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Article

Brief window for carry trades

The dollar's downside should be relatively limited against low yielders like the euro and yen whilst providing a short term window for carry trades

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USD: Dollar steady as investors put money to work

Price action in FX markets suggests investors are trying to put money to work – albeit cautiously in light of risks – largely coming out of Washington. We're seeing the higher yielding, activity currencies perform a little better as equities try and recoup some of the heavy losses seen last year. Helping that mood remains a firm view that the Fed is now on hold (US money market curve flat for 2019 and prices a cut in 2020) and some signs that the US and China are talking positively on trade (senior diplomat Liu He to visit Washington 30-31 January). The US government shutdown is probably limiting the recovery in equity markets and we suspect investors would react negatively to President Trump using emergency powers, over-riding Congress, to get his wall built. For today, the focus will be on US CPI. The sharp fall in oil prices late last year means that headline inflation will be drifting lower over coming months, but the market will instead be focusing on the core rate. This should be steady around 2.1/2.2% and support the Fed's new narrative of patience. It looks a bit early to expect an immediate re-pricing of the Fed tightening cycle, but the dollar's downside should be relatively limited against the low yielders (EUR and JPY), whilst providing a short term window for carry. DXY may be supported around 95.00, but the big decline in USD/CNY creates a supportive back-drop for emerging markets in general.



EUR: Still at risk of a short squeeze

EUR/USD remains supported by the soft dollar story. With USD/emerging markets gently softening, the risk of a short squeeze in EUR/USD remains – perhaps to the 1.1620/25 area. However, negative EUR rates and a soft macro outlook suggest Europe will struggle to attract rotational flows out of US markets.



GBP: Emergence of second referendum path yet to help the GBP

If there is a chance of a second UK Brexit referendum – e.g. one path after the presumed failure of the vote on PM Theresa May's withdrawal bill next week – it is yet to show up in the pound. We think that's because some of the alternative scenarios are very bearish for GBP. We'd prefer caution at this stage rather than opting for some lottery ticket on a sharp GBP rally.



MXN: Yield and some sensible hedging helps the peso

The Mexican peso is performing quite well on the back of firmer oil prices and the Fed pause. In our recent article on the topic of a [re-steepening of the US curve](#), we thought long MXN/JPY could be the vehicle to express this story, with MXN enjoying 8% carry. This may just be a story for a few months rather than the year, but worth looking at nonetheless. The news that the Mexican Finance Ministry has hedged its oil sales at \$55 for the year ahead (WTI now \$52) should also serve as a reminder of conservative budgetary policy – a positive.

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