



STRATEGY NOTE:

FX

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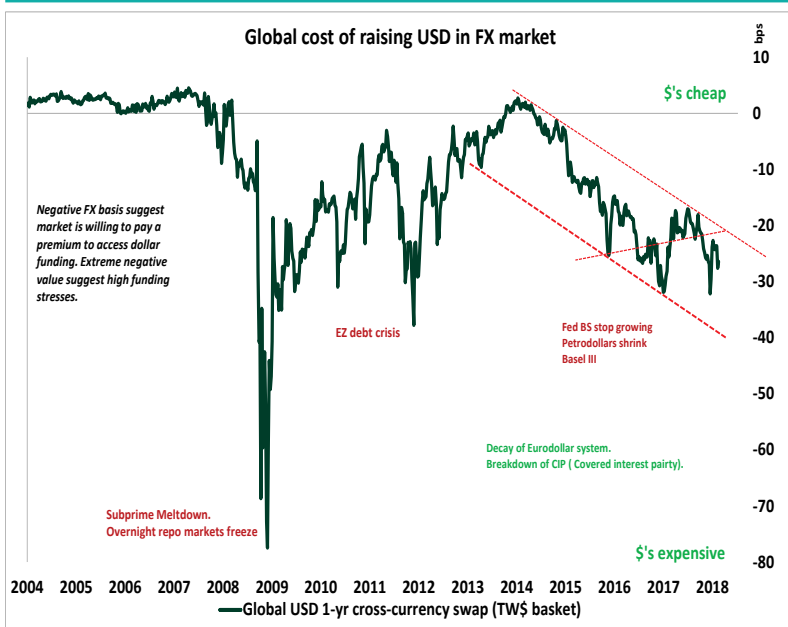
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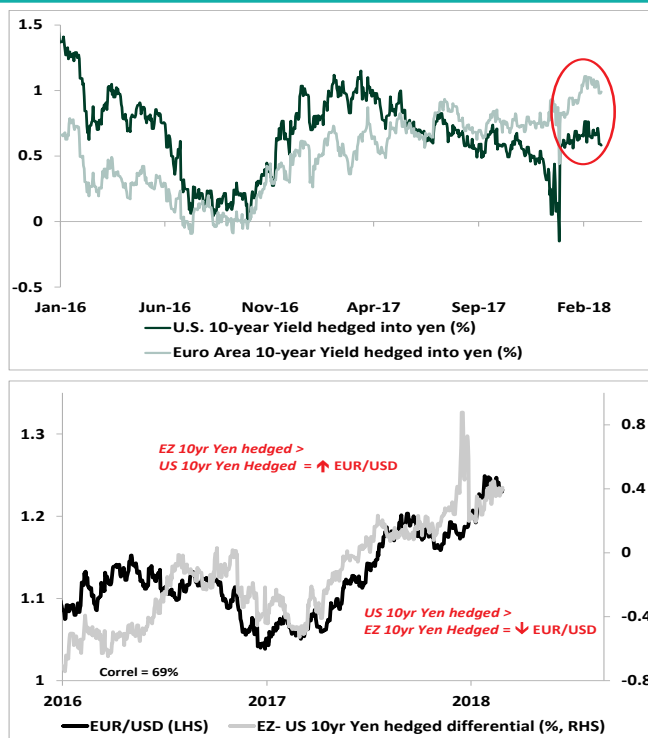
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DOLLAR SHORTAGE PERSISTS IN FUNDING MARKETS



Source: DS, Nedbank CIB Research

SUPERCHARGED EURO DRIVEN BY THE JAPANESE CARRY TRADE

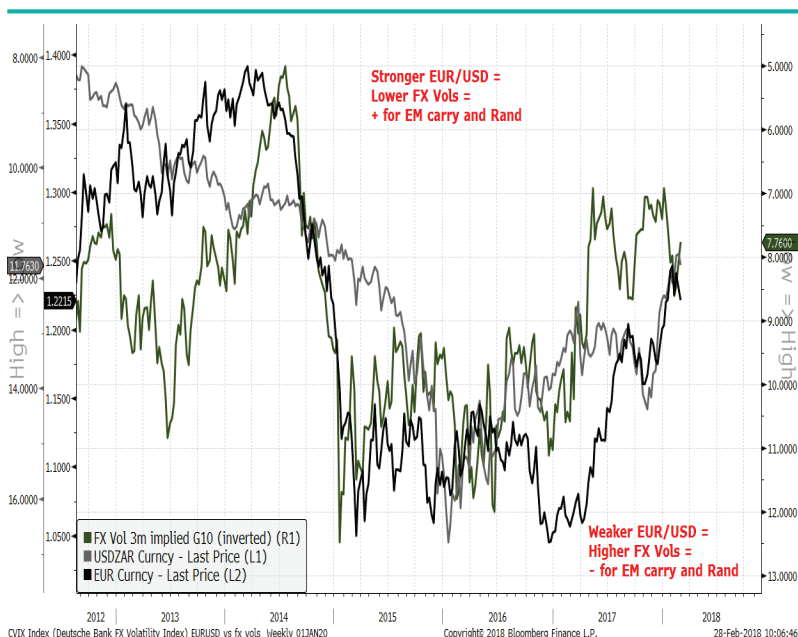


Source: DS, Nedbank CIB Research

- Our long held view, which we now reiterate, is that the world will suffer from dollar shortages going forward - this is already very evident in the funding market but not in the spot market...yet.
- The Eurodollar system (ie USD banking system outside the US) is underappreciated in our view. This system is vital in ensuring that there is always a supply of dollars to fund and secure the many carry trade transactions.
- We believe that the rising funding costs of USDs in the Eurodollar market has been the catalyst for the supercharged EUR/USD, driven by the Japanese carry trade. More on that below.

- The current 'narrative' in the market is that the USD weakness is driven by the developments around the US twin deficits, Trump's policies, and the divergence in the monetary expectations of the Fed and the ECB. We do not believe that these developments are necessarily the major drivers.
- Japan is one the largest dollar debtors in the world according to the BIS. This is due to it being one of the largest players (banks and pension funds) in the carry trade market amid the hunt for yield.
- We believe the supercharged EUR/USD since 2Q17 is due to the Japanese carry-trade.
- In the past, the gap between the real European bond yields (yields hedged into yen) and real US bond yields (yields hedged into yen) were negative. This led to a weaker euro. However this reversed in 2Q17 – ie as real European bond yields became more attractive funds fled the US bond markets for European shores. This would explain the supercharged EUR/USD. This is very evident in the bottom chart.
- Going forward, we believe that this trend is not sustainable and a reversal is due as the Fed continues on its path to hike interest rates, which will make real US bond more profitable and thus we expect a weaker EUR/USD

A REVERSAL OF THE EURO BOND YIELD (HEDGED IN YEN) WOULD NOT BODE WELL FOR THE EM CARRY TRADE AND THE SA RAND



Source: BBG, Nedbank CIB Research

EURO-\$: A CORRECTION IN THE EURO IS PLAYING OUT



Source: Reuters, Nedbank CIB Research

- Favourable US bond yields (hedged into yen) would reverse the trend that has boosted the EUR/USD. Furthermore, a weaker EUR/USD would likely lead to higher FX volatility.
- FX volatility would lead to global trade uncertainty, something that the world cannot afford given the synchronized global growth.
- Higher FX volatility erodes the return in the carry-trade through the risk adjusted ratio i.e. Sharpe ratio i.e. HY-funding currency/FX volatility.
- In this type of environment we believe that the rand will come under pressure, despite possible favourable local dynamics. We believe the main driver of the rand will be the volatility of the global carry trade (of which SA has been a major benefactor due to foreign inflows in 2016 and 2017).

- The euro rally, that started in late 2016, completed a textbook Elliott wave pattern, and the correction phase is now starting.
- The general Elliott wave rule is that upon completion of the pattern the market will retrace the fifth wave.
- This suggests a correction to 1.1537, which is the 50% Fibonacci retracement as well as a support line.
- Short-term the euro is in the process of testing a previous low, which should lend some short-term support.

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