What awaits the Euro, yen and crude oil this week?

BY MATEIN KHALID, CHIEF INVESTMENT OFFICER, ASAS CAPITAL, DIFC

The US dollar is the traditional safe haven currency during times of geopolitical or financial stress even when the cause of a risk aversion spasm is ultimately American, such as the failure of Lehman Brothers in 2008, Obama's epic budget battles with the Republicans in 2011 and the Trump White House's drone hit on Iran's most revered Revolutionary Guard commander on 3 January 2020. Strangely enough, this is not the case with the coronavirus panic that triggered Wall Street's most vicious weekly sell off since 2008 and sent the Volatility Index (VIX) to as high as 49, above its level even at the depth of the 2009 global recession.

Even though Germany (one third of the Eurozone economy) is in de facto industrial recession, the German Health Minister warned his peers about an imminent Covid-19 epidemic and stock exchanges in Frankfurt, Paris, Milan, Madrid and Amsterdam had their worst selloff since the 2012 Greek/Cyprus sovereign debt crises, the Euro actually rallied 1.5% to close at 1.1025 against the US dollar even as spasm of risk aversion on Wall Street escalated all week. Warum/pour-quoi/why? The proximate cause for the Euro's strength is its extensive role \as a funding currency in FX carry trades since it is cheaper to short than the Japanese yen and has a higher depreciation slope than the Swiss franc. As traders unwound their long Indian rupee or Russian rouble bets financed with the single currency, a short covering bid in the Euro catapulted it above 1.1000 in late New York trading. It did not hurt that OECD purchasing power parity models suggest that the Euro is 28% undervalued against the US dollar and that Europe is a net supplier, not net recipient, of capital flows in global finance. Yet I believe it is premature to bet on a sustained Euro uptrend, though I never argue with the sacred "trend is your friend until the trend comes to an end" motto of short term, tactical trading momentum so beloved by my tribe of currency gnomes.

After all, while US treasury yields have sunk to all-time lows, the German Bund yield curve is also again negative to 10 years. In fact, the negative deposit rates in the Euro made it such a popular funding investment for carry traders in high yield EM currencies. The sheer scale of the Euro's rise last week testifies to its role as a classic G-7 "carry trade" currency. I expect fiscal stimulus in the Teutonic Fatherland (both the SDP and CDU political powerbrokers will pressure Chancellor Merkel) and even easier monetary policy at the ECB conclave in March'19 will continue to put depreciating pressure on the Euro, except during periods of global risk aversion, when prime brokers force macro hedge funds to unwind Euro funded carry trades. For instance, the recent sharp falls in the Mexican peso and Norwegian kroner are all testaments to the Euro's recent "carry currency status", which also led to its 1.2% rise on its trade weighted index last week.

Goldman Sachs calls for a cumulative 75 basis points in rate cuts as the 2 year US Treasury note slid to a shocking low of a mere 90 basis points. I doubt this will happen but implied yields on the Eurodollar futures contract on the Chicago Merc forecast at least two Fed rate cuts this spring/summer and Chairman Powell hinted the Fed may act in response to the coronavirus panic. The ECB does not face any draconian pressure to cut its already negative policy rate. Political risk in the US is also rising as self-styled socialist Senator Bernie Sanders of Vermont emerges as the Democratic Party's front runner with his huge Nevada win. The Euro will grind higher as the US Treasury-German Bund interest rate spread contracts. True, as a Nomura strategist argues "the Euro is not the new yen." I must reiterate my skepticism about a major Euro uptrend as I believe Club Med sovereign risk spreads will rise – as the selling of Greek, Spanish and Italian government debt. escalates. Consequently, I would look to short Euro-dollar at 1.12 for a 1.07 target to reflect my view of the next twist in this tragic macro tale. After all, Europe is far more vulnerable to the big chill in China/world trade than the US and a devaluation of the Chinese yuan beyond 7.20 will increase pressure from the Élysée Palace and the Bundesrepublik Chancellery on the ECB for a kinder, gentler – and weaker Euro.

Japan is now in deep recession. The Japanese economy contracted a frightening 6.3% in Q4 2019 due to the US-China trade war big chill, a spectacularly ill-timed sales tax hike and violent typhoons that battered the island Empire of the Rising Sun last autumn. It will be a pity if the $30 billion Tokyo Olympic Games will be cancelled due to the global coronavirus pandemic. This event was supposed to symbolize Japan's re-emergence on the global stage after two lost decades of financial crises, the Fukushima tragedy, political drift and angst about China and North Korea. In retrospect, Shinzo Abe's promise of Big Bang, Thatcher/Raegan scale structural reform has been unfulfilled. The only arrow of Abenomics that really worked was the epic money printing spree by the Bank of Japan that led to a triple bagger in the Nikkei Dow Index since 2012, a plunge in the Japanese yen from 78 to its current 108.12 against the US dollar and fiscal stimulus that only enriched the powerbrokers of the faction/spoils driven ruling Liberal Democratic Party (LDP). Expensive, ageing, risk averse Japan faces both economic recession and political drift as the scramble to succeed Shinzo Abe gathers momentum.

The Japanese government has decided to cancel public events and close schools due to virus fears. This means the economy will continue to contract in Q1 2020. It is now only a matter of time before the Bank of Japan signals even easier monetary policy moves at its March 19 conclave even as virus hysteria leads to safe haven yen buying and panic selling in Marunouchi.

After all, the yen surged from 112.25 to 108.00 against the US dollar, a fraction of its surge during the 2008 post-Lehman financial Armageddon. Even as US Treasury yields sink to all-time lows on risk aversion, I doubt if the Japanese yen will rise much beyond 106 and its medium-term path of least resistance is ultimately to depreciate to 112 – 114. Crude oil hit a death cross on the charts and both Brent/West Texas are down 30% from their peaks just after the US drone hit on Iran's General Soleimani in Baghdad. The scale of demand destruction in the Chinese jet fuel/gasoline market is incalculable but at least 3MBD, a seismic shock in the 100MBD global wet barrel market. OPEC plus cannot offset a demand shock of this magnitude even if it was united, which it definitely is not. Venezuela, Libya and Iran are offline due to civil war and US sanctions. Russia has resisted Saudi Arabian calls for a proactive output cut in February.

In fact, Russia, Iraq, Algeria and Nigeria are not even in compliance with the December 2019 OPEC plus 1.7MBD oil output cut pact. Saudi Arabia has now called for a 1MBD output cut at the March 6 ministerial conclave in Vienna. If the Kremlin does not support Saudi Arabia's role as OPEC's "swing producer", all bets are off in the oil the market. The glut in black gold is so severe that supertankers full of crude cargoes are floating off Singapore and the ports of the North Sea due to cancelled refinery contracts and a lack of buyers. As Italian virus cases surge to 1,100 cases, the Lombardia/Piedmont/Veneto area, Italy's economic hub and its financial capital Milan could face a lockdown. Luxury hotels in Venice report a 40% drop in summer bookings and the port of Long Beach, California posted a 40% drop in container shipping even as tanker loadings in the GCC oil terminals plummeted in February. This means that the demand destruction in the jet fuel and maritime fuel segments of the global refined product markets extends well beyond China. The Sough Korean auto manufacturing industry is a vivid, if traumatic, case study in the new virus economics distress.

The global economic recession has unquestionably now begun. If OPEC does not act decisively next week in Vienna, crude oil prices can well plummet to 2016 lows at $30 a barrel. The stakes are as high now as in 2009, when Saudi Arabia led OPEC in an epic 4MBD oil output cut, the biggest in the history of a cartel that is now impotent to set prices in a world where US shale output has surged to 13MBD. If ever there was a moment for Prince Abdelaziz to act decisively to protect the national interest of the kingdom, as he did after the Houthi missile hit in the Eastern Province last September, next week will be it. The budget breakeven price for Saudi Arabia is $85 Brent and the kingdom alone can prevent another catastrophic oil price crash that could wreak havoc on the economies and public finances of the oil exporting states, as the 1999, 2008 and 2015-16 oil price crashes did. For now, oil traders have made colossal fortunes by shorting Brent, WTI and energy stocks on Wall Street. *A* version of this article is available **here.**