CitiFX Strategy Weekly | August 11, 2016

CitiFX Strategy: Election fear, loathing and asset markets

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In this week's issue:

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Election fear, loathing and asset markets

This week we take another look at how the US election can affect asset markets. At present asset prices other than MXN show no fear of the election outcome and our questions are 1) is this justified? and 2) which of the economic proposals will have the greatest impact on USD and asset prices? The Macro team concludes that the most USD positive outcome would be combination of severe trade disruption and fiscal expansion, even if long-term and asset market economic implications are negative. The Quant team analyses the sensitivities of G10 currencies to polling measures of Trump support. They find that AUDUSD has a consistent negative correlation making it the best G10 Trump hedge, while JPY has been fairly unresponsive and USD broadly appears to strengthen on rising Trump support. This week the Technicals Team looks at the S&P 500, LATAM FX and Asia FX, suggesting that there is further room to run with regard to the risk rally.

On the Macro strategy side (Link Here) we analyze the proposed economic policies of presidential candidates and see whether there are predictable market implications from Clinton/Trump economic plans. The most tangible conclusion is that spending/tax cuts without revenue is mostly likely to be USD and equity market positive in the short term.

Our Technicals team (Link Here) takes a look at the S&P 500 (as a proxy for US Equities as a whole), LATAM FX and Asia FX. They suggest that despite possible jitters into the election, risk should remain well bid into year end. The Technical setup remains constructive and they note that bearish sentiment surrounding Equities and cautiousness with regard to Local Markets has more likely than not been supportive of risk as a whole.

Our Quant team (Link Here) investigates sensitivities of G10 currencies to US presidential polls and find that AUDUSD has had the most consistent negative relationship with Trump support. The results hold both in contemporaneous correlations as well as lagged ones. Short AUDUSD looks to be best hedge against Trump victory in G10 FX. The Quants also note that JPY has been surprisingly unmoved by US polls so far and evidence on overall USD direction is mixed with only lagged polls pointing to USD strength, on average.

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G10 Strategy – USD fiscal, trade policy and asset market outcomes

- This election is different because unfunded, expansionary fiscal policy is a policy option
- This would be USD positive in the short and medium term …
- … even if aggressive trade measures are put in place …
- … and even if the long term economic and asset market implications are negative

Election years usually bring a round of unfunded Democrat and Republican spending/tax proposals. What makes this year different is that many economists and policymakers think that fiscal expansion is exactly what is needed, whether the funding comes from borrowing at low rates or is ultimately provided by the Fed. Our objective is to analyze what we know about the candidates' platforms (Figure 1 below) and see whether there are predictable and different asset market implications as between the Clinton and Trump economic plans. Neither set of proposals looks fiscally neutral – and both could turn out to be significantly deficit widening.

The most tangible conclusion is that spending increases/tax cuts without revenue raising is most likely to be USD positive and probably equity market positive as well in the short term. Given the demand for assets and low yields globally additional spending/tax cuts would not crowd out spending over the near and probably medium term. Current low long term yields probably reflect the fear that US domestic demand is structurally weak, and will continue to be unresponsive to a fiscal/monetary mix that relies exclusively on monetary policy. Were the Fed to augment its balance sheet to helicopter the spending, it is probably the case that the USD and long term yields would rise.

Surprisingly there is a good chance that the combination of trade disruption and fiscal expansion would also be USD positive (that doesn't mean it is an attractive policy combination). The two policies in combination would solve the FOMC's low inflation worry, even if other problems are substituted. In a world of low yields and stagnant growth, we suspect that a steeper sloping US yield curve will make the USD irresistible, even if the US supply-side is impaired.

The USD move is more likely to have a sharp upward move versus G5 currencies on polices that stimulate equity prices, such as low tax earnings repatriation or cuts in tax rates. This would likely be positive for global equity prices as well, so EM would outperform. Paradoxically a move towards trade restriction on its own would also spur USD strength, but probably more versus EM because both US and global equities would fall.

Historically, probabilities for US election markets begin firming mid-September through mid-October. At present Clinton/Kaine are projected to have 246 electoral votes (an additional 24 are needed to win), while Trump/Pence have 154 (need 116 more to win). 138 are up for grabs or too close to call. That skew significantly favors the Clinton campaign, and is why she is trading at 73% chance. Only in 10 states is the vote close enough to say it's a toss-up. For instance – winning Florida (a toss-up state) would seal the ticket for the Democrats. The skew also explains why so little seems to be priced into asset markets other than MXN. Below we discuss how different elements of the proposed economic packages will likely paly put in asset markets. For now, the experience of the UK referendum makes us cautious on assuming a one-sided vote. And there could be some quick hedging if the odds narrow.

Figure 1. Trump vs Clinton Economic Stance Comparison

	Trump	Clinton
Tax Reform	• Lower taxes for everyone and zero rate for low income workers • Reduce number of tax brackets from seven to three – 12%, 25%, 33% • Increase standard deduction amounts • Exclude childcare expenses from taxation • Abolish inheritance tax • Possible payroll tax holiday • Eliminate the Carried Interest Deduction • Repeal federal estate taxes • Reduce corporate tax to maximum 15% • A 10% repatriation tax (HIA style) • Estimated to reduce tax revenue by $9.5 trn over 2016-26	• Higher taxes on upper income and corporations • Create 43.6% bracket on earnings over $5mil; minimum 30% tax rate for earnings over $1mil • "Exit tax" on foreign earnings of tax inversion firms • Increase estate and gift taxes to 45% and lower threshold for exemption • Raise short term capital gains tax on earnings above $400k • Tax high frequency trading and close tax loopholes on Wall Street • Tax cuts to middle class/small business • Investment tax incentives in struggling manufacturing communities • Estimated to increase tax revenue by $1.1 trn over 2016-26
Federal Spending	• Infrastructure and social improvement – promises 2 x Clinton spending • "Penny Plan" to reduce 1% spending each year • Increase spending on veterans and defense	• Infrastructure improving $27.5 bn annually • $35 bn annually to refinance student debt; promote technical education. • $27.5 bn annually to support early education; $16.6 bn annually to treat children disabilities
Regulatory	• Promised a plan to "dismantle" Dodd-Frank • Audit Federal Reserve • Interest loopholes • Issue a temporary moratorium on new agency regulations • Review regulations that inhibit hiring • Reduce cost from excessive regulation	• Dodd Frank – impose risk fee on banks with $50+ bn in assets, high debt levels, or heavy reliance on short-term funding • Bonus claw-backs on senior bankers • Close the Volcker Rule loophole that allows banks to invest public money in hedge fund • Enhance transparency of "shadow banking system"
Trade	• Withdraw from TPP • Renegotiate NAFTA terms • Label China currency manipulator and prohibit China subsidy (7point trade reform plan) • Tariffs on China and Mexico	• Renegotiate TPP terms to expand U.S. trade growth but also protect workers and environment. • Overall NAFTA supporter and WTO
Energy Reform	• Lift restrictions on all sources of American energy	• Launch a $60 bn clean energy challenge • Revitalize coal communities
Future proposals	• Increase choice in childcare • Childcare deductible up to average cost • Plans to increase police and law enforcement funds and support • Rebuild military, get allies to pay their fair share for the protection US provides • Repeal Obamacare and replace with free market programs	• Firm-paid family leave to encourage women in the workforce • Raise minimum wage to $15/hr • Pro-Obamacare. Reduce prices for prescription drugs, expand coverage

Source: https://www.citivelocity.com/t/eppublic/yCj8, https://www.citivelocity.com/t/eppublic/yCj8, https://www.citivelocity.com/menu/FX_OV?CVFXWireID=1971211&cvapplnk=true, https://www.citivelocity.com/t/eppublic/yFIp, https://www.donaldjtrump.com/positions/economic-vision, http://useconomy.about.com/od/fiscalpolicy/p/Hillary_Economy.htm, http://time.com/4443382/donald-trump-economic-speech-detroit-transcript/, https://www.hillaryclinton.com/issues/

Comparison of programs and their economic impact
Figure 1 gives a summary of some of the major economic provisions that Trump and Clinton are advocating. Citi economists have published a very detailed analysis of the economic proposals such as they exist present (link). What is striking is how closely they adhere to traditional Republican and Democratic agendas (setting aside trade) and how hard they are to cost out. The Republicans emphasize tax cuts and the Democrats social spending. Both have big infrastructure agendas (Trump promising to book at least double Clinton's infrastructure spending).

If you are Paul Krugman or any economist who thinks that fiscal thrust is what is needed, you probably support the economic platform of the candidate who will increase the deficit the most. Long on spending/tax cuts, short on financing is a virtue in this world.

There is a second order argument on whether tax cuts or spending is the preferred way of increasing aggregate demand. The virtue of tax cuts is that they work relatively quickly and have whatever efficiency comes with having resources allocated by the private sector. There is a widely perceived need for more infrastructure spending, but anecdotally the 'shovel ready' spending of the last stimulus package did not have a big impact. And there is a further debate on whether infrastructure spending should be done as efficiently as possible or be viewed in part as a transfer to working class construction workers and contractors. Most broadly, the striking feature of the literature on productivity is how little of the variation in productivity can be explained, let alone controlled or programmed.

The Trump program so far has few financing provisions – the only concrete revenue increase comes from repealing Covered Interest Deduction and presumably whatever would be collected in tariffs from the targeted countries. Some financing might come from Trump's 1% spending reduction per year, but such spending cuts are rarely implemented. In terms of stimulus he promises double the Clinton infrastructure investment and much lower personal and corporate income taxes.

Trump has his 1% reduction in government spending and Clinton has her tax increases. To be clear IRS adjusted gross income is approximated reasonably well by the sum of wages and salaries and personal income receipts on assets. Currently this is running just over $1trn before tax. So raising taxes by 5% on the top 10% of the income distribution would raise just over $50bn it's a decent pot but not a huge one relative to many of the spending proposals that are being discussed. Other revenue raisers are pretty modest.

Asset market implications

The USD and asset market implications of the programs depend on which elements are implemented and what time horizon is examined. In the short term to medium term, the dollar outcomes are bimodal, reflecting two major USD drivers – risk appetite and rate differentials.

1) Trade disruption

a) Full scale trade disruption
Extreme trade disruption is likely to impair production supply lines, profits and equity markets. Paradoxically this could lead to temporarily higher inflation, as a significant disruption in trade would be equivalent to a major supply shock. Most trade is in goods, and low goods prices globally have underpinned the inflation shortfalls in many G10 countries.

Trade disruption would also likely shock GDP downwards, taking profits and equities with it. This would probably induce extremely easy Fed policy. The Fed would ignore inflation initially and focus on boosting aggregate demand. Given that rates are near zero and their leverage would be limited and we would see a quick resort to QE. US Treasuries would be the major asset market winner.

The USD outcome is ambiguous but we lean to stronger versus EM, neutral versus EUR and GBP, and weaker versus Japan. From previous economic downturns, we know that the US trade deficit tends to narrow when growth is impaired. The question is whether a trade war would weaken demand for USD assets. Unlike the 1980s and 1990s, the rest of the world is growing slowly and the trade 'opponents' are far less dynamic now than they were then, Even were there to be strategic selling of US Treasuries by some reserve managers, there are likely to be both domestic and foreign buyers in response. We suspect that USD will be bought against EM. In any event, China and Mexico, most frequently mentioned in trade discussions, have more incentive to buy USD and retain competitiveness rather than sell.

b) Full scale trade disruption plus heavy-duty fiscal

Inflation, inflation, inflation. This is likely to be a very USD friendly outcome for a couple of years, combining aggregate demand with goods price inflation much higher than anything we have encountered in recent years. Investors are likely to focus on the yield curve, making little distinction between real and nominal rates. This would take pressure off the Fed to stimulate demand and would probably lead to rates normalization quicker than any other set of policies. Global investors are so starved for yield that they would probably buy the USD hand over fist, despite the fact that the policies don't add up over the long term. The equities outcome is less clear as both the numerator and denominator in the dividend discount model calculation would be rising and the trade impact on profits would still be there.

The Fed fails in a) as they simply do not have the monetary tools to deal with a major slump. In b) fiscal stimulus – whether by cutting taxes or increasing spending – would be the preferred tool to offset the negative aggregate demand shock – and both Barkis' are willing in this election. This is also likely to generate the investment demand that everyone is longing for. At first glance, this doesn't sound so bad, Throw in some reverse Stolper-Samuelson and you could have pronounced real wage growth at the low end of the wage distribution.

Where does it go wrong? The first issue is that if you disrupt the supply of grapes, the wine you make is likely to be both expensive and mediocre. Everyone might be working and some might be better off in real terms, but the odds are high that a broad swath of goods will become much more expensive. The inflation would be very intense in the short term because business would not be sure that the new trade regime would last, so import-replacing investment would be sluggish. Top line nominal GDP growth would be very strong, as inflation plus fiscal stimulus Fed through, so the equity market response may be more limited, although probably still negative. The yield curve would probably steepen sharply but we could end up with 1970s style inflation.

c) '*Friendly' trade restrictions*

The 1980s and 1990s answer to trade disputes was for foreign countries to come to an agreement to limit exports to the US. These are forbidden under WTO rules but are very attractive politically because they protect market share for domestic producers, while raising prices for both domestic and foreign producers, protecting profits. Consumers lose.

The practicalities of governance may preclude abrogating treaties and slapping on tariffs, but both foreign exporters and US firms competing with foreign exporters may find that such measures are an acceptable compromise. The WTO may turn a blind eye because a full scale trade war carries much worse global implications.

More generically, there may be some compromise measure that appears to deliver on campaign promises, but is not as disruptive in economic or financial markets terms. This is more likely to be viewed as sustainable by business and would have more moderate equity, inflation and rates consequences than cold turkey trade disruption. In this world, inflation would rise, bonds would lose and equity outcomes would be more ambiguous, especially if such 'friendly' restrictions were accompanied by a dose of fiscal expansion.

2) Fiscal stimulus, trade on backburner

a) Spend, no tax; cut taxes, don't fund

Scratch the trade rhetoric and just go for aggregate demand is very USD and asset market positive in the short term. Given how low rates are, it looks like stimulus without pain in the short-medium term whether the funding comes from the market or the Fed. Given how tight the US labor market is already, it is almost certain to generate some domestic inflation pressure but the pressure should rise gradually being largely driven by internal demand tightness. The US rate rise is likely to be held back by low rates abroad, but within G10 and even versus some EM, the US could become a high yielder. So we are likely to see demand pressure reflected in both the USD, nominal and real yields.

In the short term this is a very equity market friendly outcome. It generates topline growth, the Fed is likely to remain accommodating initially, and it does not carry the negative supply baggage that trade disruption carries. The spillover of stimulus abroad is likely to be positive for foreign asset markets as well. It is possible that the USD strengthens against both G10 and EM currencies but USD strength is likely to be most pronounced against G5.

The benign outcome for asset markets would terminate if the Fed every seemed close to declaring victory and raising rates. Pushing up the discount factor would scare investors more than better top line growth would encourage them. We could have a couple of years of really upbeat asset markets initially, while the Fed tolerated an inflation overshoot, followed by a steep fall.

b) Infrastructure and productivity enhancing programs

The Republican pipedream is tax cuts that pay for themselves, the Democrat pipedream is demand stimulus that induces supply side gains. Trump and (especially) Clinton claim that their policies will generate better productivity outcomes than we have seen in recent years.

It seems intuitive that better infrastructure, more private sector investment, better education, better healthcare and worry free child-care will generate long-term and possibly short term productivity literature. The problem is that it is harder than you would think to show that these positive productivity effects exist, however intuitively appealing the logic. The impact of the programs should be divided into three components: 1) the aggregate demand component; 2) the redistribution component and 3) whatever productivity component can be demonstrated. 1) may be desirable on macro grounds and 2) on redistribution grounds, but it may be misleading to justify them on the basis of 3) if there is scant evidence.

In terms of asset market impact, 2a) and 2b) probably do not differ much. If there is a big supply side impact from b) we are likely to see more modest inflation impacts and a larger impact on long term equilibrium rates, particularly over the medium term. The medium equity impact of an upward shift in real growth potential is more clearly positive than from a pure demand shock, and it may mean that the long-term USD is more sustainable than in 2a).

c) Tax, spend and regulate

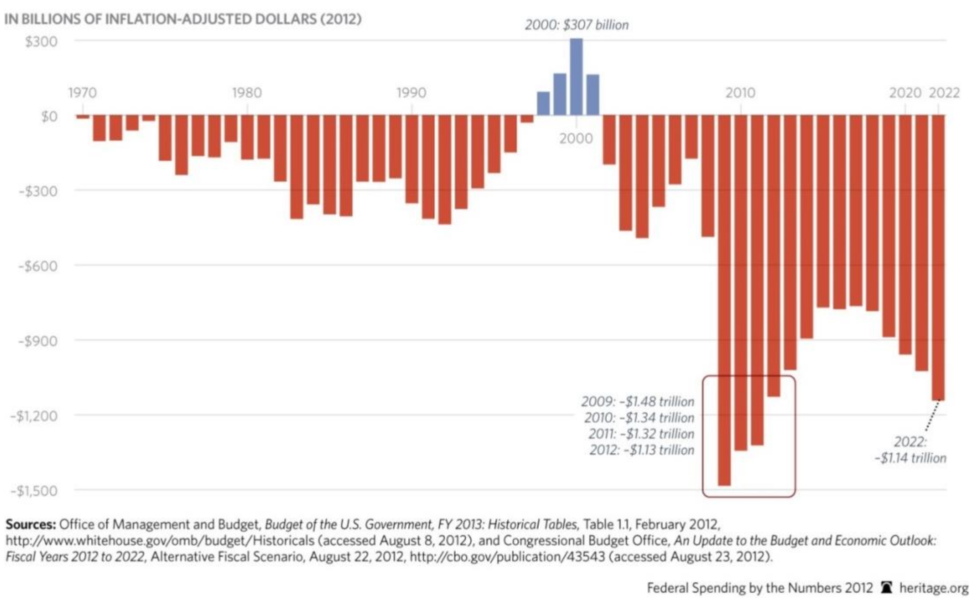
Let's be clear – not all taxes, spending and regulation are bad. But putting a wedge between earned income and spending decisions and regulation that ignores rational cost-benefit analyses have a supply-side cost (just as arbitrary restrictions on trade do). If what we need is aggregate demand, raising taxes to pay for spending is prudent but will not necessarily get us the economic and asset market outcomes that we are looking for.

It is possible that raising corporate and personal income taxes will have a negative impact on demand via the wealth effect that offsets the higher propensity to consume at the low end of the income scale. We would not preclude the possibility that the spending and regulation would be so targeted as to be productivity neutral or positive, but there is also the risk that it is not. Overall, a revenue neutral tax and spend agenda that has damaging productivity effects and puts even more pressure on the Fed could be the most USD negative outcome in the short-term. If anything, private investment could fall further.

d) And what about the debt and the long term?

So far we have been taking the viewpoint that fiscal thrust may be needed, whatever its source. And our conclusions are that in economic and asset market terms the stimulus may offset some of the near negative supply-side implication of aggressive shifts in trade or regulatory policy.

Figure 2. The Federal Budget Is Recording Chronic Deficits



Source: Office of Management and Budget

The impact of greater deficits has been historically mixed for the USD, so we are cautious not to emphasize any universal relationship between deficits and the dollar. The USD rallied aggressively during the first part of the Regan presidency when the deficit was doubled from 1981 to 1983. During Bill Clinton's second administration cutting the deficit to surplus also coincided with broad dollar strength (Figure 2). We can't underestimate the impact the Volker anti-inflationary policies had on the dollar in the early 80s, but it is clear that the deficit on its own is not a reliable guide to the dollar.

It is almost a commonplace to recommend short term fiscal stimulus and long term contraction. What the recent US and Japanese experience has taught us is that the long-term is not your friend, you can't assume that monetary ease can offset fiscal contraction and fiscal contraction may look unattractive in both long and short term. So far global demand for long term assets mean that rates are low enough that high debt ratios are forgiven in G10, although not necessarily in EM.

The IMF has long standing research arguing that increasing fiscal deficits tend to be negative over long horizons, by deterring investment. This is too far forward to be tradable now, but the reserve status of the US dollar is not immune to ultra-loose fiscal policy over the long term. It is a useful thought exercise to ask whether the USD would holds its long-term value with an easy money, easy fiscal combination. In the US case now, there is already a sensitive decade between 2025 and 2035 when the US is hit by demographic shocks and social liabilities (Medicare and Medicaid). Heavier deficits now bring this existing risk forward.

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Technical Strategy –Keep calm, carry's on

- Despite US election risk later in the year, it is our sense that the bar is high to disrupt this risk rally in Equities, LATAM FX and Asia FX (carry trade). This week we summarize some of our thoughts from this week's Weekly Roundup.

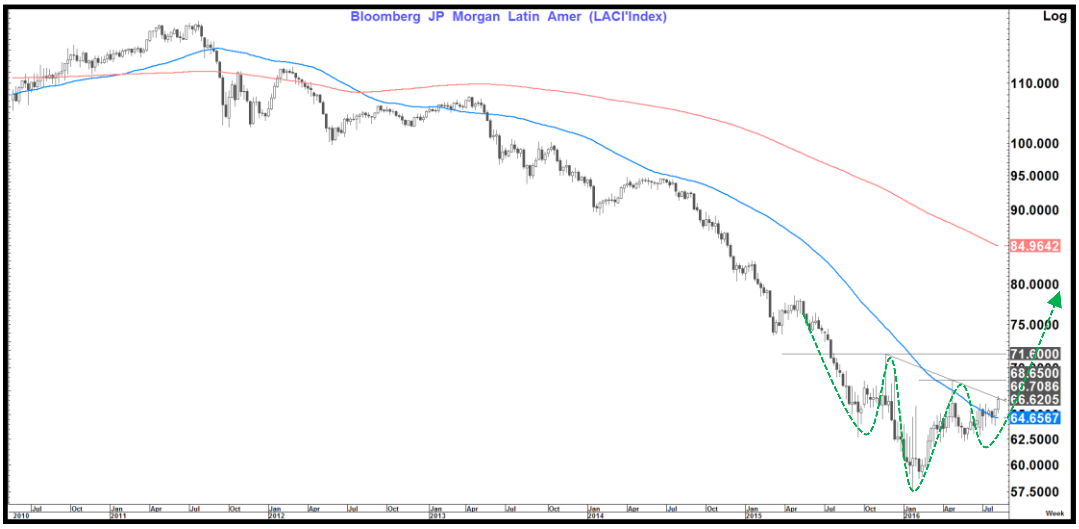
As we have discussed in our Weekly Roundups, we feel as though the pro-risk dynamic has more room to run this year, especially in US Equities and LATAM/Asia FX. Although jitters surrounding the US election cycle may manifest themselves in the coming weeks/months, we feel as though the backdrop for risk should remain constructive. We also feel that given cleaner positioning (after the blowout lows earlier this year) and bearish sentiment, there is a high bar to derail this move in risk.

Figure 1. S&P 500

Source: Aspen graphics/Bloomberg; August 11, 2016.

Nothing says 'the trend is your friend' like the post-crisis chart of the S&P 500. Although a lot may have been 'priced in' during the QE3 "risk-on" rally, price action from late 2014 to early 2016 appears at this point to have been simply part of a consolidation within the broader uptrend. Around this time last year we were concerned about a correction in US Equities given the 55-200 week moving average setup possibly in play (given that it was already developing on the Transports Index). The S&P 500 low in February was just shy of the 200 week moving average (not shown) and the Index has rallied since then despite the recent correction in Oil, despite concern surrounding European banks and despite the June Brexit. We feel as though bearish sentiment (expressed perhaps via outright short structures) and hesitance (with regard to buying all-time highs) has contributed to the push higher, in addition to sound US fundamentals and a dovish Fed. Considering the shocks the market has been able to withstand over the last 12 months (yesterday is one year since the 'China deval'), a US election seems as though it is a 'drop in the bucket.' Nevertheless, we would not be surprised to see jitters exaggerated, further feeding into a bearish narrative that has been fighting the trend since February to no avail. (Read more about the setups and levels across US Equity markets in our July 14 Weekly Roundup.). It remains our view that this could culminate in a move to the mid to high 2,300's in the S&P before year end.

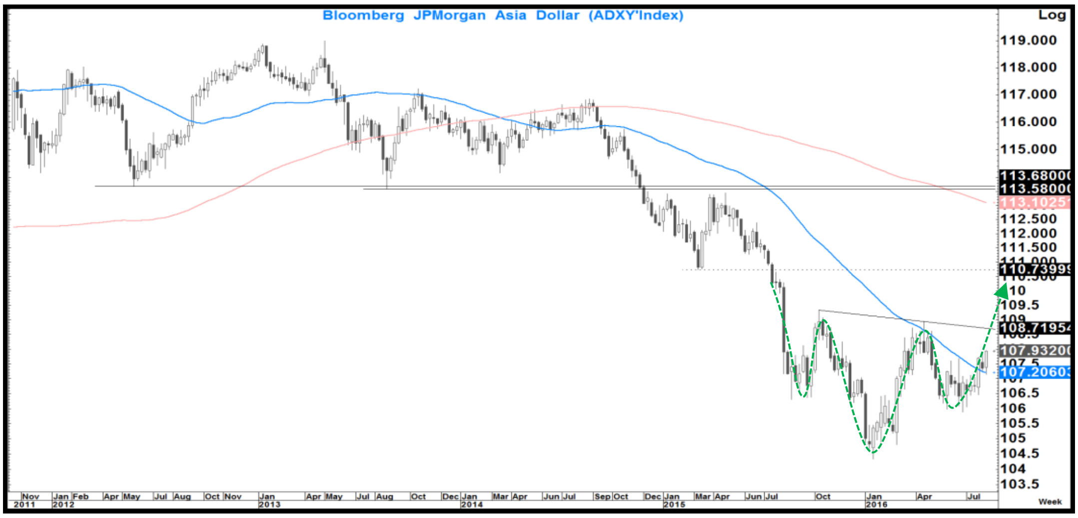
Figure 2. LACI Index (Latin American Currency Index)



Source: Aspen graphics/Bloomberg; August 11, 2016.

There is market concern that one candidate in particular may be a negative shock to one particular country (and perhaps region). With the LACI (LATAM) Index trading 25% below its 2009 crisis low, with blowout lows having occurred in the LACI Index and Commodities, and with Commodities basing well, we would reference The Roots in asking: **Do You Want More?!!!??!**. In other words, a lot of 'bad' has been already priced in. Meanwhile, the Technical pattern could not be more constructive with an inverse head and shoulders pattern and a 55-200 week moving average dynamic that suggests, on a weekly close above 66.71, an acceleration towards the 200 week moving average at 85 (moving target).

Figure 3. ADXY Index (Asia Currency Index)



Source: Aspen graphics/Bloomberg; August 11, 2016.

A very similar setup is in play on the ADXY Index with an inverse head and shoulders pattern (confirmed on a weekly close above 108.72) and a 55-200 week moving average dynamic. This pattern is also being seen in Local Market Equities (MXEF Index) and we believe that confirmed breakout is leading the move here. What is dragging the ADXY Index down in the medium-term is CNY (41.8% of the Index), but a weaker USD/G10 (on what feels like anchored Fed dovishness) should serve CNH and CNY well vs. the USD as it is 'managed' on a basket basis. (Read more about the setups and levels across Equities, LATAM FX and Asia FX in our August 11 Weekly Roundup).

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Quant – Short AUD Is the G10 FX "Trump Hedge"

- We find that AUDUSD has the most consistent negative relationship with Trump support relative to Clinton in opinion polls. Evidence on other currencies is more mixed with contemporaneous correlations coming in weak or positive and lagged correlations predominantly negative.
- No clear 'safe' currencies emerge in case of a Trump victory. The results for JPY are in line with other, more risk-sensitive currencies and evidence on USD is mixed.

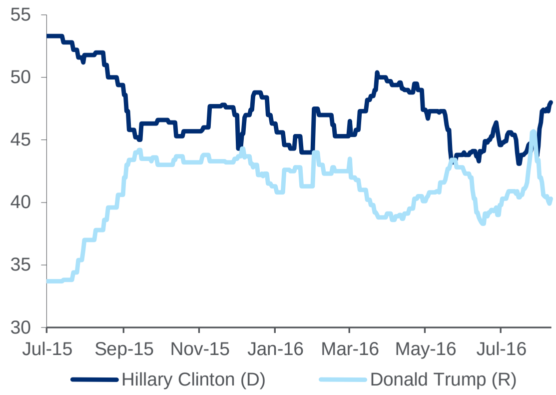
Citi Research have on several occasions written about the impact of the US presidential election on emerging markets, concluding in their most recent 28 July 2016 piece Emerging Markets and Trump that a "stronger USD, weaker equities, weaker commodities, and an unclear direction of US Treasuries" is their global base case for a Trump presidency. Mexico and most of Asia would be most negatively impacted, while the effect on Russia might be positive.

In this article we look at the possible impact of the two presidential candidates on G10 currencies from a quantitative perspective by studying their sensitivity to US opinion polls. Due to the large number of individual polls we rely on the aggregated data from Real Clear Politics, which is also available via Bloomberg function {BI ELEC <GO>}.

Figure 1 below shows the most recent output from opinion polls, pointing to a 7.7 percentage point advantage of Clinton vs Trump. The spread has widened after the Democratic National Convention, but with just under three months to go until the election, it is premature to assume that a Clinton victory is a foregone conclusion based on current polls. On 23 March 2016 the spread stood 11.4 percentage points in Clinton's favour, but less than nine weeks later, on 22 May 2016 Trump was ahead by 0.2 points.

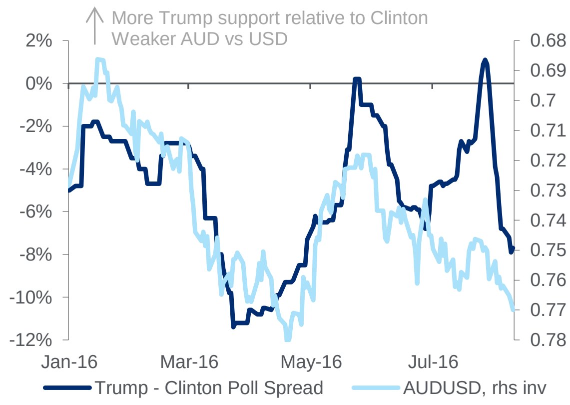
Figure 2 shows the spread between Trump and Clinton poll spread and AUDUSD spot year-to-date, suggesting that the two have moved inversely proportional to each other (the scale for AUDUSD is inverted). When Trump has gained support over Clinton, AUD has weakened on average and vice a versa. The relationship has lost some of its magnitude during the past couple of weeks' of poll swings, but directionally still holds.

Figure 1. Poll Average: Clinton vs Trump



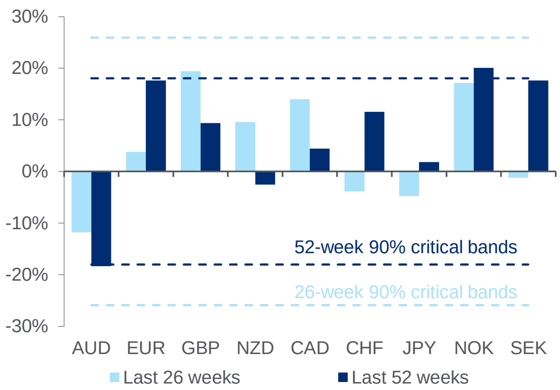
Source: Real Clear Politics, Sample: 1-Jul-15 – 10-Aug-16

Figure 2. AUDUSD vs Poll Spread



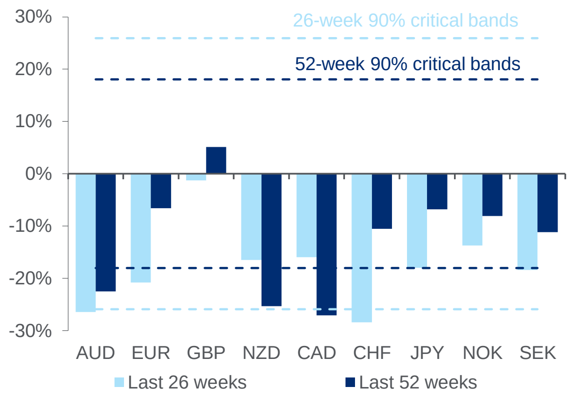
Source: Bloomberg, RCP, Sample: 1-Jan-16 – 10-Aug-16

Figure 3. FX Correlation with Trump Clinton Poll Spread (USD crosses, weekly changes, contemporaneous)



Source: Citi, As of: 5-Aug-16

Figure 4. FX Correlation with Trump Clinton Poll Spread (USD crosses, weekly changes, polls lagged by 1 week)



Source: Citi, As of: 5-Aug-16

Figure 3 and Figure 4 show currency correlations with the poll spread. In order to avoid potential spuriousness introduced by common trends, we correlate weekly changes rather than levels. We think a weekly frequency is more appropriate, because there aren't new polls every day and in any case with elections still several months away, we think markets are more likely to respond to trends in polls in the more medium term rather than trade each release intraday.

The choice of weekly frequency restricts our look-back windows to six months and one year, as it would be difficult to interpret the statistical significance of results obtained from less than 26 data points.

Figure 3 shows the results of contemporaneous correlations. AUDUSD stands out as the only currency with a negative correlation to Trump-Clinton spread. The results for the past 26 weeks fall far short of the 90% significance critical threshold, but the 52-week negative correlation is significantly different from zero.

Contemporaneous correlations for other currencies tend to be positive on average. This suggests that USD has on average suffered from increasing Trump support relative to Clinton, raising questions about the status of USD as a safe haven in case of a risk aversion spike on Trump victory.

However, when we lag polls by one week relative to currency moves, a different and more consistent picture emerges. AUDUSD still shows the most consistent negative correlations with both 26 and 52-week look-back windows producing results in excess of the 90% confidence band. With the exception of GBP which has reacted more to Brexit than US polls recently, all other currencies also report negative correlations to Trump-Clinton spread.

Interestingly, JPY doesn't shows up as a clear Trump 'safe haven' in either Figure 3 or Figure 4, suggesting that the Trump effect in currencies doesn't yet extend beyond a few select high-beta currencies or that markets are uncertain about what a Trump victory might mean for Japan in the context of possible trade frictions and a weaker security arrangement for Asia.

Evidence on USD is mildly balanced towards strength in case of a Trump victory, mostly because we attach more importance to the lagged results of Figure 4. As the election date approaches, markets will start paying more attention to polls and a clearer picture of sensitivities will likely emerge.

CitiFX Quant Headlines

FX Positioning Indicator (link to latest update)

- Active FX traders remain solidly long USD on balance, with the indicator rising further from +1.75 to +2, indicating exposure at 200% of the medium-term average, over the last week. Elsewhere in G10 short positioning collapsed in AUD and SEK, both from fairly large exposures to neutral as of Tuesday's close. At the same time, managers are committing capital to short CAD and EUR, driving the indicators to -1.25 and -2 respectively.

- In EM fund managers put on additional risk long LATAM, particularly in PEN and MXN. Thematically, positioning favors high yield and EM, with managers moderately net long (+0.5 each) both categories.

Economic Surprise Index (CitiVelocity page and Bloomberg **ALLX CESI** <GO>)

- The US index remains positive but the uptrend has stalled, and the index is roughly unchanged on the week at +16.8 versus +17.8 last week, with few large surprises since last week's NFP. The Canada index fell 24.8 points on the week, from +27.9 to +3.1, with poor housing data today continuing the negative trend that started on Friday with very disappointing jobs data.

- The Latama and Cemeea indices in EM are largely unchanged on the week, while the Asia index continues an upward trend, rising to +23.5 from +11.2 one week earlier. The uptrend this week was supported most strongly by very strong prints in IP and exports in Malaysia. This has led to a sustained break of the aggregate EM index into positive territory, where it now sits at +6.4.

Commodity Terms of Trade (CitiVelocity page and Bloomberg **ALLX CTOT** <GO>)

- Divergence in energy has had a mixed impact on commodity exporters. A bounce in oil combined with weak natural gas and gasoline imports has benefited BRL and COP while weakening the terms of trade for NOK and RUB. Base metals and coal outperformed precious metals, benefiting AUD and ZAR on the whole and causing the index for PEN to fall on the week.

Macro Risk Index (CitiVelocity page and Bloomberg **ALLX MRI** <GO>)

- The long-term macro risk index now sits at 40.7%, stabilizing below the neutral threshold of 50% and signaling improving risk sentiment globally. TED spreads and swaption volatilities continue to indicate stress, while VIX and EM spreads near lows for the year most strongly favor risk-on.

Risk Flow Indicator (link to live update and download)

- The EM risk flow indicator is neutral while the G10 indicator has stalled in negative territory, signaling steady net selling of high-risk currencies in the region. In G10 there have been large outflows from AUD and CAD, while in EM hedge funds have been buying SGD, IDR, and RON while selling PEN, CLP, MYR, and INR.

Summary of recent CitiFX Quant publications:

FX Positioning Indicator: Building MXN Shorts	11 Aug 2016
FX Global Scorecard Update: Long APAC, Short G4	2 Aug 2016
Early Warning Signal: August 2016 Update	1 Aug 2016
Alert: Drivers of US Economic Surprise Index Rise	28 July 2016
In Focus: Economic Data – Surprising Before Release?	14 July 2016

This week's highlights

Retail sales preview -- internet sales the special factor – Link

The initial market reaction on strength would probably be fear, loathing and across the board USD buying. Investors have been trading on the view that there is no good news that will shake the FOMC off its no-hike course, and September is now priced at 10-15%. A fourth strong retail number in a row and the markets Fed complacency will begin to waver a bit.

Steve Englander

RBNZ unlikely to deter NZD buying – Link

NZD is likely to hold on to its gains since the RBNZ didn't hit enough dovish notes to surprise relative to dovish market lean. More importantly, the RBNZ may have been dovish on an absolute basis, but the moves fail to go beyond 'business as usual' so they are unlikely to be sufficient to upset the recent pattern of NZD buying on the basis of global macro factors. The Bank cut by only 25bps not 50 bps. The language on the exchange rate was largely unchanged, stopping short of the language that is typically used to signal risk of outright intervention. The assessment of the domestic economy is fairly benign, with ongoing focus on housing and the need to determine the impact of macroprudential measures. The guidance is negative, but the RBNZ again adds a minor qualification mirroring that seen in the recent updated economic assessment. The downgrade of the bank bill fails to go beyond market pricing.

Todd Elmer

Implied vol back to pre-SNB levels… – Link

Implied vol for short tenors (1-month, light blue) is where it was before the SNB move in January 2015. 3-month vol is slightly higher but nothing that suggests any concern about shocks or risk. The VIX is at the lows of 2016. This explains why we are seeing equities, high-beta G10 and EM currencies rally. we have low vol, intentionally provided and rising asset markets and, for now, investors lazily buying risk.

Steve Englander

Strong NOK – Stick with it? Yes but… – Link

High inflation and better survey data has raised the question – have we seen the end of the Norges Bank easing cycle? Real rates look too low. Less dovish makes sense, but December is still live. Oil prices and higher NOK bank funding costs represent an important counter. We see EURNOK lower but would be cautious chasing the latest leg down. A bounce in oil and a less dovish Norges Bank (Sept 22) is required for the fundamentals to keep pace with FX.

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Week ahead – US/CA/UK CPI, UK/AU/NZ Jobs, FOMC/ECB/RBA minutes

North America

The highlight of next week will be squarely on the CPI release on Tuesday and the July FOMC minutes. Headline CPI is expected to slow to 0.9% YoY from 1.0% in June. Core CPI however is expected to print 2.3% YoY for the second consecutive month. We don't see this as shifting expectation on the Fed and thus do not consider this a market moving event, barring any surprise. The Fedspeak calendar is fairly busy next week. Wednesday, July FOMC meeting minutes released which should provide clarity on the "data dependence" aspect of 2016 hike. Lockhart (Tues), Bullard (Weds), Dudley (Thurs) and Williams (Thurs) will make appearance next week. Of the four Bullard and Dudley will be most important. Second tier data next week includes Housing starts/Building permits and Industrial Production number on Tuesday. Both see slightly downward forecasts for July.

In Canada, attention is on Friday's retail sales (MoM 0.8% e, 0.2% p) and CPI number (YoY 1.5% e, 1.5% p). After last week's disappointing trade number and unemployment rate, next week's data provides insights on Canada economy and any surprises will likely drive CAD movement. Manufacturing sales is released on Tuesday, with forecast (0.7%) higher than June print (-1%).

Ran Ren

Europe

Slightly more data pads next week in Europe with some key release in the UK and the ECB minutes.

Jobs, inflation and retail sales numbers in the UK will give some update on where the economy is over June/July. Still, it is just CPI which gives a full post Brexit sample and we don't expect that real data (retail sales and jobs) will show much of a shock yet. In fact, the more headline jobs figures are for June. With this in mind, GBP reactions to the data may not stick. Instead we suspect GBPUSD to remain heavy and for rallies to be sold.

ECB minutes seem unlikely to excite but color on Brexit discussions and/or scope to change asset purchases will be the highlight. We lean short EUR. Finally, the ZEW and trade numbers out of Norway should be largely irrelevant for markets.

Josh O'Byrne

Asia

The coming week sees few major events in Australia and NZ. At the height of the northern hemisphere summer this may see relatively quiet trade and it strongly suggests that external factors will continue to dominate price action. Amid G4 central bank dovishness and broad yield seeking, this should spell continued upward drift from AUD and NZD. The RBA releases the Minutes to its latest policy meeting. We doubt they will bring major surprises and are likely to reinforce the central bank's relaxed tone. Employment data due later in the week shows high propensity to surprise, but even a slip would do little to reverse what has been a strong trend. The back and forth on a month to month basis is unlikely to prove a lasting driver for

AUD. NZ also releases employment data. NZD selling has begun to reverse following the not dovish enough RBNZ statement, but there may be further room for an unwind of shorts to run. This could boost sensitivity relative to that seen for the Australian data. Strength would reinforce the view that the RBNZ only has limited flexibility to combat currency strength given strong underlying conditions. This would be NZD supportive insomuch as it limits the risk that domestic developments will disrupt the positive, externally motivated trend.

Next week in Japan Q2 GDP (8/14) and Trade data for the month of July (8/17) will be the highlights. Median expectations for real GDP growth is 0.7% QoQ annualized following a 1.9% rise in Q1. Weaker growth should lend support to USDJPY as it will build expectations for BoJ to add further stimulus. A stronger than expected number however should weigh on USDJPY pushing it closer to the 100 level.

Todd Elmer, Kiranpal Singh

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