FX Special

Focus on EURUSD and Investment Process

MI2 Partners is an independent research firm focussing on global macro developments. MI2's top-down research provides actionable, practical conclusions for investing, trading and hedging in the major asset classes, including Fixed Income, Foreign Exchange, Equity Indices and selected Commodities. Our analysis and recommendations are honed by a senior research team with decades of investment and capital market experience.

Foreign Exchange is at the heart of macro analysis and is the focus of the sample report below. It illustrates how MI2 leverages top-down analysis, flow of funds, assessment of consensus forecasts and technical analysis to inform our practical, actionable recommendations.

MI2 currently has a bias for cyclical USD weakness as we progress into 2024, but this weakness could easily morph into an environment of secular USD decline. The early signs of USD weakness are falling into place, and with the current complacent consensus of stable FX relationships within the G4, the risk is building for a decisive break from the prevailing regime. Below, we segment our analysis to line up our skittles for a consensus-busting weak USD impulse.

Highlights:

- An unstable USD equilibrium: reserve currency status, current account, and US Exceptionalism have all aided the USD.
- US vs EU growth differentials have been in favour of USD but that can change in 2024.
- Interest rate differentials may narrow in G3 as US rates fall.
- Consensus forecasts are narrowly distributed around the forward price.
- Sentiment has shifted marginally USD negative, EUR positive.
- Indicators including volatility analysis and speculative positioning confirm the limited positioning of market participants. Charts of technicals are coiling for a break of the status quo.
- Commodities: perceptions could inform the potential persistence of USD weakness.

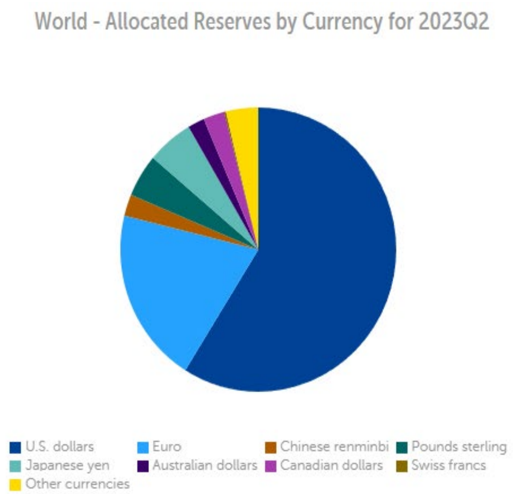
USD: An unstable equilibrium

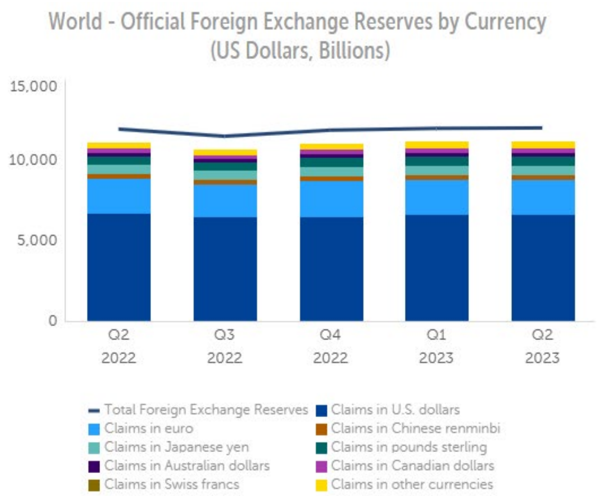
At its heart, the USD's value and reserve status are pushed and pulled by cyclical, secular, and exogenous factors, creating a dynamic, unstable equilibrium.

On the most basic level, the USD remains the undisputed principal reserve currency and the denominator of the lion's share of global trade. Indeed, although USD as a % of reserves has been on a downward trajectory for some time, attempts by China and the global South to replace USDs as the reserve currency remain more aspirational than effective. What's more, exogenous shocks have failed to shake its dominance. Deglobalisation amid rising tensions between the US and China, exacerbated by Covid, has led to the emergence of a new industrial policy in the West, with a shift in focus from "just-in-time" to "just-in-case" supply chains, which has come with a wave of on-shoring and friend-shoring. Additionally, the second wave of the Ukraine war in 2022 saw the "sequestration" of Russian reserves, showing that USD reserves come with the risk of being frozen should a nation fall out of the US's good graces. And yet… despite everything, the USD's share of reserves is little changed over the last year or so.

	Q2 2022	Q3 2022	Q4 2022	Q1 2023	Q2 2023
Total Foreign Exchange Reserves	11,981.65	11,534.16	11,916.16	12,027.71	12,055.26
Allocated Reserves	11,123.39	10,693.55	11,040.07	11,150.01	11,170.45
Claims in U.S. dollars	6,645.02	6,426.89	6,460.26	6,571.71	6,576.90
Claims in euro	2,187.63	2,086.40	2,252.06	2,208.42	2,230.34
Claims in Chinese renminbi	308.22	281.12	287.81	288.31	274.10
Claims in Japanese yen	572.65	560.11	608.17	610.39	602.86
Claims in pounds sterling	538.73	489.95	543.11	543.05	544.51
Claims in Australian dollars	209.14	204.78	217.08	221.62	219.67
Claims in Canadian dollars	275.75	260.92	262.62	270.60	278.43
Claims in Swiss francs	27.63	24.78	25.31	27.66	20.63
Claims in other currencies	358.62	358.59	383.65	408.25	423.00
Unallocated Reserves	858.26	840.62	876.10	877.70	884.81

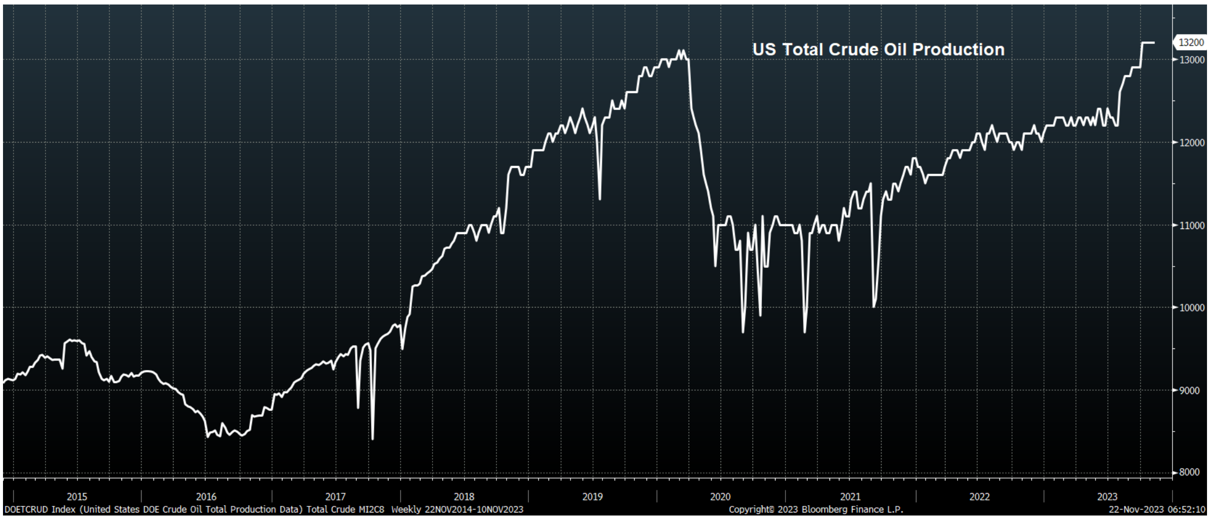
Ordering of the currencies follows SDR basket weights (SDR currencies) and alphabetical order (non-SDR currencies).





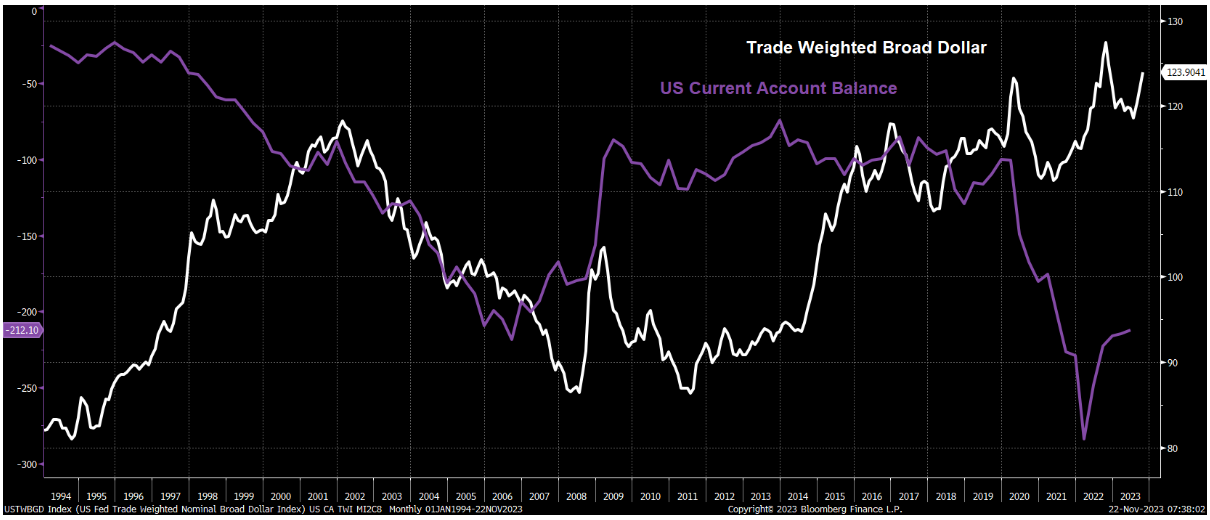
Also affecting the USD are the vicissitudes of the Current Account balance. The fiscal response to Covid and the war in Ukraine saw the US C/A deficit explode, which sent USDs rippling through the rest of the world. While this would presumably have caused some kind of reaction in USD reserve balances or private sector USD holdings, the relative stability of those two metrics can be partially explained by those deficit dollars being recycled into US assets, helping to perpetuate the era of US Exceptionalism and the outperformance of US Equity markets, especially Tech.

The Current Account deficit is now shrinking again, not least as US oil production marches back to record highs…



N.B. the relationship between USD and Oil changed over time as US production soared from 2 million to 13 million barrels per day.

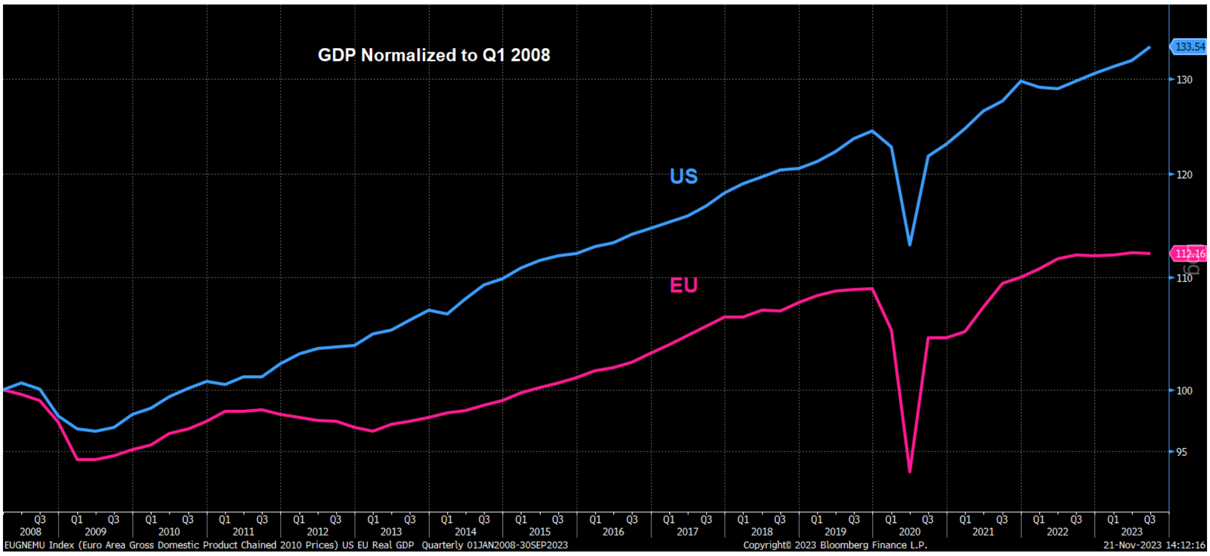
Though it may be contrary to popular perception, and largely because of the recycling of USD surpluses into USD-denominated assets, the current account deficit of the US, as the global reserve hegemon, has a tenuous relationship with the external value of the currency. This can be seen in the chart below.



We must look elsewhere for our smoking guns. No doubt the "kindness of strangers" debate will resurface over time, but we can park that in the "worry-about-it-later" folder for now. That said, while it may be in the "worry-about-it-later" folder, our trade models do hint that we should not become complacent.

Growth Differentials

Indeed, beyond just the optics of rising stock prices, we can argue that it is the fundamental US growth differential vs other major trading partners that has led to this extended period of US Exceptionalism.



As deglobalisation, on-shoring and friend-shoring proceed, the US is likely to benefit in the long term from "last mover advantage". This will likely bring a productivity wave in its wake. But not any time soon. Although the productivity boom many AI enthusiasts expect may indeed occur, it is not likely in a timeframe that informs relative currency valuations for the time being. (Another analysis for the "worry-about-it-later" file.)

More relevant will probably be the interplay of monetary and fiscal policy. It is axiomatic in the FX markets that relatively loose fiscal, tight money is currency supportive while tight (or at least constrained) fiscal, loose money (as the EU demonstrated post its Sovereign debt crisis) undermines a currency's trajectory. We are likely to enter a period of continued fiscal spending on both sides of the pond as each currency block tries to deal with the exigencies of war (cold and hot), along with its associated defence spending AND climate change, requiring enormous sums to enable economies to transition to a reduced carbon footprint (never mind carbon zero). Indeed, ECB's Lagarde recently guesstimated that an annual EUR 620 billion would be needed to fund Europe's green transition between now and 2030, and a further EUR 125bln annually would be required for digitalisation. These are 5%+ GDP spending numbers.

Thus, we can surmise that the positive growth differential in the US has supported USD, US profit margins and business confidence. The preference of fund managers for growth stocks over value stocks is mirrored in a similar preference for US growth over European value. The point at which this relationship inflects will coincide with significant cross-border capital flow to Europe (and Japan). Evidence of this currently remains scant but needs constant re-evaluation.

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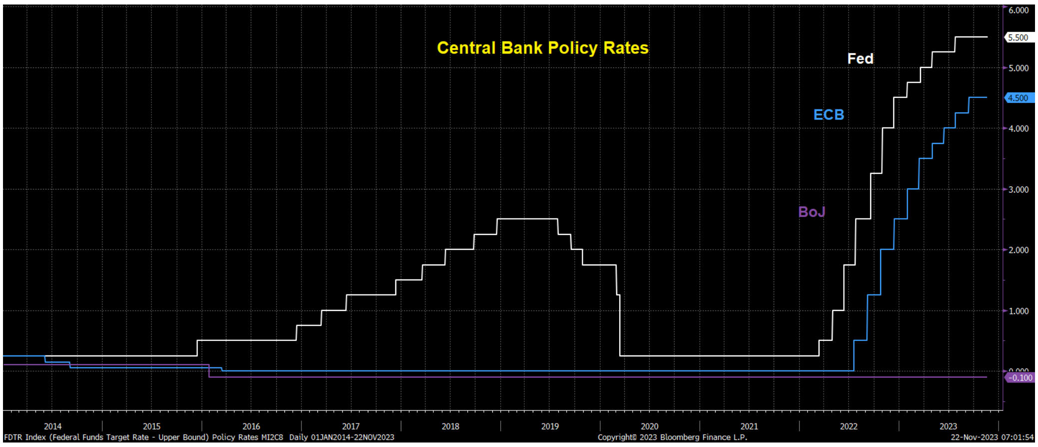
Interest rate Differentials

This leads us further towards more promising territory in our analysis of relative currency valuation.

Positive or negative interest rate differentials between currencies act as a headwind or tailwind to investors' currency preference, along with the forward curve, which prices expected future changes in rate differentials. The anchor for the differential is set by policy rates, shown below since 2007.



That USDs have offered positive carry vs EURs is nothing new. Indeed, rate differentials have favoured USD since 2014 as the Eurozone was dealing with the fallout of the Eurozone sovereign debt crisis. Mario Draghi famously said he would do "whatever it takes" to maintain the integrity of the currency block all the way back in July 2012, and the differential fell as far as ~-300bpts by the turn of the year 2018/19. This marked the peak of the FOMC's attempt to go it alone in tightening monetary conditions.

While the relationship is far from linear, the broad direction of travel has been clear. EURUSD fell throughout the 2010s from 1.60 in the aftermath of the ECB's Trichet misreading the inflationary implications of the 2008 oil crisis. It continued to fall erratically as the world emerged from the GFC, throughout the European Sovereign Debt crisis and the persistent associated divergence of fortunes between the US and Europe that followed (illustrated above). EUR reached a low of sub-parity in the shadow of the 2022 Ukraine shock when Europe felt constrained to delay its exit from NIRP even as the US began to tighten monetary policy.

We have used nominal interest differentials here, but real interest differentials also favour the US, where real yields are over 150bpts higher in the US than in Germany in 10-year tenors*.

(*We choose to refer to longer-dated real yields to minimise the noise from the erratic moves in inflation we have seen since the onset of the Ukrainian hostilities.)

The easiest way for interest rate differentials to narrow is via an FOMC pivot to lower rates. However, Fed Funds and SOFR forward curves are already pricing lower policy rates next year. In other words, weak data, especially for employment and inflation, will be needed to justify the market's assumption that the Fed will be cutting rates next year. Indeed, to emphasise that correlation, EURUSD weakened in early November as yields in the US came sharply lower after payroll prints were somewhat weak.

As can be seen from the chart at the top of the previous page, the contrast with Japan is even more apparent and has been a major contributory factor to recent chronic JPY weakness. (Hold that thought.)

From Macro to Sentiment and Positioning

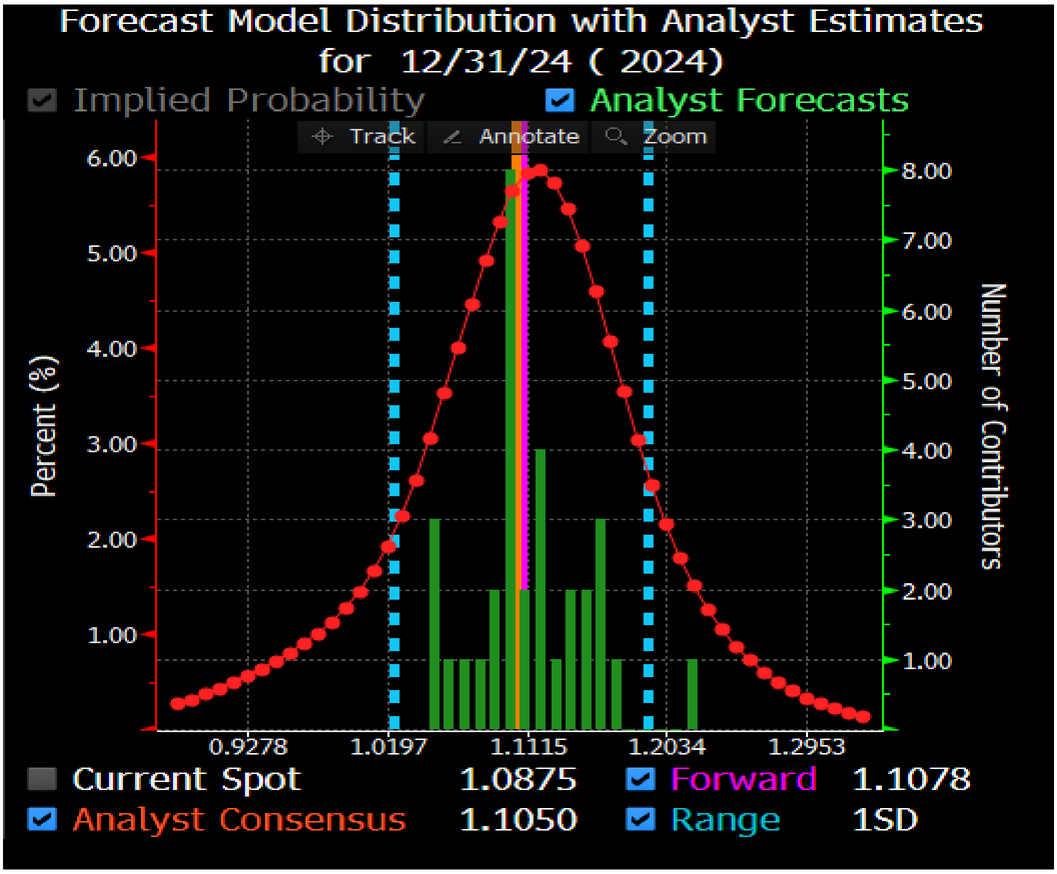
All of the analysis above just scratches the surface of the macroeconomic analysis undertaken by the MI2 research team. What we have provided above has no pretensions to be comprehensive. We routinely and consistently model leading indicators of growth and inflation across major (and some minor) economies using over 15 years of proprietary research, modelling, and analysis. This approach gives us an edge in assessing whether the market is correctly pricing the probabilities of any particular outcome. This macro model-driven approach using data already available (i.e., not forecasts) anchors our economic outlook.

While our approach informs our expectations, it is clearly important to be able to compare, contrast and differentiate those expectations from consensus opinion. The best opportunities are derived when consensus expectations are materially different from our own assessment of likely outcomes. This was the case in early 2022 when policymakers and market participants alike wildly underestimated the inflation dynamic that our models had identified even before the invasion of Ukraine.

Thus, the next step is to assess consensus expectations and how they shift back and forth. How they are informed is interesting, but the real value comes from positioning. In other words, understanding where survey respondents are shining their spotlights is useful, but what the market is pricing, and the extent to which the market has heavily skewed positions gives us something to kick against.

Consensus, Sentiment and Surveys

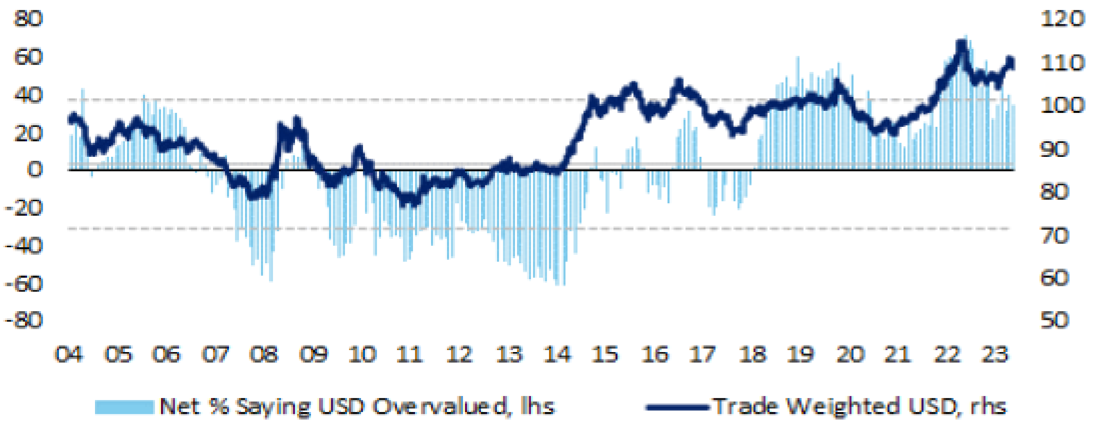
The season is upon us when analysts start to prepare their forecasts for the coming year. In FX particularly (although also true in other instruments from time to time), more often than not, the median forecast is fairly close to the forward price (spot adjusted for relative interest rate differentials). This pattern is particularly striking this year, with end 2024 EURUSD forecasts plumb on the forward price of EURUSD (namely ~1.1050-1.1075 at the time of writing). Even more striking is that only one analyst has predicted a price outside the one standard deviation band, despite (or even because) of all the imponderables of 2024 alluded to above, not to mention US politics and the Presidential Election in November.



This narrow range of expectations is consistent with recent implied and realised volatility. The former reflects the fact that EURUSD has not gone anywhere this year despite probing higher and lower prices in oscillation. EURUSD recently mean-reverted to the 100-day and 200-day moving average which are both currently just on either side of 1.08 and almost exactly where the forward outright price was on 1st January this year. It turns out that doing nothing in 2023 was the winning strategy for longer-term investors in EURUSD. Break trading and momentum strategies have had a torrid time.

A useful source of information on institutional investor currency perceptions can be gleaned from the excellent monthly BoAML Global Fund Manager Survey. In a diffusion index, a net 40% of respondents in early October perceived USD as overvalued, which reduced to 35% in November. On the other side of the pair, only 5% thought EUR was undervalued in October, but this rose to 19% in November.

Chart 38: USD Valuation and Trade weighted index
Net% of FMS investors saying USD overvalued



Source: BofA Global Fund Manager Survey, Datastream

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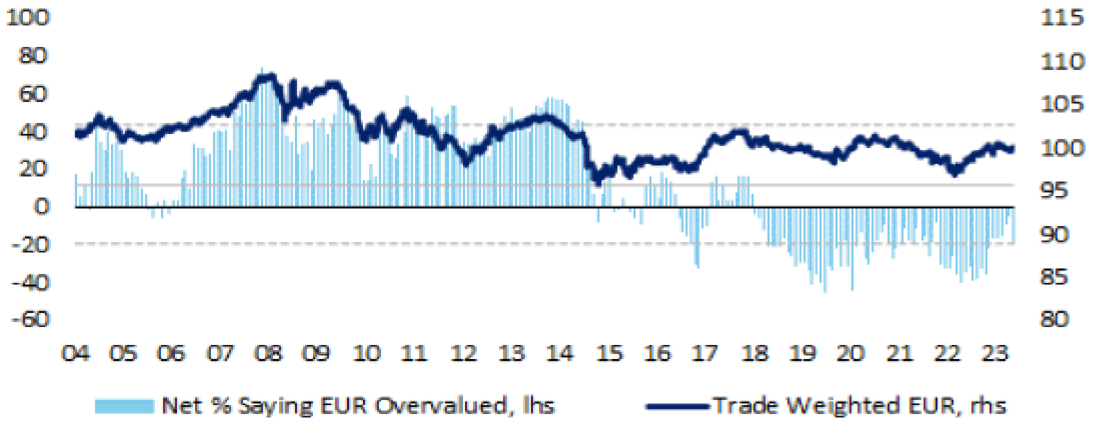
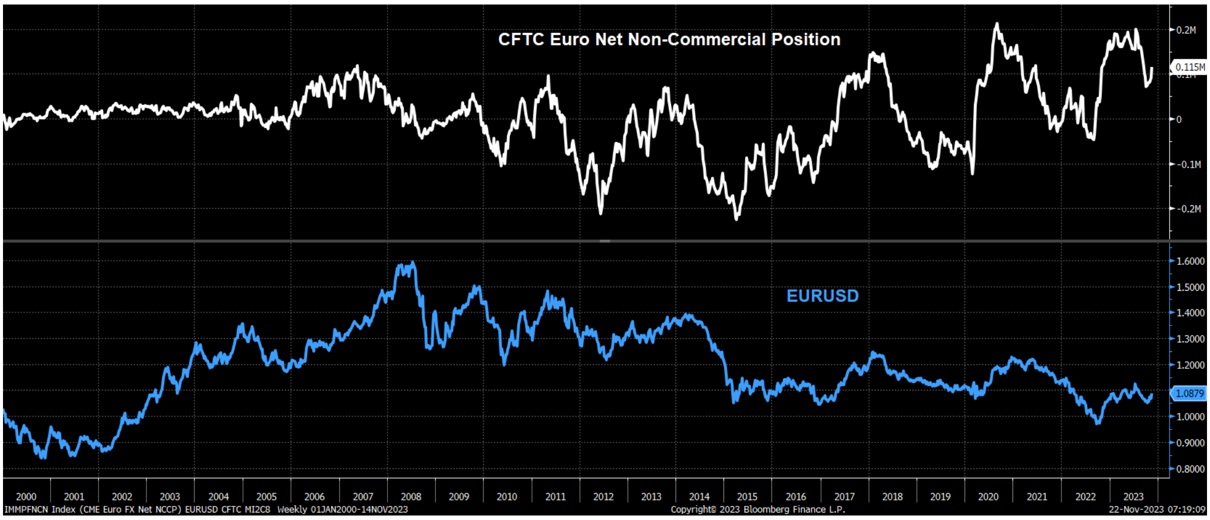
Chart 39: EUR valuation and Trade weighted index
Net% of FMS investors saying EUR overvalued



Source: BofA Global Fund Manager Survey, Datastream

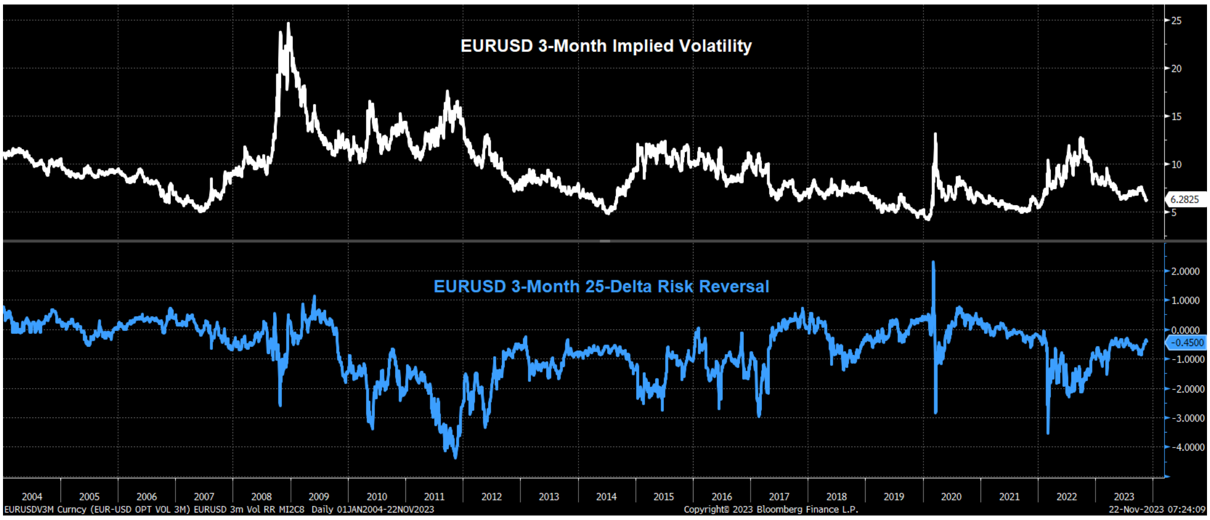
BofA GLOBAL RESEARCH

Thus, it seems that a rising proportion of investors perceive EURUSD to be undervalued, but it is far from clear they have acted on this perception. Non-Commercial Futures and Options positions reported by the CFTC show speculators somewhat long EUR, but not aggressively so. Looking at this subset of investors should not be treated as being truly representative but can nevertheless be a useful addition to other analysis.



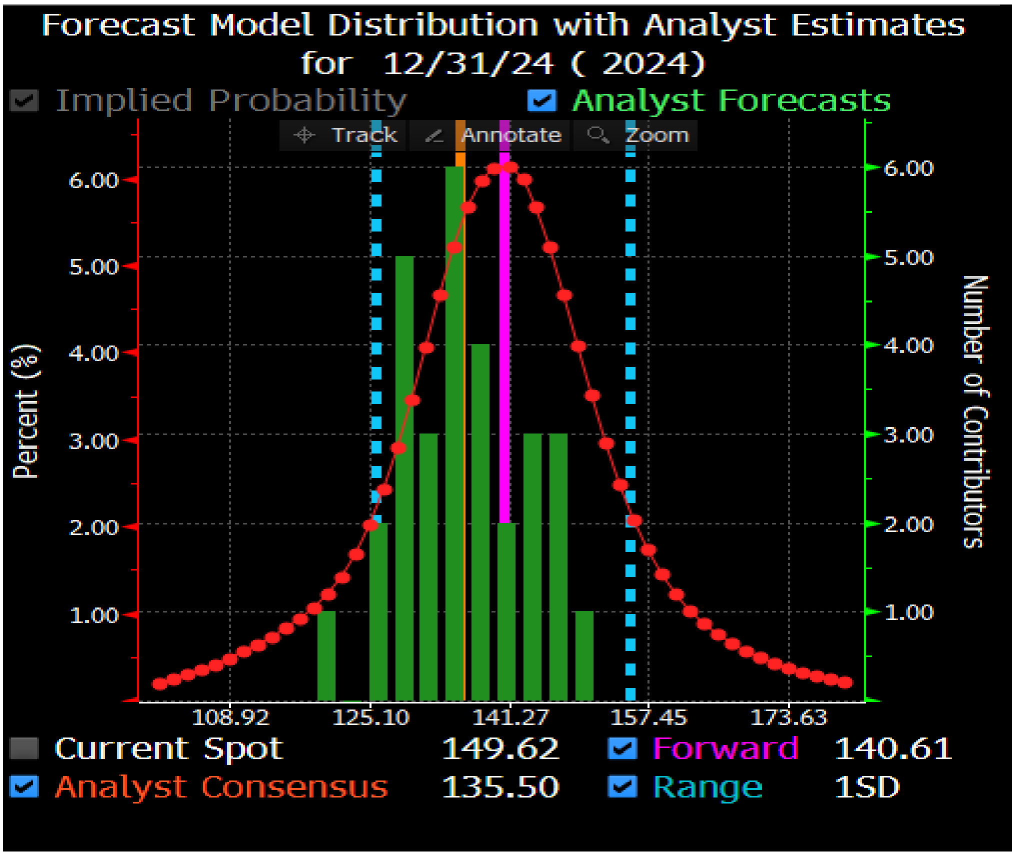
There are two key further thoughts here. One is that the urgency to act is always diminished by the negative carry. That has not gone away. Secondly, the range of expectations is so narrow that pre-emptive, defensive action just isn't at the top of the list of people's things to worry about, i.e., there is no fear of outsize moves priced into the market.

One way to confirm this is to look at implied volatility and skew in the FX options market. Here, you can observe that 3-month implied volatility with a 6% handle and modest skew for EURUSD downside confirms the expectation of limited FX moves in the near future.



Sidenote on Japan and JPY

As hinted above, the divergence between US and Japanese policy rates is striking, so there is a sense in which Japan has an even more intriguing set up. Median forecasts are somewhat below the forward price. However, analysts' forecasts are also mainly within the 1 s.d. range. The key determinant of the USDJPY cross rate is likely to be how the BoJ reacts to upcoming data and whether they feel confident enough to move away from years of NIRP. Their tentative steps to recalibrate YCC hint at those next steps. January will be an important period for policymakers.



The significant positive carry of being short JPY has spawned an enormous JPY carry trade. In our experience, carry trades can unwind fast and furiously. Or, as we like to say…up the escalator, down the lift shaft. The lift shaft risk is rising, especially as we move into the holiday season and approach the all-important decision period for BOJ watchers in January.

Technical Analysis

The lack of realised volatility in EURUSD this year explains the fact that Bollinger bands are contracting down to unusually narrow levels. They simply reflect the narrowness of the range this year and the currency pair's mean reversion to the 200-day moving average. The chart below shows the 50-week 1 s.d. band width. The chart reminds us that EUR launched at 1.1686 in January 1999 and has only rarely been this stable.

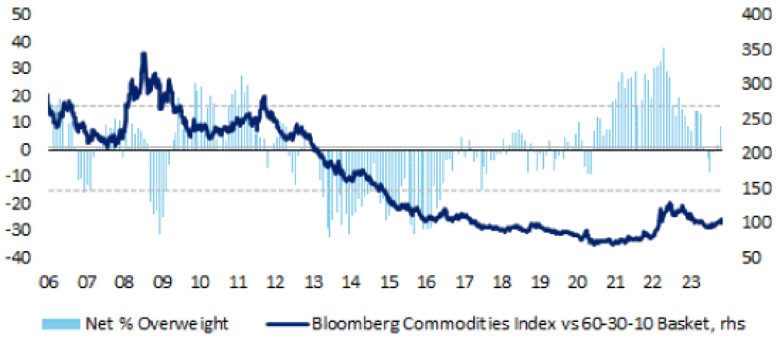
This helps to illustrate the low realised volatility observation already made elsewhere in this piece and is an example of how we use a variety of technical inputs, including our proprietary momentum indicators along with approaches as diverse as Ichimoku, Renko, Demark, etc… to support other elements of our analysis. We use them as part of our holistic approach and do not rely on any of them individually.

Other associated biases: commodity positioning implies preparing for weakness.

Lastly, however, if it is USD weakness rather than EUR strength that is likely to inform our trading/hedging strategy, the fact that there is a growing interest in commodities as an investment vehicle should alert us to the potential for a sea change in 2024. Below, you can see from the survey data provided by the BoAML GFMS that, after a number of false starts, commodity exposure and consensus perception are on the rise this quarter. If this development can be sustained and then extended, despite the expectations of weak global growth next year, it should not be ignored.

Chart 37: Net % AA Say they are overweight Commodities

Net% of FMS investors overweight commodities



Source: BofA Global Fund Manager Survey, Datastream.

BofA GLOBAL RESEARCH

Allocation to commodities was down 5ppt MoM to net 3% overweight.

Current allocation is 0.1 stdev above its long-term average.

Summary

MI2 starts with a top-down macro analysis. We then compare our expectations to the expectations of policymakers and market commentators. From there, we examine prevailing sentiment and positioning to see if the risk/reward favours implementing a strategy based on our divergent analysis. The whole process is capped by using technical analysis to frame the scale of likely reactions or counter-reactions.

The article above provides a taster for how we synthesise our currency views, mainly in the context of EURUSD, where we have an innate bias towards a weaker USD outcome as the cycle turns. Although we are not definitively there yet, at the appropriate time, this synthesis will ignite a dynamic trading/hedging strategy. C8 subscribers will then be provided with signals and trading strategies compiled by the experienced portfolio managers within the team derived from these strategies.

We hope that this limited analysis will whet your appetite to engage further with C8 and MI2 and look forward to what is setting up to be a fascinating and exciting 2024. If you'd like a trial of MI2's research or have further questions for the MI2 Team, please do not hesitate to reach out to support@mi2partners.com .