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VAGUE DESTINATION

coddiwomple

verb | cod•di•womple | \kä-də-wäm-pəl
: to travel in a purposeful manner towards a vague destination

Landon D. Whaley
Founder and CEO
Whaley Capital Group

Despite the fact that economies and financial markets constantly march towards Vague Destinations, a successful investor must remain purposeful, which means being data-dependent, process driven and risk conscious.

This week in "Somewhere Between Love and Hate," we coddiwomple through the current state of Euro Zone inflation and the implications on the Euro…

Author Shannon Alder wrote, "Somewhere between love and hate lies confusion, misunderstanding and desperate hope." Last week, Mario Draghi spoke at the ECB forum in Sintra, Portugal, and the investor reaction to his comments made it clear that euro bulls are caught somewhere between love and hate.

These poor souls immediately piled into the long side of the trade at the fastest pace in five years, bidding the euro to a one-year high in the process. The bulls are desperately hopeful and confused, and have completely misunderstood Draghi and his intentions for ECB policy.

Mr. Misunderstood

You know when you argue with your significant other about something inconsequential and the only thing they remember is your one mean comment about leaving their damn Dachshund dog—the one that barks every time you move a muscle—in a basket on a church doorstep?

That's exactly what happened last week. Draghi covered many things in his speech, but investors heard only one thing: that factors weighing on eurozone inflation are "mainly temporary."

This single statement was interpreted as a preamble to an ECB taper, and sent the euro tearing higher. Investors completely ignored Draghi saying that a "considerable degree of monetary accommodation is still needed" because inflation is not yet "durable and self-sustaining."

Just the day before, Draghi had said that lower interest rates create jobs, foster growth and benefit borrowers. Does this sound like a man who has even considered a taper?

In contrast, recall what Bernanke said in his May 2013 taper speech: "In the next few meetings, we could take a step down in our pace of purchase." Now that, my friends, is a declaration of the taper train coming down the tracks.

The market's reaction to Draghi's comments was so overdone that ECB Vice President Vítor Constâncio went on CNBC the next day to set the record straight. Constâncio said the markets' reactions aren't always understood, but that all of Draghi's remarks were "totally" in line with the ECB's existing policy.

Even if nothing else in the world convinces you to trade the euro from the short side, Constâncio's interview should be the confirmation you need. Folks, the ECB is so dead set against euro strength that it felt compelled to take to the airwaves to talk it down.

The surest way to the poorhouse is to trade in a manner counter to the central bank's prevailing policy. If the ECB wants the euro to go lower, it will bring out its version of weapons of mass destruction to get its way. Do you really want to be on the opposite side of that trade?

Stories are for Children and Vacations

As regular readers know, I don't care for narrative in my financial market research. Narratives are for poolside cabanas and tucking your kids in at night. When it comes to making investment decisions, leave the stories out of it and stick to being economic and market data-dependent.

When the latest eurozone inflation readings, both headline and core, came out in WHEN, they influenced the euro quite differently to last week's scramble. The readings beat the estimates, and we know how much the market loves expectations, don't we? The bulls got what they wanted, which is inflation readings running hotter than people expected.

Yet at that point, the euro was sold off. This is because the most critical aspect of the inflation report, the monthly trend in the annual inflation rate, won out with its bearish influence. Headline inflation fell for the third consecutive month. It now sits at 1.3%, down from a peak of 2% in February. Eurozone inflation is definitely moving in the wrong direction for an ECB taper.

I have even more bad news for folks thinking the ECB is going to taper any time soon.

Base effects, coupled with continued weakness in oil prices, will shave even more off the headline annual rate of inflation in the months ahead. Keep in mind that just seven months ago eurozone inflation was running at 0.6%, which means it could be months before it finds a floor.

Gravitational Framework Says What?

As long as inflation slides and the ECB remains committed through words and actions to easing policy, then the Fundamental Gravity for the euro is decidedly bearish.

Quantitatively, the euro has rallied headlong into a significant wall of resistance at $1.1445. Yes, the euro's year-to-date rally has been impressive, but two things should be concerning to bulls. First, volatility accelerated during the last four months of the euro's post-U.S. election rally. Remember, the ideal bullish set up is price rallying while volatility falls. Second, volume has flatlined since November 2016, which tells me there is a lack of conviction behind this rally. These are telltale signs of a bearish countertrend rally without sustainable legs.

Behaviorally, an 8% rally to start 2017 has left speculative positioning screaming that the long euro trade is extremely consensus. Long positioning is near three-year ***highs***, while short exposure has cratered and is now sitting at the ***lowest*** levels for the last three years.

Everyone is long and no one wants to wade into the short side, despite a bearish Fundamental Gravity and a Quantitative Gravity that is indicative of a short-able rally. Can you say "opportunity"?

The Bottom Line

The data says inflation is rolling over, and the further it declines from 2%, the further the ECB gets from tapering. The process says when the price of a market that has been in a downtrend for a decade meets significant resistance that is two years old, you look to get short. Risk consciousness says that when everyone is a bull and you can't see a bear for miles after an 8% rally in a currency, there is very little behavioral risk to a short trade.

While the rest of the world is splicing and dicing central bank speeches for any evidence that backs their perma-bullish beliefs, you should fade the consensus, and, as always, remain data dependent, process driven and risk conscious.

CONTACT US

If you would like to receive Vague Destination each week, please email andrew@whaleycapitalgroup.com.

Whaley Capital Group
400 Locust Avenue, Suite 4, Charlottesville, Virginia 22902
434.202.5072
www.whaleycapitalgroup.com

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