Financial Source: Fundamental FX Drivers

W/c 11 September 2021

Analyst: Arno Venter

Overview | Fundamental Strength

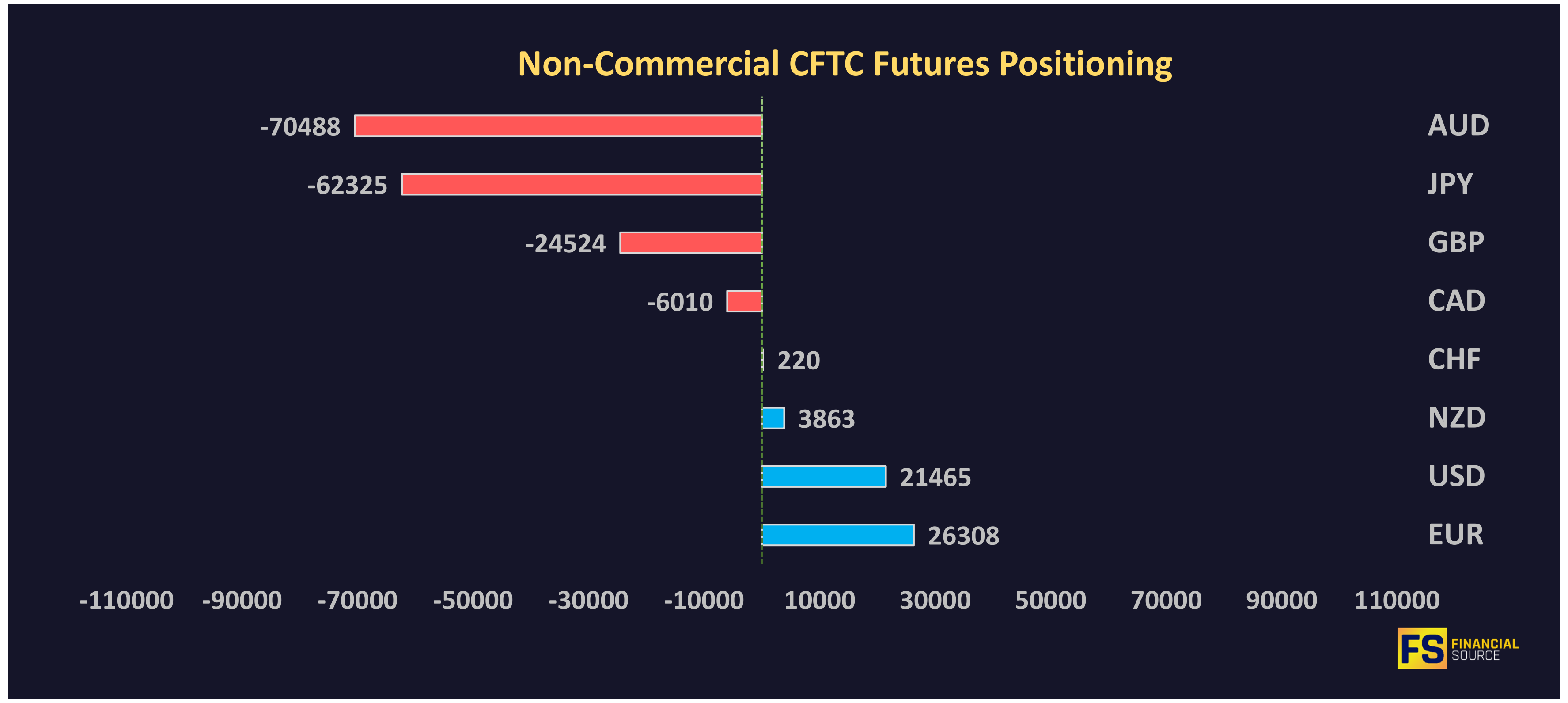
Below is an overview of our current major currency Fundamental strengths. This report has been designed to give you an overview of our fundamental biases for each of the major currencies which includes the primary drivers for each, as well as a more detailed explanation or rationale for each driver.

Even though the above strength meter provides the fundamental bias, it does not automatically translate into immediate trade opportunities.

Ideally, we always want to pair the strongest with the weakest currencies, but there will be other considerations that we need to consider before jumping in with a trade such as, [1] the short-term sentiment at the time, [2] the overall positioning, [3] the proximity of major risk events, [4] technical analysis.

Overview | Commitment of Traders

The weekly COT report (released Friday's) by the CFTC reflects the aggregate holdings of different participants in U.S. futures markets as of Tuesday the same week. It shows us how participants are positioned (futures & options only), whether net-long, net-short or neutral and how they change from week to week.



This can provide valuable insights into current sentiment and potential shifts, but it's always important to remember that COT data should never replace proper fundamental and sentiment analysis. It provides clues about sentiment but shouldn't be used as a trade signal on its own.

* All COT net positions which fall within a range of between +1000 and -1000 contracts have been deemed as Neutral.

Australian Dollar (AUD)

Fundamental Bias	Neutral

Primary Drivers	Rationale
1. The country's economic and health developments	There are three key factors that created recent uncertainty for Australia's med-term outlook: **[1]** The virus situation where most recent data have shown further increases in case numbers and no sign of restrictions lifting anytime soon. A Q3 GDP contraction is priced in and has pushed back tapering & hike expectations. **[2]** Then there is China, where we're watching the health of the economy after the slowdown has been bigger and faster than most had anticipated, also causing the PBoC to do a 0.5% RRR cut a few weeks ago. China is Australia's biggest trade partner and the 2nd largest contributor to global GDP so it's an important driver for AUD to keep on the radar. Politically, the risk of further tariffs and bans on Australian goods is also something to keep on the radar. **[3]** Iron Ore is Australia's biggest export (24%), and the almost 40% drop from YTD highs in the past few weeks is expected to negatively impact the country's terms of trade. It's true that the 19% rise in Coal prices (18% of exports) from the start of August has taken some of the sting out of the Iron Ore drop, but it's not been enough to avoid a negative impact on overall terms of trade.
2. The Monetary Policy outlook for the RBA	The RBA didn't leave markets with much to get excited about this past week. They were hawkish in deed but not in word. They decided to go ahead with their planned September tapering plans, but their statement and tone were overall dovish and explained that even though they expect the economy to bounce back from covid, they are far less certain about the timing and pace of that bounce. The bank also moved out their next planned assessment of their QE program to at least February, which means they essential increased and extended their current QE purchases. Thus, overall a mixed bag for markets and means the med-term bias remains neutral for the AUD.
3. Developments surrounding the global risk outlook.	As a high-beta currency, AUD has benefited from the market's improving risk outlook over recent months as participants moved out of safe-havens and into riskier, higher-yielding assets. As a pro-cyclical currency, the AUD enjoyed upside alongside other cyclical assets going into what majority of market participants think was an early post-recession recovery phase. As long as expectations for the global economy remains positive the overall positive outlook for risk sentiment should be supportive for the AUD in the med-term, but the recent short-term jitters and risk off flows once again showed us why risk sentiment is also a very important short-term driver for the currency.
4. CFTC Analysis	Latest CFTC data for the AUD (updated until 7 Sep) showed a positioning change of -10410 with a net non-commercial position of -70488. Very surprising to have seen yet another build in net-shorts for the AUD despite stretched positioning. Looking at a simple z-score on a 1-year and 6-month lookback the build-up in shorts are sitting at a -3.09 and -2.16 standard deviation, which means the odds of mean reversion higher in the AUD is still a probability so keep that in mind in the week ahead, especially if risk sentiment improves from last week.

Canadian Dollar (CAD)

Fundamental Bias	Bullish

Primary Drivers	Rationale
1. The Monetary Policy outlook for the BoC	At their September meeting the BoC delivered on market expectations by not providing any new information. The bank acknowledged the recent hit to growth has been bigger than expected, but also explained that they deem the hit to be temporary and still expect solid growth this year. They also reiterated that even though inflation is currently high and expected to climb, they deem current price pressures as being mostly transitory. Right now the meeting did nothing to change the market's expectations that the bank will go ahead to announce another tapering of C$1 billion at their October meeting, especially after this past week's jobs report painting a picture of a growing and recovering labour market, albeit at a slightly slower pace compared to the June and July.
2. Commodity-linked currency with dependency on Oil exports	Oil staged a massive recovery after hitting rock bottom in 2020. The move higher over the past few months has been driven by **[1]** supply & demand (OPEC's production cuts); **[2]** improving global economic outlook and improving oil demand outlook (vaccines and monetary and fiscal stimulus induced recoveries); **[3]** rising inflation expectations. Even though further gains for Oil will arguably prove to be an uphill battle from here, the bias remains positive in the med-term as long as the current supportive factors and drivers remains intact. We will of course have short-term ebbs and flows as we've seen in recent weeks which could affect the CAD from an intermarket point of view, but as long as the med-term view for Oil remains higher that should be supportive for Petro-currencies like the CAD.
3. Developments surrounding the global risk outlook.	As a high-beta currency, CAD has benefited from the market's improving risk outlook over recent months as participants moved out of safe-havens and into riskier, higher-yielding assets. As a pro-cyclical currency, the CAD enjoyed upside alongside other cyclical assets going into what majority of market participants think was an early post-recession recovery phase. As long as expectations for the global economy remains positive the overall positive outlook for risk sentiment should be supportive for the CAD in the med-term, but the recent short-term jitters and risk off flows once again showed us why risk sentiment is also a very important short-term driver for the currency.
4. CFTC Analysis	Latest CFTC data for the CAD (updated until 7 Sep) showed a positioning change of -3162 with a net non-commercial position of -6010. After some substantial unwinding of oversubscribed net-long positioning over the past couple of months, we've now seen CAD positioning move into net-short territory, and since the bias is still bullish in the med-term that means there is a lot of room left to run to the upside in line with the overall bullish fundamentals. As the market's view on tapering expectations for October is in tact we might see CAD trade more sensitive to overall risk sentiment and Oil price action compared to the monetary policy outlook.

Swiss Franc (CHF)

Fundamental Bias	Bearish

Primary Drivers	Rationale
1. Developments surrounding the global risk outlook.	As a safe-haven currency, the market's risk outlook is the primary driver for the CHF. Swiss economic data rarely proves market moving; and although SNB intervention can have a substantial impact on CHF, its impact tends to be relatively short-lived. Additionally, the SNB are unlikely to adjust policy anytime soon, given their overall bearish tone and a preference for being behind the ECB in terms of policy decisions. The market's overall risk tone is improving with coronavirus vaccines being rolled out as well as the unprecedented amount of monetary policy accommodation and fiscal support from governments. Of course, risks remain as many countries are now battling third waves of the virus. As such, there is still a degree of uncertainty and risks to the overall risk outlook which could prove supportive for the CHF should negative factors for the global economy develop; however, on balance the overall risk outlook is continuing to improve and barring any major meltdowns in risk assets the bias for the CHF remains bearish.
2. SNB Intervention	Despite the negative drivers, the CHF has remained surprisingly strong over the past couple of weeks. This divergence from the fundamental outlook doesn't make much sense, but the CHF often has a mind of its own and can often move in opposite directions from what short-term sentiment or its fundamental outlook suggests, thus be careful when trading the CHF and always keep the possibility of SNB intervention in mind. In a recent note ING investment provided their rationale for the recent strength in the CHF and suggests that the lower inflation in Switzerland compared to the EU means the real trade-weighted CHF is trading too cheap. Furthermore, the ECB's bond buying has meant that their balance sheet is expanding more rapidly compared to that of the SNB, which could have been reasons why the SNB did not see the need for any meaningful intervention lately. However, as intervention is always the possibility it's a risk to always keep in mind when trading the CHF.
3. CFTC Analysis	Latest CFTC data for the CHF (updated until 7 Sep) showed a positioning change of -3755 with a net non-commercial position of +220. The CHF positioning continued to unwind some of its recent surprising strength over the past few weeks. The CHF still the third largest net-long positioning among the majors, which is at odds with the current fundamental bearish outlook for the currency. Even though we expect the currency to weaken in the med-term, any drastic escalation in risk off tones could still continue to provide support for the safe-haven currency.

Euro (EUR)

Fundamental Bias	Weak Bearish

Primary Drivers	Rationale
1. Virus Situation	At present, the outlook appears to be moving from strength to strength as the EU has reached their goals to vaccinate 70% of their adult population by the end of summer. That removes one of the biggest hurdles from the economy and bodes well for the overall recovery.
2. The Monetary Policy outlook for the ECB	The ECB provided an overall balanced policy decision at their September meeting. They chose to slow the pace of asset purchases, explaining that the current levels of financing conditions allow them to buy assets under the PEPP at a 'moderately' slower pace compared to the pace of purchases seen in Q2 and Q3. However, as expected, the bank made it very clear that the move was not tapering it was merely a recalibration of purchases (when you plan to perform less QE that's technically tapering but who's counting). The bank raised their inflation projections for 2021, 2022 and 2023, and even though the 2021 projections were arguably not as high as markets were hoping for, the more important med-term projections still showed inflation moving to well below the bank's 2% target to affirm the transitory view of recent price pressures. All in all, the decision was broadly balanced and as a result failed to inspire any meaningful reaction in European assets. For now, market's attention turns back to the incoming data as that should pave the way for some clarity at the December meeting on the future of the PEPP and API (and it's possible transition) going into 2022.
3. The country's economic developments	Earlier issues with vaccinations and lockdowns at the start of 2021 weighed on EU growth prospects, with growth differentials against the US and UK still quite wide, despite some of the recent strong economic data after the vaccination roll out finally got underway. Fiscal support is another factor where the EU Recovery Fund is yet to be ratified while the US and UK have both rolled out additional stimulus and the US plans more in the months ahead. However, recent activity data suggests the hit to the economy from the most recent lockdowns was not as bad as feared and data has surprised to the upside. That alone though is not enough to change the current weak bearish bias for the currency. Another factor we are keeping track of is the discussions among European states to allow the purchase of green bonds not to count against the budget deficits of EU countries. If such a decision were to be approved, it could drastically change the fiscal picture and would expect to be a positive for the EUR and very positive for European equities (especially for equities from countries like Italy and Spain)
4. CFTC Analysis	Latest CFTC data for the EUR (updated until 7 Sep) showed a positioning change of +15832 with a net non-commercial position of +26308. The build in net-longs comes from the solid push higher we saw in the EUR two weeks ago which was of course mostly driven by overall weakness in the greenback. What is interesting though is that our z-score that tracks the pace of positioning changes is no longer flashing red, which could mean that market positioning is more balanced and looking for med-term downside opportunities could be on the cards. However, given that we have US CPI coming up and the FOMC the week after that some patience might still be the best course of action.

Great British Pound (GBP)

Fundamental Bias	Bullish

Primary Drivers	Rationale
1. Virus Situation	The successful vaccination program has allowed the UK to open up faster and sooner than peers & provides a favourable environment for GBP
2. The Monetary Policy outlook for the BOE	The BoE meeting on 5 August provided a flurry of comments with something for both the doves and the hawks. The QE vote split was more dovish (7-1) with BoE's Saunders the only dissenter, while upgrades to growth and inflation were positive, even though price pressures is still views as mostly 'transitory'. Reasons for a patient stance was the uncertainty surrounding the virus at the time as well as waiting for the end of the furlough scheme to assess the impact on the labour market. Thus, the bank will be in wait-and-see mode until at least Oct or Nov. The other important change was the reduction in the bank's QT threshold from 1.5% to 0.5%, with the bank looking at a bank rate of 0.5% to stop reinvesting maturing assets and a rate of 1.0% to start selling assets and reducing its balance sheet. Market participants are mixed about what this means (it's positive since the bank has enough confidence to lower the balance sheet even while rates are low, but on the other hand it means rates can stay lower for longer which is a negative). However, all in all the most important take away was the continued optimism about the economy despite virus uncertainty and comments that modest tightening will be required.
3. The country's economic developments	Hopes of a fast economic recovery has seen the BOE and IMF upgrade GDP projections for the UK which has widened the growth differentials between other major economies and has been a positive input for GBP. However, a lot of these positives are arguably already reflected in the price which means a continuation of the recent misses in economic data could make further solid gains more difficult for the GBP to maintain. Even though the announcement of more fiscal tightening than expected saw some short-term downside in Sterling, the hawkish comments from the BoE more than offset the prior negative sentiment and provided a solid push higher, and as long as there aren't any more fiscal tightening surprises it should not matter much for GBP in the med-term. This week's data dump will be important, but probably not enough to alter the outlook for monetary policy.
4. Political Developments	Remember Brexit? Yeah, me neither, but recent rhetoric between the UK and EU hasn't gone in a very positive direction with the UK side explaining to the EU that they are looking at all the options on the table (including article 16) if they can't reach an agreement with the EU regarding the Northern Ireland Protocol. For now, Sterling has looked through all the rigmarole and should continue to do so as long as the cans are kicked down the road.
4. CFTC Analysis	Latest CFTC data for the GBP (updated until 7 Sep) showed a positioning change of -9624 with a net non-commercial position of -24524. The recent flush lower in positioning means current levels for GBP still look attractive for med-term buyers, especially after the hawkish BoE comments. However, the short-term upside does look stretched at -2.07 and -2.45 standard deviation so watch out for possible mean reversion.

Japanese Yen (JPY)

Fundamental Bias	Bearish

Primary Drivers	Rationale
1. Safe-haven status and overall risk outlook	As a safe-haven currency, the market's risk outlook is the primary driver of JPY. Economic data rarely proves market moving; and although monetary policy expectations can prove highly market-moving in the short-term, safe-haven flows are typically the more dominant factor. The market's overall risk tone has improved considerably following the pandemic with good news about successful vaccinations, and ongoing monetary and fiscal policy support paved the way for markets to expect a robust global economic recovery. Of course, there remains many uncertainties and many countries are continuing to fight virus waves, but as a whole the outlook has kept on improving over the past couple of months, which would expect safe-haven demand to diminish and result in a bearish outlook for the JPY.
2. Low-yielding currency with inverse correlation to US10Y	As a low yielding currency, the JPY usually shares an inverse correlation to strong moves in yield differentials, more specifically in strong moves in US10Y. However, like most correlations, the strength of the inverse correlation between the JPY and US10Y is not perfect and will ebb and flow depending on the type of market environment from a risk and cycle point of view. The rangebound price action in US10Y from July has meant our conviction in JPY shorts has reduced versus the US Dollar, and until US10Y can convincingly break higher and take out its recent range highs we will stay more patient with USDJPY longs.
4. CFTC Analysis	Latest CFTC data for the JPY (updated until 7 Sep) showed a positioning change of +805 with a net non-commercial position of -62325. With positioning still, the largest net-short among the majors we want to be careful of the risks going into September which is historically the worse performing month for equities. That alone doesn't mean we are expecting equities to push lower but given the frothy price action over recent weeks (haven't seen a 5% correction in the S&P500 in 11 months) as well as seasonality and the growing chorus of participants calling for a bigger correction, we don't want to ignore the possibility of some increased volatility this month. That doesn't mean we start buying the JPY of course, it just means that if we do see some jitters creeping in for risk assets it is expected to be positive for the JPY, and with the biggest net-short for the majors there is a lot of downside in the JPY that can be unwound in such a scenario.

New Zealand Dollar (NZD)

Fundamental Bias	Bullish

Primary Drivers	Rationale
1. Developments surrounding the global risk outlook.	As a high-beta currency, NZD has benefited from the market's improving risk outlook over recent months as participants moved out of safe-havens and into riskier, higher-yielding assets. As a pro-cyclical currency, the NZD enjoyed upside alongside other cyclical assets going into what majority of market participants think was an early post-recession recovery phase. As long as expectations for the global economy remains positive the overall positive outlook for risk sentiment should be supportive for the NZD in the med-term, but the recent short-term jitters and risk off flows once again showed us why risk sentiment is also a very important short-term driver for the currency.
2. The Monetary Policy outlook for the RBNZ	New Zealand's Zero Covid strategy caused quite the rigmarole for the NZD this week as market participants were forced to unwind some of their very aggressive expectations for rate hikes going into the meeting. The unwind was so aggressive that OIS prices dropped from a 100% chance of a hike to just above 50% at some stage. The RBNZ chose to leave rates unchanged, but despite the virus escalation they offered a much more optimistic tone compared to their prior meeting by updating their rate path projections to show 7 projected hikes between Dec 2021 and H1 2023 (bringing the OCR to 2.0%). This was even more aggressive than the already aggressive bets heading into the meeting before the covid news hit the wires. The Governor also later explained that they need to continue to move on policy and cannot wait for uncertainty as they have a lot of work to do to get back to the neutral rate of 2.0%. Also, when asked about Oct Governor Orr said the meeting is live, but also acknowledged that they've made it very clear their next move is likely a hike so they can afford to wait. Thus, with the upgraded rate path the med-term bullish outlook remains intact for the NZD. Last week we saw very hawkish comments from RBNZ's Hawkesby who stated that the bank's decision not to hike rates last week was mostly to do with optics and not due to perceived risks, and also explained that the bank contemplated hiking rates by 50 basis points, confirming the bank's hawkish tone and placing the RBNZ once again miles ahead of any other major central banks in terms of policy normalization and tightening.
3. The country's economic and health developments	The main focus right now will be on how quickly the New Zealand government can get the virus situation under control. We've already heard some good news that the government has been able to trace the source of the recent outbreak and should be able to get the situation under control. This will be a key factor to watch for the NZD in the next few sessions. This week also sees quarterly data in the mix and after recent hawkish RBNZ comments might be enough to spark expectations for a hike in October if growth surprises meaningfully higher.
4. CFTC Analysis	Latest CFTC data for the NZD (updated until 7 Sep) showed a positioning change of +6004 with a net non-commercial position of +3863. With the overall optimistic rate path from the RBNZ, the bias for the currency remains unchanged, and with a small net-long positioning the current spot levels for the NZD still looks attractive for med-term buyers, but short-term moves do still look a bit overdone at current levels.

United States Dollar (USD)

Fundamental Bias	Neutral

Primary Drivers	Rationale
1. The global risk outlook.	Global economic data continues to surprise lower and should continue to struggle to surprise to the upside after the pandemic rebound. As the USD usually moves inversely to global growth that should be supportive for the USD.
2. The Monetary Policy outlook for the FED	In July the FOMC noted that the economy has made progress toward their goals, and they'll continue to assess progress in coming meetings. They also took a more sanguine view of the virus situation by removing prior comments that sectors affected by the pandemic '*remain weak but have shown improvement*' and instead replaced it with '*sectors most affected by the pandemic have shown improvement but have not fully recovered*'. This was initially seen as less dovish, but Powell used his usual dovish tone to correct any 'hawkish' takes by stressing that employment still has a 'ways to go' and noted that there was still "some ground to cover" when it comes to the labour market. He also reiterated that any decision to announce tapering will be done well in advance. For now, markets are looking at the incoming data to decide whether tapering will be announced at the Jackson Hole Symposium or in the fall. This past week we some interesting comments from Fed's Waller who tilted their language and stance towards Bullard and Kaplan in expecting that two more solid employment prints (800K-1M) would mean substantial further progress has been met and tapering could then start at a faster pace. This was bullish for the USD, but the more important and market moving comments came from Fed's Clarida who has seemingly moved into the Neutral camp (previously dovish) by saying he agrees with the median Fed projections of a first hike by early 2023 and more importantly his comments about inflation has moved away from the sanguine view expressed by the doves and is more concerned about current price pressures. This shift saw Dollar upside with all eyes on the Sep NFP to see whether markets will expect Sep or Dec to be the official tapering announcement meeting.
3. Real Yields	Despite recent divergence between the USD and US real yields, we still think further downside in real yields will be a struggle so close to new cycle lows and that the probability is skewed higher given the outlook for growth, inflation and tapering and should be supportive for the USD.
4. Economic Data	This week was all about NFP…where the miss showed just how difficult it's been for economists to forecast where post-pandemic labour prints will land. Even though the headline NFP saw a monster miss (235K vs consensus of 750K), the data under the hood wasn't all that bad with average earnings printing at 0.6% (above max forecasts), and the Unemployment rate still falling to 5.2% from 5.4% and participation staying flat at 61.7%. Thus, with the overall outcome being more of a mixed bag, the only thing the print has done is give the Fed time to kick the can down the road for another month. Catch our Top Trading Opportunities report for colour on this week's upcoming US CPI print on Tuesday.
4. CFTC Analysis	Latest CFTC data for the USD (updated until 7 Sep) showed a positioning change of 775 with a net non-commercial position of +21465. For now, with the fundamental outlook still neutral, and with positioning at current levels the incoming data will remain the key driver for the USD's short-term volatility, with Fed Speak and the upcoming CPI on Sep 14th and FOMC on the 22nd the main events to keep on the radar.

FINANCIAL SOURCE

financialsource.co

Financial Source: Central Bank Analysis