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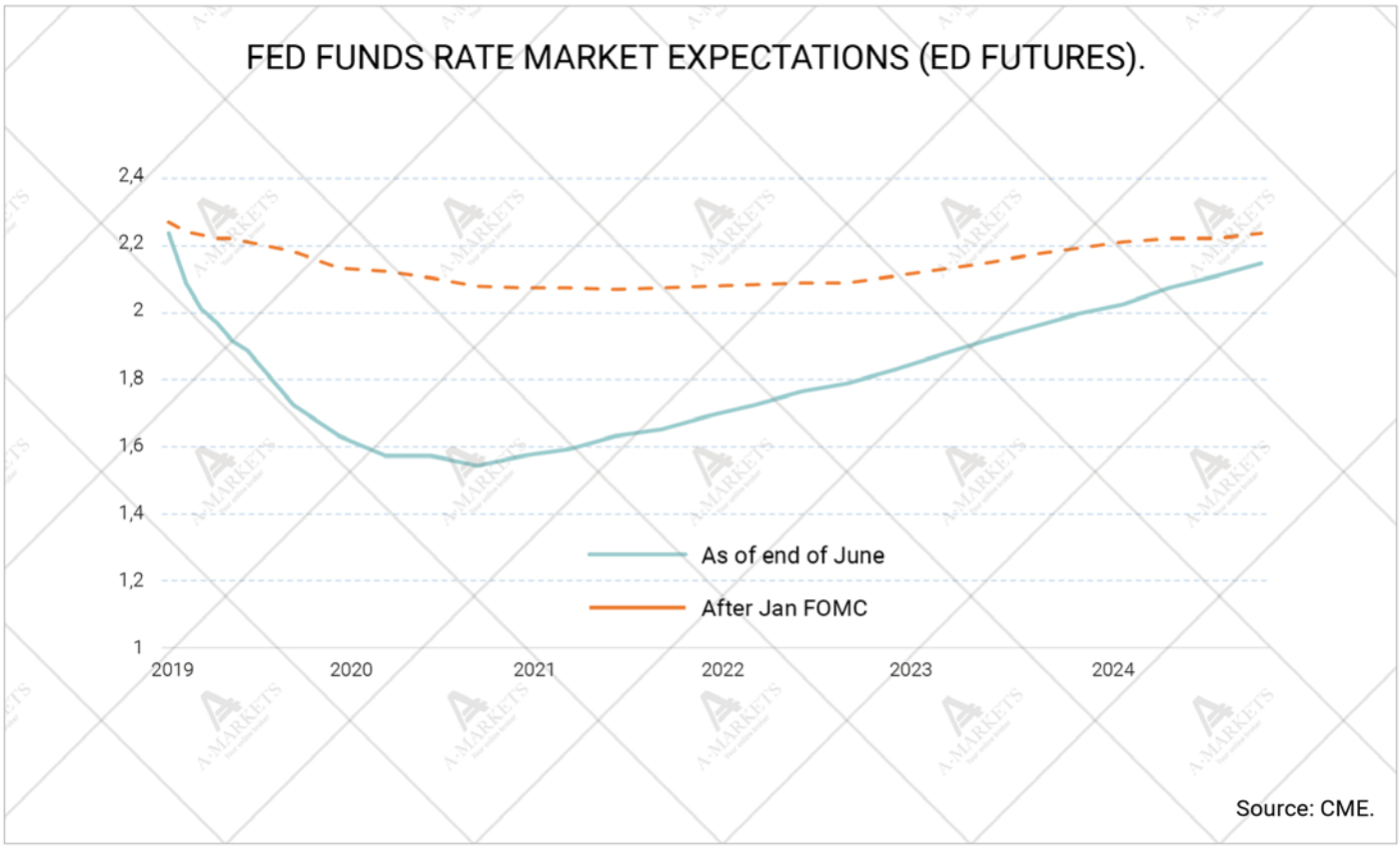
Summary:

- The Fed is torn between feeding risk appetite and not having any fundamental reasons to significantly ease the policy.
- We expect the ECB to resume QE and the Bank of Japan to cut rates by 20 b.p. in September.
- The H2O is on the edge of collapse due to its holdings of illiquid bonds. The company's troubles are a sign of systemic trouble.

The market closes out the first half of the year on a high note with nearly every asset class yielding positive returns. For the stock market, Q1 was pivotal with news on the Fed's policy U-turn, the U.S.-China truce, and rallying commodities. Most of the move in stocks happened during the first three months of the year. Then, however, fears of an escalating trade war drove investors into safe-haven assets and buying shifting to debt. In the FX market, the leaders are the unusual pairing of safe havens (CHF, JPY) and high-yielding EM-currencies. Then again, this has already happened quite a few times in recent years.

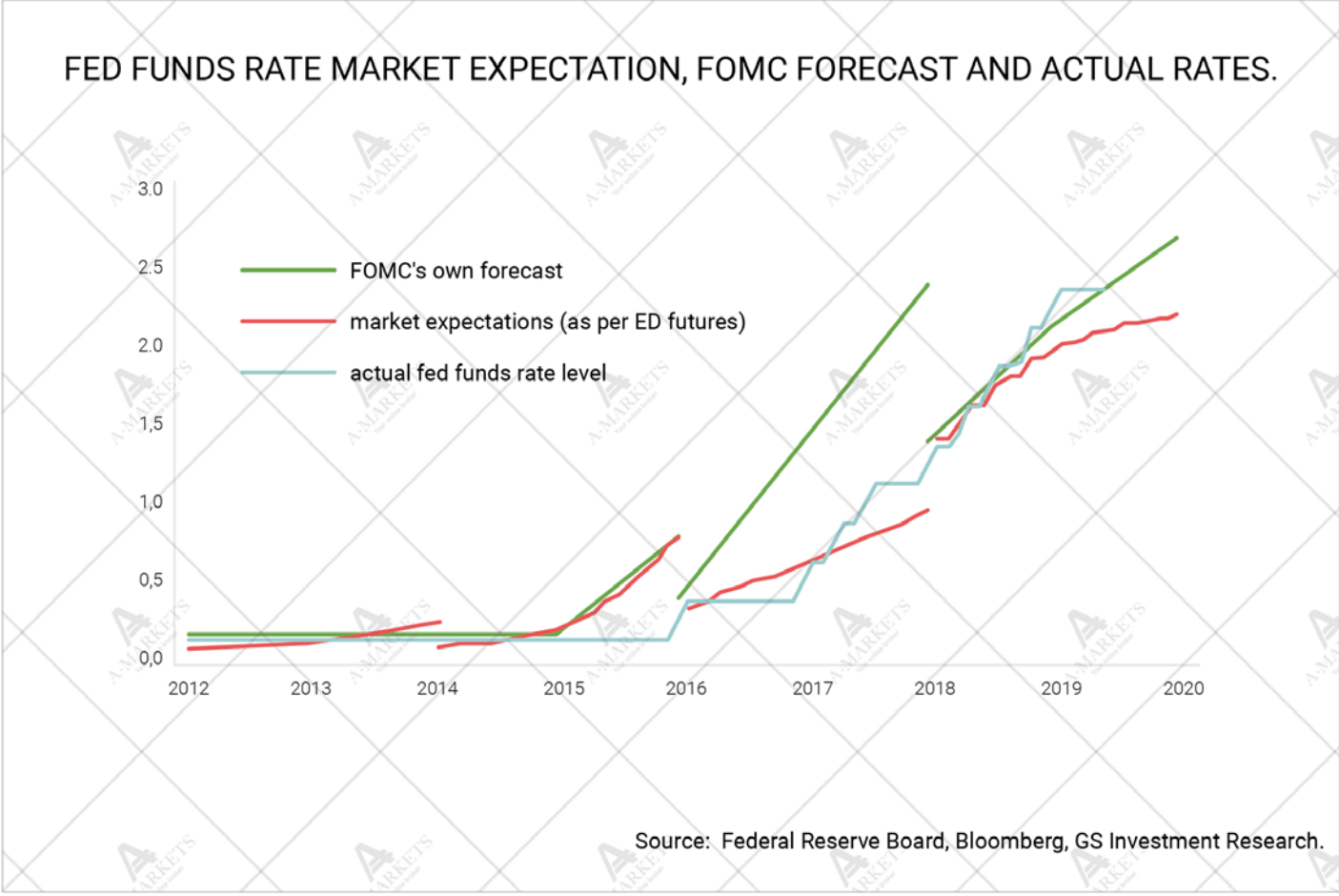
It is extremely important to understand the role the Fed played, as they were very different in Q1 and Q2. In late 2018—early 2019 chair Jerome Powell made the drastic move of announcing that the monetary policy tightening had been completed and loosening would follow. Today, however, especially after the June meeting, it is clear that the bar for a series of rate cuts is quite high and has not been reached yet.



Let's put that into numbers. The market is currently pricing in four 25 b.p. rate cuts over the next 12 months. Just a few days ago, the fed funds futures were also discounting a 50% probability of a 50 b.p. move in July. However, this scenario was priced out following Powell's and Bullard's comments. The market sentiment was quite surprising as the Fed has never started a loosening cycle with a 50 b. p. move unless the economy was in a recession (as it was in 2001 and 2007). For this same reason we would not bet on 100 b.p. of total rate cuts through mid-2020—this has never happened in a non-recessionary environment.

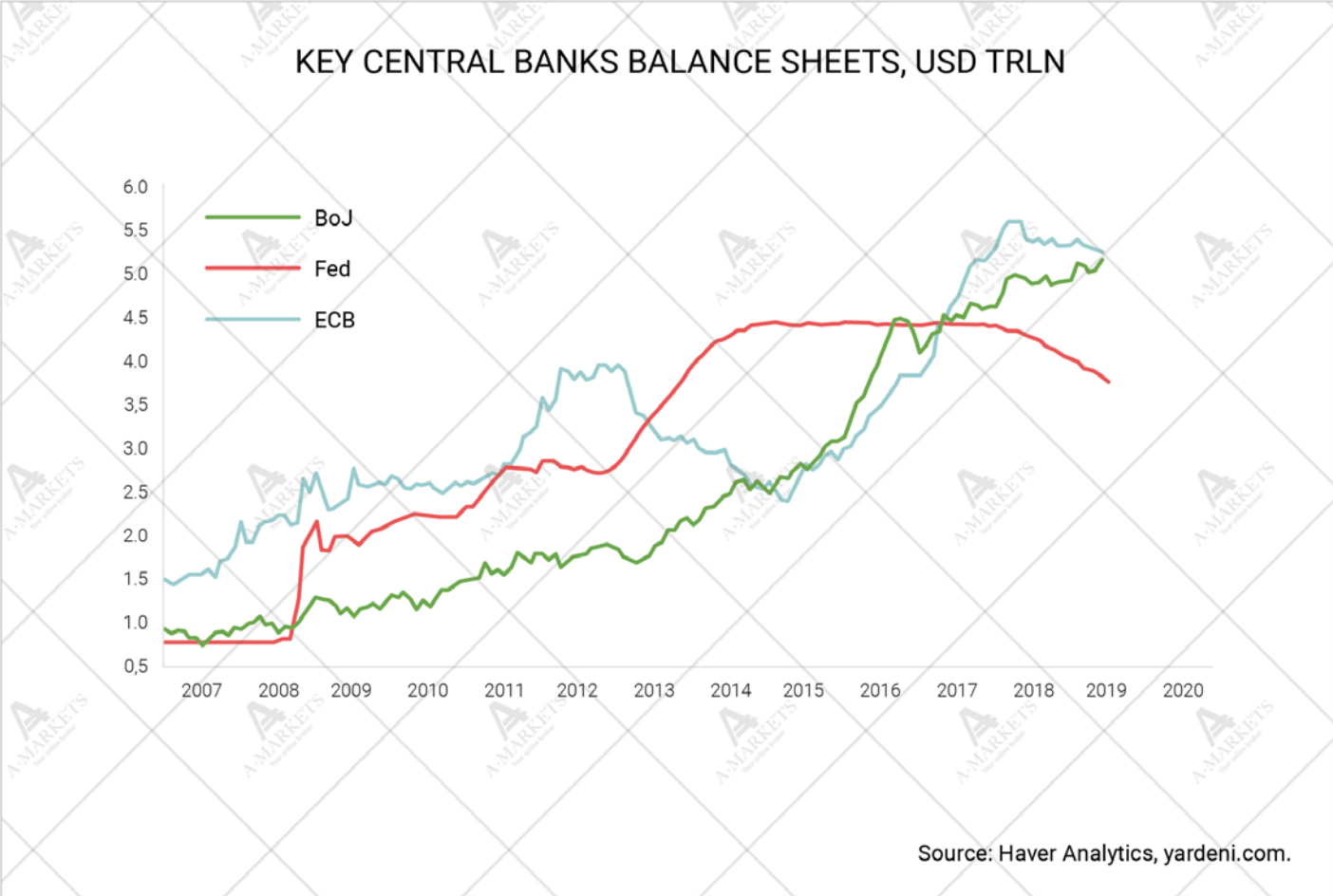
The central bank is, of course, now open to all sorts of options. And, on the off chance that the economy stops creating jobs (meaning that payroll employment remains the same or even decreases for a couple of months in a row), the FOMC would consider very dovish paths to go, one of them being 3 or 4 rate cuts within a year. This, however, does not look to be the base cases scenario just yet. We expect that the Fed will cut by 25 b.p. in July, and then once more, also by 25 b.p., in September or December. 2020 is an open question which will depend heavily on macroeconomic data and how the U.S.-China trade war plays out.

As previously stated, the market is betting on at least three rate cuts within the next 12 months, and the expectation itself is okay. Throughout the whole tightening cycle the fed funds futures have been priced for a lower rate than the fed actually set. The average gap over the past 5 years is about 50 b.p. and it's likely that this will happen again.



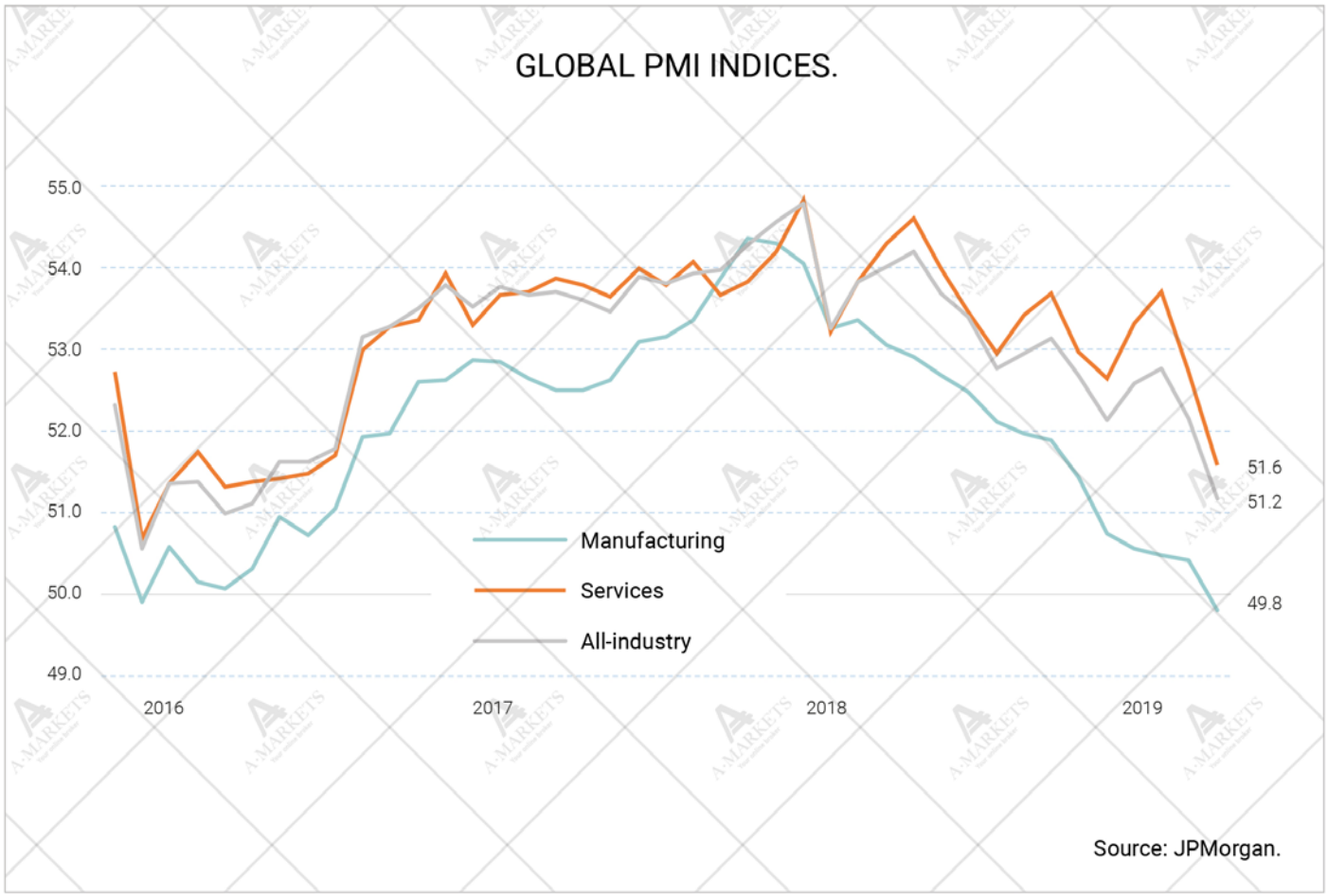
The positive market sentiment in June was also supported by other central banks' rhetoric, specifically Mario Draghi's Sintra speech. The ECB chair signaled readiness to pump more monetary stimulus into the economy should Eurozone inflation rates remain depressed. The market took those words quite seriously due to an important detail: a new ECB president will take office as early as in November. And, as a rule, the outgoing chair tries to give their successor as much freedom as possible, i.e. refrain from making any major commitment. But Mr. Draghi sounded firm and basically voiced an intentioni. This means that the central bank is taking the situation very seriously and is indeed ready to continue easing—which was immediately priced in. Finally, the Bank of Japan has also suddenly changed its rhetoric. Now we're looking at a rate cut by 20 b.p. which is likely to happen during the bank's September meeting.

It would seem that the reaction on the FX market was abnormal. The euro and the yen strengthened against the dollar, with the latter doing so quite significantly. Why would it happen when all the respective banks' rhetoric got more dovish? The reason is simple: it's much easier for the market to price in a dovish Fed, than a dovish ECB or BoJ. In other words, the Fed can actually afford a true policy loosening. Nominal rates in the U.S. are far from zero now, and there's been some balance shrinking. The situation is fundamentally different in Europe and Japan. The rates there failed to break away from zero and quantitative tightening was out of the question. Therefore, the market priced in a bigger loosening making the USD relatively weak.



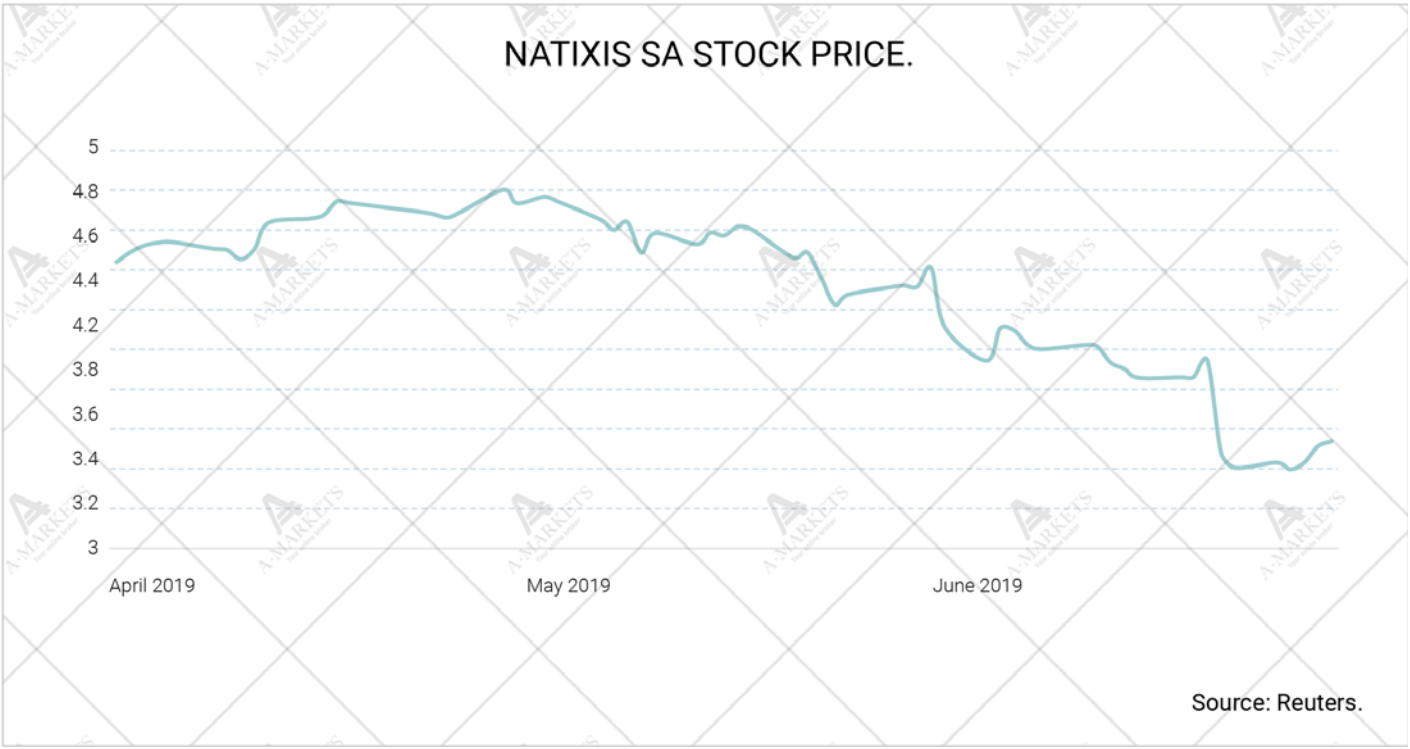
What happens next? With dovish central banks and weak global data, the situation shouldn't change much. EUR will continue to take the title of a funding currency away from JPY and CHF. This is why we're keeping an eye on every cross with the European currency, with a EURNOK short already in our portfolio. As for the dollar, its fate is largely dependent on the developments in the U.S. economy, as well as the trade war with China. If any agreement with Beijing is reached and/or the economy shows signs of increasing growth, the greenback will stop declining. On the contrary, should the situation worsen, the market will bet on the Fed loosening its policy, and the USD drift further down.

The second scenario appears more likely. While a ceasefire has been achieved, China does not seem to be ready to accept Trump's conditions, while the U.S. are in too deep to shift their position. There's no reason to expect fundamental economic improvement either. Instead, the implications of the trade war are only starting to seep into the macroeconomic data. If the Fed decides to loosen its policy in response to the labor market slowdown, it shouldn't affect the dollar across the board. Rather, the market will continue investing into "recessionary" assets (the yen and the franc).



There's also a risk of a negative surprise, which can seriously hurt risk appetite. First, it's the Trump admin's completely absolutely unpredictable trade policy, which can go any way following Trump and Xi's meeting at the G20 summit. We would also keep an eye on the date the Congress has to decide the debt ceiling as it's a very convenient opportunity to sabotage Trump's re-election campaign. This might be a story for September but it's worth starting to watch the short end of the U.S. yield curve now

Now, onto one more extremely important June story. H2O, one of asset management subsidiaries of French bank Natixis, lost over more than a quarter of its assets in less than a week. The fund suffered outflows of more than €5 billion (its total AuM stood at over €20 billion not long ago) following concerns over investments in illiquid bonds. It's clear, however, that there's a much more serious process behind H2O's troubles as the total amount of questionable paper accounted for just €1.2 billion, which is much less than what's being pulled from the fund.



Taking the 2008 scenario as an example, the following should happen next. Two or three more similar funds will take a hit, and investors will be told that those are individual cases that don't pose any systemic risk. Things will calm down for a bit, but then similar trouble will hit big banks' bottom line. Could it be that the H2O episode is just a one-time occurrence? We do not believe so. In a zero-rate environment, funds have been piling into huge amounts of low-quality paper in attempt to get positive yield. We believe that this poses systemic risk that is only going to get worse as global growth slows down.

NZDUSD: recovering as the Fed turns dovish.

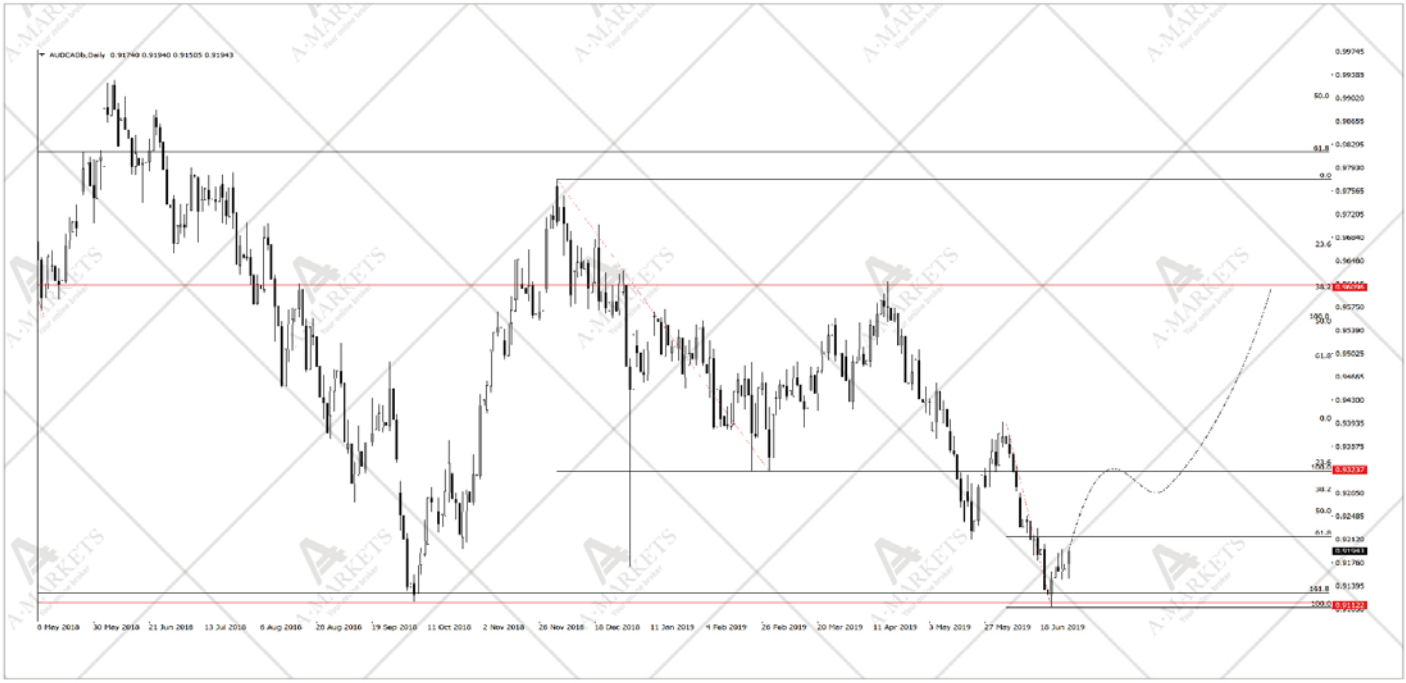
We buy NZDUSD once 0.668 is taken out targeting 0.692, stop-loss at 0.6645.

The dollar suffered a major sell-off on the back of a dovish Fed. As per usual in such cases, the outsiders turned into leaders and are now aggressively correcting against the USD. The main ones are of course the Australian and New Zealand dollars. Just two months ago we pointed out that the NZDUSD had shown signs of a mid-term reversal but given the low volatility it wasn't enough. Now, however, it's safer to say that the cross has bottomed out and has every chance for further recovery.

We already hold a long in NZDCAD (see the "Battle of the weak" part of our May review) and suggest restructuring this position. Due to the fact that the technicals are now clearer for NZDUSD and AUDCAD, it makes sense to follow these charts. The risk-profit profile looks favorable for the kiwi: stop-loss orders can be placed at 0.6645, while the next target lies at 0.681. Ultimately looking to reach 0.692 and, possibly, 0.702. Given how unstable the risk appetite has proven, our judgement is that the latter mark is too high to chase.

AUDCAD: a classic reversal at multi-year lows.

We buy AUD at market targeting 0.96, stop-loss at 0.911.



The cross has reached the lower bound of the range it's been in since 2013. The 0.91 level has been tested three times on the long-term setups, and remains a solid support. On top of that, the unit has completed its medium-term downtrend and at least a corrective a move up should follow. The first resistance lies at 0.9299, but we don't expect it to be a significant obstacle. Once 0.93 is passed, the cross can very well reach 0.96 and 0.9785. As in the case of NZDUSD, the higher target is not probable enough to position for. However, 0.96 should be taken out over the course of July.

EURNOK: another classic end of cycle, with sound fundamentals.

We sell EURNOK at marget targeting 9.43 and 9.245, will add to the position at 9.93, stop-loss at 10.1.

Another pair worth attention is the Euro to Norwegian Krone. We rarely turn to Scandinavian currencies, but now there's a good reason to talk about the NOK. Norway's central bank, Norges Bank, is the only one tightening its policy today. At its latest meeting, the regulator raised the rate by 25 b.p. to 1.25% and hinted at another 25 b.p. hike in 2019. Yes, the rate is still fairly low, but it's the direction of the policy is the opposite to the rest of the world. Most importantly, this is happening as the ECB is considering a new round of quantitative easing. Which is why from the fundamental viewpoint EURNOK is the short to watch rather than, say, SEKNOK.

From the technical point of view, the cross is also looking ready to head south. A longer-term uptrend has been completed. It seems to have been exhausted after reaching the 10 mark in late 2018. The cross then made two failed attempts to take out 9.836, and these, therefore, should be viewed as corrective moves up. On the other hand, the cross is yet to pass the key support, which would fully establish a mid-term downward trend. The critical area is 9.55-9.63. Once below that, the targets are 9.43, 9.24 and 9.1. Again, the furthest mark is rather hypothetical for now.

We also remain long in USDMXN and wait for an entry point for a short position in S&P500, will add to the short position in Brent.

The EURGBP position is closed at stop-loss and requires strategic reevaluation.