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Political disarray and monetary decisions

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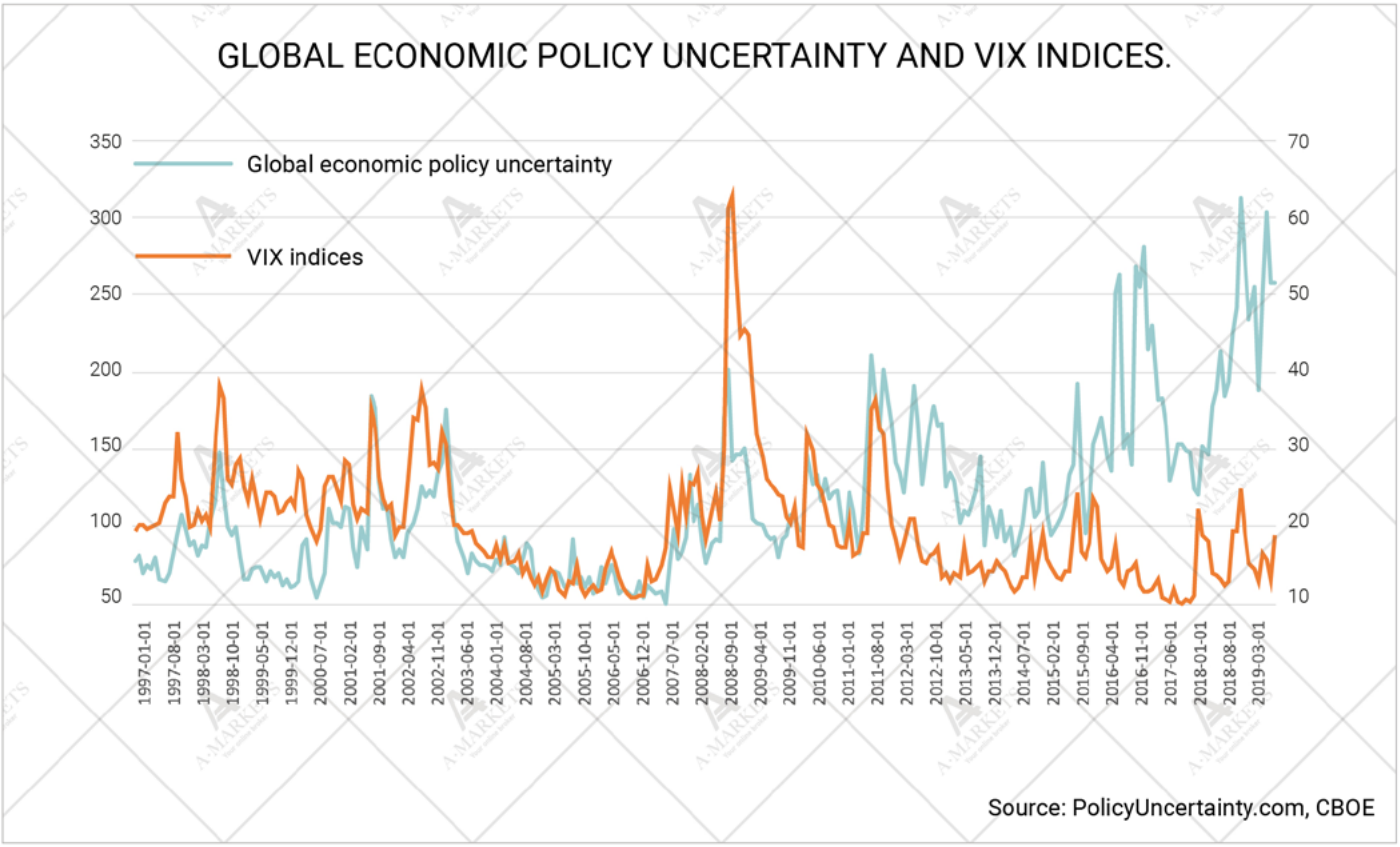
Summary:

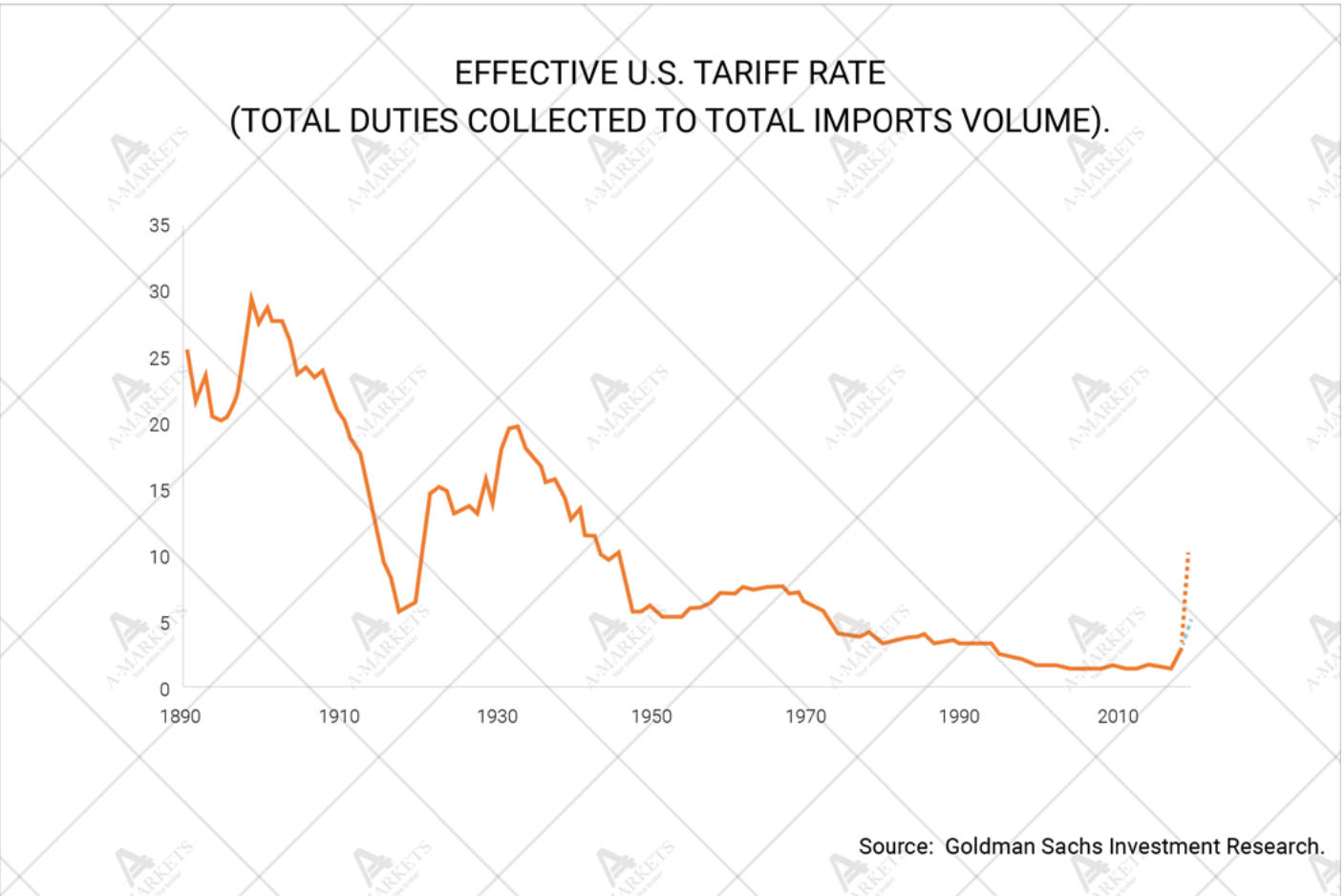
- U.S.-China trade war has escalated dramatically; the unrest in Hong Kong poses significant political and financial risks.
- Both the Fed and the ECB are set to cut rates in September, accompanying statements to sound contradistinct.
- Precious metals are at cycle highs as the space of negative yields keeps on expanding.

Summer wrapped up with generally mixed markets, but was marked by unusually saturated newsflow. The two exceptions are fixed income and precious metals. Both remain firmly in an uptrend, and it's a self-feeding loop. Another asset class with clear directionality is the emerging market currencies, and, to a somewhat lesser extent, industrial commodities. Although these exhibited only limited downside, more weakness is likely. Stocks, meanwhile, are moving sideways amid heightened volatility.



The U.S.-China trade war remains the key story, which escalated even further last month. On August 1, Trump announced that he would slap a fresh 10% tariff on $300 billion of Chinese goods. It would be imposed in two steps, on September 1 and December 15. The approach is meant to reduce the negative impact on the Christmas shopping season and, therefore, Trump's chances to get re-elected. Yet even with this schedule, all U.S. imports from China risk falling under higher rates by the end of 2019.

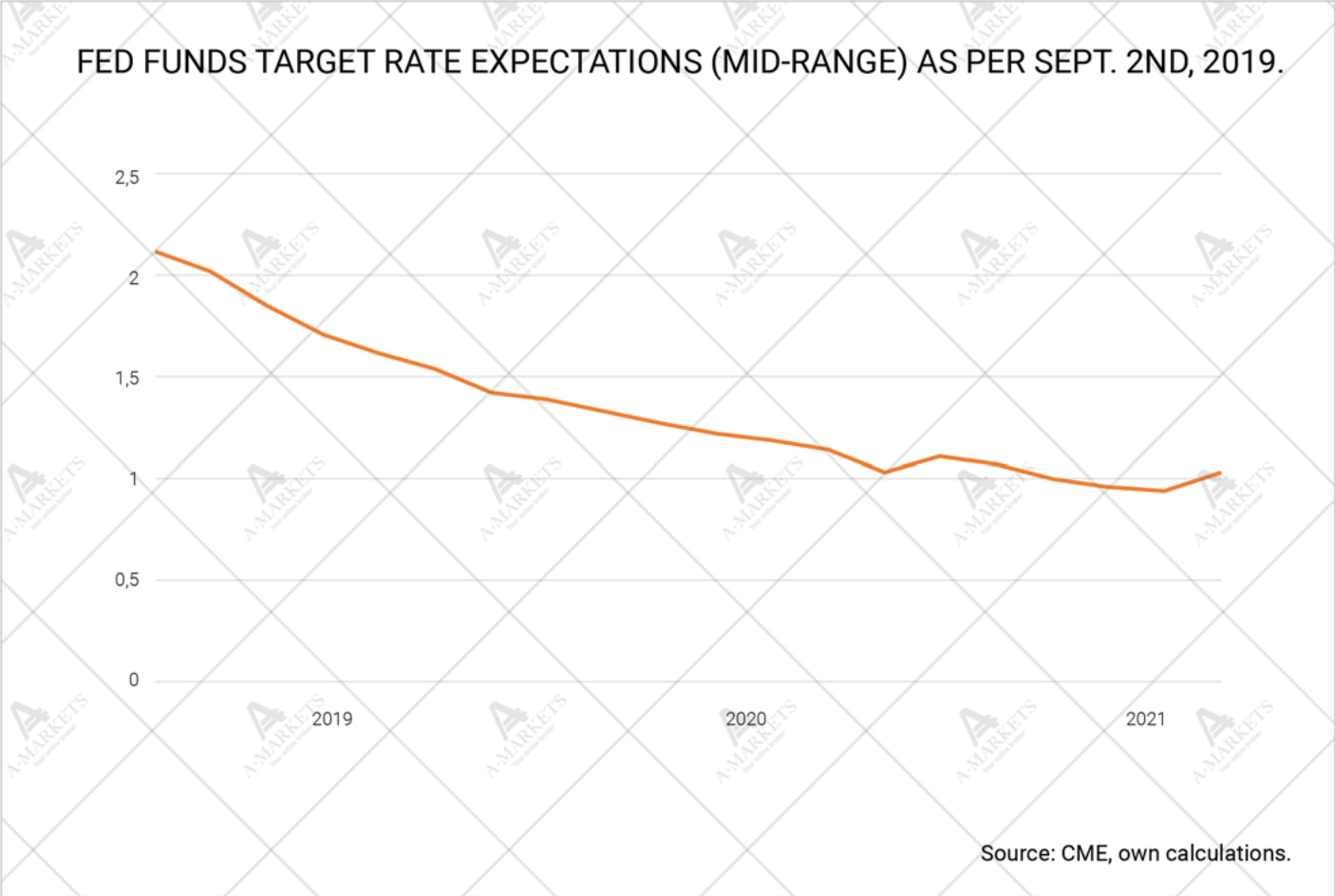
In response, Beijing announced new tariffs ranging from 5% to 10% on $75 billion of U.S. goods. Enraged Trump then ordered American companies to "immediately start looking for an alternative to China" and raised tariffs again that same day. The 25% rate was increased to 30%, while 10% turned into 15%. Meanwhile, the PBoC allowed the yuan to weaken and the U.S. Treasury Department called out China as a currency manipulator. That's quite a lot for just one short month.



Things were moving so fast that Trump's tweets might have even overshadowed the Fed's annual meeting in Jackson Hole. And inappropriately so. While Jerome Powell's speech was a tad bit more optimistic than a month earlier, he also expressed more concern over building downside risks. All of this points to another 'hawkish rate cut' in September, where the rate is lowered by 25 b.p., but the statements underscores that this is a one-off measure rather than the beginning of a cycle. The market is pricing in -50 b.p. by the end of the year, which is by far not warranted.

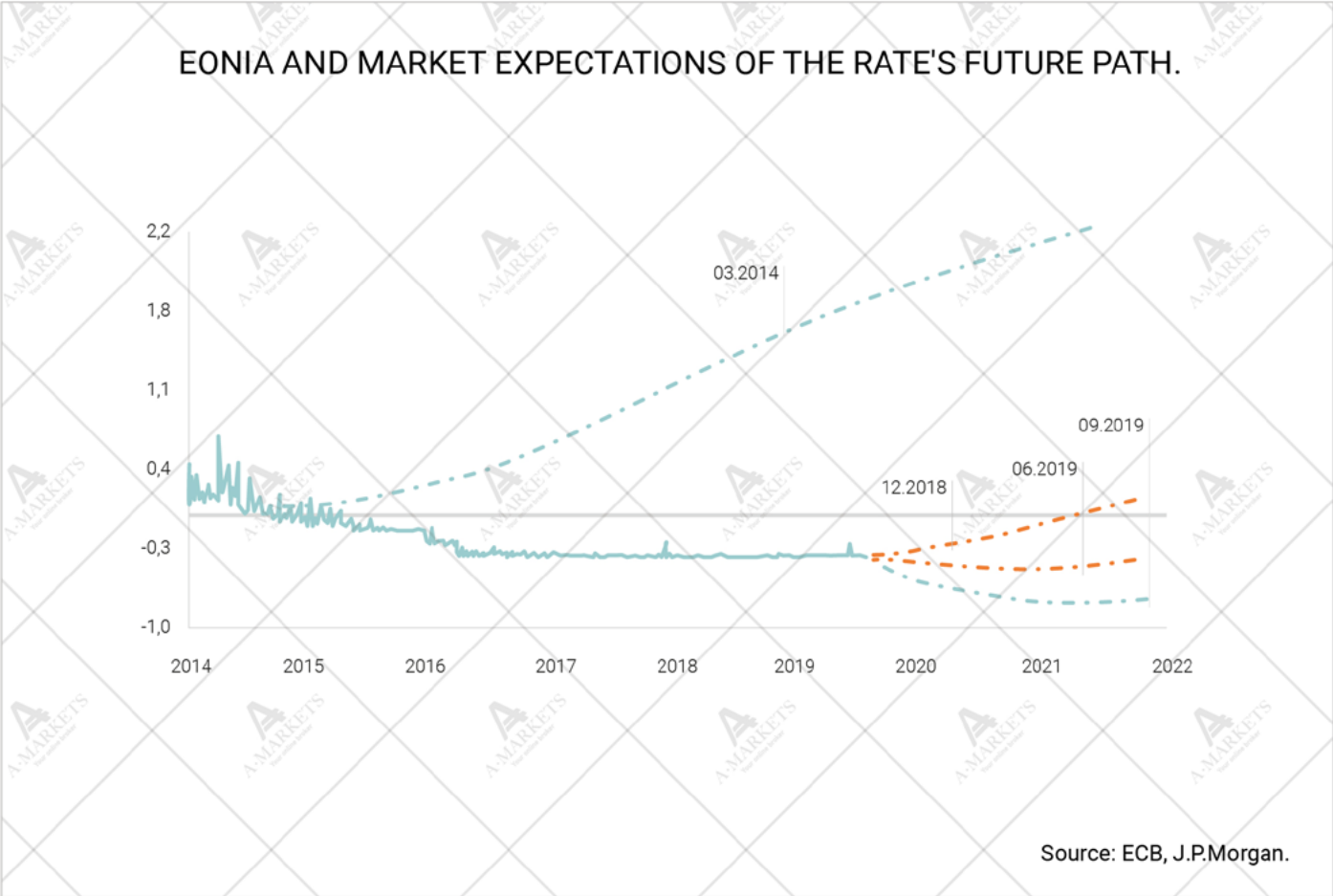
The Fed clearly has no idea how to handle Trump's trade war. It does create tremendous risks that can materialize at any moment. But it's not an interest-rate problem. Therefore, policy softening is fairly ineffective solution that could buy some time at best. The PBoC is the one who will have to handle the situation, and they will eventually do what China needs (lower the rates and let the renmibi weaken).

There is unusual split within the FOMC itself. It was very well illustrated by Bill Dudley's bold op-ed, in which the former Fed official slammed Donald Trump and urged the central bank not to enable his trade war. He asked the Fed not to lower rates, adding that the trade war is Trump's mess to clean. Mr. Dudley even goes on to write that if the officials want price stability and general certainty, they should make sure that Trump isn't re-elected in 2020.



Of course, we are not suggesting that this is literally how discussions at the Fed go. But it's true that the central bank has found itself in a situation where it has to lower rates because of the administration's actions. We anticipate that in September the officials will step-up the 'insurance' rhetoric, saving further policy loosening as a last-resort option. For the markets that means further absence of risk buying.

Generally, the reaction to the above has been stronger than usual. This is likely so because the latest round of Trump's tariffs is directed at final the consumer goods. Responding to this, financial assets have also moved more consistently from the macroeconomic point of view: bond yields down, stock market down, commodities down. We expect industrial goods (crude oil, metals) to drift further down. EM-currencies are likely to remain under pressure as well.

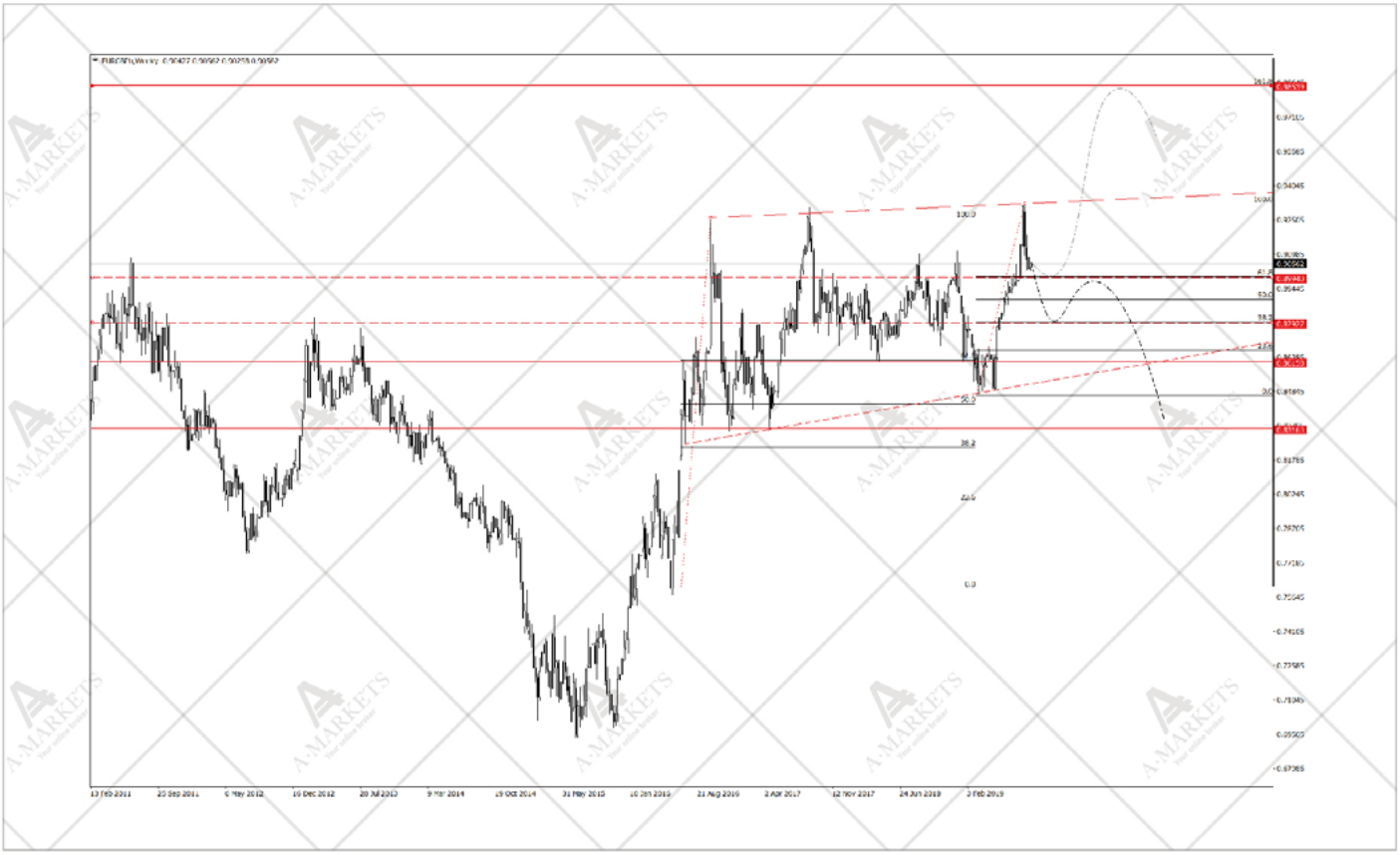


One hypothetical winner here is the euro, but the ECB leads it away from a full-fuldged rally. Mario Draghi will fire his bazooka one last time in September (see our previous review), which challenges bullish outlook for the EUR. Generally though, it has clearly become a funding currency that strengthens during risk-off episodes. As the trade war rages on, the franc and the yen should see some demand as well, as they're the traditional safe-haven currencies. Interestingly, the pound is also fairly stable despite the negative newsflow from the UK.

The Brexit was another story that took a dramatic twist in August. The new Prime Minister Boris Johnson has received the Queen's approval to suspend the work of Parliament from September 9-12 through October 14. Now, the so-called "hard Brexit," meaning withdrawal from the EU without any deal, is the base case scenario—and the market understands that. Speculative contracts are suggesting a 57% probability of Britain crashing out. Which leads to one important conclusion: a no-deal Brexit is already largely priced in, and the pound is still trading at 1.2. More on that in a bit. The bottom line is that currently the Brexit factor creates as much uncertainty as it possibly can. From here the past of least resistance is actually towards less uncertainty, and that's what markets are likely to discover in two-months' time.

GBP: parity is out of reach.

We're looking for entry point to buy GBPUSD and sell EURGBP.



With Brexit less than two months away, volatility will be extreme. A full big figure swing intraday should be treated as a temporary norm. Any negative headline can send GBPUSD to 1.2, and the moves on the actual Brexit day can be enormous (our estimates suggest a 10-figure gap between the high and the low). We don't, however, expect the pound to reach parity versus either the dollar or the euro, even when highest possible pressure is there. The furthest downside target for GBPUSD holds near the 1.05 mark, respective level for EURGBP is at 0.985. This implies EURUSD at 1.034— which is possible as a form of contagion, should sterling crash that hard.

It is now safe to say that Brexit is hardly likely to bring about the end of the world to the market. The whole divorce drama quickly turned into a local story and stopped impacting general risk appetite over a year ago. Then in August the downside in GBP-denominated assets showed signs of exhaustion. As the market basically discounted the hard Brexit, the pound barely fell. Under our base-case scenario, GBPUSD will see a sharp jump in volatility, but will generally hold around 1.2. We don't expect new highs for EURGBP either. It is clearly a risk, but not an idea that looks tradeable. Over the medium term, we expect GBPUSD to rebound towards 1.33 and EURGBP to fall to 0.8 later in 2020.

USDMXN: a year of EM weakness ahead.

We remain long USDMXN, will add to the position at 19.7 targeting 22.5/23.9/27.8, stop-loss at 18.4.

Going short on EM-currencies is a strategic idea. Selling emerging markets is usually expensive due to large negative carry, but we believe that now is a good time to add to the position. The two assets that stand out as the weakest links are ZAR and MXN. The former is under tremendous fundamental pressure due to local macroeconomic climate; the latter is suffering from problems caused by the Trump administration that have spilled over to systemically important elements (those wanting to study the matter further should look into the reports on the Mexican company Pemex over the past six months).

From the technical viewpoint, both USDZAR and USDMXN are in a firm uptrend. The clearest set-up is in the Mexican peso, as it completes its 3-year consolidation triangle. The chances of an impulsive move up are high. We expect the EM-currencies broadly to be under pressure through the entire 2020, while a number of them to go through a full-fledged devaluation. The final targets for USDMXN are 24.2 (conservative estimate) and 27.74 (the last target of the long-term uptrend). The 22.6-24 area is the first stop once the triangle is breached.

XAUUSD: strong uptrend confirmed.

We will buy XAUUSD at 1480-1490 targeting 1602-1640, stop-loss at 1435. Alternatively, synthetic long XAUEUR at market (1386) targeting 1581, stop-loss at 1298.

Precious metals have confirmed a long-term bullish reversal. The only meaningful mark that still hasn't been taken out is 1600 in XAUUSD. Still, the key resistance for the unit was in the 1452-1480 area (see our previous review) and it has been cleared. Gold is setting all-time highs in a number of currencies (about three dozens of them, including the euro), which is, of course, the best indicator of how strong the trend is. Similarly, silver is also posting sharp gains.

Our assumption is that this is the beginning of a mid-term uptrend. Gold is the preferred trade here as other precious metals are sensitive to industrial demand. The main driver for the rally is the rapidly growing space of negative yielding debt. Risks are clearly skewed towards even lower rates in the EUR markets as the ECB launches a new round of QE. Therefore, XAUEUR is fundamentally a better way to position for further gains. To do that, one can simultaneously open two positions: long XAUUSD and short EURUSD.