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Article

Investors reap what Trump sows

While we cannot rule out the current US equity correction extending further, it's probably too early to call a major top. The dollar could correct, too, but this isn't a knockout blow

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USD: After massive outperformance, US equities finally correct

Having out-performed the rest of the world this year on the back of fiscal stimulus and share buybacks, US equities are finally showing signs of fatigue. The correction might have come a little earlier than some in the buy-side had expected - surveys had suggested that US 10-year Treasury yields above 3.50% would be the level where investors would consider rotating into bonds. Profit-taking ahead of mid-term elections (were the Republicans to lose the House, less chance of 2019 fiscal stimulus) may be playing a role here as well as the ongoing trade wars. While the White House may be enjoying the new lows in the year for Chinese equity markets, it will not be appreciating the blowback into US equities so shortly ahead of the mid-terms. Indeed investors might be unnerved by President Trump's implicit criticism of the Federal Reserve this week. While we cannot rule out the current US equity correction extending further (we've seen 5% in the S&P 500 so far, compared to a 12% correction at the start of the year) it's probably too early to call a major top. For the near term, however, position adjustment should dominate FX markets. Investors have been long the dollar across the board and USD/JPY should lead the dollar lower now that US equities are finally correcting – let's see how it performs at 111.65 support. High yield FX would normally be under pressure now, but investors are already short on the US rates/trade war/China slowdown story, thus losses will be more muted. In terms of emerging markets, the more equity-driven Asian bloc should underperform and the more debt-driven central and eastern European bloc outperform – although crowded Czech koruna positions are at risk. All in, the US dollar index could correct to 94.70, but this isn't a dollar knock out.

EUR: Current account and short euro positioning are the biggest support

Equity-driven position adjustment has helped EUR/USD higher, although a US equity sell-off isn't great news for the pro-cyclical euro. The eurozone's near 4% of GDP current account surplus does provide some insulation, but this EUR/USD move may well stall at 1.1580/1620. After all, unless US equities crash, there seems no reason for the Fed to slow its normalisation process (US September CPI today) and the Italian budget process looks set to get very noisy later this month.

GBP: DUP to vote down the UK budget?

Despite some GBP bullishness on the prospect of a deal before next week's EU leaders' meeting, Prime Minister Theresa May's coalition partner – the DUP – is again flexing its muscles by threatening to vote down the UK budget and potentially May's leadership in early November if their wishes aren't respected on the Irish border. GBP/JPY has been surprisingly range-bound and may drop near term.

MXN: An expensive sell

If the US equity correction does trigger some broader position-adjustment, then the Mexican peso (MXN) could soften again. 8% annualised domestic rates make MXN an expensive sell, but long MXN is a crowded trade and a move in USD/MXN to 19.70 this month (3%) is a possibility. Also look out for a potential referendum on the new Mexican airport later this month. Referendums are difficult to control and a rejection of the continued construction would be a negative sign for foreign investors.

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