May 23, 2013

DrobnyGlobal Monitor

Biases:

EQUITIES:	
BONDS:	Bearish Major Country (non peripheral Eurozone) Equities
FX:	Bearish Yen
EMG:	Bearish Asian EMG interest rates;

Current Exposure:

EQUITIES:	
BONDS:	Short TYM3 (May 6);
FX:	*Long USD/CLP (May 20);
	*Long USD/SFr (May 23);
CMOD:	

More on Normalization

*Please note latest changes to biases and/or exposure

Mr Bernanke told the bulk of the story. The US can start to unwind QE if data confirms the rebound looks sustainable. Today's unemployment claims number fits that requirement and suggests that the unemployment rate will keep coming down over the summer. First comes the QE unwind. Then should come rate hike fears.

And, with the property market on fire, there may actually be only one way to stop it: higher mortgage rates. Real rates are negative and credit spreads are narrow, which means normalization will likely involve TIPs, swaps and credits underperforming Treasuries (BE inflation may not rise as might typically be expected.... imagine what happens to BE inflation if actual inflation starts to rise and FED rate hikes look necessary for the wrong reasons!).

Another part of the story involves more soft data out of China. The rebalancing problem. But, a big puzzle over there is that the economy has softened yet it seems that their property market may not have cooled substantially. That will have to be dealt with. This adds to downside risks for commodity prices and Latam currencies. The potential for a normalization of US rates combined with weakening commodity prices seems a recipe for more Latam FX weakness.

And, then there was the SNB's Jordan. The equity shake out produced an unwind of liability currency shorts, such as the Yen and Swissie. A return to that risk-on/off stuff. At a time when some technicians argue the USD rally is looking a bit tired.

Yet, this is a shake out due to fears of rate normalization, not a credit bust. Asset values may have to make a one-time adjustment to a departure from ZIRP, and that of course generates increased risks of a return to asset fragility and economic vulnerability.

That's why the data, especially the US recovery, is so important. If normalization happens in the context of improving data out of the US (and Japan), and hopefully with more of those green shoots out of the Eurozone as well, then all this turbulence isn't a reason for a big unwind of the USD rally.

And, Jordan made it clear yesterday that the SNB, like the Japanese, are determined to do what is necessary to promote recovery. That includes raising the Euro/SFr floor or moving to negative rates. The June 20 SNB policy review is becoming increasingly important. The prospect of higher US rates combined with negative Swiss rates creates the potential for a pretty fierce move in USD/SFr this summer.

One last little point about Japan, Asia and the process of Yen normalization. There was a piece yesterday about how Yen weakness is generating trouble for the rest of Asia ('Abenomics will only damage Japan's neighbours', David Li, FT, May 22, 2013). This echoes a growing chorus of complaints that a recovery in Japan is a recipe for trouble, not hope.

Li's argument, though at first sight attractive, doesn't seem right. The Yen TWI has fallen fiercely, that is true. And, this may cause initial reverberations. But, it has been normalizing from an extremely overvalued level to something more towards some kind of average level or fair value. Moreover, unlike in the past, this is a Japan with a trade deficit, not a surplus. And, Abenomics includes a meaningful fiscal stimulus.

So, Japan may be regaining lost competitiveness relating to their neighbors, sure. But, if the Japan recovery is sustained, this will likely include substantial new demand for imports from their neighbors as well. A sustained recovery of growth in Japan means more demand for goods from abroad, which should provide a powerful countervailing force for their neighbors against the effects of currency depreciation. This goes back to an old dictum in economics: income elasticities of demand are greater than price (and exchange rate) elasticities.

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****Past reports can be accessed at www.drobnyresearch.com***