# FX Weekly

## Foreign Exchange Strategy

BMO Capital Markets
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## Will geopolitics eclipse the focus on Jackson Hole?

*The USD gained slightly last week. Commodity currencies also gained even though the CRB commodity index fell. CAD was the best performing G10 currency but correlated financial prices suggest it should have fallen a bit. The biggest event on the docket for this week is the Jackson Hole Symposium. Both Draghi and Yellen are slated to speak. We would lean in the direction of USD strength this week, although the calendar doesn't suggest a lot of volatility is due.*

### Brief summary of last week

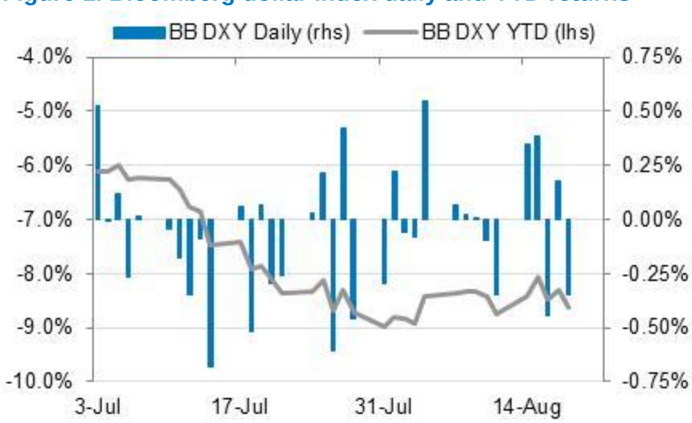
Last week's key happenings included a step back from US-NK brinksmanship, another round of US political drama and another tragic terrorist attack in Europe. The confluence of the Barcelona event and US political discord triggered the 3rd biggest down day for global equities in 2017. However, even with Thursday's 0.8% slide, the USD-denominated **MSCI World equity index still posted only a 0.4% decline on the week**. MSCI World (USD) is still up 10.7% year-to-date (YTD).

The **CRB commodity index** quietly fared worse that equities with a **1.2% decline for the week** that brings the YTD return to -6.7%. Despite the equity decline, the **USD-denominated 2Y swap rate ended the week 2bps higher at 1.57%** after Fed's Dudley offered remarks that were more hawkish than expected. The corresponding **EUR-denominated swap rate rose by 1bp** to -0.16%.

In FX, Bloomberg's liquidity-weighted **USD index (BBDXY) rose 0.1% last week** to bring its YTD return up to -8.6%, as shown in **Figure 1**. The lack of USD movement belies the variation across the spectrum of currencies, which was a bit more dramatic, as shown in **Figure 2**. Among **the G10 currencies**, **CAD was the best performer** with a +0.7% weekly return. **GBP was the worst performing G10 currency** with a -1.1% return.

Local market currencies were generally quiet. **ZAR and BRL were the exceptions with 2.3% and 1.5% gains.** In Asia, **CNH slid by 0.1%** while KRW only gained 0.2% even after the calming in North Korea-related rhetoric.

**Figure 1. Bloomberg dollar index daily and YTD returns**




Sources: Bloomberg, BMO FX Strategy

**Figure 2. Spot returns against USD for week ended Aug. 18**


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 August 15), the biggest currency position in notional terms was the short side of JPY, which was worth USD11.0bn. To factor in the liquidity of the various IMM currencies, we like to scale positions by comparing each currency side to its respective 3Y maximum. By this metric, **this week's JPY short stood at 71% of its 3Y max**. As shown in **Figure 3**, other currency

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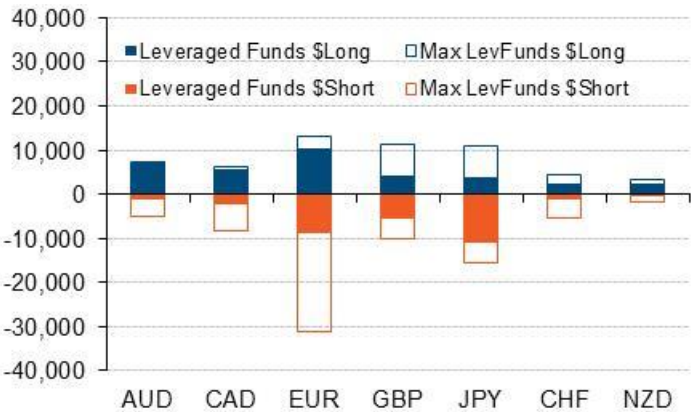
sides can also be compared to their 3Y extremes. Although the **long-AUD side** (worth USD7.5bn) isn't as big as the short-JPY side in USD notional terms, it is bigger **in percent-of-max terms at 99%**. **Long-CAD, at 91% of max, is also an exceptionally large position**. Other currency sides that are bigger than 50% of max are **long-EUR at 79%**, long-NZD at 72%, long-CHF at 56% and short-GBP at 55%.

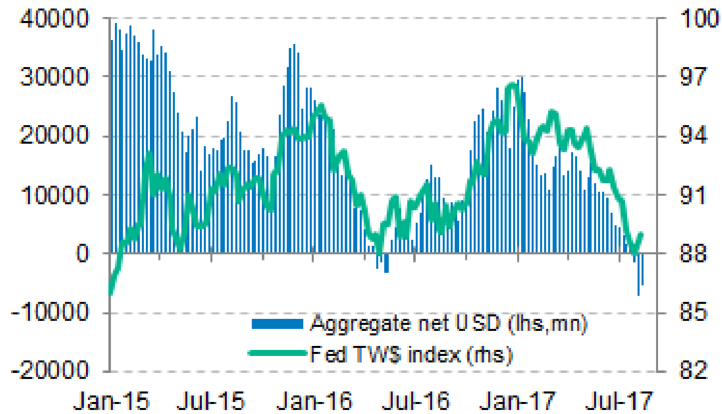
To gauge broad positioning in the USD, we look at the aggregate of {AUD,EUR,CAD,CHF,GBP,JPY,NZD}. For that aggregate, the **short-USD side was worth USD36.5bn, which is 92% of the three-year maximum** (which occurred the prior week). The **long-USD side was worth USD 31.0bn, which is 51% of the 3Y max.** As shown in Figure 4, the net position in the USD against the aggregate was short-USD by 5.5bn. **Leveraged funds' open interest** (sum of shorts and longs) in the aforementioned currency futures stood at 67.6bn, which is **106% 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

## Janet at Jackson but USD unlikely to shimmy

With the market now short-USD, and with market participants knowing that the preponderance of positions is short-USD, the pace of downward movement almost invariably had to slow. And in fact, the USD is three weeks removed from its cycle low (based on the BBDXY index as shown in Figure 1). **We expect further USD downside in coming months, but we expect something like 0.5% of upside over the next week or two.**

It seems too much like astrology to try to predict the US's next political firestorm, which will almost certainly *eclipse* economic data in terms of market impact. However, we will note that **Friday** is the key economic event day. The July Durable Goods report will be released and then Fed Chair **Janet Yellen will deliver her Jackson Hole Symposium speech** later in the morning.

Her topic has been announced as 'financial stability' so the scope for moving markets seems limited. However, we do point out that '**financial stability**' (or at least proactively discouraging asset bubbles) **is the key argument for further Fed tightening at this stage, so there may be a subtly hidden message buried within Yellen's remarks**.

## CAD a market darling but the financial fundamentals don't back much further appreciation

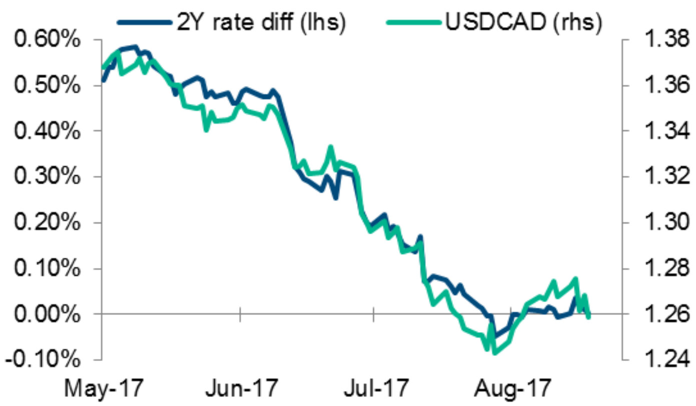
Although CAD was the top performing G10 currency last week, its fundamentals weren't all positive. **West Texas crude was down 0.2% on the week**, while the WCS grade of oil was down 0.3%. Interest rate differentials (IRDs) are more correlated with USDCAD than commodities right now and the financial factor that is the most correlated of all is the 10Y swap rate differential.

The 10Y IRD was flat last week, while **the 2Y IRD moved 1bp in the USD's favor**, as shown in Figure 5. Our rotating financial factor model's **fair value for USDCAD rose by 55 pips last week to 1.2537**, even as spot USDCAD fell 92 pips to 1.2585 (see Figure 6). Fair value is close to being in a 1M uptrend, which would trigger our model to exit its short USDCAD position.

One catalyst for CAD outperformance was **Friday's CPI reading for July**, which **showed total CPI accelerating by 2 tenths** to 1.2% YoY and an average of the three core measures rising by 1 tenth to 1.5%. That result kept a September

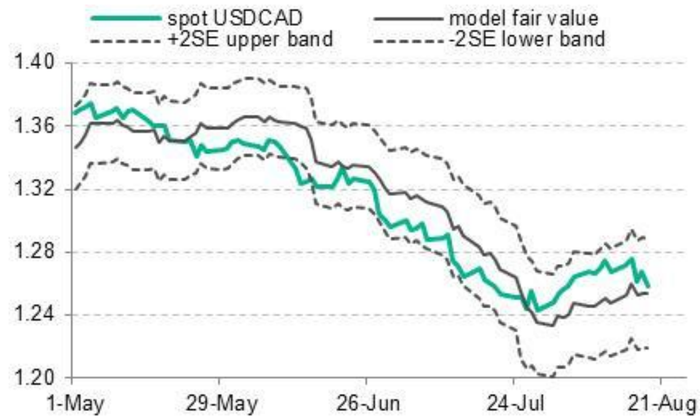
6 rate hike by the BoC on the list of potential risks, although **our economists continue to expect the next hike to come October 25** (see page 6 of 18Aug2017 Focus for more). For the week ahead, the key data point is June Retail Sales, which our economists expect to come in at +0.2% MoM (in line with the Bloomberg median).

**Figure 5. USDCAD and the 2Y swap rate differential**




Sources: Bloomberg, BMO FX Strategy

**Figure 6. BMO model's fair value and spot USDCAD**

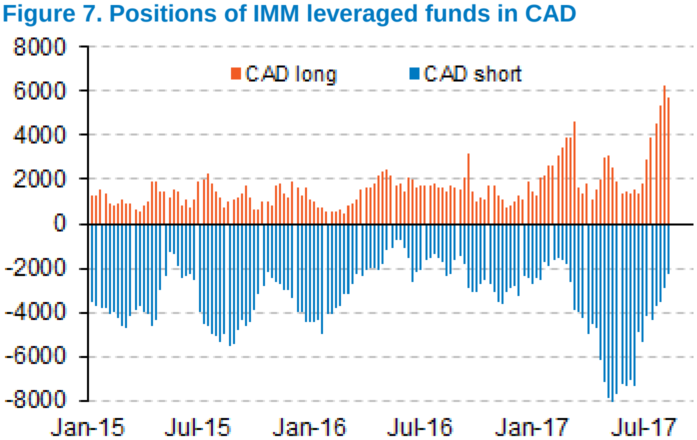



Sources: Bloomberg, BMO FX Strategy

Given the fact that USDCAD bottomed out 3 weeks ago and had bounced nearly 3% of its lows as of the time of the CFTC survey, we expected to see the net long-CAD (short USDCAD) position of IMM leveraged funds shrink substantially. However, the data showed only a slight reduction in USDCAD shorts that was essentially offset by a similar reduction in USDCAD longs, as shown in **Figure 7**.

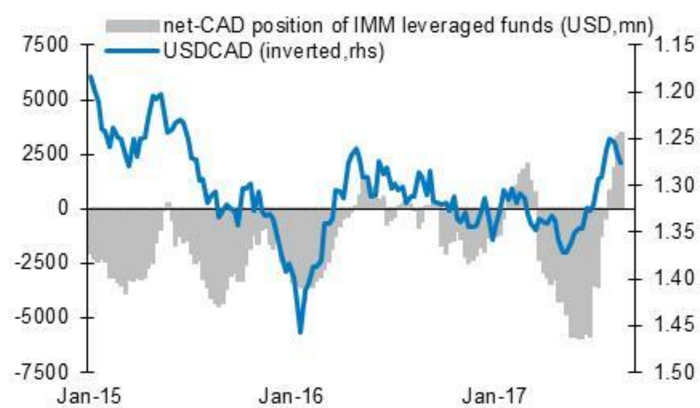
As a result, the data shows **IMM leveraged funds still holding a large net short-USDCAD position**, as shown in **Figure 8**. We think this data somewhat exaggerates the positioning that we are able to observe in the bigger OTC market, but the market is still somewhat short USDCAD and therefore vulnerable to pain if USDCAD moves higher. **Our view for this week, given how little data is on the calendar, is that USDCAD is more likely to move 1% higher than lower. But we'd still be longer-term sellers of USDCAD if we saw an entry point as good as 1.2780.**

**Figure 7. Positions of IMM leveraged funds in CAD**




Sources: CFTC, Bloomberg, BMO FX Strategy

**Figure 8. IMM LF net CAD position and USDCAD (inverted)**




Sources: CFTC, Bloomberg, BMO FX Strategy

## EUR struggling to make further gains

Although ECB 'sources' attempted to downplay the importance of **Draghi's Jackson Hole speech on Friday**, they will still remain a focal point for FX investors this week, especially after last week's ECB minutes. We think the ECB 'sources' headlines were probably genuine, largely because they echoed the tone of the official account of the minutes of the July ECB meeting.

Therefore, **we expect Draghi to bend over backwards to avoid saying anything that could push EUR higher**. In addition to ECB verbal intervention, the force that should continue to work against EURUSD upside is positioning, with the market substantially long EURUSD. FX markets tend to seek pain when there is a paucity of news to trade, as seems likely to be the case this week. W**e expect EURUSD to remain within its downward trend channel this week** (drawn from the August 2nd high). We would look for resistance in the 1.1800 area and support in the 1.1630/70 range. Despite this short-term bearish stance on the EUR, we are still medium-term bullish and would view a dip into the 1.1550/1.1650 range as a 3-6M buying opportunity.

## GBP in Brexit limbo with risk aversion weighing

The GBP should trade in a sideways fashion this week vs the EUR and the USD. Two weeks of thin August vacation trading remain, but September is the month packed with event risks for the GBP. However, **it is worth noting that as equity market risk aversion surfaced last week, the GBP was the worst-performing G10 currency**. Perhaps the GBP's correlation with risk appetite is tenuous, but based on the recent price action **we would avoid being long GBPUSD in the event of a further uptick in risk aversion**.

With the exception of the **second estimate of Q2 GDP (Thursday)**, tier-1 data are noticeably absent from the UK calendar this week. Even though leveraged funds are already net-short of the GBP, **a downward revision would probably have the bigger impact on FX market psychology and the GBP than an upward revision**.

The UK government is also scheduled to provide the public with a series of Brexit position papers this week, with possible details on the government's vision for the EU/UK trading relationship post-Brexit. **We think it's too early in the cycle for Brexit details (or the scarcity of details) to have a dramatic effect on the GBP**, but there hasn't been any real progress from Brexit negotiators on shifting the discussions from exit conditions over to trade. **This lack of progress is unlikely to change next week regardless of how the government's position on Brexit is evolving, and we would therefore look for any GBP rallies inspired by the papers to be short-lived**.

GBPUSD appears to have moderate resistance in the 1.2950/1.3000 range. However, regardless of what happens with risk appetite and UK data, the forthcoming political risks in September should deter GBP gains north of 1.3050. Near-term support is in the 1.2800-12830 range.

## RMB likely to experience a further sell-off

**We would caution against expecting a continuation of USDCNH downside this week**. Not only have offshore rates been edging lower, but the CNH is also trading at a small discount to its onshore counterpart. Moreover, the **CNY has already appreciated vs the USD at annualised pace of roughly 6.0% thus far in 2017**, and US President Trump's latest remarks towards China on trade have been less than conciliatory. We expect PBoC to maintain a tight relationship between the broad value of the USD and the trade-weighted RMB (CFETS CNY Index).

In view of the stabilisation and slight appreciation of the USD in August, there should be limited downside in the CFETS CNY Index for the time being, although we would expect the Index to underperform the USD slightly, yielding modest upward pressure on USDRMB. Amidst a dearth of tier-1 mainland data this week, we expect strong USDCNH support in the 6.6550/6.6600 range. **We would view a break of the 6.7050/6.7100 range as a confirmation of our bias to remain long the pair.**

## Weekly Economic Diary: G10 (and China)

| Europe | Monday (21st) | Tuesday (22nd) | Wednesday (23rd) | Thursday (24th) | Friday (25th) |
|---|---|---|---|---|---|
| **Eurozone** | - | EZ Aug ZEW Survey, SP Jun Trade Balance, ECB's Constancio speaks | EZ Aug Preliminary Markit PMIs, EZ Aug A Consumer Confidence, **ECB's Draghi speaks at Lindau Meeting** | FR Aug Manuf. Confidence, SP 2Q F GDP, Bank of Italy Governor Visco speaks | GE Jul Import Price Index, GE 2Q F GDP, FR Aug Consumer Confidence, SP Jul PPI, GE Aug IFO Survey, **ECB's Draghi speaks at Jackson Hole Symposium** |
| **U.K.** | - | Jul Public Finances, Jul Public Sector Net Borrowing, Aug CBI Trends | - | **2Q P GDP,** Aug CBI Retailing Reported Sales | - |
| **Sweden** | Q2 Industrial Capacity Utilization | - | - | Jul Unempl., **Riksbank's Jochnick speaks** | Jul PPI, Jul Household Lending |
| **Norway** | - | 3Q Consumer Confidence | Jun Unemployment rate AKU | **2Q GDP** | - |
| **Switzerland** | Total & Domestic Sight Deposits | Jul Trade Bal. | - | 2Q Industrial Output | - |

| North America | Monday (21st) | Tuesday (22nd) | Wednesday (23rd) | Thursday (24th) | Friday (25th) |
|---|---|---|---|---|---|
| **United States** | Jul Chicago Fed Nat. Activity Index | Jun FHFA House Price Index, 2Q House Price Purchase Index QoQ, Aug Richmond Fed Manuf. Index | Weekly MBA Mortgage Apps., Jul New Home Sales, Fed's Kaplan speaks | Weekly Jobless Claims, Jul Existing Home Sales, Aug Kansas City Fed Manufacturing Index | **Jul P /Durable Goods Orders, Fed's Yellen Speaks at Jackson Hole Symposium** |
| **Canada** | Jun Wholesale Trade Sales, Ireland PM Varadkar visits Canada | **Jun Retail Sales** | - | - | - |

| Asia | Monday (21st) | Tuesday (22nd) | Wednesday (23rd) | Thursday (24th) | Friday (25th) |
|---|---|---|---|---|---|
| **Japan** | Jun All Industry Activity Index, Jul Nationwide Dept. Sales | BoJ Outright Bond Purchases | Aug P Nikkei Manuf. PMI, Jul F Machine Tool Orders | Weekly Int'l Sec. Transactions, Jun F Leading Index | **Jul National CPI**, Aug Tokyo CPI, Jul PPI |
| **Australia** | - | - | Jul Skilled Vacancies | - | - |
| **New Zealand** | Jul Credit Card Spending | - | - | **Jul Trade Bal.** | - |
| **China** | Jul Foreign Direct Investment | Conference Board China July Leading Economic Index | - | - | - |

## DISCLAIMER