Trade Idea – Foreign Exchange

Disappointment creates opportunity

23rd September 2016

Meetings fall short

- The US Federal Reserve (Fed) delivered a dovish message at its monetary policy meeting this Wednesday, causing the trade weighted US Dollar to fall approximately 1.2%. Clear indications of a December rate hike from Fed chair Janet Yellen were overshadowed by downward revisions to the Fed’s 2016 full year growth forecast (by 0.2% to 1.8%) and projected policy path, now forecasting only one hike this year followed by two in 2017 (compared to two and three respectively predicted in June – see Figure 1). The change in the Fed’s assumptions appeared be underpinned by a greater focus toward sustaining the recent rise in inflation, justifying a more “wait and see” approach to the current tightening cycle. It remains our view that by following this tactic the Fed is at risk from making a policy mistake as domestic inflationary pressures continue to mount and threaten to de-anchor inflation expectations (see Why the FOMC should hike but won’t). With the Bank of Japan (BoJ) also delivering an insufficiently accommodative monetary policy framework on Wednesday, the USD/JPY soared 2.61% intraday, pushing the pair to increasingly oversold levels.

- We believe that the US labour market reports scheduled for release in the next three months will come in strong and prompt greater pricing of a rate hike in December, causing the USD to rally into year end. This view is best expressed by gaining bullish exposure to the USD/JPY and bearish exposure to AUD/USD, both of which look extended following market disappointment over the past few days.

Market pricing unchanged

- Market pricing of December rate hike has barely moved following Wednesday’s meeting, slightly falling to 58.4% from 58.7%. This is surprising given the fact that Yellen explicitly stated that the “case for an increase had strengthened” and three members of the committee (namely Esther George, Loretta Mester and Eric Rosengren) dissented, voting towards an immediate increase in the policy rate. Put in perspective, this time last year only one committee member, Jeffrey Lacker, voted for a hike. We therefore see current market pricing of a December hike as insufficient and believe expectations will rise as incoming US labour market data affirms progress towards the Fed’s policy objectives, providing a lift to the US Dollar over the next few months.

*All figures quoted are sourced from Bloomberg unless stated otherwise.
Attractive entry points

- The dovish nature of the Fed meeting saw the USD/JPY and AUD/USD approach the bottom and top of their respective ranges, running into support/resistance levels established in the middle of August. USD/JPY tested the psychologically important 10 level while the AUD/USD came near 0.77 which it hasn’t closed above since April. Momentum indicators also suggest the pairs are looking increasingly extended meaning that present levels offer attractive entry points for bullish USD/JPY and bearish AUD/USD positions which would benefit from greater market pricing of a December rate hike.

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- ETFS 3x Short JPY Long GBP (SYP3)
- ETFS 3x Long JPY Short USD (LJP3)
- ETFS 3x Short JPY Long USD (SJP3)
- ETFS 3x Long AUD Short EUR (EUA3)
- ETFS 3x Short AUD Long EUR (AUE3)
- ETFS 3x Long AUD Short GBP (AUP3)
- ETFS 3x Short AUD Long GBP (SAP3)
- ETFS 3x Long AUD Short USD (LAU3)
- ETFS 3x Short AUD Long USD (SAU3)

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- ETFS 5x Long JPY Short USD (LJP5)
- ETFS 5x Short JPY Long USD (SJP5)
- ETFS 5x Long AUD Short EUR (EUA5)
- ETFS 5x Short AUD Long EUR (AUE5)

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