QCAM
Currency Asset Management

# QCAM MACRO UPDATE

## Only the ECB got markets moving this week

15 June 2018

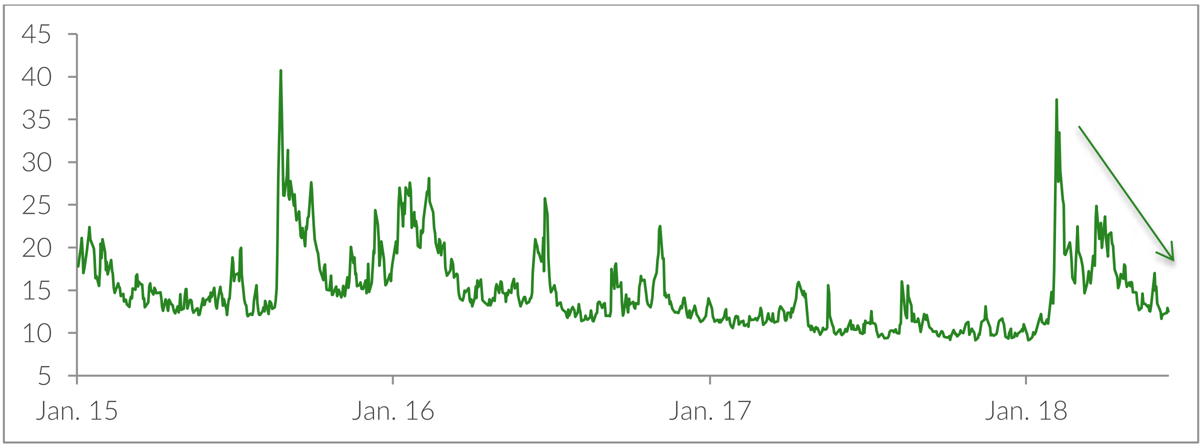
The last few days were full of potentially market moving events: the G7 summit in Canada, the historical meeting of Trump and Kim Jong-Un in Singapore and the meetings of the Fed and ECB policy boards.

- The G7 summit ended with a rift and harsh words between the US and its key Western allies. In contrast, the US – North Korea summit was all smiles and handshakes with a promise of lasting peace. Old friends become new foes and old foes become new friends.

- The Fed displayed comfort in its outlook for solid growth and firming inflation and consequently raised interest rates by 25bps and also added to the rate hike projection for 2018 another 25bps. The ECB announced that it intends to end new asset purchases by the end of the year, but Draghi pointed to increased uncertainties and left the impression that policy may have to stay easy for longer.

Markets basically ignored the outcomes of the summits in Canada and Singapore. Perhaps the outcomes were anticipated, but implications are far reaching both for the better and the worse. Surprising was the reaction to the more hawkish outcome of the Fed meeting. The USD rallied briefly immediately after the meeting, but quickly gave up its gains. Only the more dovish outcome of the ECB meeting pushed EURUSD from above 1.18 to below 1.17, but USDJPY stayed largely unchanged. Part of the slower market response is the sense that risks have declined. The VIX, which jumped in early February to a three-year high has gradually rolled back close to the lows of last year.

S&P500 VIX




Source: CBOE

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## Nothing to worry about?

So, should we trust the market instinct and lean back and relax? We are more cautious. In our judgment, there are three potential sources for volatility going into the second half of the year.

- The first is the upcoming US midterm election. Trump has already started his campaign to defend the Republican majority in the House of Representatives and the Senate. His strategy is to show that he delivers on his campaign promises. That spells more trouble for the US relation with its Western allies but also China, both on trade as well as geopolitics (Iran and Middle East in particular).

- The second is the Euro's unresolved Italian problem. As we note in this month's FX monthly, the problem is not just politics. In fact, the political shift in Italy is probably just an accelerant for the underlying debt sustainability problem. Italy has the potential to sink the Euro. We believe that reason will probably prevail in the end, but chances are high that the situation escalates towards a crisis before it takes a turn for the better.

- The third issue is growing cracks in Emerging Markets. A full-blown Emerging Markets crisis seems unlikely at this stage, but some countries are shaky, notably Argentina, Brazil and Turkey. The prospect of more Fed tightening is poised to make life even harder for those Emerging Markets with large USD debt and an economic need to lower interest rates.

And all that happens against the background of an aging and diverging business cycle. While global growth was highly synchronized last year, divergence is coming back this year. After more than a year of upward revisions across the globe, forecasts are being trimmed again, most notable in Europe, Japan and some Emerging Markets. The big exception is the US, where the Fed just raised its growth forecast. The US holding up is good news, but the question is when it will run out of gas. The Fed seems determined to gradually close the tap and the fiscal stimulus from tax cuts is set to fade. Economic conditions are solid but the economy is pushing more and more its human and physical capacity constraints. Moreover, savings rates are low and business is reluctant to invest more in an environment where the opportunities for margin increases are diminishing.

## The Dollar rally has still some room, but not infinitely

For the time being, however, the odds favor the USD. The USD's failure to move higher after this week's events, especially the more hawkish outcome of the Fed meeting is probably technical fatigue after the USD's prior rally. The next round of economic news will probably confirm that the US continues to outperform on the growth side. And so far the trade conflict has not hurt the US as much as its partners. Add to that the uncertainties surrounding Italy and the ground is prepared for another USD move.

Bottom line, we remain tactically long USD for the next few months. However, the USD has handicaps as well. One is the mid-term election. Losing control over Congress would impair Trump's ability to move his agenda. Politically that may be desirable but a lame-duck President is not good for the USD. Second, there is still the twin deficit. Especially the fiscal deficit is a concern. In the eight months of the current fiscal year, the federal government deficit rose by $100 billion versus the same period in the previous fiscal year. Meanwhile, the Fed is increasing its Treasury divestments. In a rising rate environment, the government may eventually find it harder to persuade foreign investors to buy more Treasury notes.

Kind regards
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