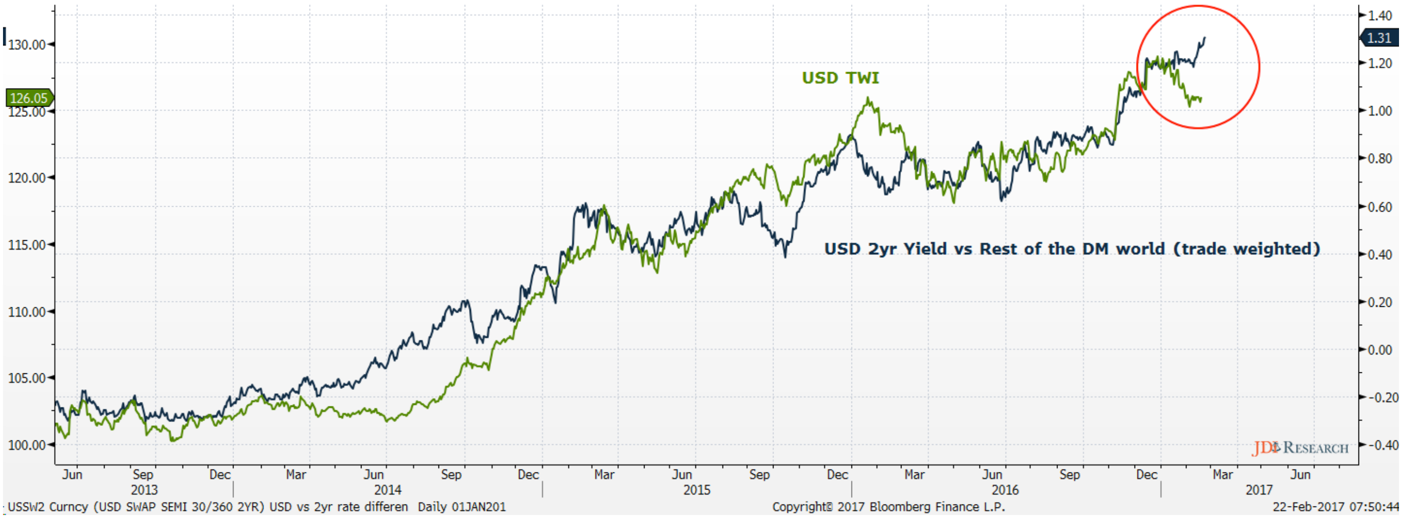
My weaker USD call has been received with suspicion

This report delves into the reasons to sell USD with conviction…

Is the greenback undervalued ?



... Or Overvalued ?

- I continue to recommend **long EM FX but expect the USD weakness to broaden out.** I have increased my **short USD bias since the last report by cutting the short EUR and JPY I held vs long RUB and BRL for a small profit. This left me net short USD versus MXN, TRY and BRL** (6.25%, 6.5%

E: juliette.declercq@jdiresearch.com W: www.jdiresearch.com T: +44 (0) 7769724879

and 5% + carry in the money); I have recommended exiting the short USD vs RUB at 56.65 for a 5.5% profit. Post GFC, the stronger USD has been the main tool in the Fed's policy toolbox due to global macro imbalances. **Global imbalances are now behind us and the US is moving to the end of its cycle (Trump and the Fed can only affect the speed at which the cycle will end), this suggests that the 20%+ USD move in this tightening cycle will reverse. I have re-entered long GBP versus USD at current levels and will be looking to add short USD vs DM FX (AUD?).**

- **US 5s30s UST flattener (10bps in the money).** I have converted the outright 5yr treasury short in a 5s30s flattener at 122bps spread equivalent. Whilst not currently "in play" the position should provide a great hedge to bouts of USD strength (whether driven by a pro-growth fiscal announcement by Trump on March 28th, more hawkish Fed talks or better data in the short-term – PCE, NFP).
- **Stay long European equities** (1.75% in the money).

European elections: Populism is certainly reshaping the political landscape in Europe but I do not believe that it is as close as feared to gaining power.

The first test is imminent: the **Dutch parliamentary election on March 15th.** Although support for the euro-sceptic PVV Party has recently been slipping, it is still expected to win the election:

Polls suggests that 11 parties will be represented in parliament with the PVV leading the polls with 20% of voting intentions. Establishment parties have ruled out forming a coalition with the PVV and non-establishment parties are currently polling below the absolute majority necessary to form a coalition; this means that the PVV is likely to stay in the opposition.

That said, the fragmented state of the parliament suggests that a minimum of 5 parties will have to form a coalition. Accordingly, uncertainty around the ultimate outcome of the election is likely to linger which could give way to populist temptation. In 2010, coalition talks lasted four months!

Under current law, *advisory* referendum (initiated by the public) can only be called on new legislation. This rules out a EU referendum initiated by the public. That said, a non-binding *consultative* referendum could be called by the parliament. A PVV proposal for a EU referendum was voted down last year by a wide margin.

In my opinion, when populism takes hold, past parliament's past behaviour offers little clue as to the direction future votes may take. After all, the UK parliament was widely against Brexit before it became politically irrational - after the EU referendum - to continue to legislate against so-called "people's will". Politicians can only be relied upon to sail where the wind blows so any post-election uncertainty could be fertile ground for a subtle move towards populism if the PVV's "victory" is confirmed. Therefore, a non-binding referendum cannot be categorically ruled out.

Even if non-binding, a EU referendum in the Netherlands would be a close call. Last July, a poll suggested that only 52% were in favour of staying in the EU versus 40% favouring "leave".

The real wild card is the **French election** (April 23rd & may 7th). It has understandably kept markets jittery.

Alain Juppé (former PM), February 21st: *“Marine Le Pen is improbable but no longer impossible”.*

The situation in France is still in flux with the positive Le Pen dynamic keeping markets on their toes. Current polls show that she would lose to both center-right Fillon or centrist Macron in the 2nd round but with a shrinking margin (still 20% vs Macron but only 12% vs Fillon from 20% pre Penelope scandal). Note that **an unusually large share (40% to 50%) of the electorate remains undecided (unsurprisingly given the traditional left-right political landscape has all but disappeared) and that it is most likely flattering Le Pen's margin.** Indeed, after the Fillon's debacle and with the lack of a clear program on Macron's side, the “undecideds” are most likely to be split between centrist Macron and center-right Fillon. **The extreme vote is more deeply anchored and less likely to benefit as the undecideds make their minds up.**

As we continue to scale a European wall of worry, the EUR may stay under downward pressure. However, this only strengthens my bullish European equity view - based on attractive valuation and a firm belief that Le Pen is not Trump and that Brexit does not mean Frexit. In fact, I continue to believe that 2017 is the year when France may resolutely embrace reforms (famous last words?). Meanwhile, the rise of populism in Europe could be a blessing in disguise as it provides the incentive for pro-establishment parties to reform and potentially move forward with European integration.

1. Reflation: from a blessing to a curse?

The Fed is closing in on its inflation and employment dual mandate but the growth outlook looks challenging to say the least…

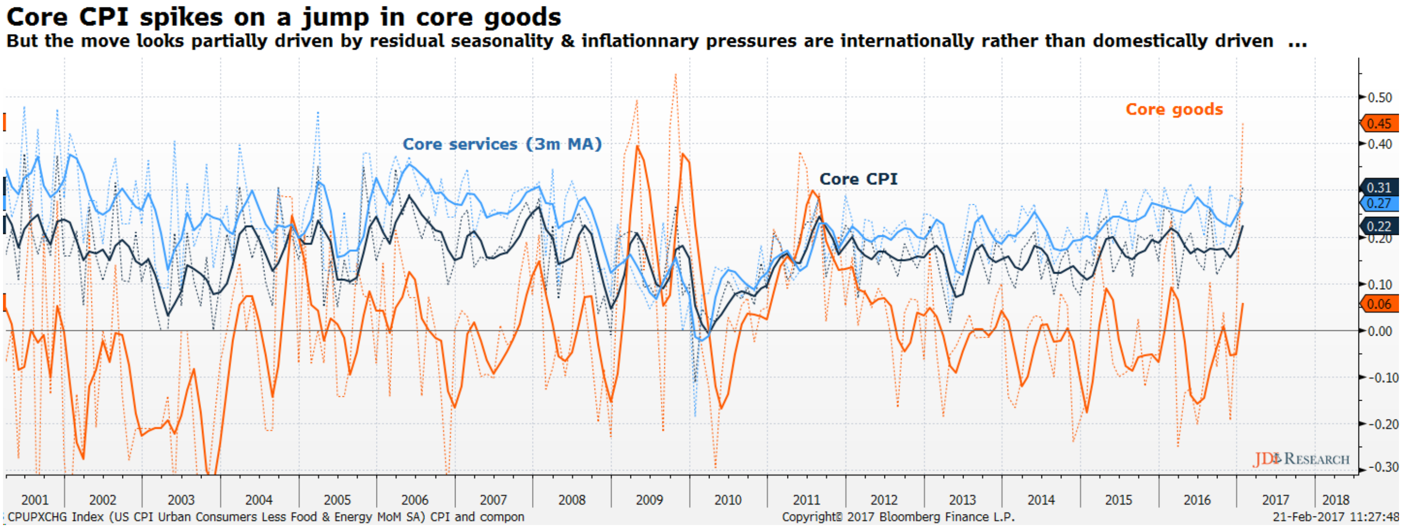
Since my last report, inflation has come out stronger than expected. In absence of much stronger wage gains, this will be a strong headwind for real consumption.

- **Recent CPI upside driven internationally and half the spike is most likely due to residual seasonality**

Just the once won't hurt: I would like to delve into the nitty gritty of the CPI number released last week. In this case, a glance at the aggregate numbers does not tell the whole story.

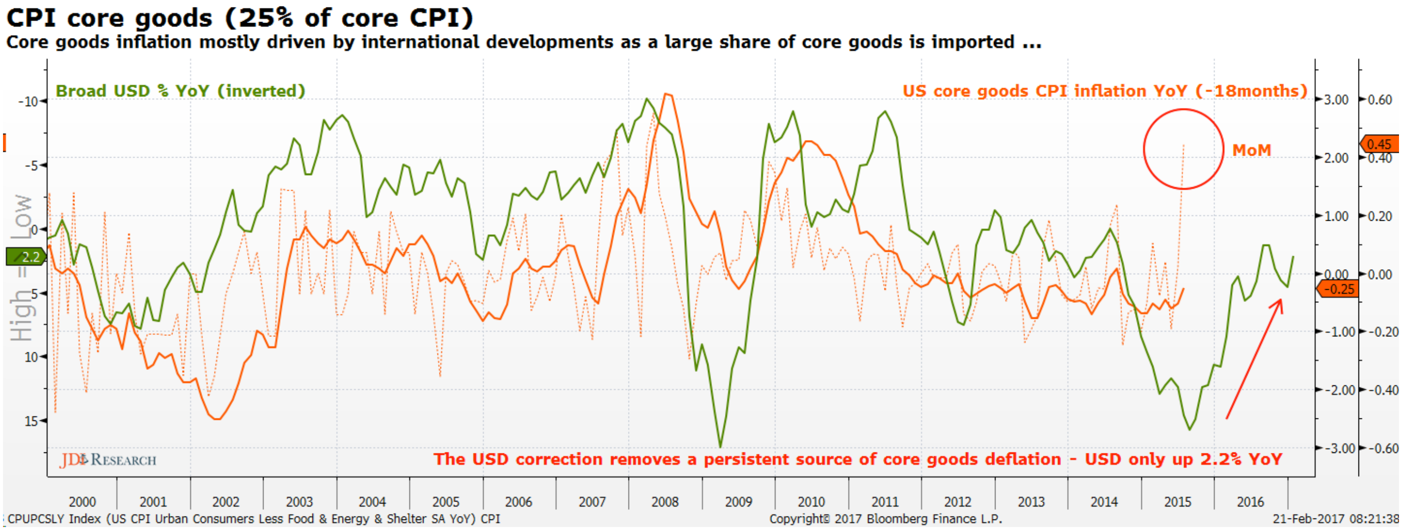
It appears that core **CPI is indeed accelerating** but 1) not as much as the Jan number implies and 2) **driven by international rather than domestic pressures.**

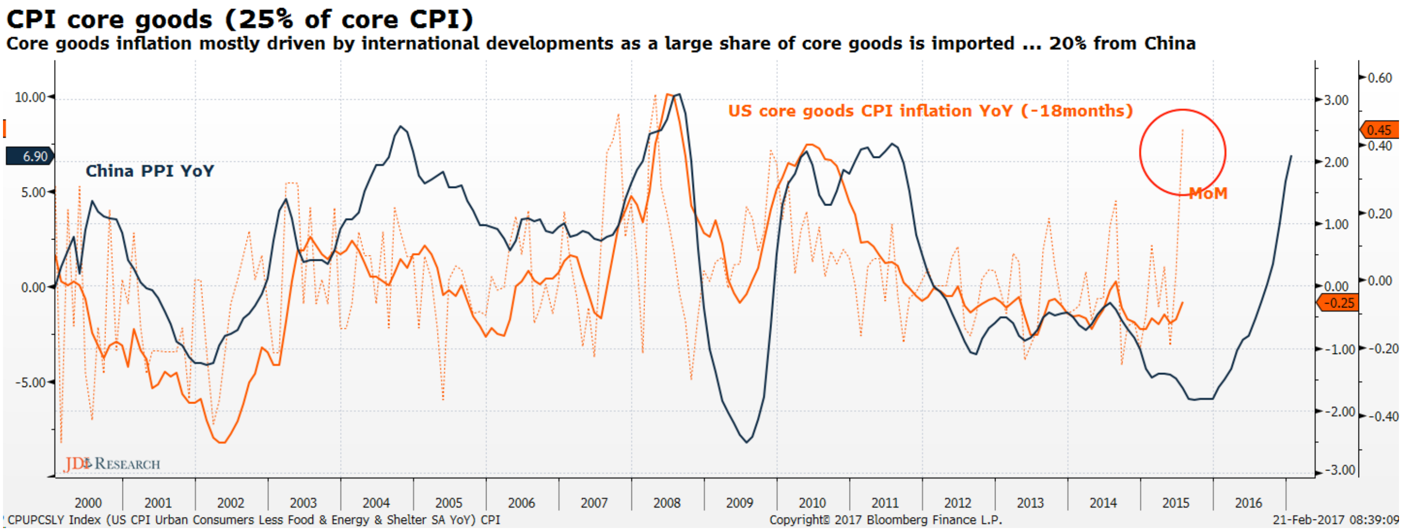
1) Part of the January pickup most likely reflects residual seasonality in Q1 and a catch-up on the soft Q4 trends:



2) The **move was also mostly driven by core goods rather than services.** With a large share of core goods imported, the implication is that the strong

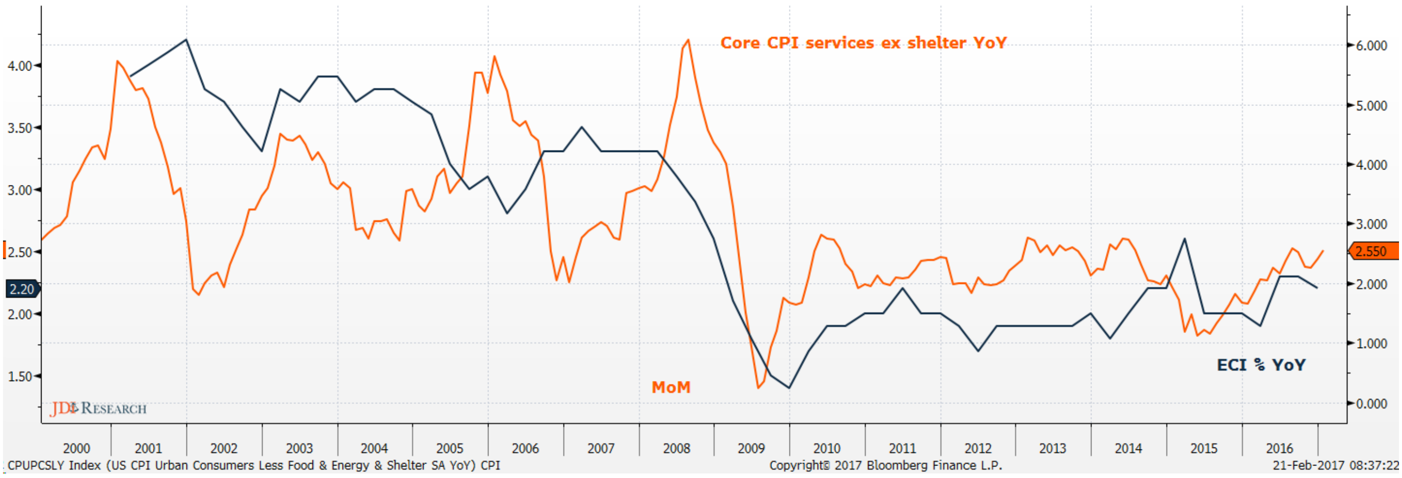
USD has ceased to be a persistent source of core goods deflation and that the spike in China PPI may finally be taking its toll on imported prices:





Meanwhile, **domestically-driven services inflation – which is most tightly correlated with wage gains – remains relatively subdued:**

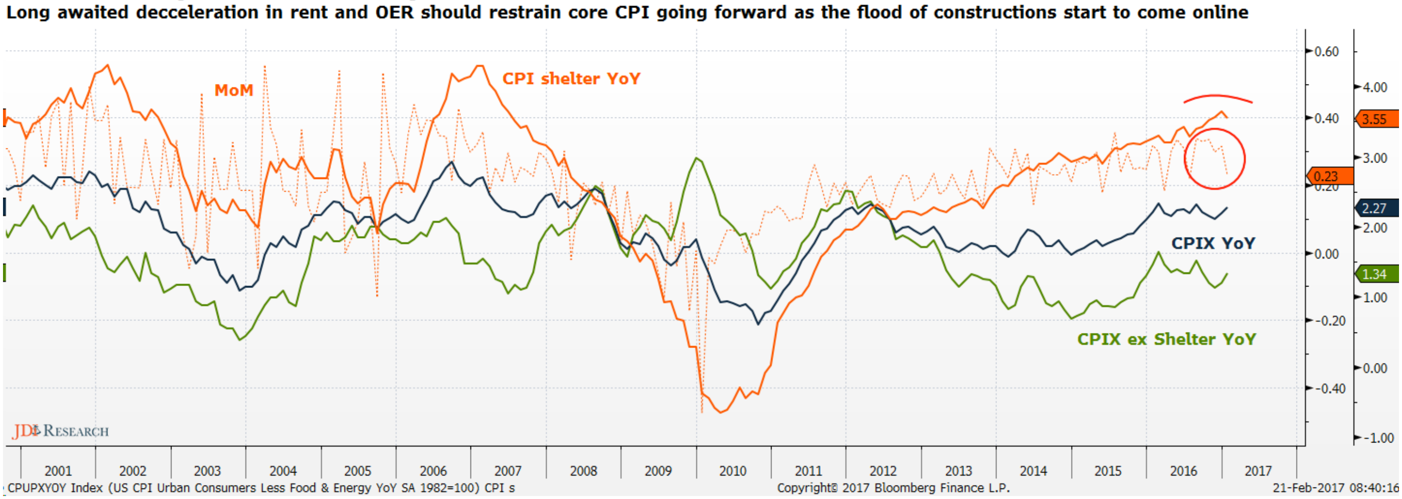
CPI services ex shelter (30% of core CPI)
Domestically-driven core services (most correlated with wage gains) remain subdued ...



Whilst likely to reassure the FOMC in its conviction that it is closing in on its inflation mandate, **seasonal considerations and the fact that inflationary pressures seem to be mostly stemming from abroad mean that the Fed is unlikely to re-spond in a rush.** Core PCE – to be released on March 1st – should continue to move towards the Fed's target, probably printing 1.8% yoy for January, but **risks of an overshoot remain limited.**

The slowdown in shelter inflation, a large part of core CPI and main driver of CPIX upside in recent years, should also restrain core CPI:

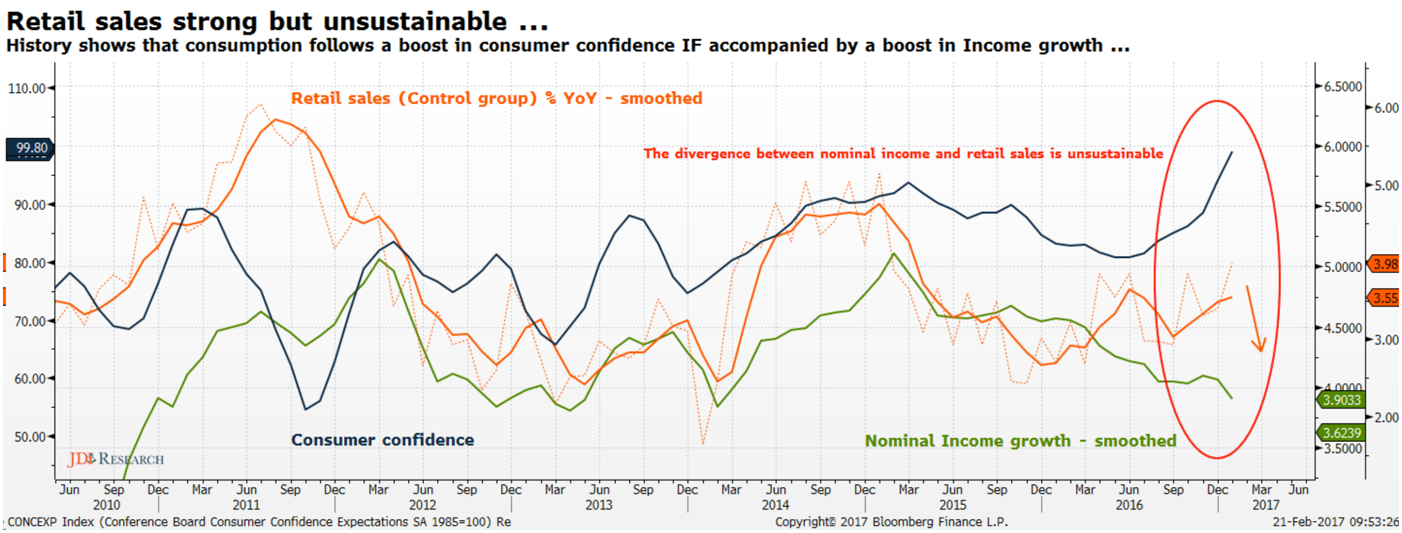
CPI shelter (40% of core CPI)
Long awaited decceleration in rent and OER should restrain core CPI going forward as the flood of constructions start to come online

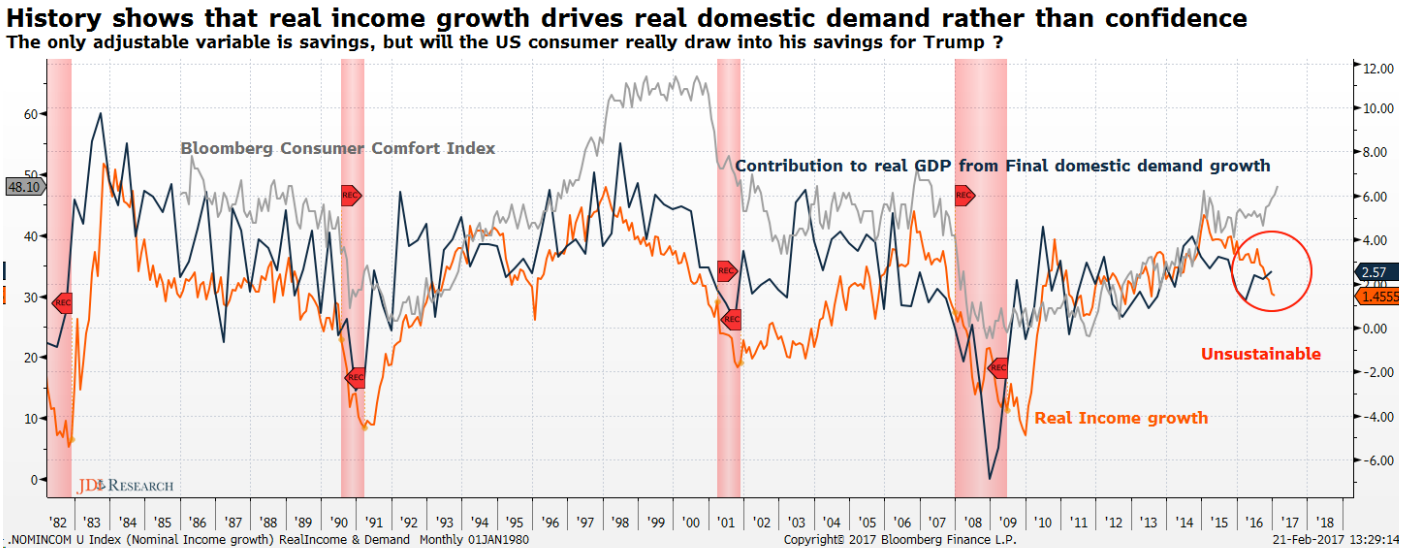


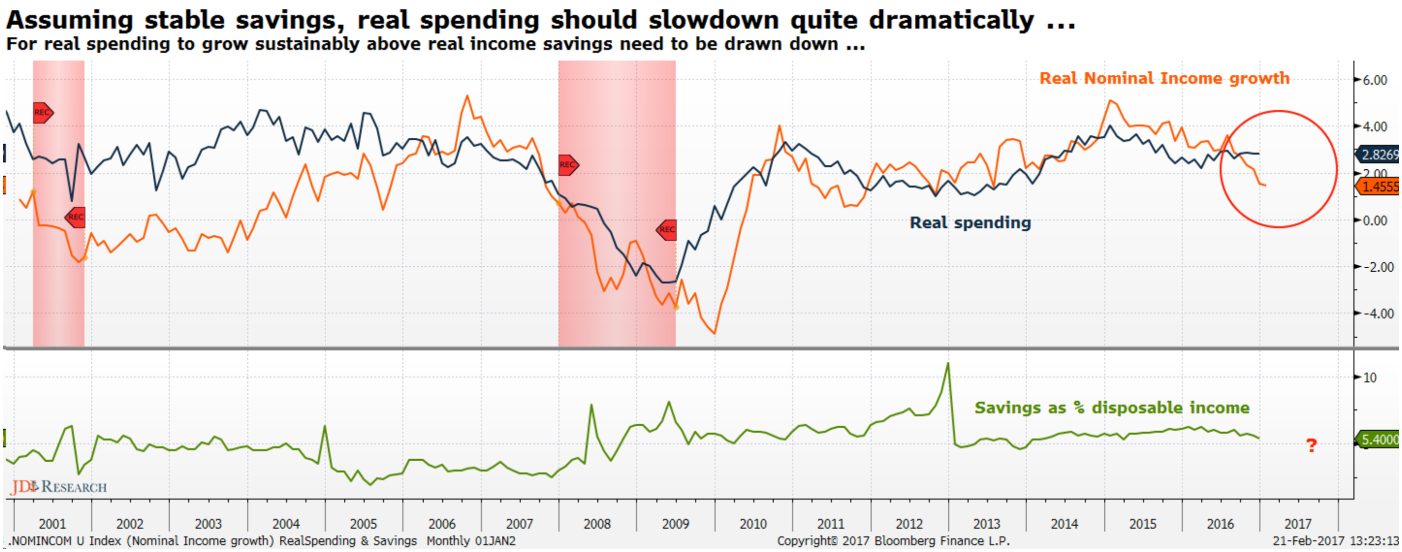
- **Manufacturing activity has been strong, supported by solid consumption but the short-term outlook looks murky at best:**

The reason for the strong manufacturing upswing in the US is a solid pick up in retail sales in 2016 as inventories were rebuilt and confidence recovered. The inventory boost will by design be temporary and **the sustainability of the cyclical upswing crucially relies on the consumer. After all, household consumption is more than 2/3 of the US economy.**

On this, although the recent data releases appeared to point in the right direction, the devil is in the details: consumer price inflation has outpaced wage gains and this is not sustainable. Although retail sales have so far responded positively to the boost in consumer confidence, **the divergence between real income growth** (nominal income growth deflated by headline inflation) **and real spending means that the US consumer will be forced to draw into his savings for real spending to remain supported:**



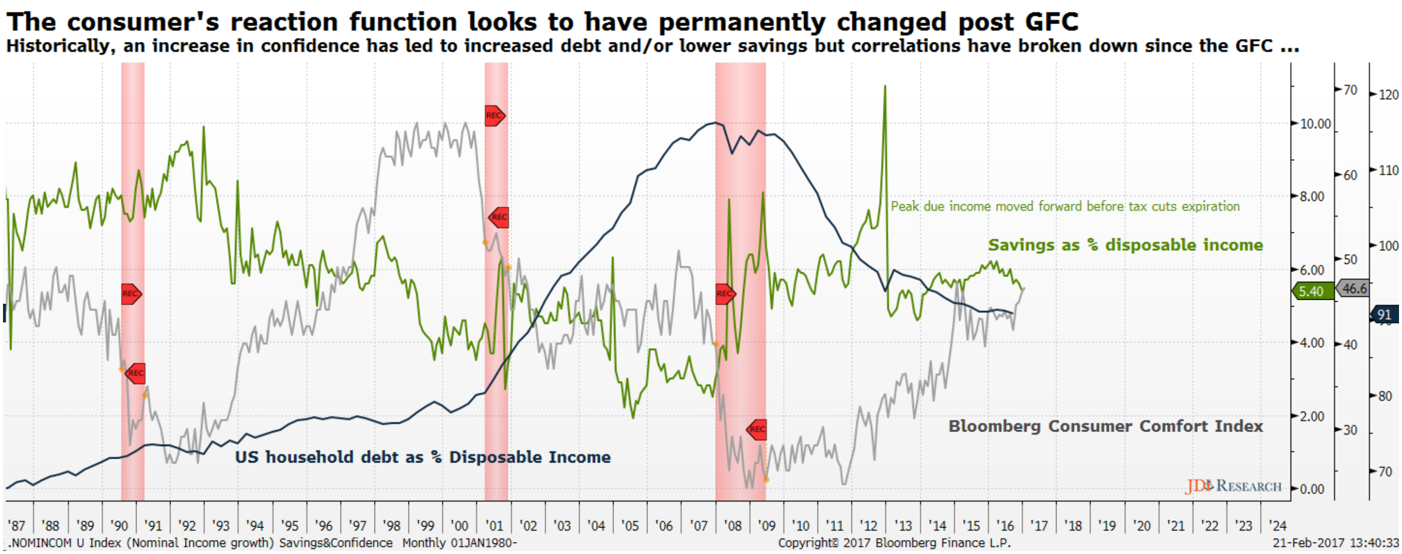




To be sure, savings have been coming down recently but this was a delayed spending of the oil dividend – unlikely to be repeated. **Trump has certainly helped to rebuild consumer and business confidence but it is difficult to see him being successful in bullying consumers into drawing down their savings:**

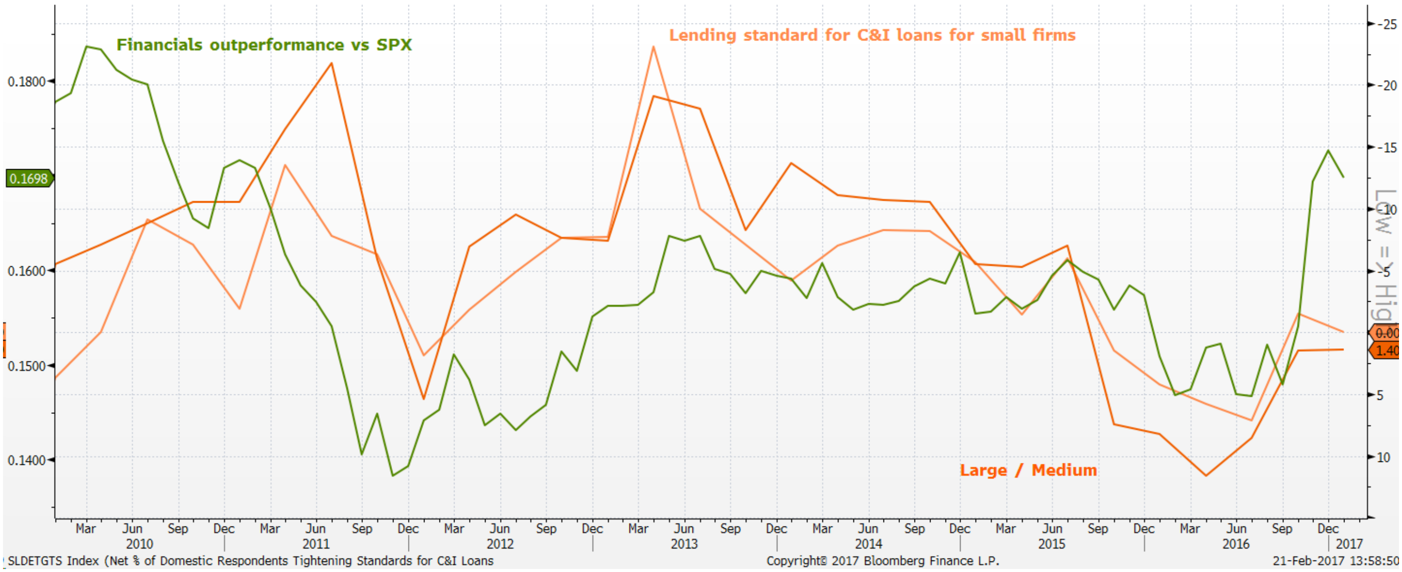
1) This is something I have discussed at length in previous reports; due to inequalities, aggregate numbers do not paint a fair picture of the reality. In aggregate, household finances look healthy: the savings rate is historically high and the household debt level is near a two-decade low. However, it

masks a much gloomier reality. Like the income distribution, the savings distribution is also very skewed - almost half the population has a negative savings rate. In the past, real spending has managed to overcome the inequality obstacle and outpace real income thanks to over-leverage. However, the consumer was burnt in the Global Financial crisis and his reaction function seems to have permanently changed. Thus, a debt increase is unlikely to follow the increase in confidence. Lowest income cohorts are unlikely to push their savings further into negative territory (for one the banks will not let them) whilst highest income, with a lower propensity to consume at the margin, are likely to keep their savings constant.

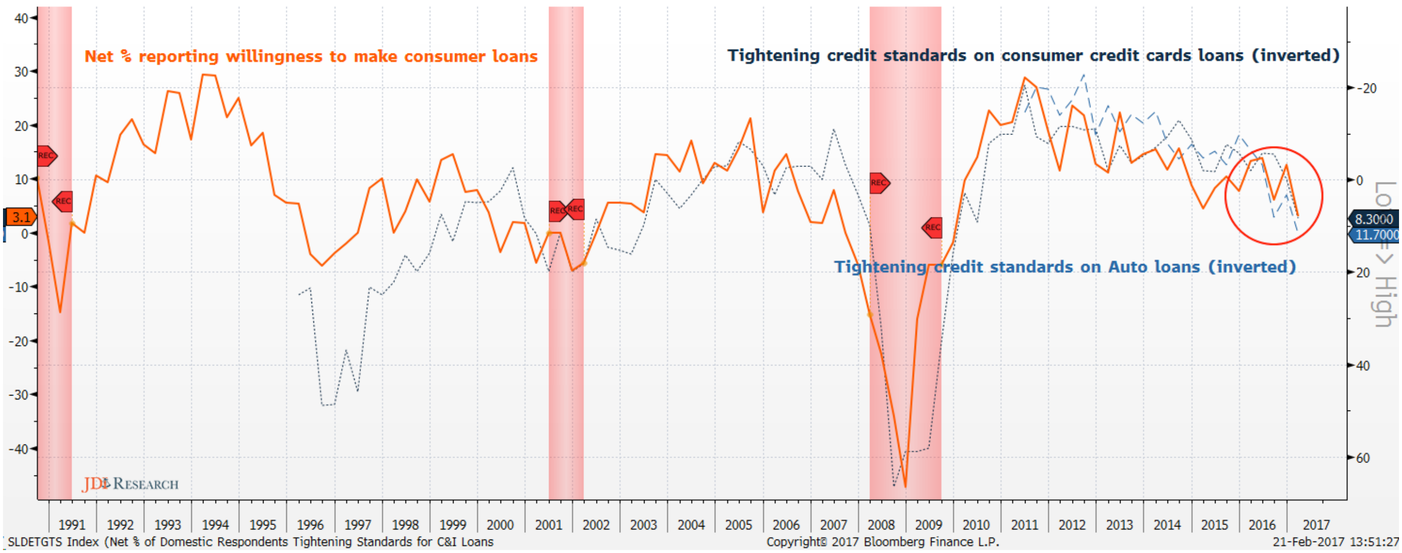


2) Financials may have hit a bottom, but banks remain reluctant to lend to the consumer, which is typical this late in the business cycle:

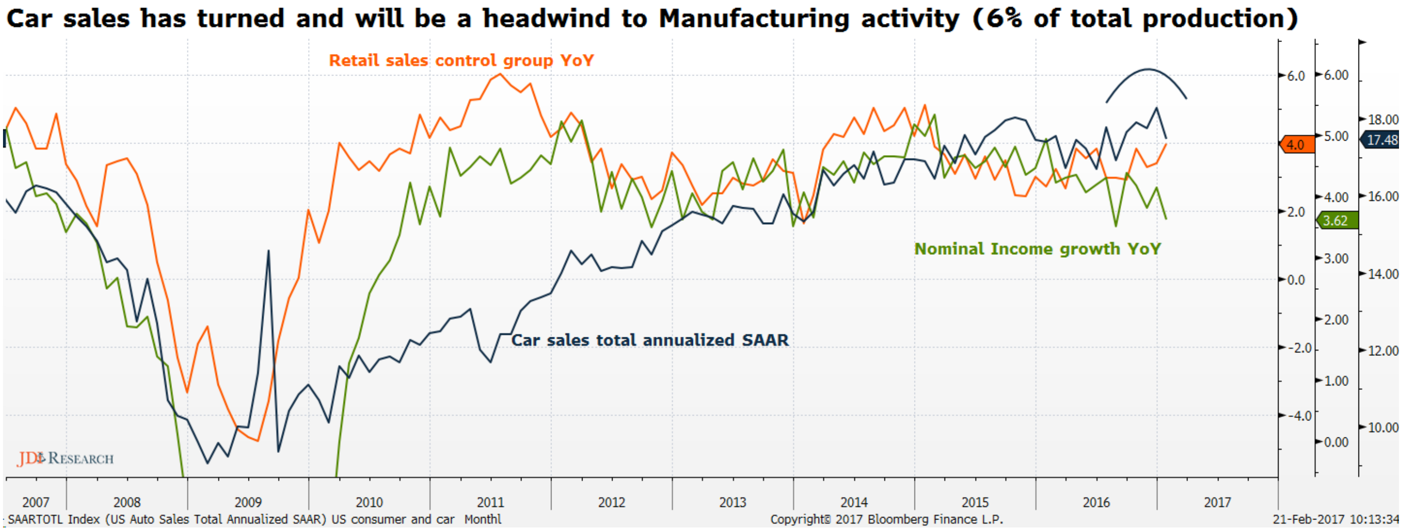
The turn in financials performance has allowed lending standards to ease for companies...



No such luck for the consumer !
Consumer lending standards have in fact continued to tighten ...

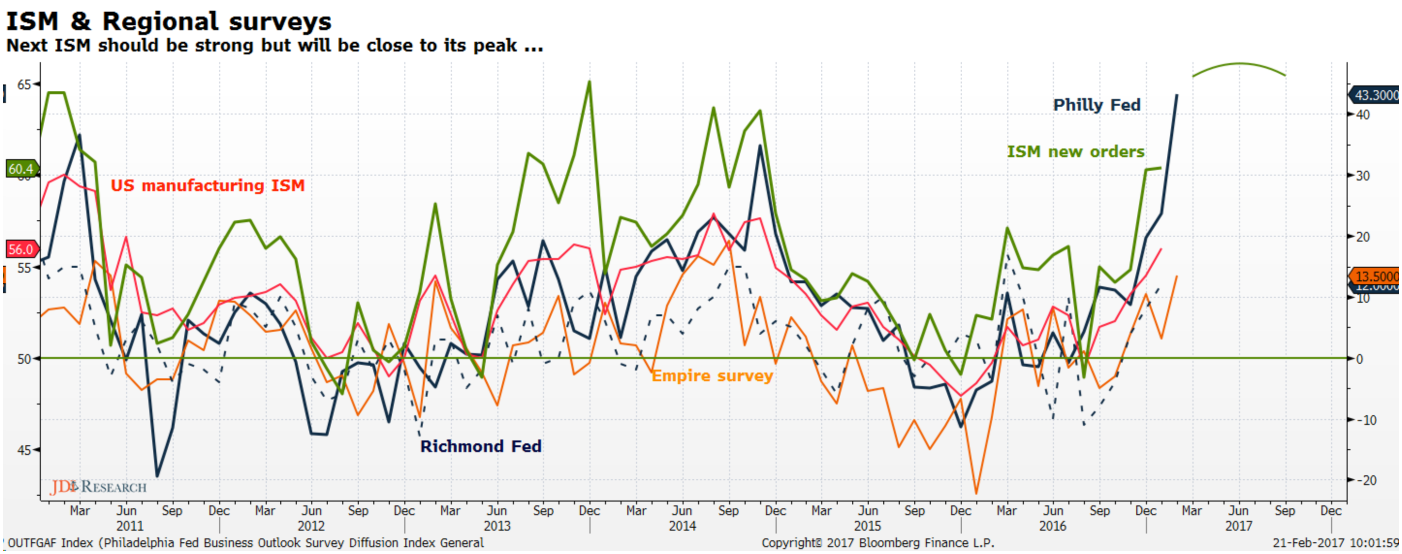


Car sales (6% of total manufacturing production) appear to have already peaked:



If it becomes apparent that the boost in final aggregate demand is only temporary, businesses will be reluctant to invest and productivity and wage gains will be held back. **The virtuous circles hold on very thin grounds this late in the cycle. A pick-up in consumer inflation combined with the inevitable slowdown in nominal growth does not bode well for future US growth.**

Barring an imminent personal tax cut announcement targeted at the lowest income quintiles (unlikely), which would succeed in invigorating animal spirits, next week's ISM should mark the top of the cycle:

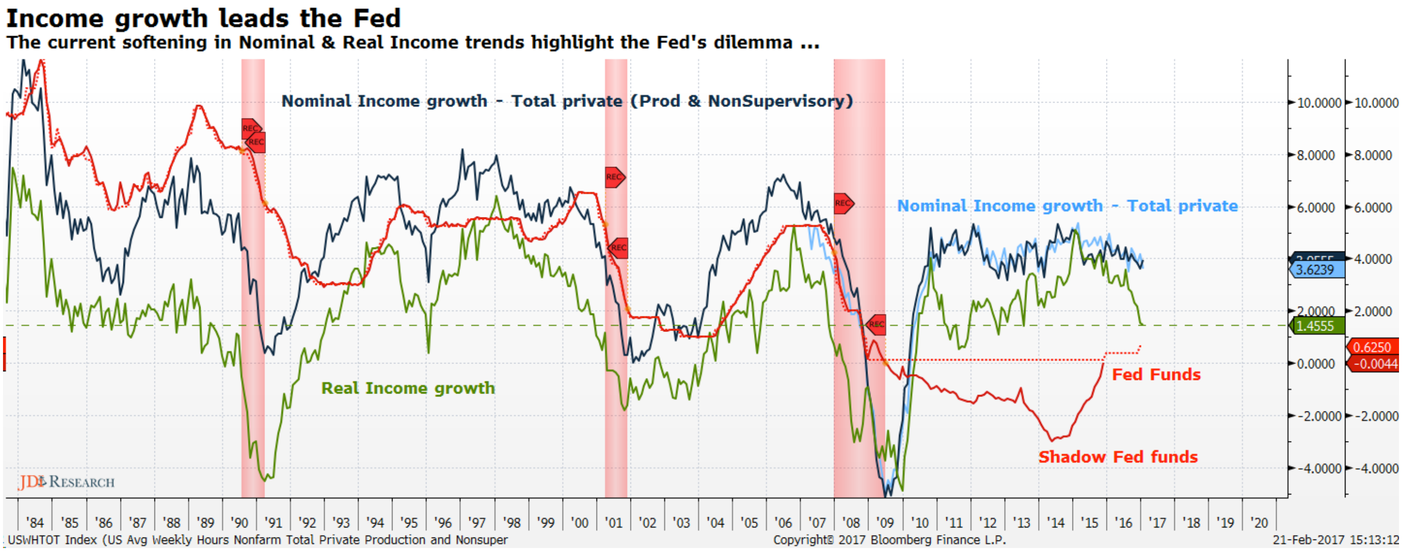


With this, I hope I have convinced you of the necessity for the Fed to remain cautious.

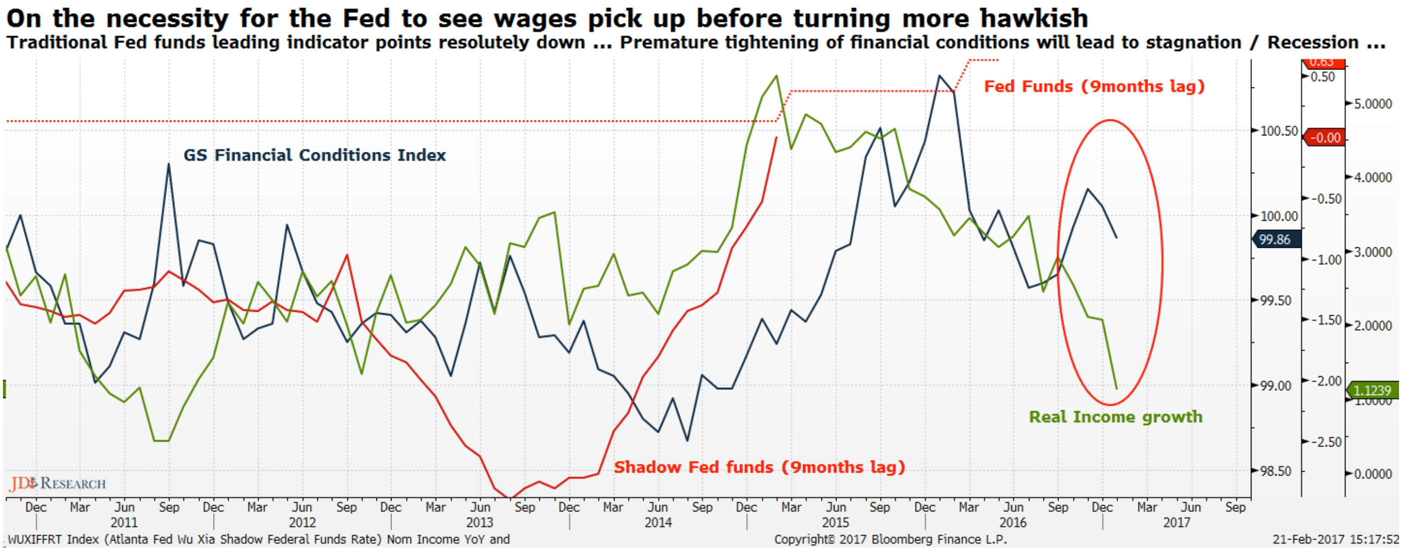
2. The Dollar strength may be seen as a by-product of the Fed's monetary policy or as a policy tool itself

Financial conditions have to stay loose for the business cycle to be prolonged… Weaker USD ahead?

Historically, **income growth has consistently been leading Fed funds:**



Zooming into the current business cycle, there has been no difference in the Fed's reaction function: The Fed has been reacting, perhaps with a longer lag to the income growth trajectory. The main difference is that **instead of embarking into a traditional hiking cycle, the Fed has had to create the conditions for financial conditions to tighten in response to the surge in real income:**



With global growth fundamentally imbalanced at the time when the FOMC started to feel the urge to tighten on the back of healthy aggregate income gains, the main monetary policy lever over the cycle has been the Dollar rather than traditional rate hikes.

- ➔ **Going forward, with global growth more balanced, there may be room for the Fed to "normalize rate gradually" but the counterpart of rate hikes will necessarily be a weaker Dollar because income growth trends suggest that Financial Conditions need to remain loose for the US to avoid recession or stagnation.**

Two decades of Fed's monetary policy:

In other words, the **USD strength in this cycle should not be seen as the collateral damage of QE tapering or rate hikes. It WAS the monetary lever itself.** Looking at past Fed tightening phases by considering the USD strength as part of the monetary package rather than a by-product of rate hikes allows for a better understanding of this cycle:

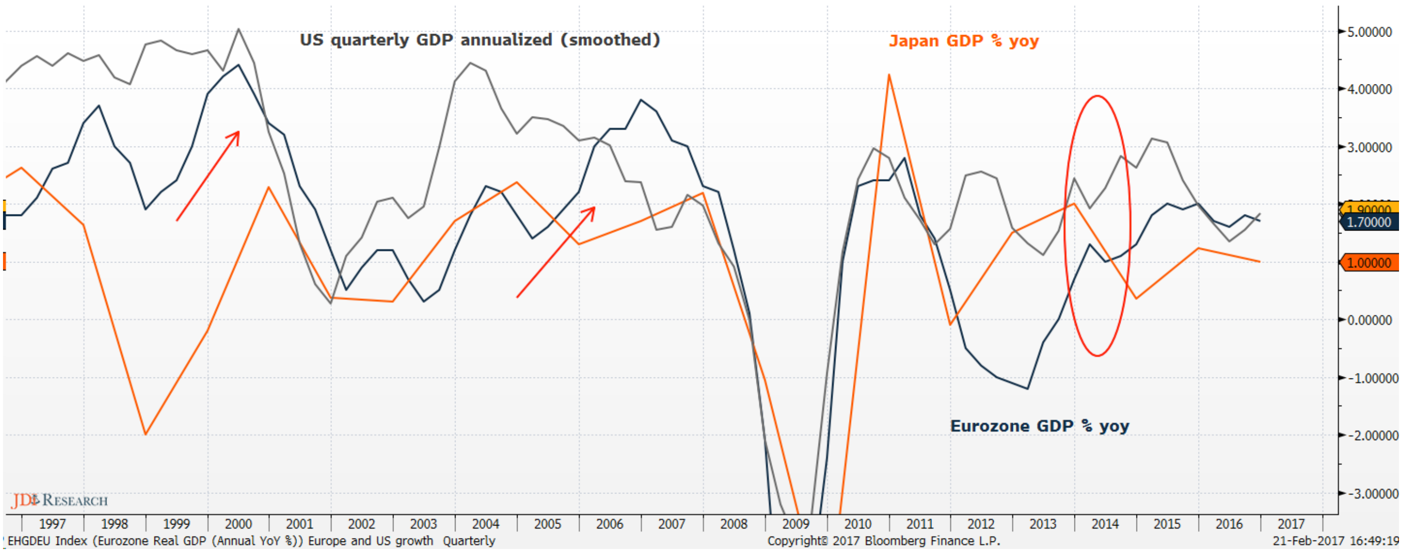
The 1999 tightening cycle combined 175bps of hikes with a 10% appreciation of the trade-weighted USD, while the 2004 cycle combined 400bps of hikes with a 10% USD depreciation. With different monetary policy goggles, the current cycle does not appear as such a conundrum; two modest hikes combined with a 20%+ appreciation of the USD against the trade-weighted basket. We could be dangerously close to the end of the cycle.

On the back of strong CPI and retail sales data last week, US nominal yield spreads vs the rest of the DM world widened to a decade high leading many markets analysts to recommend buying the "undervalued" greenback:

Do not get fooled into buying the greenback on yield divergence!

I strongly believe that it is missing the bigger picture:

The most recent bout of Fed tightening happened at a time of strong macro divergences intra DM
US has been leading the global cycle but Europe and Japan are now catching up ...



E: juliette.declercq@jdiresearch.com W: www.jdiresearch.com T: +44 (0) 7769724879

➔ As investors continue to be lured into bullish USD positions by upcoming Fed hikes and hawkish Fed talks, I advise focusing on wider time frames and would continue to sell USD rallies.

Only one third of the 2014's 20% USD move reflected the Fed's hawkish tilt (see the move in the USD real yield differential versus the rest of the world on chart above "Two decades of Fed's monetary policy"). The rest of the USD move reflected idiosyncratic moves (EU and BoJ's QE and NIRP) amplifying the **monetary divergence** and snowballing into a stronger USD due to reserves and sovereign wealth funds depletion (where USD pegs or semi pegs started to bite) and by the **macroeconomic divergence** with the rest of the world.

In other words, the US has been leading a global imbalanced cycle, which means that the Fed's tightening cycle resulted in a modest two hikes but 20%+ of USD appreciation. The upswing is now global and despite all Trump's efforts, it is likely too late cycle for him to make a difference in the US. Meanwhile, risks are now tilted towards the ECB and BoJ exiting emergency monetary policies.

E: juliette.declercq@jdiresearch.com W: www.jdiresearch.com T: +44 (0) 7769724879

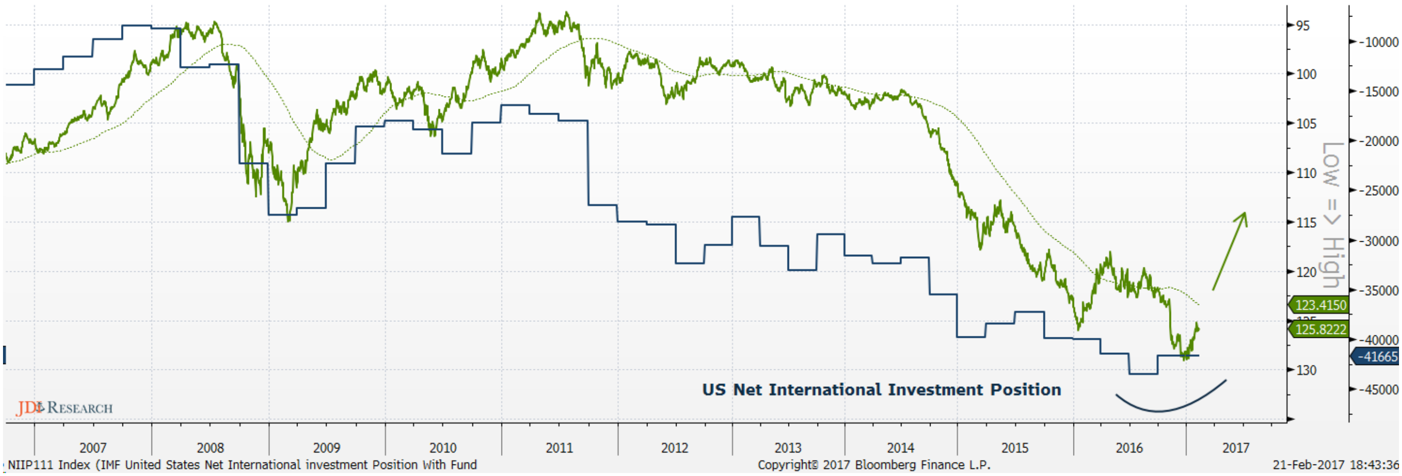
This means that the macro divergence theme has come and gone and the monetary policy divergence theme will be next to succumb.

- ➔ The consequence is that the **USD will weaken in a broad move versus countries with excess capacity - where the ongoing global upswing is more likely to manifest itself through higher growth rather than higher inflation.**

- ➔ **As it becomes apparent that capital flows in the US will be limited by the relatively poor growth prospects in this part of the cycle (the same way the US led the upswing, it will also lead towards the next soft patch) and unattractive real yields, the Dollar could retrace a large chunk of its 2014 move.**

US NIIP & USD Broad TWI

Capital flows have been one way only in the US since 2011, this should reverse going forward...



In short, **widening US interest rate differentials will no longer support the USD unless higher short-term higher rates coincide with a credible medium term revival of the US business cycle.** Can President Trump durably re-invigorate the animal spirits at his Congressional address on Feb 28th? It is difficult to envisage that he could make a difference this late cycle. Barring an overly protectionist stance, short-term bullishness should continue to express itself via higher short-end

US rates and equities rather than a stronger USD. I am still looking to add to my core USD short on rallies and will look for levels to add long AUD to my book.

3. Should we fear a March rate hike?

Today's loose monetary conditions are a precondition to tomorrow's higher rates…

The two key data releases to watch to handicap the March decision are: PCE on March 1st and Aggregate Income Growth data (from NFP) on March 10th. However, May is already 2/3 priced and June fully priced, hence a March hike would mostly affect timing rather than the cumulative hikes priced. In fact, the US curve would most likely flatten prematurely on a March hike. **This is the reason I recommend holding a 5s30s flattener alongside my short USD and long equities core positioning.**

- As per my first two paragraphs, I believe that the Fed will continue to nurse an aging cycle, staying behind the curve to give wages a chance to catch up with CPI. With hopes of a pro-growth fiscal policy alive and well, this means that real rates will stay depressed and the dollar will remain well-offered versus high yielders in a continued "risk on" move.

- Conversely, if I am wrong and the Fed turns resolutely more hawkish, the USD is still unlikely to strengthen. This is because markets will rightly price that the Fed is likely to have to shortly reverse course to keep the economy afloat and the US curve will flatten. I have demonstrated in this report that the US needed financial conditions to stay loose in order to keep growth from stalling. Other than short term knee-jerk reactions, the Fed can only influence the greenback if macroeconomic fundamentals warrant tighter financial conditions; this is not currently the case. In this scenario, the USD will also stay offered but in a "risk off" move that favors EUR and JPY. At that point, I would get out of long equities and possibly initiate a short.

To conclude:

- **The US cycle's is fragile. This should keep the Fed behind the curve and the USD will continue to weaken.**
- **Global imbalances are now behind us and the US is moving to the end of its cycle (Trump and the Fed can only affect the speed at which the cycle will end), this suggests that the 20%+ USD move in this tightening cycle will reverse at least partially.**
- **Clean tax cuts and a weaker USD are politically more palatable proposals than the border tax and/or a trade war. Both could backfire through undesirable retaliation, higher consumer prices, a stronger USD.**
- **Do not fight the equity bullish trends. Fifth waves can be disheartening. I am looking for more upside.**

Juliette Declercq
juliette.declercq@jdiresearch.com
(+44 7769724879)

The above is only meant to be a roadmap to help CIOs navigate risks more safely. Specific levels and trades can be discussed separately on BBG or phone.

This report is a piece of research ("JDI research") provided by JDI Research Limited a private limited company registered in England and Wales, company number 09977951 ("JDI research limited").
JDI research is provided only to investment professionals who have been pre-qualified to receive it by JDI research limited. Each piece of JDI research is sent to one or more investment professionals who have requested that JDI research limited provides research to them. Each piece of JDI research is intended for the use of the person to whom it is addressed (the "Addressee") and the colleagues affiliated to the same entity as the Addressee as agreed in writing between the Addressee and JDI research from time to time (the "Additional Addressee(s)"), if any. If you are not the Addressee or an Additional Addressee, please delete this piece of JDI research and destroy any copies. Please also email or telephone Juliette Declercq at JDI research (+44) 7769724879 or juliette.declercq@jdiresearch.com so that JDI research can take steps to see that you do not receive further JDI research.
JDI research is not an offer to buy or sell any specific investment. JDI research is and is intended to be a general market view. It is not and is not intended to be general or specific investment advice nor a personal recommendation concerning a specific investment, investment product or investment service. JDI research limited expects that all investment decisions taken by Addressees or Additional Addressees will be decisions made by the Addressee or Additional Addressee based on specific advice or specific recommendations made by an investment adviser or taken by an investment manager. Since JDI research limited does not provide investment advice nor carry on any other investment business it is not regulated by the U.K Financial Conduct Authority nor by any other regulator of investment business.
JDI research is based on publicly available information, obtained from sources that JDI research limited considers to be reliable. However, JDI research limited does not represent that it is accurate and it should not be relied on as such. The opinions and conclusions expressed in any piece of JDI research are current as of the date of publication and JDI research limited does not accept any responsibility to update any such opinions or conclusions in the light of developing events or circumstances. All forward looking statements, even if they appear to be presented as fact, must be treated as opinions or judgements, and JDI research limited accepts no liability or responsibility if any opinion or judgement proves to be inaccurate in whole or in part. Without limitation of the foregoing, JDI research limited shall not be not liable for any loss or damage of any kind resulting in any way from or alleged to result in any way from JDI research or the use of JDI research by any Addressee or Additional Addressee or by any other person.