Macro Strategy

DOLLAR DEMAND DANGER

Oliver Brennan

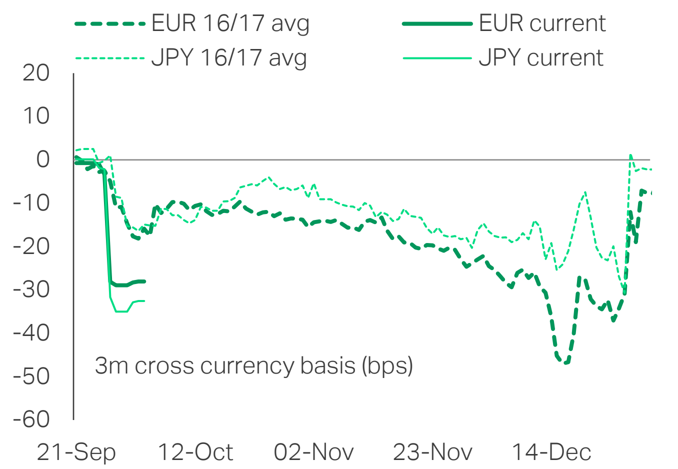
- **Wider basis swaps a reminder that offshore dollars are still scarce**
- **Last year's combination of factors unlikely to be repeated, but new risks mean liquidity squeeze remains possible**
- **Fixed income undergoing regime change, exacerbating risks in a fragile environment**

The 3m EUR and JPY bases have widened by 30bp this month, as the 3m date rolled over to year-end: foreign banks are seeking USD funding to shore up their end-2018 balance sheets. The timing of the widening is in line with moves over the last few years, but the size is larger.

And if the trend of previous years is repeated, the cross-currency basis could widen by another 30bp before year-end. This has historically supported the dollar. Although the relationship between USD and the cross-currency basis has broken down in 2018, this prospective seasonal widening increases the chances of a USD rally with potential to trigger knock-on effects in other markets (we have written elsewhere about the balance of risks around USD: positioning, valuation and EU portfolio flows argue against USD strength against EUR, but that does not preclude strength against other currencies.)

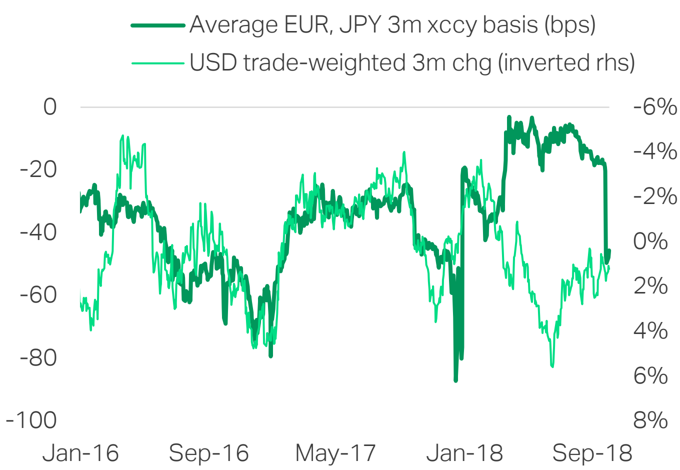
We analysed dollar funding costs in Macro Strategy earlier in the year, arguing that the changing profile of Treasury issuance, repatriation of corporate cash held offshore and QT were all partly to blame for tighter financing conditions. Since then, conditions have eased somewhat. But the sharp widening in the cross-currency basis shows that offshore demand for USD continues to

Cross-currency basis wider ahead of y/e



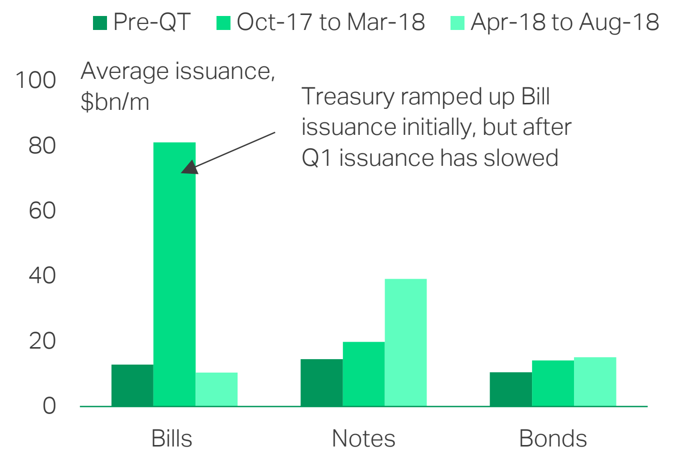
Source: Bloomberg, TS Lombard

Wider basis tends to strengthen USD



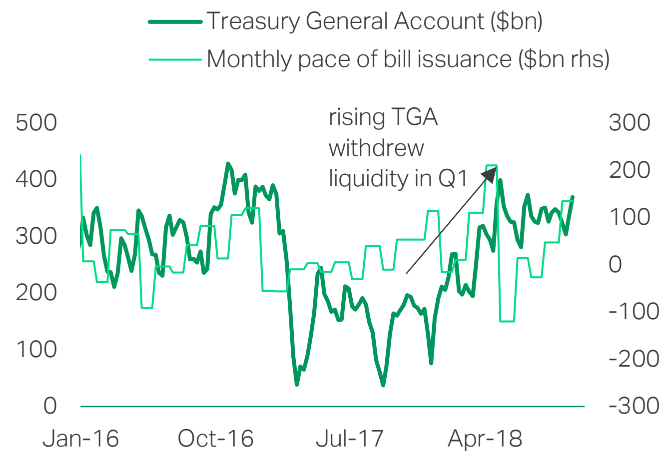
Source: Bloomberg, TS Lombard

Treasury issuance concentrated in 7-10y now



Source: Treasury, Bloomberg, TS Lombard

TGA balance no longer rising: liquidity-positive



Source: Federal Reserve, Bloomberg, TS Lombard

outweigh supply, and suggests that there is still a risk that tightening financial conditions could trigger broader market weakness.

Treasury Bill supply now in line with demand. In Q1, the Treasury ramped up Bill issuance, but kept much of the proceeds on deposit at the Fed. This had two effects: 1) the Bill-OIS spread narrowed to zero, erasing the historic premium at which Bills traded (due to longstanding under-supply) and thereby raising the average risk-free yield; 2) liquidity was withdrawn from funding markets as the Treasury did not spend the proceeds of its Bill sales. But in Q2 and Q3, the Treasury's behaviour has been more conventional. Bill issuance is in line with its pre-QE average and the Treasury General Account at the Fed has not risen, i.e. the Treasury is spending its issuance proceeds and so is no longer a drain on market liquidity.

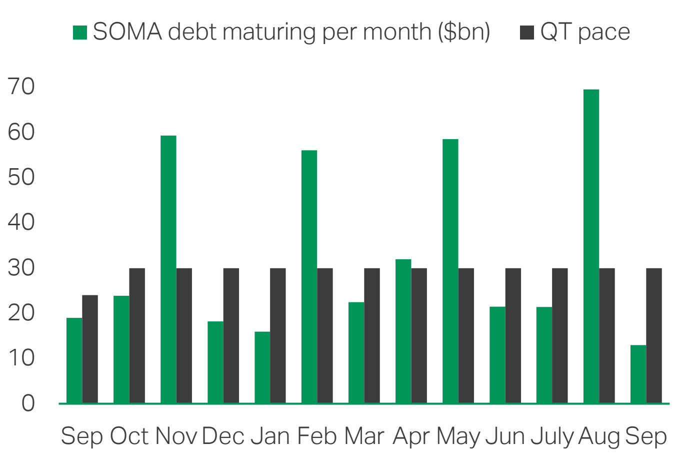
Corporate cash repatriation continues. The withdrawal of USD deposits by US multinationals, which had been holding profits offshore to avoid a tax charge on bringing them back home, totalled $300bn in Q1 and $170bn in Q2. The pace of repatriation has slowed, but is still likely to cause a shortage of dollars for offshore borrowers to tap (as we reported in earlier notes, corporates are earmarking the repatriated funds for buybacks or current spending, so the money is no longer available for lending to offshore USD borrowers).

The market has so far absorbed Fed QT, but risks loom as the pace rises. In 2017Q4 and Q1 this year, there were occasions when overall central bank liquidity contracted because of Fed QT combined with a tapering of ECB QE. These episodes coincided with sharp rises in US Treasury yields. As the pace of QT has quickened, periods of liquidity contraction have become more frequent, but the bond market appears to have taken them in its stride.

The next test will come this quarter, when the scheduled monthly reduction in the Fed's balance sheet will be greater than the sum of maturing bonds in October and December (chart below). The Fed has so far stuck faithfully to the QT schedule it set out before it embarked on the programme last November. Still, the central bank has a choice: it could tighten liquidity actively (rather than passively) in October and December, or it could slow the pace of QT in those months and ramp it up in November, when there are more maturing bonds. Either way, the Fed's actions are likely to prompt a sharper-than-usual tightening in liquidity this month or next.

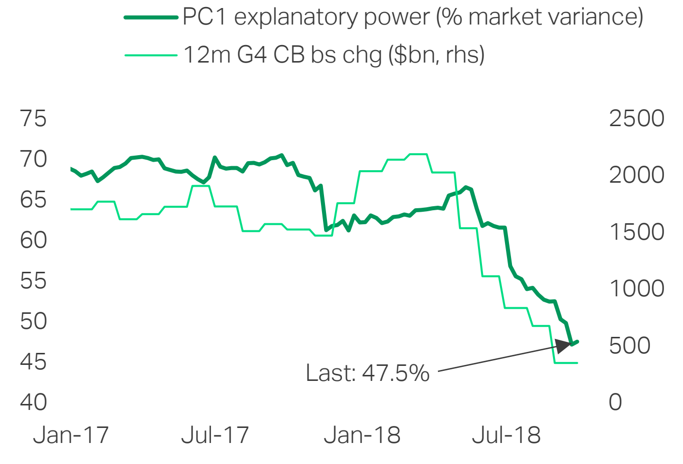
Fixed income markets undergoing regime shift. Most importantly, all this is taking place as global fixed income market behaviour fundamentally changes. In Macro Strategy last month we highlighted how the dominance of QE in fixed income markets was falling. Now, for the first time

Maturity profile dictates change in QT behaviour



Source: Federal Reserve, TS Lombard

Regime shift in fixed income



Source: Bloomberg, TS Lombard

since 2015, the first eigenvector (the "QE factor") in our PCA explains less than 50% of fixed income market variance. The QE factor declined in importance during the euro area crisis, but never by so much or for so long. The underlying drivers of fixed income markets are changing – Italian yields are no longer constrained by ECB buying. And as the ECB continues to step away from backstopping the market, global risk premia are set to rise.

The above factors suggest liquidity headwinds will begin to gather again. The conditions are in place for another liquidity squeeze. The squeeze in Q1 eventually tripped Turkey and Argentina into a crisis (with a helping hand from domestic politics). We do not think current tensions in Italy over the coalition government's maiden budget will snowball into a euro area crisis (we reckon political brinksmanship is a structural feature of the EA). But one cannot discount mistakes, either in Italy or elsewhere.

Last month's Global Financial Trends analysed tightening global liquidity and fingered rising Eurodollar (offshore USD) costs as the main pressure point for the next crash. Wider EUR and JPY basis swaps have so far failed to lead to contagion, but they show that the offshore dollar market remains fragile. None of this suggests financial conditions in the US will become restrictive. In fact, some of these factors (profit repatriation supporting capex, more bond issuance to fund fiscal stimulus) are positive for US growth. But tighter liquidity is a key risk for financial markets in the rest of the world and another reason for caution on the ex-US outlook.

Portfolio update

But our caution has not yet paid off. We discussed why the market has not priced in the chances of full trade war tariff escalation in Monday's Daily Note. That means some of our risk-off trades have hit stops: our CDX IG protection trade and short CNH/JPY trades were both stopped out on Monday. Likely thanks to onshore official support in CNY, USD/CNH has traded in a tight range just below 6.90, but we reckon risks are still skewed to the upside and maintain our year-end digital call option.

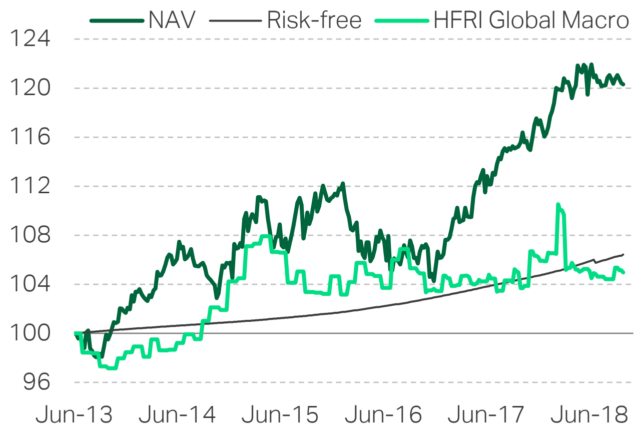
The Brexit update in last week's Global Political Drivers laid out the timeline for panic and resolution over at least the next six months. We originally sold EUR/GBP with the view that the UK and EU would reach a deal before the end of October, allowing the Bank of England to take a more hawkish tone at its November policy meeting. The timeline for this trade is likely too short now, so we take off our EUR/GBP put spread for a small loss and wait to buy GBP again on a panic-induced dip.

Current trade recommendations

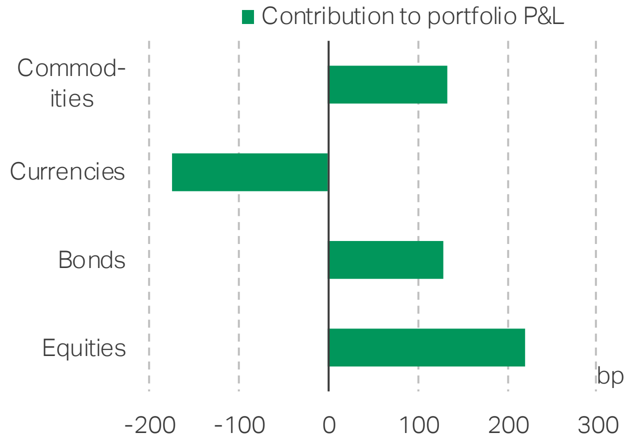
Theme	Trade	Date opened	Entry level	Last	P&L	Target	Stop	Original rationale / comment
Global cycle								
	Long CDX IG 5y protection (short	**20-Jun-18**	**67bp***	**58bp**	**-8bp**	**79bp**	**59bp**	**US investment grade to underperform as credit cycle past its**
	Short MSCI EM vs MSCI DM	01-Aug-18			6.5%			Liquidity conditions to tighten again, and trade w ar risk still looming
	Long EUR/AUD	26-Sep-18	1.6180	1.6154	-0.2%	1.67	1.59	Domestic headw inds, erosion of yield advantage to hurt AUD
Trading trade troubles								
	Long USD/CNH via 21-Dec 7.20 digi	15-Aug-18	15%	7.6%	-7.4%			CNY likely to continue w eakening to offset tariff risks
	Short CNH/JPY**	**15-Aug-18**	**16.00**	**16.50**	**-3.1%**		**16.50**	**Further CNY weakness could trigger broad risk aversion**
ECB Taper								
	Short Gilts vs Bunds	12-Sep-18	107bp	108.9bp	1.9bp	135bp	84bp	Gilt outflow and diminishing QE to w iden Gilt-Bund spread
Brexit in name only								
	Short EUR/GBP via 4m put spread	**11-Jul-18**	**26bp**	**23bp**	**-3bp**			**Despite the noise, BINO is the most likely outcome and is bulli**
Oil price normalization								
	Short Brent/WTI spread	19-Sep-18	$9.00	$9.68	-$0.68	$4.00	$11.50	Spread usually narrow s post-hurricane as US exports return

Bold indicates new trades or changes made this w eek. *stopped-out on Monday **stopped-out on Friday

Model portfolio historical performance



Performance contribution – last 12 months



Model portfolio metrics since inception

	Portfolio	HFRI Global Macro
Since Inception return	20.31%	4.95%
Annualized Return	**3.53%**	**0.91%**
2015	3.99%	-1.26%
2016	-4.89%	0.14%
2017	9.67%	2.47%
YTD	3.63%	-0.86%
MTD	0.25%	
Volatility (ann.)	4.63%	4.03%
Sharpe ratio (12m)	**0.52**	**-0.07**
Sortino ratio (12m)	**1.58**	**0.10**
Alpha (12m, vs HFRI)	6.63%	
Beta (12m, vs HFRI)	0.17	
Corr (12m, vs HFRI)	0.24	
Corr (12m,vs MSCI World)	0.31	
Corr (12m, vs JPM GBI)	0.13	
Max draw dow n (12m)	-2.35%	-4.12%

Best and worst trades – last 12 months

Best and worst performing trades of last 12 months	
Best	**Contrib. (bp)**
Long 1y10y USD 2.9% payer (28-Nov-17)	152
Long Canada 10y / short USTs 10y (18-Oct-17)	145
Long WTI / short Brent (06-Oct-17)	86
Long OIH US equity (14-Feb-18)	82
Long WTI (14-Feb-18)	66
Worst	**Contrib. (bp)**
Long Bund 10y / short BTP 10y (20-Sep-17)	-145
Long AUD/USD put (25-Oct-17)	-61
EUR/USD Call Spread (16-May-18)	-45
Short CNY / long JPY (15-Aug-18)	-35
Long USTs / short Bunds (24-Jan-18)	-33

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