



STRATEGY NOTE: THE US DOLLAR BREAKS OUT

2 May 2018

NEELS HEYNEKE

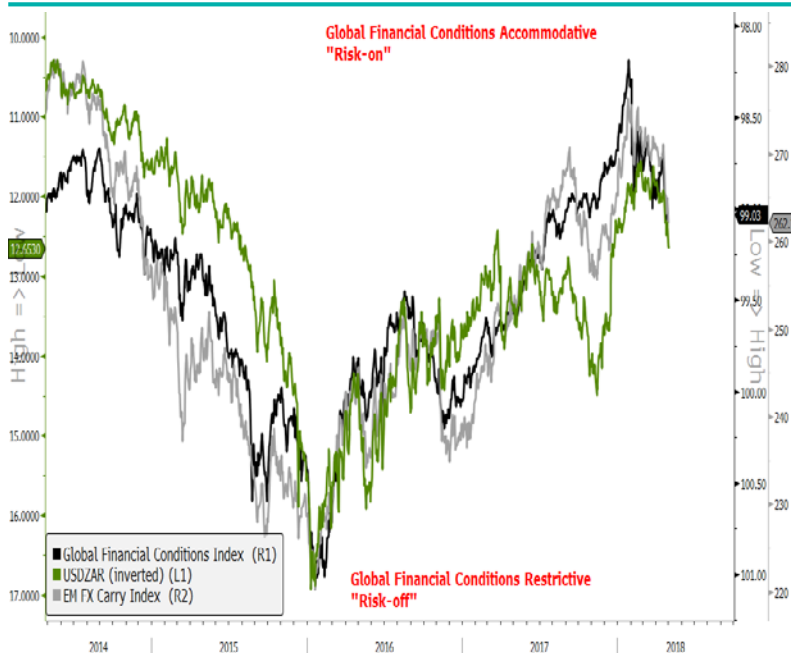
Senior Strategist
Tel : +27 11 535 4041
Nheyneke@Nedbank.co.za

MEHUL DAYA

Strategy: Research Analyst
Tel : +27 11 295 8838
MehulD@Nedbank.co.za



GLOBAL FINANCIAL CONDITIONS BECOMING RESTRICTIVE



Source: Reuters, Nedbank CIB Research

- Global Financial Conditions have been accommodative since the start of 2016, driven by a number a liquidity tailwinds that we have written about in length in numerous publications.
- Global Financial Conditions are now tightening as reflected in the stronger U.S Dollar and is now taking its toll on risk-assets (carry-trade) like the rand.

US DOLLAR INDEX, BULLISH BREAK TARGETS 95



Source: Reuters, Nedbank CIB Research

- The \$-index turned up from an important trendline that has been intact since 1985, after completing a 5-wave bear trend.
- The general rule is that a market will correct the 5th wave during the correction phase, post the completion of a 5-wave trend. This indicates a rally to 95. We also expect resistance against the resistance line at 93.55.
- A break above 95 would project a move to the early 2017 high at 103.
- On the short-term hourly charts the market is overbought and we expect a correction back to 91.30 before the bull trend continues. An extended target for the correction is 90.56.
- It is extremely rare for symmetrical wedges to be reversal patterns; hence the sharp move as the market broke up out of the wedge.
- Our 2018 outlook has been and remains that the dollar will strengthen as global liquidity tightens.

\$-RAND, SHORT-TERM CORRECTION LIKELY



Source: Reuters, Nedbank CIB Research

- As the dollar rallies, we expect that the carry trade will come under pressure. It is not just because the rally in the funding currency is eating away the carry returns, but also that the rising FX volatility is negative for the risk-adjusted returns.
- As long as the dollar rallies, the unwinding of the carry trade will drive the \$-rand higher.
- Short-term the dollar has reached our 12.68 target, with a completed a 5-wave pattern. We expect a short-term correction. The target levels for this correction are 12.43 and 12.27.
- The hourly MACD has started to diverge, indicating the bull trend is losing momentum and a correction is imminent.

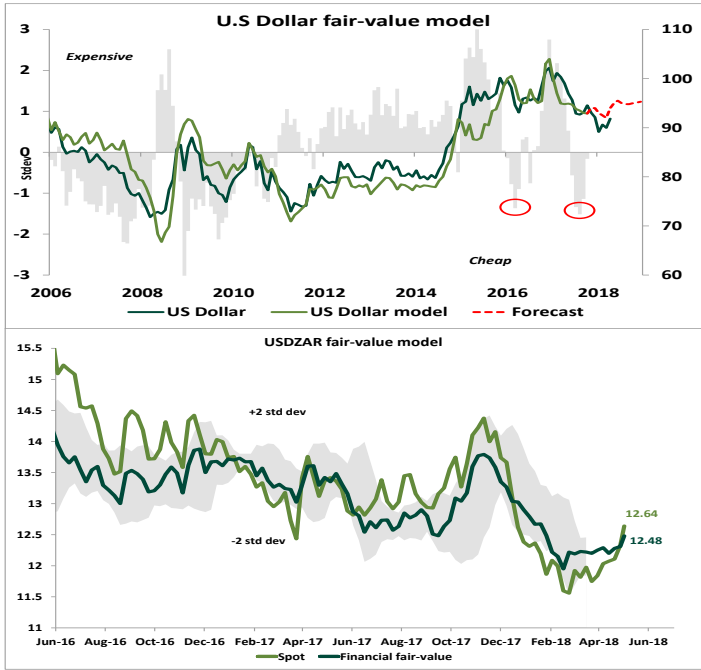
BLOOMBERG EM FX CARRY INDEX, CLOSE TO TREND REVERSAL LEVEL



Source: Reuters, Nedbank CIB Research

- The EM carry index is correcting within the bull channel that has been intact since 1Q16.
- We feel that it is unlikely that this index will break below the trend reversing 260 support line on the first attempt. Since we expect a correction in the dollar index, this 260 support level is likely to hold.
- A break below 260 post a consolidation phase would however confirm a major trend-reversal, targeting a move to below the early 2016 low.

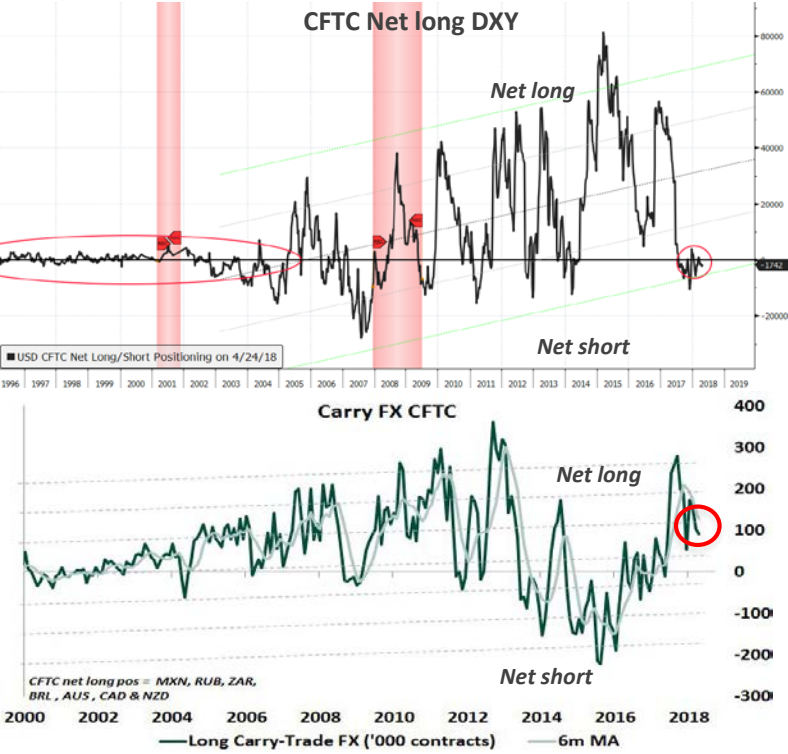
FAIR VALUE MODELS



Source: DS, E-views
Fair value models based on PPP metrics and also other financial variables e.g. oil price, VIX, Global financial conditions index

- Our **U.S Dollar fair value** model, based on a number of factors that we monitor, indicates the U.S Dollar is now less undervalued after the rally.
- We maintain our forecasted fair-value on the **U.S Dollar Index of 95**, seeing as a number of liquidity tailwinds (which contributed to dollar weakness) lose momentum.
- The **rand** has been the beneficiary of the improving liquidity in 2016 and 2017 and lately of an improvement in political sentiment. We believe the global tailwinds are losing momentum which would not bode well for the carry-trade and the rand. These forces are likely to overshadow the improving local forces, just as the tailwinds in 2016/17 overshadowed the Zuma presidency and downgrades.
- Our forecast for the \$-ZAR for the end of 1H18 is 12.48, and for end 2H18 it is 13.00.

POSITIONING FOR THE NARRATIVE AT RISK



Source: Reuters, Nedbank CIB Research.
'000 contracts CFTC speculative positions

- Market positioning indicates a high conviction in the current 'narrative' – ie that global synchronized growth will continue. We believe that global growth has peaked.
- We believe that this consensus and these outsized positions are fraught with risk, seeing as financial conditions are tightening.
- Typically when positions are as large as they are currently, the risk is that if the prevailing narrative of the time does not play out perfectly, violent reversals will ensue.
- **Tighter Global Financial Conditions** are likely to put pressure on these outsized positions.