



Strategy Note:

Have the canaries started to fall over?

14 May 2018

NEELS HEYNEKE

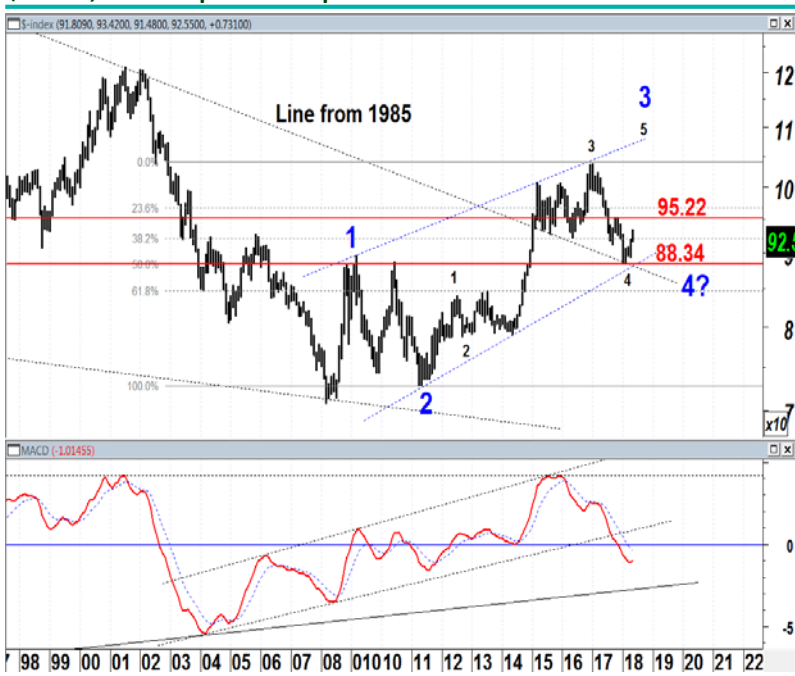
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\$-index, turned up from the proverbial Rubicon line



Source: Reuters, Nedbank CIB Research

Re-adjustment of the term-premium

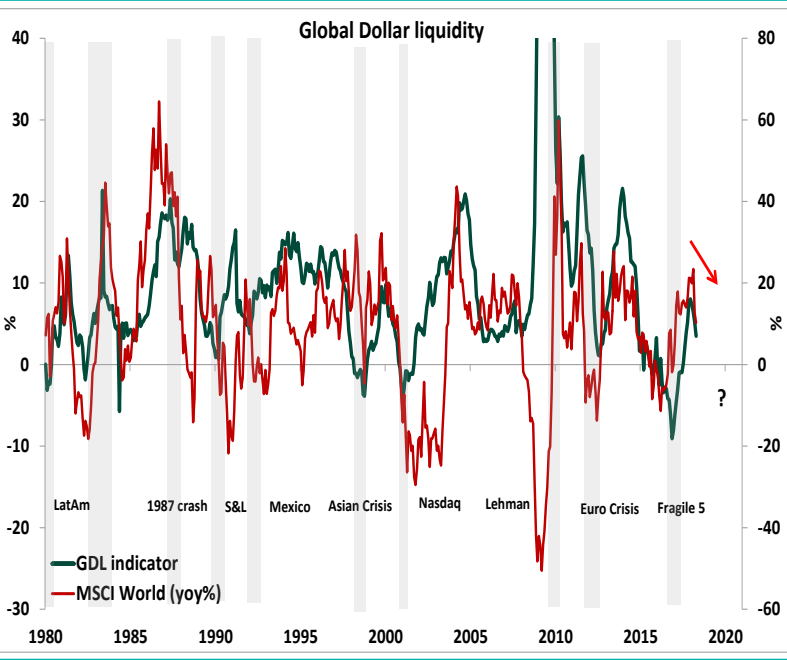


Source: BBG, Nedbank CIB Research

- In this report we look at certain markets and indices that we follow to assist us in monitoring the dollar. Our view: We expect further consolidation over the short-term, but we believe this is the beginning of a prolonged risk-off phase (as global dollar liquidity has started losing momentum).
- Our secular view, since the 2008 GFC, has been that the world will struggle with deflation and a stronger dollar (this would be both a consequence and a driver of this environment). Since the start of 2017 our tactical outlook has been for a weaker dollar, but we called the bottom prematurely in September 2017.
- The dollar turned up from a very important support line (from the 1985-high), and the latest rally was very strong. The million dollar question is whether this will be a false start again. We do not believe that it is.
- There are many "canaries" that are starting to "fall over" – hence we are deeply concerned about current market conditions. We are faced with very large risk-on positions (ie record net-long positions in oil, copper, EUR/USD etc).

- Why is it important to "get the dollar right"?
- The US dollar is still the dominant global currency, and a stronger dollar is an indication of tighter global financial conditions.
- If this is the case now again, and we believe it is, then we can expect real rates (term/risk premium) to rise, which would be negative for risk assets. The tighter financial conditions would also be deflationary by nature.
- We therefore expect the US10yr to rally (continuation of the 30yr bull trend), reflecting the deflationary forces of a stronger dollar and contraction in the Global \$-Liquidity – this would not bode well for risk-assets (like SA bonds/FX/equities).

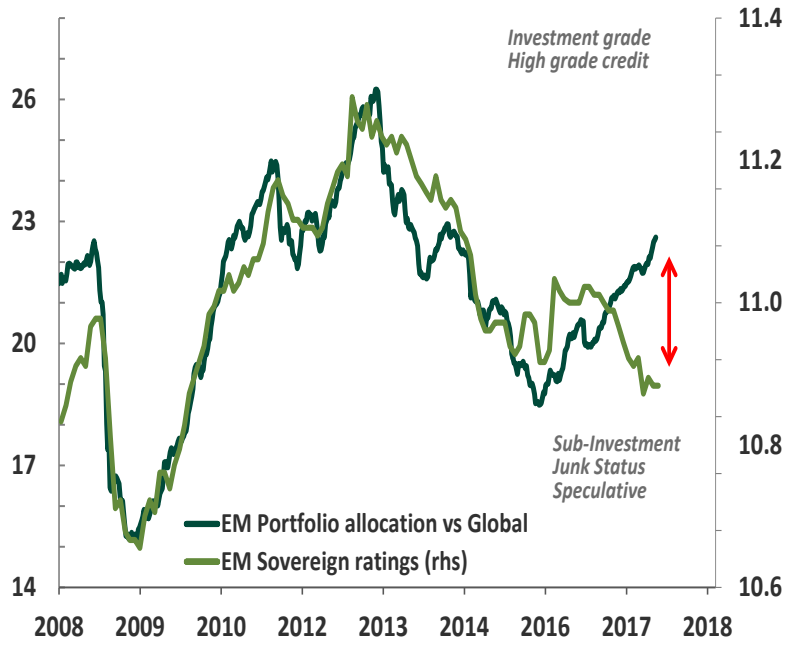
\$-Liquidity is like dynamite fishing...



Source:DS, Nedbank CIB Research

- Our Global \$-Liquidity indicator is losing momentum due to the tightening monetary conditions by the US Federal reserve (and as US current deficit shrinks).
- Oil is one of the largest contributors to Global \$-Liquidity. If oil loses momentum, it reduces the number of petrodollars in the financial system, and adds to the \$-Liquidity shortage.
- As dollar liquidity slows down, it is likely to unwind the extreme positioning and enforce a strong dollar (ie de-risking).

EMs the beneficiaries of a misallocation of liquidity



Source: IIF, Nedbank CIB Research

- A contraction in Global \$-Liquidity, as reflected by a stronger dollar and tighter financial conditions, is likely to correct the distortion between deteriorating EM fundamentals and the carry-trade (portfolio allocation to EM).

Bloomberg EM FX carry index has broken out of bull trend



Source: Reuters, Nedbank CIB Research

- The carry index is an important “canary” to monitor. The index has broken out of the bull trend at 260 and has rallied from the 255 neckline on Friday to test 260 from below.
- The next few days will be important, as a consolidation below 260 would confirm a major reversal.
- A break below the neckline at 255 and below the wave-A high at 252 would project substantial downside (to below the (red) wave-C low of early 2016).
- The MACD has also confirmed the break out of the bull trend.

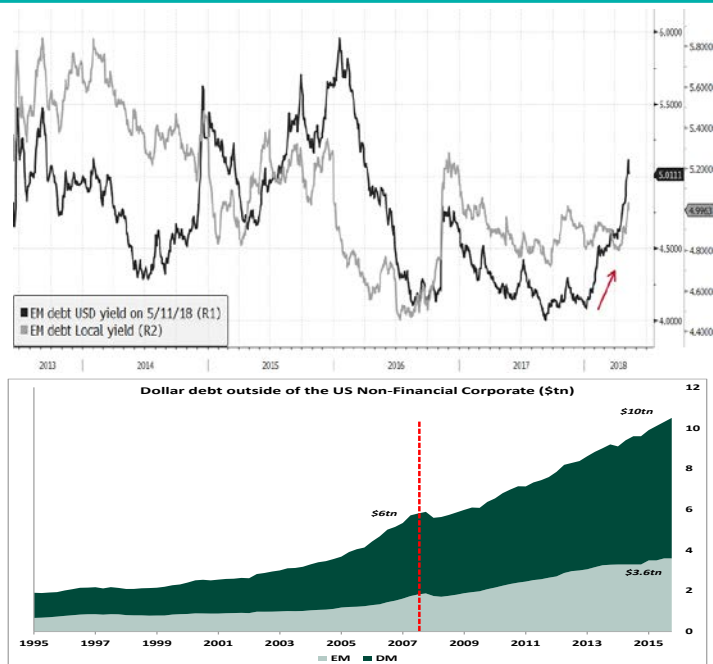
MSCI EM, testing trend-reversing support levels



Source: BBG, Nedbank CIB Research

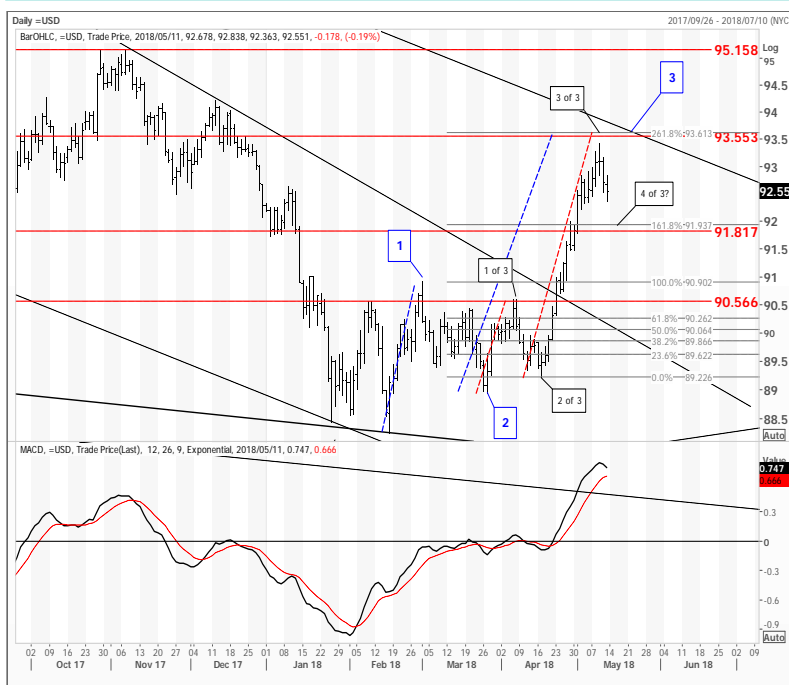
- The EM stock markets rallied in a similar vein (ie similar to the EM currencies) since the start of 2016, and peaked in early 2018.
- The MSCI EM index is currently trading against two major support lines and it is too early to confirm a reversal.
- There are two sides to the investment process, the funding of the investment (savings or debt) and then the investment destination. As long as the debt super-cycle was in full swing the market never had to pay any attention to the source of money. This has changed since the 2008/09 GFC, with central banks influencing M directly in the MV=PQ equation. Hence the source, M, is now equally important to the destination.
- MV=PQ: Monetary base X Velocity of Money equals Price and Quantum.

Cost of EM debt rising



Source: BBG, Nedbank CIB Research

DXY, the dollar has started to trend



Source: BBG, Nedbank CIB Research

- The Bloomberg Barclays EM local and USD denominated debt spreads has taken out the highs of 2016 and has broken into the late-2016 lows.
- This is likely to be more than just a correction phase and should target the neckline at 5.50%.
- The world, and in particular emerging markets, has been on a dollar debt binge – one that has issued over \$3.5tn (rest of world \$10tn) in dollar debt. Hence our concern that a slowdown in dollar liquidity would not bode well for dollar-indebted nations/corporations.
- If the EM currencies above fail over the next few days to break back into the bull trend that has been in place since the start of 2016, then it is just a matter of time in our opinion before the EM currencies force foreign investors out of the EM markets.

- The strong rally in the dollar since middle April 2018 is nearly a 261.8% Fibonacci extension of the rally in February 2018.
- In a corrective pattern, it is extremely unlikely that a move will extend 261%. At most the C-wave should extend 161.8%. In layman's terms this means the dollar is now very likely in a trend and not in a correction phase.
- The short-term charts indicate the dollar index is likely to consolidate between 91.81 and 93.53, before rallying to our target level at 95.
- In our opinion, a break above 95 would trigger many major trend reversals, would cause the carry index to move to below 252, and cause EM stock markets to break lower.
- The carry trade in 2016 and 2017 was overpowering local fundamentals all over the EM world, and the unwinding of this trade would have the same effect in our view.
- We often face the question of “why will funds return to the advanced markets if there is no yield there?”. We must however remember that there is a lot of gearing in the carry trade and that when the trade unwinds it is to pay back the original loan firstly.

\$-rand, has corrected to the break-out level



Source: Reuters, Nedbank CIB Research

- In our FX report last week we indicated the \$-rand is due for a correction and could pull back to the trendline and previous lows at 12.23.
- We do not expect the \$-rand to break below 12.23 on a sustainable basis and expect further consolidation between 12.23 and 12.52 before the bull trend continues.
- We believe the \$-rand will reach 13.55 during the second half of the year.
- Only a break below 12.09 would force us to reconsider our short-term bullish dollar view.
- The SA rand is the high beta play in the EM space and can therefore be vulnerable should the dollar strengthen dramatically.

R186, expect short-term correction then higher levels



Source: BBG, Nedbank CIB Research

- Wave 3 was 161.8% of wave 1, and the market is currently busy with a correction phase that is most probably not over.
- We expect the corrective rally to reach the neckline at 8.26% with an extended correction to 8.16%. We would however ascribe a low probability to the latter outcome.
- Technically we expect the R186 to weaken to 8.70%, post the completion of the short-term correction phase.
- The major driver of this expected bear move would be global forces and the unwinding of the carry trade in our view. Foreign investors own half of the SA bond market and it is therefore crucial to understand the forces that would influence these flows.

