions by side and currency relative to historical extremes (USDmn)



Sources: CFTC, Bloomberg, BMO FX Strategy

Figure 4. IMM leveraged funds' aggregate net position in USD against the 7 currencies in Figure 1 (USDbn)



Sources: CFTC, Bloomberg, BMO FX Strategy

FOMC, finally

Although the outcome is likely to be anticlimactic, the Fed meeting on Wednesday should bring closure to a risk factor that has been circled on calendars for months. **With this being the 4th hike of the tightening cycle, it carries no shock value and very little signal value**. These are the main channels whereby rate moves impact FX.

If Wednesday's hike turns out like March's, equities and bonds will rally and the USD will not, despite higher rates. Of course it could turn out different this time--especially if the hike is accompanied by hawkish signals from the Statement of Economic Projections (SOEP) and Chair Yellen's press conference. **The surprising weakness of the USD and a flattening yield curve could, in theory, spur the FOMC to make this a hawkish hike, but we doubt it**. It would be so out of character for a Yellen FOMC that we can scarcely imagine it.

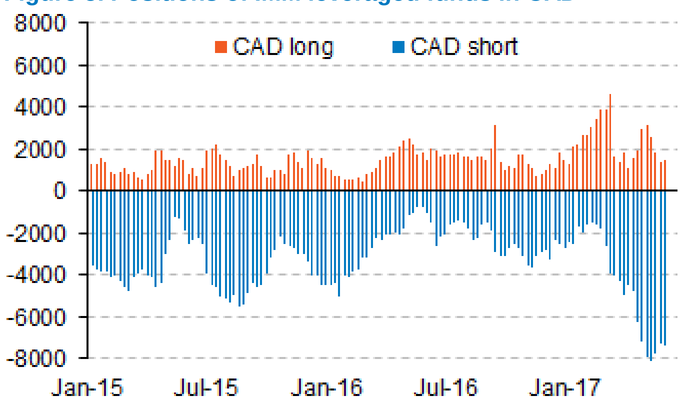
We expect minimal changes in the SOEP and in the tone of communications, with a **continued emphasis on the Fed being data dependent in the press conference** despite this being the Fed's third straight quarterly hike. For more on tone expectation, see the comments from Michael Gregory of our economics team on page 2 of 09Jun2017 Focus.

The past two Fed hikes were pretty much fully expected by the FX market. December's hike was accompanied by massive USD longs and the two-week result was a minor rally (that we'd attribute more to optimism about tax reform than to the rate hike). March's hike saw a much smaller long-USD position held by the market and no USD rally whatsoever. **It is worth noting that the scariest risk scenario for this meeting is the Fed not hiking. If that were to occur, the Bloomberg USD index would probably lose 2-3% within 48 hours.** Because a USD selloff has become such a risk, perhaps the USD could see a relief rally of sorts and gain something like 0.5% on a neutral hike and 1.0% on a hawkish hike. We think a dovish hike is expected and would translate to an unchanged USD index.

Stretched short-CAD positioning keeping USDCAD from catching up to oil

Canada's economic data continues to impress. Last week's positive data shock was the May Labour Force Survey, which showed continued strong growth in full-time jobs. While economic data is strong, positioning data suggests that IMM leveraged funds and other foreign speculators are once again trapped long and wrong in USDCAD. Although it has moderated slightly, IMM leveraged funds' short-CAD side remains near limit levels, as shown in **Figure 5**. We presume that limit long-USDCAD positioning has kept FX investors from buying the pair on the collapse in oil prices. **The WCS blend of oil dropped 5.2% last week but USDCAD gained anyway.**

Figure 5. Positions of IMM leveraged funds in CAD



Sources: CFTC, Bloomberg, BMO FX Strategy

Figure 6. USDCAD and the CRB commodity price index

Sources: Bloomberg, BMO FX Strategy

Our outlook for this week is for a slow grind up to about 1.3600 on the back of the Fed hike and oil remaining below $50. We would be buyers below 1.3450, but would be quick to take profit above 1.3600. Canada has a light week in terms of data and events, so the 'big dollar' should be the driver for USDCAD.

GBP – we look for the 1.2600/1.2950 range in GBPUSD to hold for now

The likely CON/DUP coalition is the least bad result for the GBP for the time being, though the ability of the coalition to endure over the medium-term looks questionable. The **biggest downside political risk factor for the GBP in the immediate future is a potential swing towards a Labour minority government/Labour-led coalition**, but it may take until after the Queen's Speech (June 19) for this factor to send the GBP sharply lower. However, **we would certainly not regard a breakdown in coalition talks this week as GBP-positive.**

For now, **we are running with the theme that last week's result and the remaining scenarios for the lower house will make it harder for any PM to strike a tone that suggests the government's preference is for a 'hard Brexit'**. Because the FX market associates a 'hard Brexit' with a weak GBP and tends to be forward looking, we think the aforementioned theme will **provide support to GBPUSD in the 1.2600/1.2700 range this week**. We think the **1.2900/50 range will cap GBPUSD strength** at least until the staying power of the CON/DUP coalition is confirmed.

As for Thursday's BoE decision, we believe some of the recent economic dataflow may result in the MPC minutes **displaying a more cautious stance on the near-term outlook**, and although we expect another 7-1 vote to keep the benchmark rate on hold (one MPC member voting for a hike), **our conviction level here is relatively low, and we think the risk is skewed to an 8-0 vote**. The employment data release (Wednesday) and retail sales print (Thursday) are the two most important economic releases this week. **We think it would take the combination of softer-than-expected wage growth, a softer-than-expected print on retail sales and a dovish BoE to force a test of the 1.2600 area.**

EUR anchored by the ECB as political risks are broadly neutral (for now)

On the Eurozone calendar, the focal points will be April industrial output (Wednesday), April net trade (Thursday) and the final reading of May CPI inflation (Friday). However, **the FX market is unlikely to put a great deal of weight on any of these releases, largely because Mario Draghi nailed his colors to the mast last week** by further emphasizing how tied to inflation the outlook for monetary policy is. Inflation, for that matter, remains subdued. For the time being, **we**

expect this ECB stance to anchor the EUR, and we would not look for near-term buying opportunities in EURUSD until the 1.1000/50 area comes into view (resistance in the week ahead is at 1.1300).

On the political front, the week will open up with the 1st round results of the French legislative elections in the lower house and the 1st round results of local elections in some Italian cities. **We think a solid result for Macron's La République En Marche in France's lower house is already factored into the value of the EUR**. In Italy, recent talks between parties on electoral reform have collapsed, and this has re-established a key barrier to early elections. Therefore, **the failure of 5Star Movement (M5S) candidates to make it into the run-off in all mayoral elections is unlikely to have a strong positive influence on the EUR Monday morning.**

Greece, the IMF and the country's Eurozone creditors will meet on Thursday. Here again, the political risk for the EUR is broadly neutral, because the IMF seems to be edging toward an agreement with Eurozone creditors for a loan that would disburse aid to Greece on a **contingent basis** once debt relief talks are concluded.

RMB still steered by PBoC

The offshore (CNH) premium to CNY continued to narrow last week. In part, this was due to the decline in 3M CNH HIBOR, which fell by 120 basis points over the course of the week. We think the **aforementioned shifts and prior comments from the PBoC regarding UST purchases have helped drag USDCNH back towards the 6.8000 area**.

We view the late-May RMB rebound **largely as a result of PBoC efforts to contain downside in the currency following the Moody's ratings cut. As such, we think it was a one-off event**. Furthermore, with the **recent change in PBoC's mechanism for setting the daily USDCNY mid-rate**, the central bank appears to have put further emphasis on limiting the impact of market forces on the currency.

With this in mind, **we think a move back towards the 2017 USDCNH average (6.8600) is more in line with PBoC's clear intentions of keeping the RMB very stable**, and we will continue to look for the 6.7500 area to act as strong support in the week ahead. Resistance is at 6.8500.

BoJ with nothing to do and little to say about JPY

The BoJ has a policy meeting Friday (Tokyo time). Our expectation, like the market's, is for no change in any of the Bank's policy levers. The current policy mix is keeping the economy humming along, even if the outlook for inflation isn't in tune with the BoJ's 2.0% inflation pipedream. With global commodity prices stagnant and Japan's deflationary demographics, it would probably take a quick move in USDJPY up to 125 to get inflation back to 2.0%.

Given the growth outlook and the shortage of bonds to purchase**, it makes no sense for the BoJ to attempt to trigger a depreciation that could cause problems with the Trump Administration and the neighbors**. So we look for a tame press conference and perhaps a minor drift higher in USDJPY towards 112 on the back of the Fed hiking.

Weekly Economic Diary: G10 (and China)

Europe	Monday (12th)	Tuesday (13th)	Wednesday (14th)	Thursday (15th)	Friday (16th)
Eurozone	IT Apr F CPI, SSM's Dombret & Nouy speak, ECB's Praet & Angeloni speak	EZ Jun ZEW, ECB's Weidmann speaks	EZ Apr Industrial Prod'n, EZ Q1 Employment, ECB's Knot, Hansson, Weidmann & Rimsevics speak	**ECB's** Mersch, EZ Apr Trade Bal, EcoFin meeting day 1	EZ Q1 Labour Costs, EZ May F CPI, EcoFin meeting day 2
U.K.	-	**May CPI**/PPI/RPI, Apr House Price Index, BoE's Cleland speaks	Apr ILO Unempl. Rate, Apr Weekly Earnings, May Jobless Claims	May Retail Sales, **BoE Monetary Policy Decision, BoE's Carney speaks (Mansion House)**	-
Sweden	**May CPI**	Parliament hearing on financial stability	-	-	-
Norway	-	Regional Output Survey	-	-	May Trade Balance
Switzerland	SNB's weekly Total & Domestic Sight Deposits	-	-	Apr Producer & Import Prices, **SNB Monetary Policy Decision**	-

North America	Monday (12th)	Tuesday (13th)	Wednesday (14th)	Thursday (15th)	Friday (16th)
United States	May Monthly Budget Statement, FINRA's Cook will speak	May NFIB Small Business Survey, May PPI	Weekly MBA Mortgage Applications, **May CPI, May Retail Sales, FOMC Monetary Policy Decsion (with SOEP & Yellen press conference)**	Weekly Jobless Claims, May Import Price Index, June Philly Fed Index, May Industrial Production & Capacity Utlization, June NAHB Indes, April TIC data	May Housing Starts, May Building Permits, May Labor Market Conditions, June P U. Michigan Consumer Sentiment, Fed's Kaplan speaks
Canada	Foreign Minister Freeland speaks on globalization & trade	-	-	Apr Manuf. Sales, May Existing Home Sales	Apr International Securities Transactions

Asia	Monday (12th)	Tuesday (13th)	Wednesday (14th)	Thursday (15th)	Friday (16th)
Japan	Apr Machine Orders, May PPI	-	-	W Apr F Industrial Prod'n, Apr Capacity Utilization, Weekly Int'l Securities Transactions	**BoJ Monetary Policy Decision & Kuroda Press Conference**
Australia	**Market holiday, RBA's Debelle speaks on Global FX Code**	**Apr Credit Card Purchases & Balances**	-	Jun Consumer Inflation Expectation, **May Employment Report**, May RBA FX Transactions	RBA's Debelle speaks
New Zealand	May Card Spending	-	May Food Price Index, **Q1 Balance of Payments**	**Q1 GDP**	May Business NZ Manufacturing PMI
China	-	Q3 Manpower Survey	**May Retail Sales, May Industrial Prod'n**, May Fixed Assets	-	May FX Net Settlement

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