



Macro Strategy

DOLLAR A MAYFLY; STERLING MAY FLY

Oliver Brennan

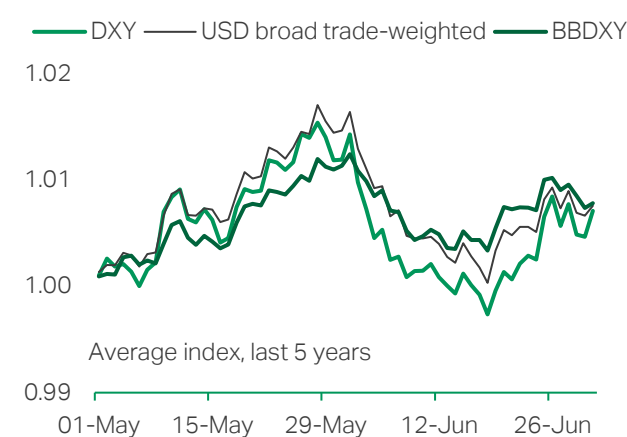
- May is historically seasonally strong for USD, but it is not the start of an uptrend
- We reckon Brexit will likely become merely BINO: ultimately positive for GBP
- Close long EUR/GBP, prepare to buy sterling dips; also buy back swaption short

USD tends to rise in May. In most of the last 10 years, May has been a positive month for the dollar. Just how positive depends on the choice of trade-weighted index: BBDXY has risen 80% of the time, while the broad trade-weighted index has risen 60% of the time. Sure enough, the dollar has started the new month on a positive note, with the narrow index (DXY or BBDXY) testing its 200-day moving average. But beware: the May rise tends to precede a June fall. This does not portend a summer of strength.

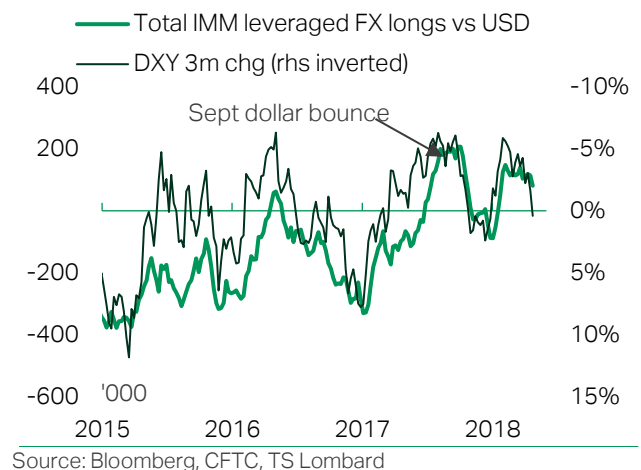
Positioning pointed to a dollar bounce. In last month's [Chartbook](#), we highlighted how net USD positioning was short and there was the chance of a rebound, just like last September. Then DXY rose by 4%; the current bounce is closing in on the same magnitude, even though short positioning was never as large as in September. And with those shorts now being reduced, this is one factor which is unlikely to give any more legs to the rally.

Dollar is supported by high yields. Deposit rates in the US are among the highest in G10. Although yield levels have been an unreliable guide to currency performance this year, USD's ascent to high-yield currency status has helped the recent rally. Indeed, the dollar may become the highest-yielding currency in G10 if the FOMC meets the market's rate expectations, further supporting USD in some cases (against AUD, for example, as we discussed in this month's [Asset Allocation](#).)

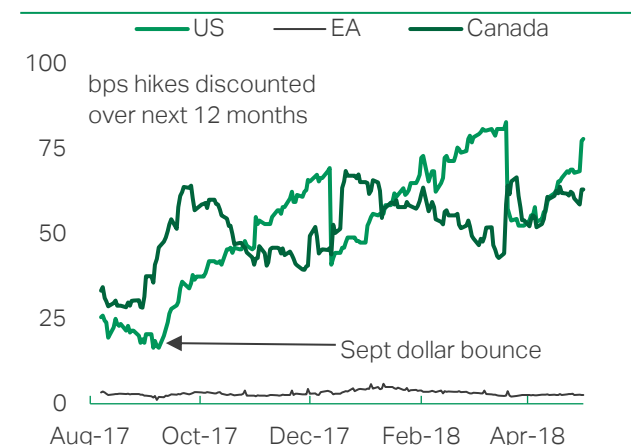
Seasonality is positive in May, not in June



USD short positioning to fall, a little more

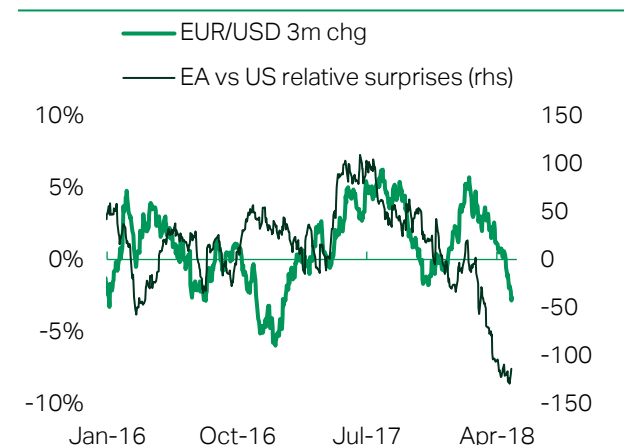


Fed rate hikes are fairly priced



Source: Bloomberg, TS Lombard

Data surprises have supported USD



Source: Bloomberg, Citi, TS Lombard

But rate rises are baked in the cake. With 75bp of fed funds hikes discounted over the next 12 months, the market is close to our view of three more 25bp increases by the end of this year. The Fed is expected to be the most aggressive central bank in G10, so the balance of risks from here on is that its peers turn more hawkish (or less dovish) and the yield gap between the US and other countries narrows. This is very different from last September, highlighted in the chart above, when market repricing of likely Fed rate rises was very much a positive factor for the dollar.

USD has benefited from weaker-than-expected euro area data. The run of negative data surprises was due to previously exuberant expectations: euro area growth has slowed, but it has slowed 'from torrid to hot'. The EA economy is fine, and we expect renewed data strength. The data surprise index is set to pick up as misplaced exuberance fades, and this should start to support EUR/USD. Again, this suggests the recent dollar bounce is unlikely to become a trend.

The dollar's rally has been strong and broad-based, and there is a risk that it becomes self-fulfilling as the currency's strength exacerbates a funding squeeze. But we remain of the view that the dollar will trade in a range this year and that it is currently near the top of that range.

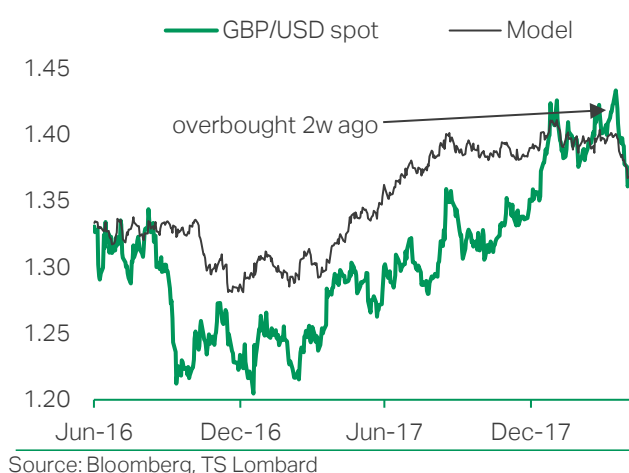
Although seasonality suggests May can be a positive month, other factors warrant caution. Positive factors for other currencies remain compelling, particularly EUR. Reserve managers are rebuilding the non-USD share of global FX reserves, leading to broad USD selling across the market. The EUR share remains much lower than it was pre-crisis, and has risen at a slower pace than valuation adjustments would imply: reserve managers remain underweight EUR, a legacy of the euro area sovereign debt crisis. As the EA is no longer in crisis, and risk-free yields are gradually rising, managers look set to rebuild their EUR allocations, generating persistent long-term demand for the single currency. Dollar strength is thus likely to be short-lived; this does not look like the start of an uptrend.

Sterling no longer overbought, and Brexit outcome changes balance of risks

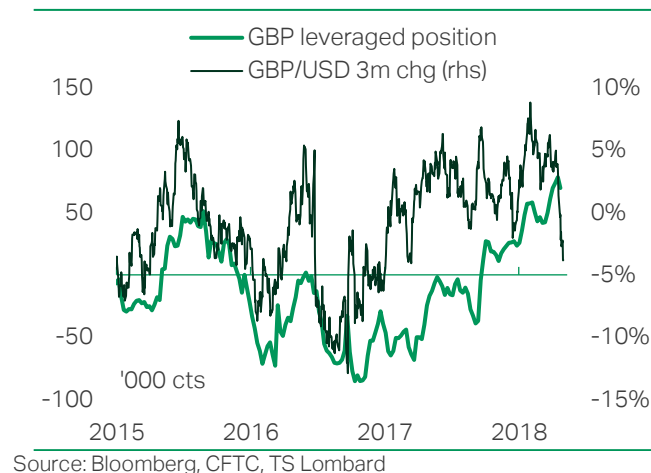
In our note two weeks ago we suggested GBP strength was overdone. We noted that the risk to GBP was for fewer, not more, rate rises than the market was discounting, including one in May. Weak GDP data and falling PMIs have now cut the chance of an increase at next week's BoE policy-setting meeting to 15% and the chance of a hike at any point this year to around 60%.

The chart below updates the model we introduced in that note, which was based on pre-referendum regressions to assess underlying valuations following Brexit. At the time GBP was

GBP/USD now fairly valued



Wait for GBP longs to fall before buying



overbought by around 3%. Now it is no longer overbought; in fact it is trading in line with the model.

High stakes Brexit is an illusion. In last week's [Global Political Drivers](#), Christopher Granville outlined our view that the appearance of high stakes in the Brexit negotiations is an illusion: "Brexit in name only" (BINO) is the almost certain outcome. The risk of a no-deal Brexit is negligible, as is the possibility of Brexit being revoked. Instead, the 'standstill transition' will last an initial 21 months (as agreed between negotiators Davis and Barnier), and probably much longer – the classic European can-kicking solution.

It will still take some time for markets to correctly price BINO. The prospect of BINO removes one of the reasons to be bearish on sterling. The currency remains around 10% below its pre-Brexit level, mostly due to the 'Brexit discount' – the risk of tariffs or other added costs once the UK quits the EU. But our assessment of BINO points to no material change in the relationship with Europe. Accordingly, the premium will eventually be unwound. GBP risks are thus no longer symmetrical.

Recent data softness in the UK is more likely weather-related than a sign of an impending slowdown (though we reckon [UK growth is firmly in the slow lane](#), suggesting BoE policy tightening will be very slow in any case.)

GBP has become a 'buy on dips' rather than a 'sell on rallies'. All these reasons cause us to **close our long EUR/GBP position**, leaving the EUR basket trade with USD, AUD and CHF shorts.

Sterling positioning remains very long, so it is not yet time to buy GBP/USD. The recent sell-off has likely cut many GBP longs, but there will be more liquidation to come. In light of our view that USD strength will be short-lived, we will look to build a long GBP/USD position over time.

We buy back our swaption short strike ahead of the FOMC meeting

We make one other change to our portfolio this week: **we buy back the 3.1% payer swaption** which we had sold as a hedge against the 1y10y 2.9% payer. It is due to expire next week, but with the current value at just 1bp and the FOMC meeting tonight, it is prudent to take it off rather than run a short option position going into the meeting.

As we discussed in [last week's Macro Strategy](#), the recent spike in US yields will probably be temporary. Depending on the outcome of the FOMC meeting, we will consider selling a new 3m payer swaption to fund the position over the summer.

Current trade recommendations

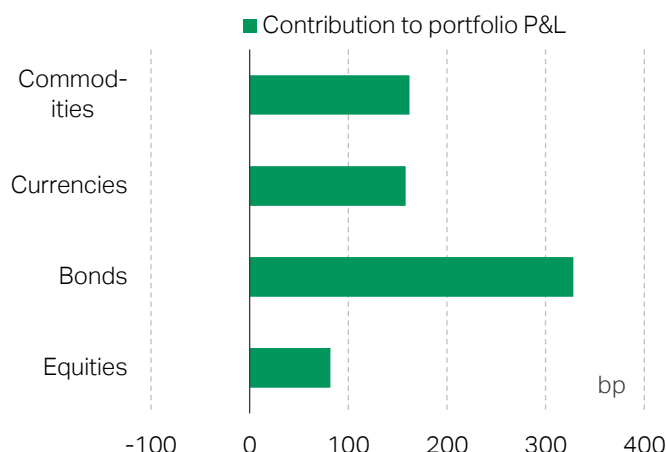
Theme	Trade	Date opened	Entry level	Last	P&L	Target	Stop	Original rationale / comment
Global reflation								
	Long WTI	21-Feb-18	\$61.50	\$67.32	9.0%	\$70	\$64.50	Strong oil performance at this stage in the cycle, US exports rising
	Long OIH US equity	21-Feb-18	\$24	\$26.91	11.4%	\$29	\$25	US oil service sector to benefit from rising US exports
Trading trade troubles								
	Short CNY/KRW	28-Mar-18	170.00	169.18	0.5%	164.00	175.00	Korea currency manipulation to end, KRW to catch up
ECB Taper								
	Long Bunds / short OAT 10y	14-Mar-18	24.5bp	22.3bp	-2.2bp	50bp	15bp	ECB cornered Bund market, OATs to react more to end of QE
	Long EUR vs GBP*, CHF, AUD, USD	04-Oct-17			2.3%			ECB taper and China growth rollover
BoJ easing								
	Long EUR/JPY 21May18 call spread	21-Mar-18	26bp	28.1bp	2.1bp			Domestic Japanese investors buying European assets again
End of QE distortion								
	Long 1y10y USD 2.9% payer incl hedge	29-Nov-17	86bp	238bp	197bp*			FI distorted by QE; unwind will raise yields and vol
New Fed Chair, new reaction function								
	Long EDZ8- EDZ9	28-Feb-18	33bp	36bp	3bp			Room for more rate hike pricing in 2019
	Long AUD/USD 31Aug-20Dec cdr sp	28-Feb-18	0.58%	0.75%	0.17%			USD dynamics to change and vol to rise towards year-end

Bold indicates new trades or changes made this week. *P&L includes p&L on 3m hedge

Model portfolio historical performance



Performance contribution - last 12 months



Model portfolio metrics since inception

	Portfolio	HFRI Global Macro
Since Inception return	21.45%	5.00%
Annualized Return	4.04%	1.00%
2015	3.99%	-1.26%
2016	-4.89%	0.14%
2017	9.67%	2.47%
YTD	4.61%	-0.81%
MTD	0.03%	
Volatility (ann.)	4.67%	4.16%
Sharpe ratio (12m)	1.74	-0.07
Sortino ratio (12m)	3.57	0.10
Alpha (12m, vs HFRI)	10.04%	
Beta (12m, vs HFRI)	0.14	
Corr (12m, vs HFRI)	0.16	
Corr (12m, vs MSCI World)	0.30	
Corr (12m, vs JPM GBI)	0.14	
Max draw down (12m)	-2.04%	-4.07%

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)	187
Long Canada 10y / short USTs 10y (18-Oct-17)	145
Long EM equity (21-Jun-17)	137
Long EUR / short GBP, CHF, AUD, USD (04-Oct-17)	92
US 2s10s flattener (08-Mar-17)	90
Worst	Contrib. (bp)
Long Bund 10y / short BTP 10y (20-Sep-17)	-140
Long US Banks / short S&P500 (03-May-17)	-139
Long AUD/USD put (25-Oct-17)	-61
GBPUSD Put spread (26-Jun-17)	-35
Long GBP / short USD (18-Jan-17)	-35

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