SMBC Capital Markets, Inc.

fxPoetry

February 4, 2021

Andrew Fately
Executive Director, Senior FX Marketer
Global Markets Marketing Department
andrew_fately@smbcgroup.com
Direct: +1 212-224-4532
Representative: SMBC Capital Markets, Inc.

Contracted, Not Grown

There once was a continent, grand
Whose culture and history fanned
Both science and art
Which helped to jumpstart
Expansion across all the land

But lately the data has shown
That Europe's contracted, not grown
This bodes ill for those
Who purchased euros
As markets take on a new tone

Entering 2021, one of the highest conviction trades amongst the analyst and investment community was that the dollar would decline sharply this year. After all, it fell broadly and steadily in 2020 from the moment it peaked in mid-March on the initial pandemic fears. But the narrative that developed was that the Fed would be the king of all monetary easers, pumping so much liquidity into markets that the surfeit of dollars would simply drive the value of the greenback lower vs. all its main counterparts. Adding to the tale was the election of Joe Biden as president, and the belief that he would be able to enact massive stimulus to help reflate the economy, thus adding fiscal stimulus to the Fed's already humongous monetary efforts. The pièce de résistance was the Georgia runoff elections, when the Democrats gained effective control of the Senate, and so all of these dreams seemed destined to come true.

However, there was always one conundrum that never made sense, at least to me, and that was the idea that the dollar would decline while the US yield curve steepened. The thesis was that all the fiscal stimulus would result in massive Treasury issuance (check), which would result in higher yields as the market had trouble absorbing all that debt (partial check) and then the dollar would decline sharply (oops). The problem is that historically, as the US yield curve steepens, the dollar typically rallies.

The other quibble with this narrative was that it seemed to ignore the facts on the ground in Europe. It was never realistic to believe that the ECB would sit back and allow the euro to rally sharply without responding. And of course, that is exactly what we have seen. In the past three weeks, we have heard from numerous ECB speakers, including Madame Lagarde, that the exchange rate is quite important in their deliberations. The proper translation of that comment into English is, if the euro keeps rallying, we will directly respond via further easing or even intervention if necessary. Remember, Europe can ill afford a strong euro from both a growth and inflationary perspective, and they will do all they think they can to prevent it from coming about.

At the same time, there is another issue that the dollar bears seemed to neglect, the pathetic state of affairs in the Eurozone economy, as well as the vast incompetence displayed throughout the continent with respect to the inoculation of their populations with the new Covid vaccines. Based on current trends, the US and UK will have vaccinated 75% of their respective populations by the end of 2021. Italy, Germany and France are looking at 2024 at the earliest to achieve the same milestone. Ask yourself how beneficial that will be for the Eurozone economy if the current lockdowns remain in place for the next 2-3 years.

The one possible saving grace for this view is that the Fed responds more aggressively to any steepening of the yield curve. While Europe cannot afford for the euro to rise, the US cannot afford for interest rates to rise, at least not very much. While yields have clearly risen from their summer lows, they remain extremely accommodative. However, if yields should start to rise further, say because inflation starts to accelerate, the Fed seems destined to stop that move, either explicitly, via YCC, or tacitly via extending and expanding QE such that they absorb all the new Treasury issuance and prevent yields from rising. Of course, this will result in much deeper negative real yields which, in my view, will be what leads to the dollar's eventual decline. Given Europe's much duller inflationary pulse, it will be much harder for the ECB to drive real yields in Europe as low as in the US. But that is a story for the second half of 2021, not the first.

Which brings us to today's activity. The discussion above was prompted by the much weaker than expected Eurozone Retail Sales data released this morning, with December's monthly growth at 2.0% and the Y/Y number at just 0.6%, half of expectations. And this was before the extended and expanded lockdowns in January. It is increasingly evident that the Eurozone is in its second recession in just over a year, again, hardly a rationale to buy its currency. Which makes it completely unsurprising that the euro has declined yet again, -0.4%, and breaking below the psychological 1.20 level. For those keeping track, this is he fourth consecutive day of declines and it is pretty easy to look at a chart and see a downtrend developing. In fact, since its peak on January 7, the euro is down a solid 3%.

But the dollar is performing well against all its G10 brethren, and most EMG counterparts as well. SEK (-0.6%) and NOK (-0.5%) are the worst performers with the latter somewhat surprising given that oil (+0.75%) continues to rally. It seems that both these countries are seeing doubts over their ability to inoculate their populations from Covid similar to the Eurozone, so it should not be surprising that their currencies decline. The same is true of CAD (-0.25%) where the current trend for vaccinations shows it will take a full ten years to vaccinate 75% of Canada's population! I imagine the pace will increase, but it does demonstrate the futility so far. CAD, however, has not been as weak as the euro given the benefits from the rising oil price seem to be offsetting some of its other problems.

In the Emerging markets, ZAR (-0.8%) is the worst performer today, falling on a combination of broad dollar strength and concerns over the possibility of a debt crisis as the nation's debt/GDP ratio has climbed rapidly to 80%, and with its still high yields, debt service ability is becoming a bigger problem. Of course, there is also a new strain of Covid, first identified there, that has increased virulence and is working against the economy. With the euro lower, it is no surprise that the CE4 have followed it down, and we are also seeing weakness in MXN (-0.6%), again, after central bank comments indicating possible rate cuts in the future. On the flipside, TRY (+0.5%) is the star performer today, continuing to gather interest given its world-beating interest rate structure and promises from the central bank to maintain those yields.

While I skipped over both equity and bond markets today, it is only because there was precious little movement in most cases and certainly no discernible trend.

On the data front, yesterday saw better than expected ADP Employment and ISM Services prints, once again highlighting the differences between the US and Europe. This morning brings a raft of data as follows: Initial Claims (exp 830K), Continuing Claims (4.7M), Nonfarm Productivity (-3.0%), Unit Labor Costs (4.0%) and Factory Orders (0.7%). With Payrolls tomorrow, all eyes will be on the Initial Claims number, but it is hard to believe any print will change market sentiment.

Finally, the BOE met this morning and left policy unchanged, as expected. However, they did tell banks to start preparing for negative interest rates going forward. While they claim the policy is not imminent, it seems unlikely that they are asking banks to prepare for a low probability event. Despite significant evidence that negative rates do not help the economy, although they do help stock prices, the BOE looks like it is going to ignore that and go there anyway. The only analyses that showed NIRP was beneficial was produced by the central banks that are operating under NIRP. This cannot be good for the pound over time.

For the day, the dollar is starting to gain momentum to move higher, and I think a slow continuation of this move is likely.

Good luck and stay safe
Adf

The author is a salesperson in SMBC Capital Markets, Inc.
The views expressed are his own and may differ from Research.