REDWARD ASSOCIATES

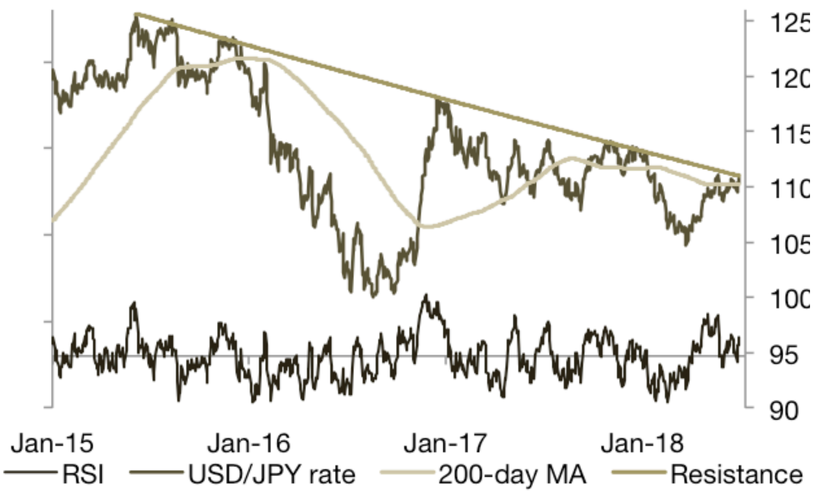
MACROMONDAY

2 July 2018

IN THIS ISSUE

- We see little prospect of a Sino-US accord preventing the implementation of tariffs this Friday.
- A contraction in Japan's basic BoP surplus - driven by rising energy costs - leaves the JPY increasingly vulnerable to elevated US-Japan interest rate differentials.
- We make significant changes to our portfolio, closing XAU, CNH and KRW exposures, reversing the CNH position, tightening our stop-losses on IDR and NZD buying USD/JPY.

Chart of the week: USD/JPY exchange rate



Source: Bloomberg, Redward Associates

Will USD/JPY break higher?

We take profit on short XAU, CNH, KRW and reduce our short NZD.

Investor focus this week is likely to remain on Sino-US trade tensions, with tariffs due to come into force on 6 July, and key US economic data releases, notably Monday's ISM manufacturing report and Friday's employment report.

We expect no progress to be made in diffusing Sino-US trade tensions and we anticipate that both countries will implement 25% tariffs on USD 72bn worth of bilateral trade. We anticipate that the imposition of tariffs may act as a catalyst for dialogue but that remains to be seen.

Analyst expectations appear to have caught up with US economic data with the Citi economic surprise index dipping -4.9 last week. This dip in economic surprises into negative territory is consistent with a downward revision of the Atlanta Federal Reserve's GDPNow estimate of GDP growth to 3.8%q/q SAAR consistent with a tightening of financial conditions. However, while it appears that the momentum of economic growth may be subsiding, financial conditions remain broadly consistent with their post-GFC average and conducive of economic growth well above potential, implying further tightening in capacity.

We expect US economic data to continue to print robust this week with the ISM manufacturing index likely to remain 50-60 and non-farm payrolls is likely to increase ⩾180k with average hourly earnings likely to be between 0.2-0.4%m/m and unemployment stable at 3.8%.

The CME FedWatch tool projects a 70% probability of a 25bp rate hike at the 26 September FOMC and around a 40% probability of four 25bp rate hikes this year.

Ahead of key data released this week we make significant changes to our portfolio.

We close our longstanding short gold position, locking in a gain of 5.3%. We also close our short CNH and KRW exposures locking in gains of 4.9% and 3.5%, respectively. We tighten the stop-losses on our short IDR and NZD exposures, reducing the latter exposure by USD 100k.

We enter a tactical short USD/CNH exposure via the 1-month NDF outright at 6.6420/USD (USD 200k) targeting 6.50/USD with a tight stop-loss at 6.6725/USD. Finally, we buy USD/JPY (USD 200k) at 110.39/USD, targeting 114.25/USD with a tight stop-loss on spot at 109.45/USD. We note that USD/JPY is currently resting close to multi-year resistance with momentum indicators suggesting a likely breach of this support leading to a rally toward 114/USD.

- Rising US interest rates coupled with a stronger USD should boost USD/JPY, especially if risk-aversion fades as we enter the Northern Hemisphere summer months.

Upcoming events	Date/Time	Our view
US Manufacturing ISM (June)	02/07, 10:00 EDT	Given strength in regional PMI's we see scope for upside surprise.
AU: Monetary board (July)	03/07, 14:30 AEST	RBA to remain 'on hold' but will the Bank signal a shift to a more dovish tone?
US: FOMC minutes (June)	05/07, 14:00 EDT	Given the June FOMC, we expect the Minutes to be up-beat.
AU: Retail sales (June)	04/07, 11:30 AEST	Expectations are for a gain of 0.3%m/m but we see downside risk.
US: Employment report (June)	06/07, 08:30 EDT	We expect a strong NFP with focus on wages, expected 0.3%m/m (2.8%y/y).

- Rising oil prices are compressing Japan's basic BoP surplus, leaving JPY vulnerable to rising US rates & a stronger USD.
- Gold appears to have become slightly 'under-valued' and 'over-sold' leading us to close our long-held short exposure.

We buy USD/JPY.

A weakening basic BoP surplus leaves JPY increasingly vulnerable to UIP conditions.

In recent days, USD/JPY has risen to 110.70/USD, testing multi-year resistance (see Figure 1). We expect resistance to be breached leading to a rapid move higher towards 115/USD and we enter a long exposure.

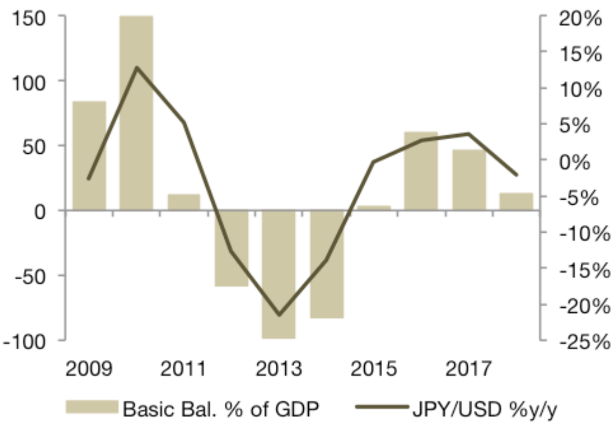
Rising oil prices are weakening Japan's terms of trade, placing downward pressure on the country's merchandise trade and current account balances. The contraction in the country's basic balance of payments surplus to almost zero this year is likely to lead to increased sensitivity to capital flows driven by Uncovered Interest Parity (UIP) conditions.

Our back-of-the-envelope calculations suggest that Japan's merchandise trade surplus is likely to compress by around USD 40bn this year driven by rising energy costs. Incorporating this into our current account balance projections, we now project a surplus of around USD 160bn (3.1% of GDP). Incorporating net FDI outflows of USD 150bn, we project Japan's basic balance of payments to contract sharply from USD 46.2bn (1% of GDP) last year, to around USD 10bn (0.2% of GDP) in 2018.

With Japan's basic balance of payments surplus contracting, the currency is likely to be increasingly sensitive to US-Japan interest rate differentials and expected changes in USD/JPY; in other words Uncovered Interest Parity (UIP) conditions. With the USD having strengthened recently and US-Japan interest rate differentials widening - the 1yr IRS yield differential is currently around 265bp - we see scope for upward pressure on USD/JPY to re-emerge.

Technical indicators also appear to favour a move higher with momentum indicators supportive while CFTC data indicates market positioning remains light with leveraged accounts only short 13.7k contracts (13.4% of total open interest). Option volatility remains low with one-month ATMF implied just 7% and risk-reversals remain skewed to USD call options by 1%.

Figure 2: JPY/USD & basic balance, % of GDP



Source: Bloomberg, Redward Associates

We take profit on our gold short.

Gold appears 'under-valued' and 'over-sold'.

Last week, gold traded to a low of USD 1,246.02/oz before closing the week at USD 1,252.60/oz (-1.4%w/w). While we expect gold to continue to weaken on a multi-month basis, it now appears to be 'over-sold' and we have closed our long-held short exposure locking in a gain of 5.3% (see MacroMonday 12 March 2018).

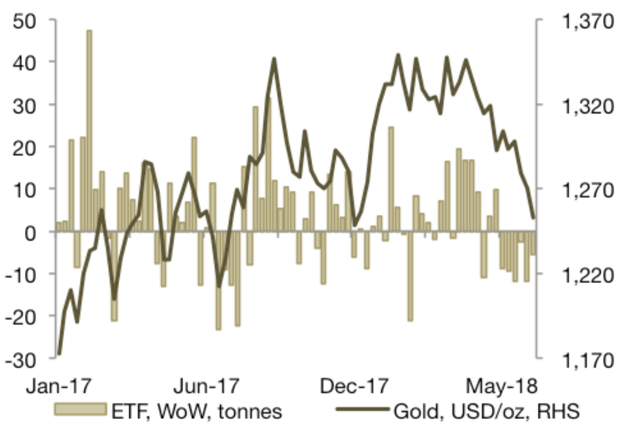
Our short-term model for gold based on our 5-country USD index, the US 10-year bond yield, the Bloomberg base metal index and the S&P500 VIX index suggests 'fair value' is currently USD 1,263/oz implying that gold is now slightly 'under-valued'. Our 'fair value' estimate has increased 1.3% since 20 June driven largely by a rise in asset market volatility - the VIX index has increased from 12.8% to 16.1% - and a fall in US bond yields with a minor contribution from a softer US dollar while base metal prices have fallen 1.5%, acting as a drag on prices. Meanwhile, a simple bivariate regression of gold relative to our 5-country USD index suggests that the price has also overshot to the downside by around 2%, with 'fair value' at USD 1,277/oz.

The decline in gold appears to have occurred in tandem with retail position liquidation with gold ETF holdings falling for six consecutive weeks, with holdings falling 50MT, to 2,188MT (see Figure 3).

While gold appears to be firmly in a downtrend, momentum indicators suggest that the metal has become 'over-sold'. Over the past 5-years, every episode of gold becoming technically over-sold to this magnitude has been associated with a substantial reversal. While gold has fallen significantly, the gold option market remains quiet, suggesting that while we are likely to see a rebound, it may not be as large as we've observed in recent years.

We maintain our longer-term bearish view, looking for gold to decline towards USD 1,200/oz over the coming year but we see scope for a relief rally, possibly to USD 1,280-90/oz. Consequently, we take profit, looking to re-establish our short exposure at more attractive levels.

Figure 3: ETF holdings & gold price, USD/oz



Source: Bloomberg, Redward Associates

- We take profit on our short CNH exposure and tactically reverse our position with a tight stop-loss.

We take profit on short CNH.

We believe it's not in Beijing's interests to risk destabilisation of the CNY.

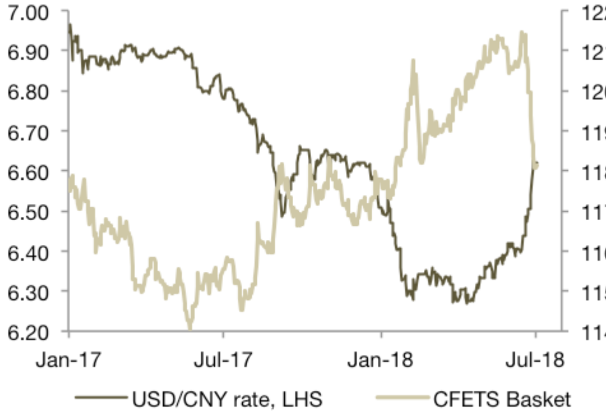
Since President Trump indicated his intention to move forward in imposing tariffs on USD 50bn worth of imports from China on Friday 15 June the CNY has weakened 3.4%, to 6.62/USD, consistent with a 2.8% fall in the CFETS basket (see Figure 4).

We believe that the dramatic slide in the CNY in recent days has become over-extended and while we look for further CNY weakness in coming weeks, we believe it is not in China's interests to continue to pursue currency weakness for now. Consequently, we close our long USD/CNH exposure, locking in a gain of 4.6%. Moreover, we see scope for a technical correction in USD/CNY back towards 6.50/USD and we enter a modest (USD 100k) tactical USD/CNH short exposure via the 1-month outright at 6.6423/USD, targeting 6.50/USD with a tight stop at 6.6725/USD.

In our opinion, it would be misguided of Beijing to continue to pursue a rapid depreciation of the CNY for three reasons: i) across all Chinese exports, the improvement in competitiveness gained from the recent weakening of the CNY likely more-than offsets the negative impact of US tariffs, ii) pursuit of further CNY competitiveness gains at the rate observed in recent days risks inflaming Sino-US trade tensions and may well be used by President Trump as justification for further measures, and: iii) further weakness runs the risk of shifting currency expectations and triggering a resumption of capital outflows. Our primary concern is the latter as capital outflows would likely tighten domestic liquidity conditions making monetary management more challenging.

We have recently argued that the People's Bank's efforts to de-lever the Chinese financial system by both contracting aggregate finance and moving off-balance sheet assets back onto bank balance sheets is likely to result in a sharp deceleration in FAI growth and a slowdown in activity in H2 2018 (see Asia-Pacific Today, 13 June 2018). In light of clear indications that this is occurring, it appears to us that the People's Bank has eased monetary conditions - although we expect them to maintain firm window guidance on credit - with front-end rates rallying and the CNY depreciating. With CNY weakening and Sino-US interest rate differentials contracting rapidly, we believe that the People's Bank will be mindful of the risk of re-igniting large-scale capital outflows. With USD 27,190bn in M2, even a modest increase in capital outflows has the potential to overwhelm China's increasingly fragile balance of payments, pushing it into deficit, leading to a sharp fall in FX reserves and tightening domestic liquidity conditions. A mere 1% shift in M2 would trigger outflows of USD 272bn requiring 125bp of cuts to banks' Required Reserve Ratio (RRR) to stabilise domestic liquidity. Consequently, we don't believe that China can pursue rapid depreciation of CNY for long and given the sharp shift in sentiment in recent days, it appears to have extended far enough.

Figure 4: USD/CNY & CFETS basket



Source: Bloomberg, Redward Associates

Foreign exchange portfolio

- Medium. **Short AUD 1M** at AUD/0.7424 (USD 300k) target AUD/0.7175, stop AUD/0.7675. P&L 0.8k.
- Medium. **Long CNH 1M** at 6.6423/USD (USD 100k) target 6.50/USD, stop 6.6725/USD. P&L 0.0k.
- Medium. **Short IDR 1M** at 13,876/USD (USD 200k) target 14,650/USD, stop 14,175/USD. P&L 1.7k.
- Medium. **Short JPY 1M** at 110.39/USD (USD 300k) target 114.25/USD, stop 109.45/USD. P&L 0.0k.
- Strong. **Short NZD** at NZD/0.7025 (USD 300k) target NZD/0.6475, stop NZD/0.6945. P&L 10.1k.
- Strong. **Short PHP** at 53.54/USD (USD 500k) target 56/USD, stop 54.45/USD. P&L -1.1k.

Notional capital = USD 1mio
Current leverage ratio is 1.7:1
Level of conviction: Strong, Medium, or Weak

Fixed income portfolio

- Strong. **Paid USD 2y1y IRS** at 2.19% (0.4k DV01) targeting 3.90%, stop 2.78%. P&L 31.9k.
- Medium. **Received KRW 1y1y IRS** at 2.31% (0.2k DV01) targeting 2.05%, stop 2.36%. P&L 4.4k
- Strong. **Received NZD November OIS** at 1.7675% (0.3k DV01) targeting 1.50%, stop 1.92. P&L 0.3k.
- Strong. **Paid USD 2y1y IRS vs. NZD 2y1y IRS** at -24bp (0.3k DV01) targeting -140bp, stop -10bp. P&L 8.1k.

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Commodities	Today	%WoW
Iron ore	65.0	0.8%
Metallurgical coal	186.0	-1.1%
Thermal coal	68.6	0.0%
Brent crude	80.3	6.1%
Gold	1,253	-1.0%
Commodity index	124.64	0.1%
Terms of trade	1.17	-1.2%

Commodities	Today	%WoW
AUD/USD rate	0.7399	0.0%
ATWI rate	62.60	0.3%
Official Cash Rate	1.50	-
AU-US 2yr IRS, bp	-0.50	0.00
AU-US 10yr bon, bp	-0.23	0.02
AUD 1M ATMF, %	8.65	0.33
VIX index	16.1	-1.24

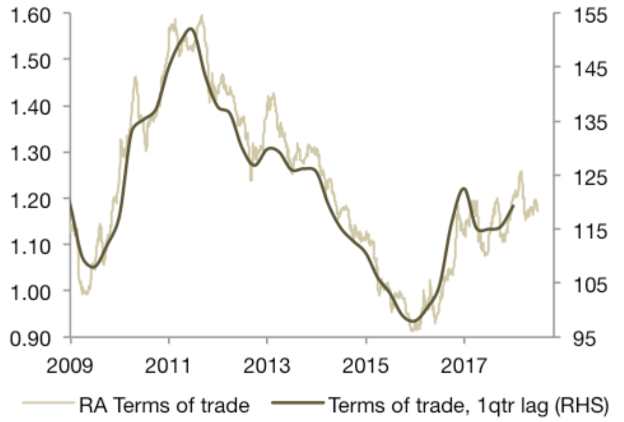
Figure 5: AUD/USD exchange rate

Source: Bloomberg, Redward Associates

Figure 6: Commodity price index

Source: Bloomberg, Redward Associates

Figure 7: Terms of trade

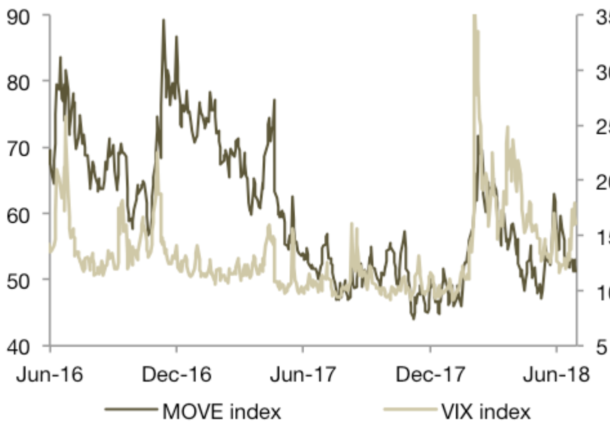


Source: Bloomberg, Redward Associates

Figure 8: Australia-US 1y1y IRS yield, %

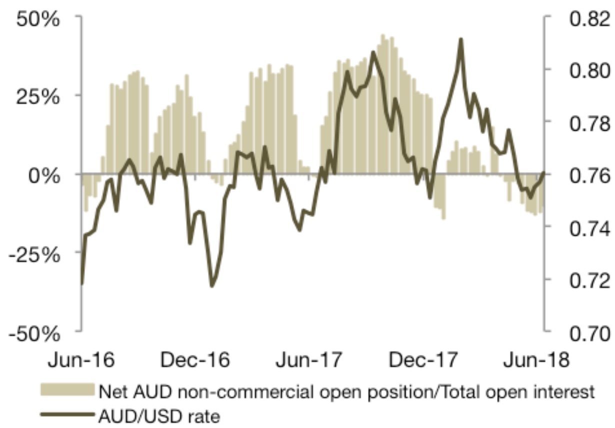
Source: Bloomberg, Redward Associates

Figure 9: VIX & MOVE indices



Source: Bloomberg, Redward Associates

Figure 10: CFTC position, % of total open interest



Source: Bloomberg, Redward Associates