Five Simple Words

Last week all eyes were on the Fed's rate hike decision, which was a foregone conclusion. But the real central banking action took place 4,000 miles away.

Before you fill my inbox with nasty grams, I'm not saying the Fed doesn't matter. In fact, it's the world's most important central bank. But the most critical central banking development impacting markets last week was not the Fed's rate hike. It was five words spoken by a guy you've never heard of, to a media outlet you've never heard of either.

These five words were so profound that they moved me. Specifically, after carrying a SHORT bias on the euro for 44 consecutive weeks, these five words moved me to the LONG side of the euro-bloc currency.

You Had Me at "May Be"

Following the Fed's rate hike last week, European Central Bank (ECB) Council member Ewald Nowotny told Handelsblatt Global that an ECB rate hike "may be on the way." Nowotny, the Governor of the Austrian National Bank, went on to say that while the ECB may begin its own normalizing process, it would most likely go about it differently from the Fed.

The Fed has normalized by going through a well-defined set of steps. First, it ended its asset purchase program. Then, after waiting a year for the market to adapt, it raised rates for the first time in a decade.

Nowotny explained that the ECB wouldn't necessarily raise all rates at one time. "The ECB could also raise the deposit rate earlier than the prime rate." He also implied that the ECB would consider continuing its bond purchase program while it normalized rates.

Look, one interview with someone *not* named "Draghi" is a long way from an initial ECB rate hike. But the importance of this development can't be overstated, because it means that talk of normalization has been on the table within the walls of the ECB.

As I've been saying for a couple of months, the ECB will find itself in a policy pickle later this year if inflation continues to ramp higher. Eurozone growth data has been steadily improving, so the only thing standing in the way of less easing and more tightening is inflation.

Regular readers know that being data dependent is my mantra, like "Aummmm" is to a Bikram yoga instructor. So, let's dig in and see what the data has to say about the likely direction of ECB policy.

Supply vs. Demand

After bottoming in the second half of 2013, Eurozone GDP growth has hockey-sticked nicely and has been hovering between 1.5% and 2.0% for the last twelve months. Growth during Q4 2016 came in at a solid 1.7%. Service and manufacturing data points to start 2017 show that both sectors of the economy are humming.

The service PMI has spiked to a six-year high and job creation is occurring at the fastest pace since 2007. What is even more important about this latest reading is that the improvement is based on stronger domestic demand, and it's happening in more Eurozone economies than before. France has been a drag on Eurozone numbers for a couple of years, but the 2017 data shows that France is now joining in the growth party.

Strong demand and the breadth of participation means this improvement may have staying power.

The manufacturing sector continues to improve as well. The latest manufacturing PMI accelerated for the sixth consecutive month. The most underappreciated aspect of this latest PMI data is what it implies about inflation.

Remember, the fact that inflation has yet to hit the ECB's 2.0% target is the only technical threshold keeping the ECB from beginning to normalize.

Companies in the PMI survey raised prices at the fastest pace in five years because of increased costs associated with higher commodity prices and a weaker euro. However, even with costs rising rapidly, factories can't keep up with orders. This is leading to the development of a "seller's market" because demand is outstripping supply. A "seller's market" tells us that inflationary pressures should continue to rise.

It's Getting Hot in Herre

But it's not just what the growth data is implying about inflation that bears monitoring; it's what the inflation data itself is telling us.

Right now, it's a tale of two inflations: headline versus core. Headline inflation has accelerated for eleven months and is now sitting at 2.0%, which is the highest reading in four years and smack dab on the ECB's mandated threshold.

However, the ECB is more concerned with core inflation, which is rising only gradually despite healthy domestic demand on higher crude oil prices. The latest core reading registered at 0.9%, which is at the top end of core inflation's three-year trading range between 0.6% and 1.0%.

The headline readings are giving the ECB the green light to tighten, while core inflation is giving it an excuse to keep the pedal to the metal, if it so chooses.

The winner of the core versus headline battle will be one of the key factors deciding whether the ECB wades into the tightening waters or stays merrily, merrily on its easing stream.

Exit Visas are Imminent

The truth is that investors have been anticipating more rate hike rhetoric since the inflation data started catching up with the economic data. But you wouldn't know about their anticipation by looking at the euro's price action. That's because there has been an anchor weighing down the euro, and it's not economic or ECB-related. Instead, it's political.

Recent developments in France and a new survey from Sentix Research Group underscore this weight. Markets don't like political uncertainty, and the latest Sentix survey shows that 25% of respondents expect the Eurozone to lose at least one member in the next twelve months. This percentage is up from 21% just a month ago, with most folks picking the Netherlands, Italy or — you guessed it — France as the candidate most likely to say "peace out."

However, once there is clear political direction in France and more clarity on which countries are looking towards the red "exit" sign, the euro could pop up like a volleyball released from being held under water.

Gravitational Framework Says What?

Fundamentally, the euro has a bullish backdrop right now with both growth and inflation accelerating. Couple that with Draghi having fewer and fewer reasons to do "whatever it takes" and you have a perfectly bullish Fundamental Gravity.

Behaviorally, being LONG the euro is an extremely consensus view. Our current Behavioral Gravity Index is sitting near a three-year high, which means that people are all-in on the bullish side of the euro, and SHORT euro exposure is non-existent.

This is exactly the set-up I like to see if I want to SHORT a market, but it doesn't automatically negate a LONG trade for me.

That said, wading into a trade that is already consensus and this lopsided makes me as nervous as a long-tailed cat in a room full of rocking chairs.

My approach in this scenario is to start with below-average position size and then build it as the excess LONG positioning gets whittled down. A few sound bites from Draghi dismissing last week's five words should do the trick.

Quantitatively, the euro is up 2.1% for the year to date, and a close above $1.10974 would break the two-year downtrend that began in August 2015. From a shorter-term perspective, it will be a very bullish development if the euro closes above $1.0870.

Another quantitative factor I monitor is volatility, because it helps me put price action into context. Euro volatility is at its lowest since 2014 and has declined 70% in the last two years. Volatility falling while price climbs is as bullish as a Quantitative Gravity gets.

The Bottom Line

An ECB rate hike is not a foregone conclusion, but it's inevitable that Draghi and the rest of the ECB will be confronted with some tough decisions before this year is over.

Keep in mind that the ECB doesn't need to actually raise rates for markets to price as if they have. Remember when the Fed stopped its asset purchases but didn't raise rates for a year? The USD ripped and U.S. inflation readings went from deflationary, below 0%, to almost 1.5%. A shift in the ECB's easing rider mentality coupled with political clarity will be enough to remove the artificial ceiling keeping the euro from maintaining any upside momentum.

If you want to be a consistently successful investor, it's imperative that you be data dependent, process driven and risk conscious. Let me add that you also need to be globally oriented. Yes, what the Fed does is critical to financial markets, but it isn't the only player in town. I don't care if you trade AT&T, Snapchat, Treasuries or muni bonds; if you want to be successful at this game then you must have an understanding of the trajectory of central bank policy from the major players outside the U.S.

Until next time, stay data dependent, process driven, risk conscious and **globally oriented**, my friends.

Landon Whaley

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