STRATEGY NOTE:
THE DOLLAR CONUNDRUM

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Our long held view, which we reiterate here, is that the world will suffer from a dollar shortage going forward – this is already very evident in the funding markets, but not in the spot market...yet.

We have opined since 2016 that understanding the carry trade will be crucial to understanding future flows in and out of emerging markets. It is therefore important to think global and not just local. **Our cyclical view remains unchanged: The major opposing forces in 2018 will be contracting global liquidity vs synchronized global growth.** Our view is that the former will be the bigger force, and that it will drive asset returns in 2018. Central to all of this is the outlook for the US Dollar.

The 2008/09 sub-prime crisis was funded by off-balance sheet activities (shadow banking system), which at the time was the ‘great unknown’. These imbalances were not funded by savings or by normal bank credit. As a result of central banks’ extraordinary easy monetary policy as well as new banking regulations, shadow activities bled into the savings industry. We believe that the ‘great unknown’ this time around is the leverage in the non-banking system, which is fuelling the carry trade and a weaker dollar. Authorities are concerned that the leverage in the savings industry will end up in low quality credit, as was the case with sub-prime in 2008.

**Bottom line:** We do not subscribe to many of the current narratives predicting further weakness in the US dollar. We think it is far more complex than what it is being made out to be. Liquidity risks continue to build (eg Libor, cross currency basis). However, these risks remain under-priced, as reflected in the dollar; hence we believe the weakness in the dollar will not be sustainable, as highlighted on page 5.

**SA:** SA assets are very exposed to the carry trade. In our opinion, the current external vulnerability metrics (current account deficits etc) understate the financial linkages (carry related flows) between SA markets and international markets. Therefore we envisage a volatile performance in SA markets during 2018, driven by external forces, in the face of improving local fundamentals.

**Investment recommendations:**

- We expect the dollar will revert to back to flow and liquidity fundamentals in 2H18. Thus, we expect a stronger dollar. This would lead to higher FX volatility, which would filter through into all the asset classes.
- The outperformance of global equities over bonds during 2H17 has stalled. We expect this relative to remain range-bound during the risk-off phase, with no clear winner in 1H18. We would recommend an overweight bond position, seeing as the bond term premiums have opened up.
- Post the ANC conference, SA bonds and the currency outperformed other EMs. However, it is now close to resistance. Further gains in the rand and bonds would have to come from further dollar weakness, and we believe this will be limited.
- With regards to the JSE: The outperformance of the Fini-15 is already in a mature phase. As the dollar strengthens, the large cap dual-listed Indi stocks should outperform towards the latter part of 2018. NPN could however be a drag on the Indi-25, as we believe the correction in tech stocks is only starting. We therefore favour Indi, over Fini, over Resi. Within the Resi we favour gold, over large-cap diversified stocks, over platinum. Within the Fini we prefer Life over Banks in 2018.
Assets have become highly correlated, seeing as most assets have become proxy yield plays within the carry trade.

The financial system is more complex than ever before, yet there is systemic complacency?

Therefore, we believe the ‘Liquidity and Credit Cycle’ below best exemplifies the system’s complexity vs the systemic complacency.
• Our secular view, ever since the GFC, has been that as long as dollar liquidity rolls over (see chart below) the dollar should remain strong.

• The dollar index has now corrected to test the original bear channel from 1985 and the bull support line from the GFC (at 88, both from above). For our bullish dollar secular view to remain intact, the dollar must bottom out at current levels. We believe this major support will remain intact, seeing as dollar funding pressures are starting to materialise in the offshore dollar-funding markets.

• The dollar is central to all our views, because it is the main driver of global liquidity and because it plays an important role in the asset allocation process.

• For SA markets, the outlook for the dollar is also very important, given how integrated our markets have become with global flows and global liquidity via the carry trade.

• The Federal Reserve always influenced the credit/liquidity cycle by changing interest rates – this resulted in the typical growth/inflation cycles.

• However, deep in the monetary plumbing of the world’s financial system, the USD monetary base grew from 2% to 16% post the signing of the Bretton Woods agreement. This meant that liquidity was always abundant enough to ‘grease the wheels’ of the global financial system, thus fuelling consumer and asset price inflation. Hence the world’s obsession with inflation; it determined the price of money. Post the GFC, central banks had to change the quantum of money as interest rates were at zero. Readers will know that we try to analyse how this changing quantum influences the economy and markets.

• After the 2008 GFC, everything changed, and the USD monetary base rolled over. However, this contraction in liquidity was countered by the expansion in central bank balance sheets (QE), which in turn distorted asset prices. We therefore believe that one cannot only use cyclical analysis (ie growth/inflation cycles) to understand the changes taking place in financial markets and the economy. We feel one has to examine changes in broader liquidity as well (ie the ‘M’ in Fischer’s MV=PO; money supply x velocity of money = GDP) in order to understand asset allocation.
CURRENT NARRATIVE AROUND THE WEAKER DOLLAR IS NOT TOO CLEAR

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The current 'narrative' around the weakness in the US dollar is, in many respects, hard for us to reconcile with a number of fundamentals and liquidity metrics that we track. We do not believe that the weakness in the US dollar will be sustainable over the next few quarters.

In this report, we demystify these forces, in order to give us a better idea of what may prompt the dollar to revert away from the 'narratives' and return it to the forces of 'flows and liquidity'.

We believe the weaker dollar is being supported by activities in the carry trade. There are a number of players involved in the carry trade (including asset managers and non-financial corporates). We also believe the carry trade is much bigger and systemic than most people would like to believe. In 2008/09 we knew about the falling credit quality in the sub-prime sector but were caught off-guard by the size of the shadow banking system. More on this on page 11.

The growing twin deficit is currently a popular reason given for the weak dollar. Historically, however, there is no stable relationship between the dollar and the twin deficits.

For example, in 1985 the dollar bear move only happened post the bottom in the twin deficits (and was probably more a consequence of the Plaza accord than of the twin deficits). Between 2000 and 2004 there was a high correlation between the deficits and the dollar, but that broke down again during the GFC. We therefore do not believe that the deficits are the main driver of the weakness in the USD (as some are professing).

Many analysts are also calling the end of the dollar reserve system. Although we believe that this will eventually be the case (some years or decades from now), we do not believe that it is here as yet.

First of all, there is no alternative. The dollar remains the dominant trading currency, and most debt in foreign currency is also in dollars. In our opinion, the dollar is here to stay for a while longer.
Global growth is a far more important driver of the dollar in our opinion. The increased velocity of money generated from global trade and an improving economic environment generates excess liquidity, lubricating the global financial system. This leads to a weaker dollar. The challenge therefore is to establish the point at which global growth slows down.

US President Trump’s policies could slow down global growth, and in turn this could slow down global trade. This would then slow down dollar creation, which would likely strengthen the dollar (i.e., the exact opposite of what US President Trump is trying to achieve).

The US trade deficit adds to the world’s dollar monetary base, and global trade is the velocity in the Eurodollar system. Many of these dollars found their way back to the US, to fund US deficits, and this kept US rates amongst the lowest in the world. This situation has changed and a trade war would put upward pressure on US rates (as local funding is sought). The new tax deal would force offshore profits back to the US, and this would starve the Eurodollar system of dollars. It would then just be a matter of time before this all works its way through into the spot market.

The drivers of currencies have evolved through the decades. Under the gold standard, trade was the only driver. Then interest rate and growth differentials dictated global flows. Lately it is future monetary policies (ΔCB balance sheets) that has become the driver of currency movements.

The EUR/USD was the first to decouple from short-term (and then long-term) interest rate differentials. Lately, the difference in 10-yr term premia (real rates) has become a driver of currencies.

Distortions in the 10 other major currencies followed, with the yen being the latest poster child. Point is, there is a breakdown in the fundamental framework that drives currency movements.

These results also indicate that the US dollar is far weaker than what interest rate movements would suggest. We therefore believe there is a risk of a cyclical snapback for the USD, especially in the face of a Fed that is raising interest rates.
**STRATEGY**

**USD FAIR VALUE MODEL IN OVERSOLD TERRITORY**

Our USD fair value model* suggests that the dollar is now 1.7 standard deviations too cheap. The weakness in the USD can be explained by the higher oil prices (more petrodollars in circulation), the lack of volatility, and an improvement in global growth.

Our model indicates that the dollar is likely to bottom in 1H18, thereafter strengthening for the rest of 2018 as the economic tailwinds (which contributed to dollar weakness) reverse.

We believe the outlook for the USD will be influenced by forces outside of the Fed’s control (ie risk positions in the carry trade, petrodollars, and other CB’s QT programs).

**EURO-$, LOSING MOMENTUM CLOSE TO THE TOP OF THE BEAR CHANNEL**

In our 2018 outlook we called a bottom in the dollar during 1Q18. Currently the dollar is testing major trend-reversing levels. We remain of the opinion that the dollar will bottom soon.

The euro rallied within the well-established bear channel and tested the blue neckline at 1.2538. This is also the 38.2% Fibonacci retracement of the bear market since 2008.

The MACD momentum indicator is not confirming the new highs, indicating that the euro bull is losing momentum.

As long as the euro remains above 1.21 we have to entertain the possibility of a rally to the major resistance line at 1.2687. We would ascribe a very low probability of a sustained break above 1.2687.

A break below 1.21 would negate any further upside potential, projecting a correction phase to 1.1417. We expect this scenario to play out during 2H18.

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*DIY Financial model consists of changes in the oil price (petrodollars) and commodity prices, interest-rate differentials (G7 nominal carry trade), and the VIX as a proxy of risk appetite.

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**Source: Reuters**

**Source: DS**
LIQUIDITY CONDITIONS ARE TIGHTER THAN WE THINK

- Post the 2008/09 GFC, major central banks around the world adopted extraordinary monetary policies in the form of Zero Interest Rate Policy (ZIRP), as well as large stimulus programmes (such as QE by the US Federal Reserve, QQE by the BoJ, and APP by the ECB).

- To measure the impact of these programmes, Leo Krippner at the Bank of New Zealand created models to measure the effective interest rates of these extraordinary policy measures – this became known as the Shadow Policy Rate.

- Currently the shadow rate in the Euro Zone indicates that liquidity conditions are far more restrictive than what the market is portraying, and that they are expected to tighten further as the ECB slows down its APP. The ECB is unlikely to hike until the shadow rate is back at zero.

- Libor spreads are also indicating that there are pressures building in the Eurodollar market. We believe it is only a matter of time before the dollar reacts.

- We therefore do not believe that the low volatility environment and the risk-on phase are sustainable.

GLOBAL BOND YIELD AND G10 CITI SURPRISE INDEX

- The levels of the global bond yields has always been important in the context of cost of capital vs return of capital.

- The central banks compressed bond yields with their QE processes, which resulted in an improvement in global growth. However the unintended consequence was that investors moved into riskier assets, with extended duration.

- Using the Citibank Economic Surprise index as a proxy, it is clear that the higher bond yields are already taking their toll on the global growth outlook. Hence, we believe global growth has peaked, which would not bode well for global dollar liquidity (and would also lead to a stronger dollar).

- One thing that we must keep in mind in a world of quantitative easing (or tightening) is that monetary policy is no longer restricted to the short-end of the curve.
DEFLATION BUSTS LED BY A RISING TERM PREMIUM

- ‘History has not dealt kindly with the aftermath of protracted periods of low-risk premiums’ - Alan Greenspan at the 2005 Jackson Hole Economic Policy Symposium. We believe that risk and money are both currently mispriced, and that this has led to a misallocation of capital.
- All the major lows in the 10-year term premium went hand in hand with financial imbalances. Rising real rates have never been kind to risk assets, always triggering an unwinding of the imbalances that had built up.
- We believe that the current environment (excessive leverage, short vol strategies etc) will end up with the same result. However, we believe that a steeper yield curve (as opposed to an inverse yield curve) will be the trigger of the next economic downturn.
- Interpreting the yield curve is more complex than only looking at the Fed’s policies. Other central banks have also contributed to the distortion in the yield curve through their own QE programs. For example, while searching for collateral, the ECB forced Euro investors out of the euro-zone; it was not just a search for yield.

INTEREST RATES AND VOLATILITY

- Normally, as the cost of capital starts to climb in a highly-indebted global economy, it is just a matter of time (24 months this time around it would appear) before volatility starts to rise.
- Therefore we expect volatility to increase as the Fed hikes continue during 2018 and as other major CBs tighten monetary policy. The rising EM FX volatility, which should be a consequence of the tighter financial conditions, should take its toll on the EM risk-adjusted carry trade.
- South Africa is therefore not likely to receive the same capital flows into its financial markets as it did during the 2016 and 2017 period, notwithstanding the improving political and fundamental backdrop.
- The falling asset volatility, that went hand in hand with improving global liquidity since 1Q16, is turning up.
- It is now all down to trying to identify the turning point in the dollar.
SHADOW BANKING

• The pre-QE and Basel plumbing was built on dealer banks lending out cash to money managers by collateralizing safe assets such as USTs via the repo market.
• The cash that was generated by collateralizing ‘safe assets’ was used in the carry trade to purchase high yielding assets (securitized home loans and other exotic assets). This funded the Shadow Banking System pre the 2008/09 GFC.
• When the IMF analysed the shadow banking system in 2011, it found that the same asset went through the repo desks three times. Hence the term ‘velocity of collateral’ (the same asset being re-hypothecated over and over). This phenomenon has now, post Basel II, moved into the savings industry.
• We face the question ‘why and when will this end?’ This is admittedly very difficult to answer. The exact trigger point of the imbalance unwinding cannot be forecasted; instead it is the build-up of the imbalances that is more important to identify, and to then understand the potential triggers.

THE SAFE ASSET SHORTAGE

• The new plumbing, which is the result of changing banking regulations and QE policies, starved the financial system of safe assets. This has fuelled demand for EM assets as a substitute.
• Post the GFC, many GSEs lost their investment-grade status, and the total pool of A-rated bonds in the world shrunk considerably. It is not just investors, but also the shadow bank activities, that get forced down the credit curve.
• The BIS is concerned about international QE spillovers via the collateral channel that is used for cross-border funding (ie the carry trade). SA and EMs have benefited from this process up until now.
• The investment industry spends a huge deal of money and energy trying to identify the investment destination. This approach is obviously very important, but we believe it has become just as important to monitor the source of the funds.
• We believe that what subprime debt was to the SBS in the late 2000s, the EM debt/HY Corp debt is to the SBS in non-banks currently.


Source: The Safe Assets Shortage Conundrum, Caballero July 2017
LEVERAGED BETA POSES A RISK TO RISKY ASSETS

According to the **IMF**, the savings industry (particularly bond funds) has increased its use of derivatives significantly since the GFC (to enhance returns in an environment plagued by low investment returns and rising pension deficits). The highest-gearred bond fund is 10 times geared.

Most of the funds with high levels of leverage are invested in a wide range of bond sectors; from US Treasuries, to Emerging Market bonds, to junk bonds and asset backed securities.

Although the use of derivatives is common in the industry, the risk of contagion and loss of liquidity is growing; especially in an environment of higher policy rates, QT, and rising term premiums.

SEARCH FOR YIELD: FUNDS HAVE INVESTED MORE IN LOWER-RATED BONDS

In the current low-yield environment, and due to the crowding-out effect of QE, investment funds have been venturing further down the credit risk spectrum (and into longer maturities).

A common pattern observed in the past few years is that institutional investors (including insurance corporations, pension funds, and investment funds) have shifted their asset allocation from higher-rated to lower-rated debt securities (such as Emerging Market debt).

An increased exposure to interest rate risk, combined with the current low-rate environment, leaves bond fund investors particularly vulnerable to any reversal in global liquidity and volatility.

**Point is:** We believe that the activities in the non-banking system are generating USD, making the USD unusually weak. De-risking (rising term premium) from Developed Market asset managers would have broad ramifications for emerging markets like SA, even with a improving domestic environment.
We believe that changes in money supply drive the inflation and deflation cycles.

As credit growth collapsed all over the world post the GFC, it lead to deflation. The global CBs had no choice but to add to the monetary base to try to counter this contracting.

The exception was China. It embarked on a credit binge the likes of which the world had not previously seen.

Japan’s credit bubble peaked in 1989, at 19% above the long-term trend growth in credit. The US peaked at 12% above trend.

China peaked at 30% above trend in 2016, and as the authorities target the credit bubble and shadow banking system, this downward trend should continue.
SA IS EXPOSED VIA FINANCIAL LINKAGES

- Compared to its EM peers, South Africa has attracted the largest amount of capital flows as a % of GDP. Notably, EM peers have used foreign inflows to build buffers, whereas SA has not.
- On the plus side, SA’s external vulnerability is lower than before (ie CA deficit at 2.4% of GDP 2018e vs an average of 3.5% of GDP). South Africa is also fortunate to not have a large amount of debt in foreign currency.
- We are not concerned about trade flows, but rather about portfolio flows via the carry trade.

STRATEGY

- As the carry trade evolved and gained momentum in 2017, it became evident that investors were being forced down the credit curve.
- There is a disconnect between EM fundamentals and asset price appreciation in EM financial markets.
- EMs did not track sovereign ratings, and the commodity currency index started to follow the carry performance index (and not commodity prices).
- We do not believe that this is the new ‘norm’. We think it is an ‘exception’, that will be reversed as soon as volatility starts to rise in the FX and bond market.

DISCONNECTS IN EMERGING MARKETS DUE TO THE CARRY TRADE

- We are not concerned about trade flows, but rather about portfolio flows via the carry trade.

Source: IMF, BBG

Cumulative Capital Inflows % GDP vs Δ FX Reserves

Source: IMF
The world is more exposed to US credit than ever

- Dollar debt of non-US non-financial entities grew from $5tn in 2008 to $11tn currently (according to data from the BIS).
- Dollar liabilities on this scale are unprecedented and leave the world’s financial system more vulnerable (to rising US rates and dollar) than ever before.
- Global debt also grew from $149tn in 2008 to $235tn today; interest rate changes therefore matter a lot.
- If the currency war gains momentum, repaying this USD debt could become difficult. Global trade creates dollars (velocity of money). If the US stops exporting dollars, it would become difficult for these non-US entities to repay their dollar debt.

EM’s exposed to USD credit

- The 1998 SE Asian crisis was a fixed exchange rate crisis.
- Today many of these EMs have free-floating currencies. This is however negated by the fact that their corporates are heavily indebted in USD denominated debt; debt that is not matched with FX assets and revenues.
- The ratio of EM USD debt to exports rose from 30% in 2008 to 50% in 2016. Dollar liabilities have also increased relative to the stock of FX reserves.
- The EMs are back where they were in 1998; they have limited control over their currencies – all as a result of the carry trade.
- As we mentioned earlier, the world is not moving away from the dollar (as many have suggested).
• A key constraint on the pace of a further USD decline is positioning.
• During periods of risk aversion or elevated market volatility (as seen in early February 2018), the USD can gain as investors reduce positions across the board.
• Dollar weakness does make for a risk-on environment, but we must remember that a self-reinforcing trend can move in both ways. As the dollar strengthens, the carry trade returns will fall, leading to further demand for dollars.

• In September last year we expected the Bloomberg EM FX carry index to peak out. The index did pull back, but it was not the ultimate top.
• The dollar bear trend accelerated during 4Q17 and the carry index rallied back up to the top of the well-established bull channel.
• The MACD momentum indicator is not confirming the new highs, indicating a loss of momentum.
• This is not the time to extrapolate the dollar bull trend in our opinion.
• The carry index must however break below 268 before a top formation can be confirmed.
• The Global Liquidity Conditions index has remained accommodative up until now, notwithstanding the higher Fed funds rates. A rally in the dollar could however change this very quickly.

• We believe that the ‘choking point’ will arrive before the curve is inverse, seeing as the rising long-end of the market is doing a lot of the work for the monetary authorities.

• A contraction in dollar liquidity has always triggered financial strains, and this time will be no different in our opinion.

The MSCI world index remains in the bull trend that has been intact since the start of the risk-on phase in early 2016. The false ‘over-throw’ in January was however a bearish signal. The market has been consolidating post the XIV sell-off, but remains in the original bull channel.

We expect the equities to break down out of the bull trend in the near future, targeting the bottom of wave-4 at the 38.2% retracement level. The relative to global bonds (bottom panel) is on its way to testing the red neckline and the bottom of the bull channel. Therefore, we expect equities to underperform bonds over the next quarter.

The US bond market is still within the near-perfect bull channel that has been in place since Greenspan took office. The JPM Global Bond Yield has however broken out of this channel and is trading against a proverbial Rubicon level at 1.69%.

We expect this support to hold, as discussed in the fundamental section above. A strong dollar is deflationary, supportive of bonds. Technically, the 2017 bear is weaker than the 2016 bear. In a true bear market the market would accelerate.
STRATEGY

EM VS SA BONDS

- The SA bond yield has been ‘going nowhere’ for more than a decade now. The yield is currently below the linear regression line at 8.38%.
- The 10yr yield is trying to break below the blue neckline at 8.07%, but has failed so far to be convincing.
- The $-rand is likely to be trapped in the middle of the channel between 12.30 and 11.70 (while the euro-$ is in the process of completing its topping process).

RSA 10YR YIELD AND $-RAND, SA NEEDS SUPPORT FROM EM’S TO EXTEND RALLY

- The JPM EM Bond yield bottomed with the dollar in September last year, and has failed to make a new low in 2018. The SA market did rally to a new low on the back of the improving politics.
- A major bottom would be confirmed the moment the dollar bottoms out and the EM yield breaks above 6.15%. The next major ABC to the upside, similar to the 2013-2015 period, would then start unfolding, targeting new highs above the 2015-high.
- The relative of the SA Over EM (TR) Bond index is against a major resistance, and we do not expect this relative to break higher.
- Unfortunately, the SA bond market is the high beta play within the EM sector. If our views play out that the carry trade will unwind, then SA will start to underperform.
**RAND FAIR VALUE MODEL**

- We set our (tactical) fair value for the SA 10y bond at ~8%, based on our inflation outlook (implied inflation of 3.3% vs 4.2%).
- However, we believe the CDS or country risk premium is too compressed, reflecting the easy global financial conditions.
- Tighter global financial conditions are likely to result in a higher CDS or country risk premium. In this scenario the SA10y could rise to 8.70%.
- We believe that global liquidity conditions are not pricing in the liquidity risks that are building up in offshore USD funding markets.

**BOND FAIR VALUE MODEL**

- We estimate the fair value of the $-ZAR by using a combination of PPP metrics. However, we also incorporate global liquidity metrics such as the carry trade, commodity prices, and USD financial conditions.
- Our forecast for the $-ZAR for the end of 1H18 is 12.40, and for end 2H18 it is 13.35.
- We expect the bulk of the move in the rand to come from weakening external liquidity conditions (i.e., the carry trade and commodity prices).
**STRATEGY**

**EM EQUITIES REMAIN IN BULL CHANNEL**

- The JSE SWIX TR index converged into a wedge (starting in 2015 and ending middle-2017).
- The JSE then broke higher, completing a clear 5-wave Elliott wave pattern (from middle 2017 to January 2018).
- The relative (bottom panel) of the SWIX TR to the ALBI rallied during this period. The false break to the upside, out of the band (circled), was however a bearish signal. The relative is now targeting a move to the bottom support line of the trading range.
- We expect the spot to correct to the neckline at 20,040. A break below 20,040 would project further downside to 18,627 with an extended target at 16,000. This level is the bottom of the trading range and 38.2% of the bull trend that started in 2009 (post the crisis).
- If the spot breaks below 20,040 we can expect the equity/bond relative to break the support line that has been in place since 2014.

**SA EQUITIES VS BOND UNDERPERFORMANCE ALMOST OVER**

- The JSE SWIX TR index converged into a wedge (starting in 2015 and ending middle-2017).
- The JSE then broke higher, completing a clear 5-wave Elliott wave pattern (from middle 2017 to January 2018).
- The EM index accelerated out of a well-established bull channel in January 2018. This was most probably the exhaustion phase.
- A major trend-reversal would only be confirmed with a break down out of the bull channel at 1,107.
- The EM over DM relative (bottom panel) remains within a well-established bull channel from 1Q16, and is losing momentum against the resistance line (backed up by the diverging MACD).

**Source:** Reuters

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