

STRATEGY NOTE:

FX STRATEGY

IT IS CRUCIAL FOR THE RISK-ON PHASE THAT THE EURUSD REMAIN ABOVE 1.13

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EURUSD: WE REMAIN SECULAR DOLLAR BULLS



Source: Reuters, Nedbank CIB

- The dollar was in a major bear market from 2000 until the 2008 GFC. The drivers of this supply of dollars pushing down the price were the commodity cycle and oil boom (causing a rise in petro-dollar balances) and FX reserves. It was also the golden era of shadow banking, creating dollars outside of the banking system and outside of the US.
- This dollar creation came to an end in 2008 but accelerated to the downside only after the peak in commodities in 2011, followed by the “taper statement” in 2013 and the falling oil and commodities prices. The new Basel rules targeting the shadow banks also tightened dollar liquidity. It also became evident over this period that interest rate differentials had broken down as the major driver of currencies.
- In early 2018, the euro turned down from the top of this well-established bear channel, and the effects of this stronger dollar are well known. The biggest impact it had on South Africa was the unwinding of the “carry trade”, putting the rand under pressure.
- The question is whether this long-term dollar bull trend since 2008 is over: we do not think so.

EURUSD: THE OUTLOOK FOR THE NEXT FEW MONTHS



Source: Reuters, Nedbank CIB

- At this point, we remain of the opinion that the correction phase in the EURUSD bear market that started in August 2018 is not over.
- If this correction phase plays out, according to the textbooks, the euro should rally to 1.18 to complete the corrective pattern. Corrective patterns normally break up in three-wave patterns, which we label ABC in Elliott wave analysis.
- If the euro starts to break below the previous lows at 1.13, and especially if it accelerates and breaks below 1.1185, we would be forced to change our view about one more rally. We would have to believe then that the next major bear phase (blue wave 3) is unfolding.
- The long position in the dollar is still at extreme levels and, therefore, we do not expect the next dollar bull phase to start now.
- The next few days are crucial and would determine whether the euro can remain above 1.13.



USDZAR: THE DOLLAR WILL REMAIN THE DOMINANT FACTOR



Source: Reuters, Nedbank CIB

- As the dollar index bull market started in early 2018, the rand came under pressure. The correction phase in the USDZAR lines up with the EURUSD correction phase that started in mid-3Q18.
- If our view is correct that another rally to 1.18 in the EURUSD is necessary to complete the corrective pattern, we expect the USDZAR to correct to 13.50 to test a previous major trendline.
- The correction to 13.55 would complete the correction phase, and we expect a much weaker rand after it tests the 13.50s.
- If the USDZAR rallies from current levels and breaks back into the bull trend that has been intact since the start of the year at 14.40, our view of further rand strength to 13.50 would be negated.

TRADE-WEIGHTED RAND: TESTING THE BREAKOUT LEVEL AT 61



Source: Reuters, Nedbank CIB

- The SA TWR has come under pressure since the start of the year and is currently testing the breakout level at 61.
- If the EURUSD rallies to 1.18, the SA TWR could recover to 62.20.
- If the EURUSD fails to remain above 1.13, the next risk-off phase would unfold, dragging EM currencies lower.

EURZAR: DOWNSIDE POTENTIAL IF EM CURRENCIES REMAIN STABLE



Source: Reuters, Nedbank CIB

- Since the end of the previous major risk-off phase from 2011 to end-2015, the EURZAR has been in a major correction phase, forming a wedge. Eventually, the EURZAR will break higher on completion of this wedge.
- If the risk-on phase remains intact and the EURUSD rallies, we expect EM currencies to recover further. This targets a move on the EURZAR to 15.13.
- If the EURUSD breaks below 1.13 and the global risk-off trade accelerates, the rand would struggle to get down to 15.13. In this environment, we expect the EURZAR to remain between 17.08 and 16.16.
- Because of our secular bullish view on the dollar, we are more concerned about the rand's performance against the dollar than against the euro.

GBPZAR: FURTHER DOWNSIDE POTENTIAL



Source: Reuters, Nedbank CIB

- As readers would know, all EM currencies came under pressure in 1H18 as the dollar liquidity squeeze triggered the unwinding of the carry trades.
- The good news for the rand against the GBP is that the two rallies in 2017 and 2018 were equal in length; this indicates it is not a continuation of the bull trend that has been in place since 1982.
- If EM currencies remain stable over the new year, a break below 18.33 to test the 17.09 level is possible. This is in light of the uncertainty surrounding Brexit.
- If, however, dollar liquidity problems resurface, a consolidation between 18.33 and the latest high at 20 would be the likely outcome.