Drobny Global Monitor

November 28, 2016

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Biases:

EQUITIES: Bearish
BONDS: Bearish; Bullish Bond Vol; Curve Steepeners
FX:

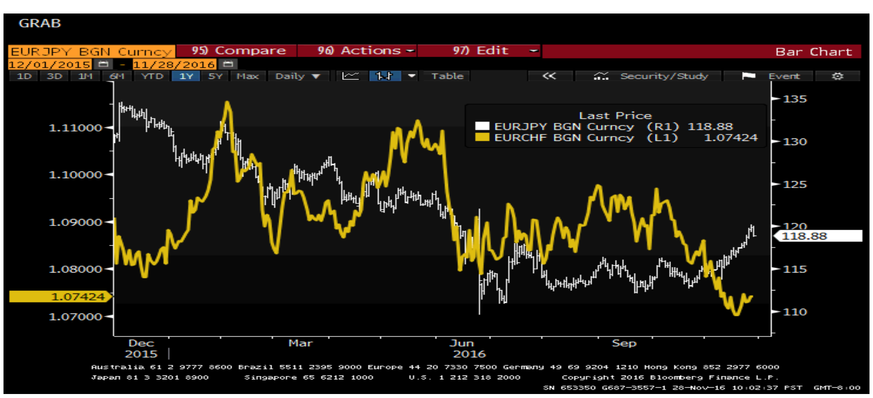
Current Exposure:

EQUITIES: Short Bovespa (Nov 10);
BONDS: Short UK 30yr TIP (Oct 25);
Short 10yr US Treasury (Sept 26);
Receive 2yr Japan swap (Sept 26);
FX: Long USD vs SFr (Nov 14);
Long USD vs HKD (July 18);
COMD:

The 2017 Contradiction

**** Please note latest changes to biases and/or exposure***

Consider the recent divergence in the performance of Euro/Yen (RHS, below) and Euro/SFr (LHS). Euro/yen has been moving higher since late October, and really picked up steam after the Nov 8 US election. Euro/SFr has gone the other way.



Now, there is no intrinsic reason why these two currency pairs should necessarily move together. As shown in the top picture overleaf, the two currencies pairs have sometimes moved very differently. That's either because of idiosyncratic Yen moves (eg 2013 Yen weakness and late 2015/2016 Yen rebound), or when unique moves into and out of the SFr took place in 2011.

But, when the catalyst for the moves stem from the Euro, the two crosses have tended to move similarly. That holds with the abrupt move in Euro/SFr in early 2015 when the 1.20 SNB line in the sand was removed. The underlying force in this episode was the introduction of QE by the ECB, which sent the Euro down pretty hard against all currencies.

So, into 2017, we face two competing forces. One is the Trump economic effect which, if the stimulus part is successful, should serve to place upward pressure on interest rates and downward pressure on zero/negative interest rate currencies. This so-called 'Trump trade' is well known to be a USD positive, but it should also have cross effects by disproportionately pulling down traditional funding currencies such as the SFr and the JPY. As pointed out in a recent **DGM,** Euro/SFr commenced a long move down from around 1.60 to around 1.00 since the global financial crisis hit in 2008 and major country interest rates fell to zero. As with the Yen, the SFr TWI would seem likely to start a long move down if the Trump stimulus effect dominates the story in 2017.

But, what happens if the Trump/Brexit political demonstration effect ripples into the Eurozone politics? That's what the market seems focused on this morning, whether it's about the threat of Le Pen in France, or the referendum in Italy and the potential for the 5 star movement to make gains. There is also the parallel fear of a risk-off event driven by protectionism and the threat of trade wars, though for now it's the Eurozone political risk that seems more pressing.

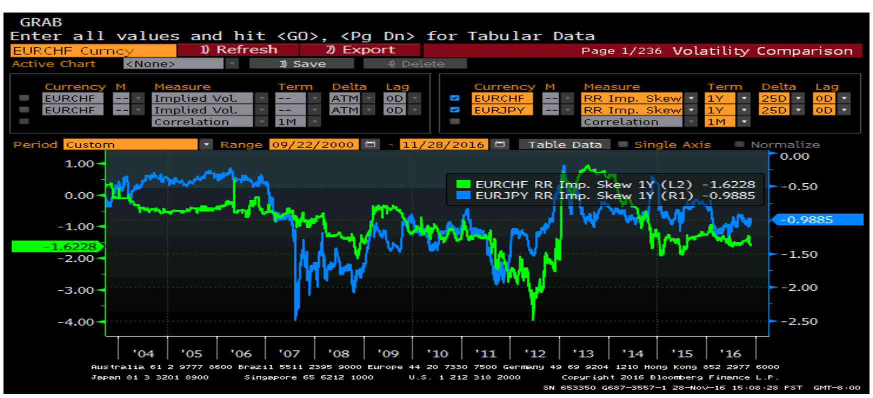
And, that's a Euro centric event. Which takes us back to Euro/SFr and Euro/Yen divergence. If the elections within the Eurozone lead to an ugly outcome, then that should send both Euro crosses lower. [It's funny how sterling bulls seem to salivate at this prospect, and especially the idea that the nexus from Brexit to Trump to Euro breakup would argue for a much lower level for Euro/Sterling. Yet, they sometimes forget that such an event could prove very messy, and has the potential to disrupt much needed capital flows into Sterling to fund the big trade deficit.]

But, Euro/SFr is already pretty low and the Swiss TWI, after its steep climb from 2008, is near its highs. Euro/Yen, in contrast, looks to be around mid-range, as is the JPY TWI (above).

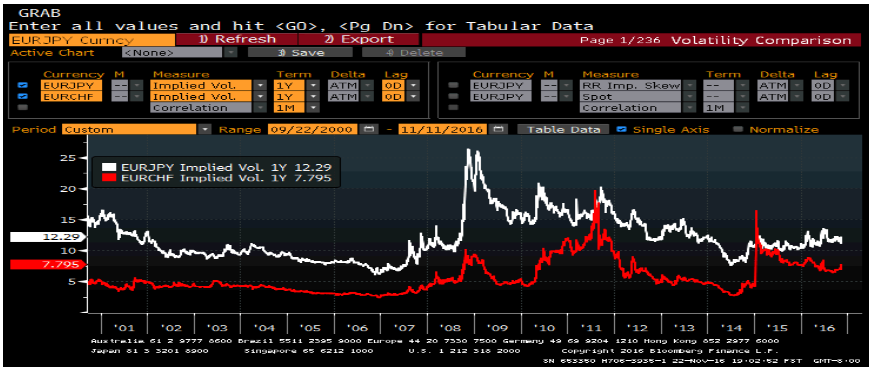
Now, one explanation for the rise in Euro/Yen is that the Japanese have undertaken steps, and are expected to take more steps, to encourage capital outflows and prompt a trend weakening of the Yen. There's a sense that we may be on the cusp of seeing the next version of the Abenomics fiscal/monetary stimulus, similar to what we saw in 2013. That's when the Yen went down particularly hard and Euro/yen rallied from around the 100 level to the 140 to 150 area.

Yet, unlike 2013 when Japan was running historic trade deficits following the 2011 tsunami, the country is again running a significant trade surplus. So, this time the capital outflows in Japan will have to be much larger to achieve the same size of currency move. It's a much bigger hurdle.

Moreover, the markets seem to be leaning in the same direction as the recent trends. The 1yr 25delta skew on Euro/Yen has been grinding higher recently along with spot (RHS, below). And, it is well above the range it traded when Euro/Yen was trending downwards in 2008-2012. The market looks poised for a further rally next year. The equivalent skew on Euro/SFr, in contrast, is near its most negative apart from some spike events. The market looks poised for more Euro/SFr downside.



And, 1yr implieds for both pairs don't look very excited, into a year with the potential to generate explosive moves (below). 1yr implieds on Euro/Yen (top line) aren't very high, especially for downside puts. They do look a bit elevated for Euro/SFr compared with the days of the 1.20 target (2012-2014), and compared with the pre-2008 crash days when there was calm in the Eurozone. But, the bias is very tilted towards the downside, and the cross is already at a very low level.



This suggests a cross currency option straddle, where you are long a call on Euro/SFr and long a put on Euro/Yen. The Euro/SFr cross is trading at a very low level and the market seems biased towards downside risks. The upside seems substantial should the Trump stimulus effect dominate proceedings next year. 1.18 is not a crazy target on a 1yr view, yet the market seems to offer something like 6-1 odds against this being hit.

The Euro/Yen cross, in contrast, has enjoyed a strong rally, and the market seems poised for further upside. Yet, the Brexit/Trump political ripple effect, should it dominate proceedings next year, could send this cross a long way lower. (So, too, could fears of an early move by the new Trump admin against Asian exporters). A 1yr one touch on Euro/Yen reaching 101 offers roughly 5-1, and in the 2011/2012 Eurozone crisis the cross fell below 100 on several occasions. And, a break of 110 on this cross, a level we breached briefly after the Brexit vote last summer, would be likely to push up implied vol considerably.

The Eur/SFr call seems the better value leg. The cross starts at an extraordinary level, and it could climb a long way if political events are unremarkable next year and the Trump Stimulus carries a good punch. The Euro/Yen leg looks like offering less underlying value to play for a Eurozone political shock next year. And, there are decent and likely better alternatives (Bund/Spanish spreads are lagging Bunds/BTPs considerably). But, there is something intriguing about Euro/Yen given the rally that has just occurred. And, after the BoJ, with lots of talk and notoriety on policy, actually didn't do anything to stimulate Yen weakness at the last meeting.

But, beneath the specific trade concepts, the idea is that there are contradictory forces that emerge from the 'Trump effect'. The Trump fiscal stimulus effect should serve to push us forward on the interest rate normalization process, with its own ripple effects onto currencies and other assets.

In contrast, the Trump protectionist instinct and, more imminently, fears of a Trump/Brexit domino effect has the potential to unleash powerful breakup forces within the Eurozone. And, that may eventually unlock a path towards normalization as well, as revaluation of a DEM (and SFr) could force a round of fiscal stimulus in Germany while devaluation of others in the Eurozone frees up their economies as well. But, this path looks very messy and seems likely to generate considerable turbulence and turmoil along the way. And, it could produce forces that undermine the path towards normalization, or at least stall some of the progress.

These conflicting 'Trump effects' is the contradiction we face headed into 2017. Each force, on its own, could lead to powerful moves. That's a world where the payback for low delta's could be huge. Yet, if they are unleashed together, these forces may confront each other and result in turbulence and considerable volatility along the way.

Andres Drobny

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