FX Weekly
Foreign Exchange Strategy

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Greg Anderson (gregory.anderson@bmo.com) Stephen Gallo (stephen.gallo@bmo.com) Week of September 25, 2017

Spotlight on central bank signals with speakers galore

The USD rallied a bit further last week as the Fed's dot retention pushed up USD-denominated interest rates. CAD gained the most among G10 currencies after the BoC's Lane re-assured markets that the BoC would keep a close eye on USDCAD as it sets future policy. BoC Governor Poloz takes the speaker's spotlight this week, but he won't be alone. The heads of the ECB, BoJ, BoE all speak this week, as does Fed Chair Yellen. We expect them to generally prepare markets for unified tightening of policy in coming months.

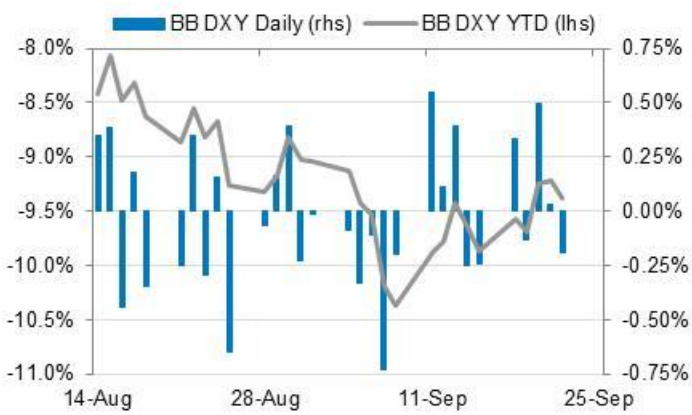
Brief summary of last week

Markets generally swallowed FOMC dots and other communications that were a bit more hawkish than expected. An escalation in the war of words between US President Trump and DPRK Supreme Leader Kim also seemed to have minimal impact. The USD-denominated **MSCI World equity index rose by 0.3% and printed a new all-time high.** MSCI World (USD) is now up 13.9% year-to-date (YTD). The **CRB commodity index** fell by 0.3% on the week to bring its YTD return up to -4.6%. The **USD-denominated 2Y swap rate rose 6bps on the week and reached a new post-2009 high of 1.71%.** The corresponding **EUR-denominated swap rate rose by 1bp** to -0.17%.

Bloomberg's liquidity-weighted USD index (BBDXY) **gained 0.5% for the week to bring its YTD return up to -9.4%**. This marked the second straight week of dollar gains and the USD is now 1.1% above its cycle low, as shown in **Figure 1**. The biggest return day was on Wednesday, when BBDXY gained 0.5% in the wake of the FOMC.

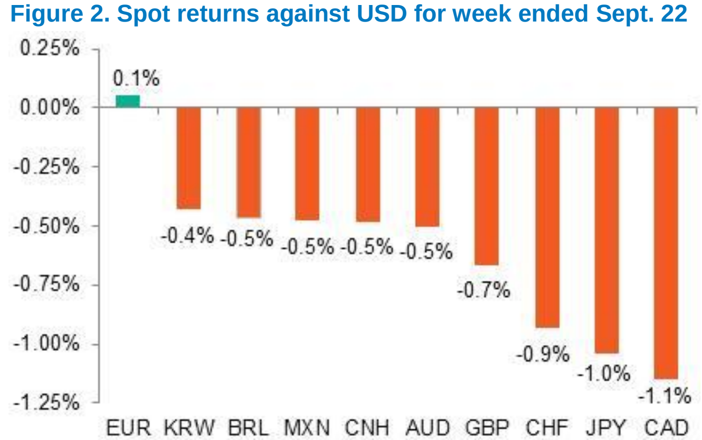
Movement across the spectrum of currencies was subdued as shown in **Figure 2**. Among G10 currencies, EUR was the outperformer with a 0.1% gain. CAD was the biggest loser with a 1.1% decline (see our CAD section for more).

Figure 1. Bloomberg dollar index daily and YTD returns



Sources: Bloomberg, BMO FX Strategy

Figure 2. Spot returns against USD for week ended Sept. 22



Sources: Bloomberg, BMO FX Strategy

Spotlight on central bank signals

The next G20 meeting for central bankers and finance ministers will take place in Germany October 12-13. With the USD still trading lower than it did at the time of the Jackson Hole Symposium, it is likely that USD weakness will be a topic of discussion. Along with the pace of FX movement, the coordination of tightening measures is also likely to be a theme. Central bankers probably rightly have fears that tightening ahead of peers will lead to a surge in one's currency. **In an environment of USD weakness, even the act of signaling future tightening ahead of other countries could be dangerous.**

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It now appears to us that most of the major central banks agreed in April that tightening en masse later in the year would be appropriate if the global economy continued to perform well (which it has). That commitment was likely renewed in informal discussions at Jackson Hole. **In the wake of Jackson Hole, we have seen the BoC raise rates, the Fed initiate quantitative tightening and the Bank of England hint loudly about future tightening**. The ECB and RBA have been more restrained, but they are also sending tightening signals.

With all of this as background, we note **that this week has an incredible amount of central bank speeches** (as detailed in our calendar on page 5). The BoJ's **Kuroda** is the first speaker with two public appearances on **Monday**. The ECB's **Draghi** will also speak on **Monday** and apparently about current conditions. The Fed's **Yellen** has a policy-related speech scheduled for **Tuesday**. The BoC's **Poloz** speaks **Wednesday**, with the BoE's **Carney** following on **Thursday and Friday**. If there is anything left to say on **Friday, Draghi** gets a chance to add it (or clarify after seeing market reactions). **We expect the general theme of all these speeches to be the promotion of cautious tightening**.

FX market positioning

According to the most recent Commitment of Traders report by the CFTC (for the close of Tuesday September 19), the biggest currency position in notional terms was the long side of EUR, which was worth USD11.7bn. 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. In this particular case, **this week's EUR long registers as 93% of its 3Y max**. As shown in **Figure 3**, other currency sides can also be compared to their 3Y extremes. Although the **long-CAD side** (worth USD6.5bn) wasn't as big as the long-EUR side in USD notional terms, it was bigger **in percent-of-max terms at 100%** (because it was **new max on that side since December 2012**). **Long-AUD, at 96% of max**, is also an exceptionally large position.

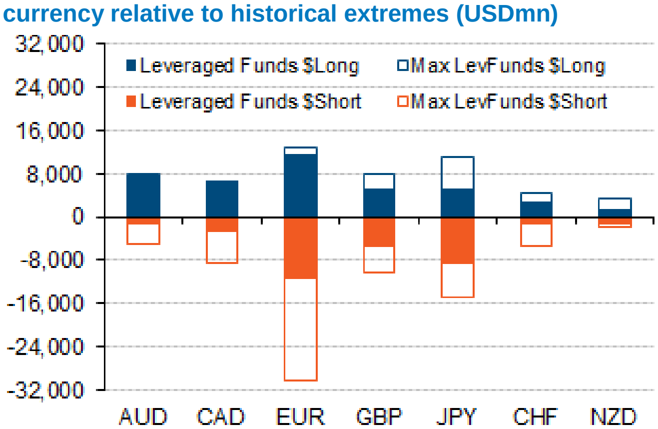
Other currency position sides that are bigger than 50% of max are as follows: short-NZD (71%), long-GBP (67%), long-CHF (66%), short-JPY (58%) and short-GBP (53%).

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 32.6bn, which is 56% of the 3Y max.** The aggregate **short-USD position was worth 40.8bn, which was a new 3Y max** (so 100%). The aggregate short-USD side hadn't been this large since 29-July-2014.

As shown in **Figure 4**, the net position in the USD against the aggregate was short-USD by 8.2bn—up 1.0bn from the previous week. This was the **biggest net short-USD position of the past three years (and the biggest since 13-May-2014)**. It was the 8th consecutive net short-USD position. Leveraged funds' open interest (sum of shorts and longs) in the aforementioned currency futures stood at 73.5bn, which is 116% of its 3Y average. In fact, this was the **highest FX category open interest reading for the leveraged funds category since 01-Nov-2016.**

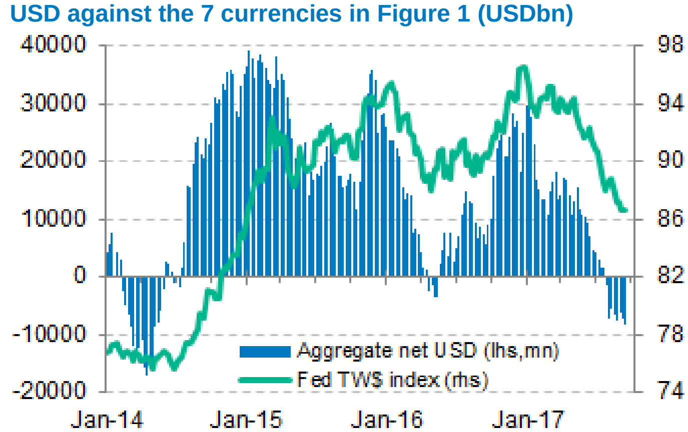
We suspect that the surprising hawkishness reflected in the FOMC dots has triggered a bit of a reduction in USD shorts. However, once IMM leveraged funds start leaning in a particular direction, it tends to take a major sea change to get them to reverse completely. So **while we think there has been a bit of position trimming, we suspect that IMM leveraged funds remain short-USD against everything except JPY and maybe GBP.**

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

USD could see more short covering but it's hard to see Yellen as the trigger

With the market short-USD, a further uptick is possible even without meaningful news. Being short-USD is a negative carry position, so if it isn't going their way, FX investors may back off and look to re-enter at a better moment and level. However, market timing USD moves has been very difficult this year. Moreover, **it's hard to imagine what Yellen could say at this stage to talk US rates and the USD higher.** And the week's data highlight—the **August PCE deflator to be released on Friday**—looks highly unlikely to trigger a more USD-positive shock than Yellen. In fact, an on-expectations number of 1.5% YoY overall PCE and 1.4% YoY core PCE might remind markets why they underprice the dots so much. With that in mind, **we would generally position to sell the USD on spikes heading into Friday**.

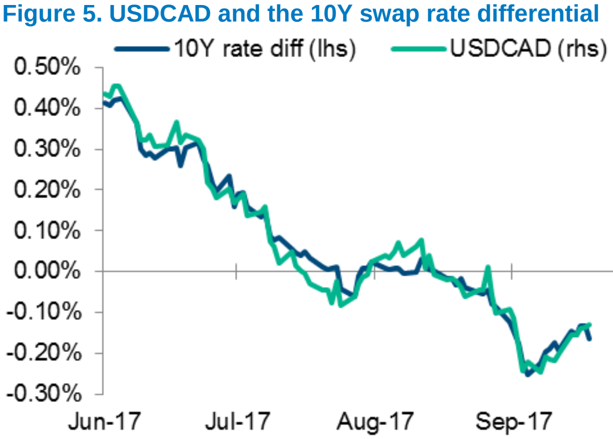
CAD looks likely to settle into a range with IRD volatility dying out

Last week's range in USDCAD widened to 1.8% and CAD depreciated 1.1% as noted in our introductory section. About half of that depreciation can be blamed on the movement of the so-called 'big dollar' in the wake of the FOMC. The other half can be attributed to **BoC Deputy Governor Lane's re-affirmation that the BoC in still in fact keeping a close eye on the currency** as it raises interest rates. Reading between the lines, Lane's message seemed to be that the BoC wouldn't hike faster than the Fed from here forward. Although the precise topic of **Poloz**'s speech hasn't been revealed, we expect him to do his best to keep markets thinking that way in the Q&A that will follow his **speech on Wednesday**.

Looking past Poloz, the week's biggest data point is the July monthly GDP number that will be released on Friday. Our economists are looking for a weak o.1% MoM reading (see page 12 of 22Sep2017 Focus for more.

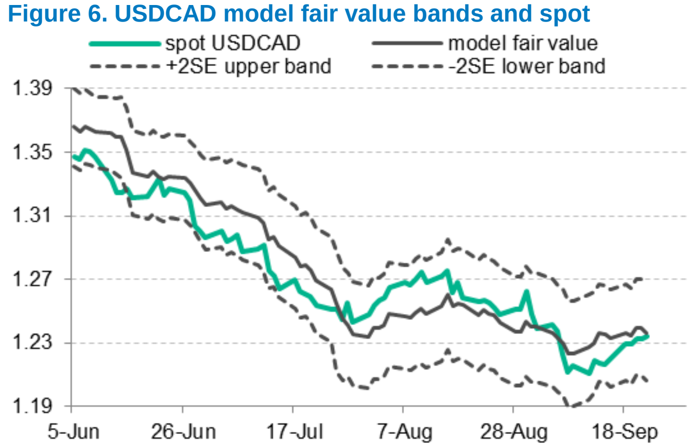
Our rotating financial factor model for USDCAD is still in a sell-on-spikes mode and is likely to remain that way for at least this week. Our model has fair value at 1.2365, so that is the spot where it would have gotten short last Friday. The model continues to rely foremost on the 10Y interest rate differential for its signals. That differential settled into a narrow range last week and so did fair value. We think spot will also settle into a narrow range for the week ahead. We would be sellers above 1.2360 for this week.

Figure 5. USDCAD and the 10Y swap rate differential



Sources: Bloomberg, BMO FX Strategy

Figure 6. USDCAD model fair value bands and spot



Sources: Bloomberg, BMO FX Strategy

German election impact on FX limited for now as investors await Draghi and inflation data

It appears as if Merkel is headed for a fourth term as Chancellor in a coalition with the Free Democrats and [probably] the Greens (**Figure 7**). The surge in the AfD's share of the vote was responsible for a modest sell-off in the EUR during the Asian open, and **while we don't disagree with that move, we think the impact of the AfD result on EUR-related assets will be limited for now**, as the more important focus for FX investors will be on ECB policy.

However, **the shift to the right in Germany is likely to have more insidious side effects for investor sentiment towards the EUR over the long-run**, given its implications for the missing architecture of the Eurozone, Greek aid disbursements, and German relations with France and Italy.

The other important EUR-related events this week begin on Monday with remarks from ECB's Draghi on economic and monetary developments. We wouldn't be hugely surprised if Draghi uses the opportunity to offer clues about what ECB policy normalisation is going to look like (Draghi also speaks alongside Mark Carney on Friday from London). **Although** hints of a 'dovish taper' at the October ECB rate decision would probably result in modest EUR weakness, it's tough for us to envisage what Draghi could say to cause a sharp decline in the EUR this week**.

We would therefore expect the 1.1830/50 range in EURUSD to continue acting as firm support in the week ahead. Following more solid Eurozone data during the prior week, we would also expect dips in EURUSD to be shallow ahead of Eurostat's Flash CPI estimate for September on Friday. **A core reading of 1.4% YoY or more (exp: 1.2%) should yield a meaningful EURUSD rally and pave the way for a new cyclical high in the pair and a weekly close comfortably above the 1.20 mark, especially if Draghi's comments point the markets toward an October taper.**

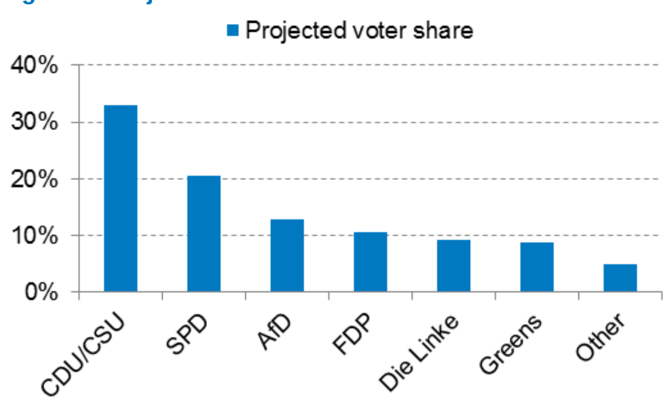
GBPUSD in a temporary holding pattern (like the MPC)

The UK economic calendar won't be a major focus for FX investors in the week ahead. The August money supply and credit data on Friday is the most important data release of the week, but it's unlikely to move the GBP materially unless it produces a major outlier. Carney is also due to speak on Friday at a BoE conference, **but we do not expect him to deviate significantly from what he has already said about the outlook for UK monetary policy** (i.e. some tightening of monetary policy may be needed 'in the coming months').

Broadly speaking, the MPC is in a wait-and-see mode regarding the economic data ahead of the next crucial monetary policy meeting in November. By and large, we think a similar holding pattern will apply to GBPUSD this week. **Barring an unexpectedly sharp move in the USD, we look for GBPUSD to consolidate in a 1.3350/1.3600 range this week.**

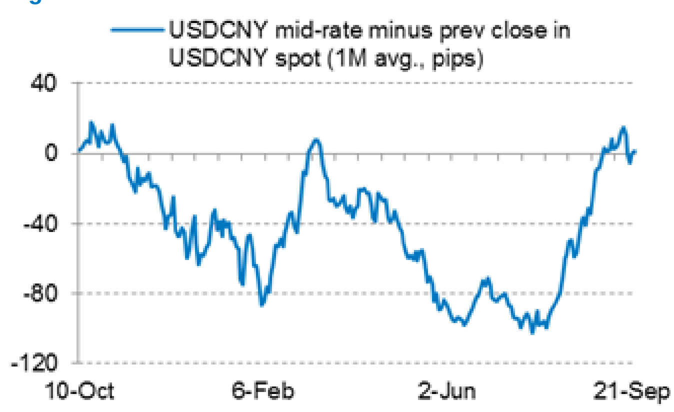
In view of the key events on the Eurozone economic calendar, we think the more important GBP-related price action to watch will be in EURGBP. Given the uncertainty surrounding Brexit negotiations in the month ahead, **we don't expect EURGBP to end Q3 with a loss (i.e. below 0.8773). However, such a result for the pair during the coming week would be notable, and it would materially reduce the odds of a firm break back above the 0.9000 level in October** (barring material deterioration in the UK economic outlook). In the event of a decline below 0.8770 next week, we would likely stand aside and wait for better levels to buy EURs at on a 2-3M investment horizon.

Figure 7. Projected voter shares in German elections



Sources: dpa-infocom, BMO FX Strategy

Figure 8. USDCNY mid-rate vs USDCNY closes



Sources: Bloomberg, BMO FX Strategy

A balanced set of forces should allow for consolidation in the RMB

We view some of the recent steps taken by PBoC as supportive for USDRMB, including the decision to scrap the margin requirement for long-USDRMB forward positions and the 1M trend in the USDCNY mid-rate vs spot USDCNY (**Figure 8**). **However, we also don't think there has been a convincing shift towards USD-positive flows either**, and price action in the big USD remains soggy. SAFE's August FX reserve data showed no evidence of intervention by the central bank to thwart RMB strength, and sales of foreign exchange by local banks to end users fell 75% in August from July.

Given this balanced set of forces, we expect USDCNH to consolidate in a 6.53/6.60 range during the week ahead, and our preference would be to go into the week with a neutral bias on the pair. However, we will be watching price action for signalling factors closely. A drift below the 6.53 level would cause us to shift from a neutral to a bearish bias, while a weekly close above 6.60 would be a moderately bullish signal. The latter development would mean waiting until the 6.64/6.65 area comes into view before selling USDs.

Weekly Economic Diary: G10 (and China)

Europe	Monday (25th)	Tuesday (26th)	Wednesday (27th)	Thursday (28th)	Friday (29th)
Eurozone	SP Aug PPI, GE Sep IFO Business Climate/ Current Assessment/ Expectations, **ECB's Constancio, Mersch, Coeure & Draghi speak**	GE Aug Import Price Index, FR Sep Manuf. Confidence, **ECB's Rimsevics & Praet Speak**	FR Sep Consumer Confidence, IT Sep Consumer Confidence, IT Sep Manuf. Confidence, EZ Aug M3, IT Jul Industrial Orders, **ECB's Rimsevics speaks**	GE Oct GfK Consumer Confidence, GE/SP Sep P CPI, SP Aug Retail Sales, **ECB's Praet & Lautenschlaeger speak**	GE Aug Retail Sales, FR Aug PPI, FR Sep P CPI, GE Sep Unempl., SP Jul Current Account Bal., EZ/IT Sep CPI, IT Aug PPI, **ECB's Draghi speaks**
U.K.	-	Aug BBA Loans for House Purchase	-	Sep GfK Consumer Confidence, **Carney speaks**	Sep Nationwide House Price Index, **2Q F GDP**, Aug Mortgage Approvals, **BOE's Cunliffe & Broadbent speak**
Sweden	-	Aug PPI	Sep Economic Tendency Survey, Aug Trade Bal., Aug Household Lending	Aug Retail Sales, **Riksbank's Ingves & Floden speak**	**Riksbank's General Council Meets**
Norway	**Norges Bank's Olsen speaks**	-	Jul Unempl., **Norges Bank's Nicolaisen & Olsen speak**	Aug Credit Indicator Growth, **Norges Bank's Matsen speaks**	Sep Unempl., Norges Bank's Nicolaisen & Matsen speak
Switzerland	Total & Domestic Sight Deposits	-	Aug UBS Consumption Indicator	-	-

North America	Monday (25th)	Tuesday (26th)	Wednesday (27th)	Thursday (28th)	Friday (29th)
United States	Aug Chicago Fed Nat. Activity Index, Sep Dallas Fed Manuf. Activity, **Fed's Dudley, Evans & Kashkari speak**	Sep Conf. Board Consumer Confidence, Sep Richmond Fed Manuf. Index, Aug New Home Sales, **Fed's Mester, Brainard, Bostic & Yellen speak**	Weekly MBA Mortgage Apps., Aug P Capital/Durable Goods Orders, Aug Pending Home Sales, **Fed's Bullard, Brainard & Rosengren speak**	Aug P Wholesale Inventories, 2Q T Core PCE, **2Q final GDP**, 2Q T Personal Consumption, Weekly Cont. Claims/Jobless Claims, **Fed's George, Fisher, Bostic speak**	**Aug PCE Core**, Aug Personal Income, Aug Personal Spending, Sep Chicago PMI, Sep F U. of Mich. Sentiment, **Fed's Harker speaks**
Canada	-	-	**BoC's Poloz speaks**	-	Aug Industrial Product Price, Aug Raw Materials Price Index, **Jul GDP index**

Asia	Monday (25th)	Tuesday (26th)	Wednesday (27th)	Thursday (28th)	Friday (29th)
Japan	Sep P Nikkei Manuf. PMI, **BoJ's Kuroda speaks, July Meeting Meetings**	Jul F Leading Index, Aug PPI	Sep Small Business Confidence, Aug F Machine Tool Orders	-	Aug Jobless Rate, **Aug National CPI**, Sep Tokyo CPI, Aug Retail Trade, **Aug Retail Sales, Aug P Industrial Prod'n,** Aug Housing Starts, **BoJ Sept. Opinion Summary**
Australia	-	**RBA's Bullock speaks**	-	**RBA's Debelle speaks**	Aug Private Sector Credit
New Zealand	-	Aug Trade Bal.	-	**RBNZ Official Cash Rate**	Aug Building Permits
China	-	-	-	-	Sep Caixin Manuf. PMI, **Sep Manuf./Non-Manuf. PMI**

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