Sucden Financial

FX Monthly Report

September 2021

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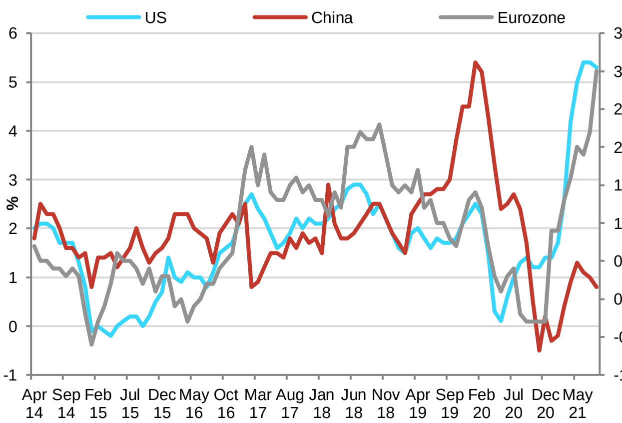
Inflation, Bonds & Precious Metals

The Fed has signalled that they could start to taper bond purchases at the end of this year. However, they are in no rush and have long said they need to see further economic progress before tapering bond purchases. , one of the critical aspects of this will be the labour market, which has continued to strengthen; the number of job openings was 10.9m in July. Hires and total separations remained steady at 6.7m and 5.8m, respectively. Job openings exceed the number of unemployed, which should increase the employment rate in the coming months. We continue to see hiring in the sluggish leisure and hospitality sectors, with hiring at 1.8m, 750k above pre-pandemic levels. The average hourly earnings have increased by 4.3% Y/Y in August, and the M/M growth was 0.6% in August. The 3month wage tracker increased 4.4% Y/Y, which is the strongest reading since June 2008.

Wage growth is currently concentrated in lower-income jobs. We expect to see inflation from the labour market and inputs in the coming months. The labour market report has eased some of the hawkish Fed member's concerns about tapering this year. In our view, we will not hear about when the Fed will announce tapering until November. However, it will be decided internally before then. Ceteris Paribus, the Fed will taper in December: risks to this are the delta variant and higher inflation. The key is the rate at which they reduce asset purchases and when they finish and reach 0.

US, China, and Eurozone CPI

CPI has rallied in the U.S. and Eurozone but remains subdued in China.



Source: Bloomberg

CPI was 5.3% Y/Y, moderately lower than the previous month's reading at 5.4% Y/Y. The M/M reading showed a CPI gain of 0.3%, inflationary pressure is prevalent, and we do not expect them to fall sharply in the near term. This is due to the supply-side costs that have dictated the market in recent months. According to the Fed's Beige Book, high input prices remain widespread, with most districts highlighting escalating prices for metals, metals-based products, freight and transportation services, and construction materials. Districts emphasised that businesses anticipated significant hikes in prices. Raw material prices are still elevated, even though lumber prices have declined, metals prices have held firm, and supply chain bottlenecks continue to prevent manufactures and producers from obtaining profit. We expect M/M CPI gains to moderate following the smallest monthly gain in CPI in seven months, but Y/Y figures will hold steady. Consumer prices have undoubtedly risen, and governments have started to increase taxes.

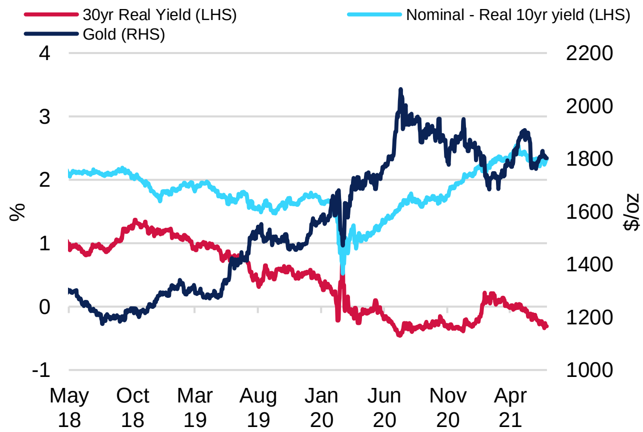
On June 19th, 2013, the Fed announced that they would taper their bond purchasing, and they maintained their upper federal fund target rate – upper bound at 0.25%; what followed was the taper tantrum.

- This caused equities to rally 31% in 2013. After the announcement, the performance saw equities decline 5.6% between June 18th and 24th; for the remainder of the year, equities rallied +18.5%.
- The dollar rallied in H1 2013 by 4.6% to June 14th. The market peaked in July at 6.42% YTD. However, from the remainder of the year dollar suffered, closing the year +0.95%.
- The 10yr yield was volatile in the first six months of 2013, with yields rising from 1.68% in January to 2.07% in March, then falling to 1.61% in May. From this point, yields surged to close the year at 3.02%.
- Gold was significantly weaker in 2013, falling 28%. In H1 2013, bullion declined 17% and then the remainder in H2 2013 following tapering by the Fed. However, gold rallied in Q1 2014 as bonds rallied and S&P 500 also firmed – traditionally unusual.

We do not expect a taper tantrum this time around as the central banks will not allow a hard landing. What is different this time? We do not expect a taper tantrum or a hard landing. The dollar has traded as a safe haven. Higher food and goods prices will cap consumer spending as disposal income declines and governments start to amend their taxation to recuperate COVID-19 borrowing.

US 30yr Real Yield vs Nominal – Real 10yr Yield vs Gold

Gold has rallied with the real 10yr yield but the 30yr yield continues to fall.



Source: Bloomberg

The dollar has stabilised, with the index consolidating around 92.472 at the time of writing. There is little conviction in the market, but the dollar stability has not been good for gold. Our house view on the dollar is neutral for the remainder of 2021. For 2022 there are two main scenarios, both on the assumption that inflation will moderate in 2022:

Scenario 1:

The tapering of asset purchases from the U.S. and Q.E. in the U.K. causes a selloff in bonds and yields to rise. Initially, this will keep funds in cash equities; however, as borrowing costs rise and yields improve, this could see a rotation of funds from equities into bonds.

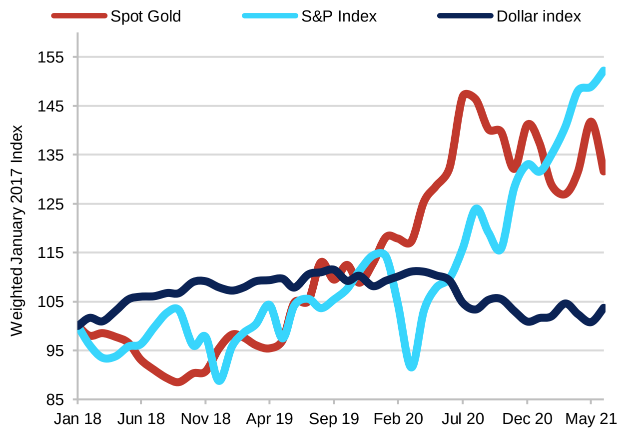
Central banks will not allow a hard landing, but economic data in the U.S. should remain strong, boosting the dollar, in turn providing headwinds to the dollar. Reducing liquidity in the bond and equity market could prompt some speculators to hedge against inflation and the uncertainty surrounding a smooth transition away from Q.E. and asset purchases to a more 'normal' monetary policy, but gold gains may be limited.

Scenario 2:

Tapering asset purchases from the U.S. and Q.E. in the U.K. causes a selloff in bonds, and yields rise. The rate at which investments decline is slow, and this supports cash equities in 2022, products continue to rise, and bonds fall as fund managers continue to hold money in cash equities as credit remains cheap and share buy-backs also support the market. Gold as a non-yielding asset is likely to suffer as dividends and returns from the equity market outweigh the opportunity cost of holding gold. We could see some speculators hedge against inflation by purchasing gold in this scenario, but once again, the dollar has traded as a safe haven in recent years, capping gold's gains.

USD Index vs S&P 500 vs Spot Gold (Index Jan 2018)

Gold prices have started to falter but the S&P 500 continues to rally.



Source: Bloomberg

While previous performance is not a direct indicator of what will happen in the coming months, it may indicate sentiment and trading psychology. We expect bonds to sell off and yields to rise, indeed with the Fed indicating that tapering does not signal interest rate hikes, the probability of equities falling declines as the Fed will not allow a hard landing. As a result, it seems the headwinds are stacking up for gold in the medium to longer-term, given the above analysis. All known ETF holdings have been stable for gold this year, indicating limited speculative activity; we expect this to remain the case in the coming months as we move into the tapering territory.

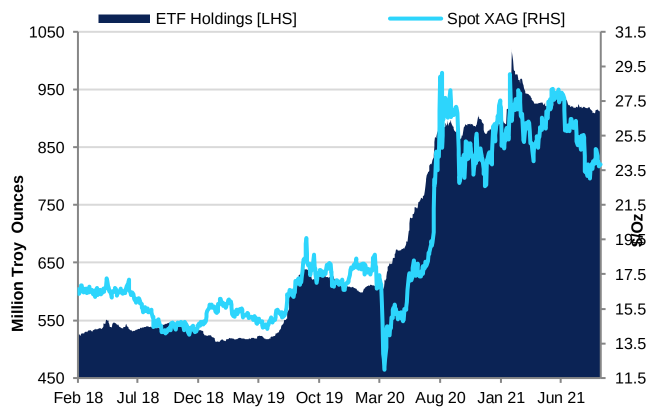
A boon for gold has been strong jewellery demand from China, with consumption in H1 2021 was up 122% at 338t. The survey from the World Gold Council will indicate that consumption of gold products is robust, heritage gold jewellery products have improved, the per-gram pricing model is returning, more consumption through social media channels suggesting a younger consuming demographic. We also saw Indian gold imports increase by 90% Y/Y in August to 118t, the highest level since 2015. This indicates that gold demand is strengthening; this is in conjunction with central bank net purchases also considerably stronger in Q2 2021 at 199.86 tonnes, up from 133.29 tonnes in Q1. World Gold Council Jewellery demand data indicates global consumption was significantly higher in Q2 at 390.7 tonnes, up 60% Y/Y. However, there is still some way to go as H1 2021 demand was 17% lower than the 2015-2019 H1 averages.

Silver

Silver has a better beta than gold but has underperformed as a safe haven asset in recent years. The beta for silver is above 1 for more extended periods (weekly, monthly, and quarterly). Approximately 50% of silver's demand comes from industrials, which clouds the performance, as retail investors found at the beginning of the year as producers sold into that rally heavily. Following this spike in interest from speculators when all known ETF holdings reached 1.021bn ounces, ETF holdings have declined to 909.386m ounces as spec interest has dried up. Due to its industrial properties and relative cheapness compared to gold should suggest silver outperforms gold.

Silver Known ETF Holdings vs Spot

Gold has rallied with the real 10yr yield but the 30yr yield continues to fall.



Source: Bloomberg

View

We expect gold to suffer in the near term and hold a bearish view on in the coming months. However, with the Fed's timeline far from certain, the speed at which central banks pulled back asset purchases is integral for the performance of gold in 2022. We expect investors may favour holding other assets over gold, such as cash equities initially. Not until yields rise, and the opportunity cost of holding cash equities is less than bonds will fund managers reallocate capital. Precious metals may play second fiddle if inflation is subdued, which it may do consumer spending declines and cost push inflation moderates. We expect supply-chain bottlenecks to ease in 2022. Prices of goods and services have risen and reduced disposable income, and this could weaken retail investors activity in financial markets going forward. We expect consumer purse strings to tighten and the demand-pull side of the inflation equation to ease; admittedly, inflation in recent months has been cost-push. While we have a neutral view on the dollar, we see the probability of the currency moving higher greater than the index declining significantly further.

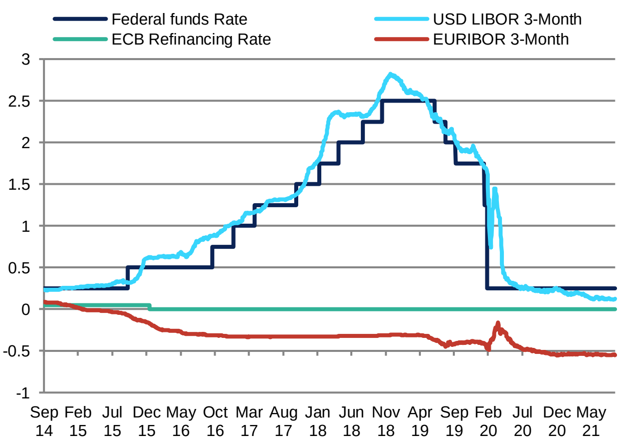
Euro Desk Comments

EURUSD is trading around the same range as it was over a year ago which is surprising given the divergences in monetary policy paths formed between the two countries and the better economic recovery and growth in the US.

ECB did reduce the pace of PEPP purchases during the last meeting but Lagard insisted this was recalibration rather than tapering. Despite the improvements in the Eurozone economy and recent spike in inflation above their 2% target (likely to be a temporary spike), monetary policy will remain accommodating with ECB persisting with QE into the end of next year, a stark contrast to the Fed. We expect the Eurozone to be of the last to raise rates from the majors and will continue to be used as a funding currency like the JPY. The desk expects the Euro to gradually drift lower till the end of the year followed by a prominent move lower in 2022. Worth keeping an eye on the German election end of this month, a left-wing shift will likely be supportive of the euro as it would allow for a more expansionary fiscal policy.

Fed & ECB rates vs LIBOR & EURIBOR 3-month

Developed economies' yields continued to decline, with real yields touching record lows.



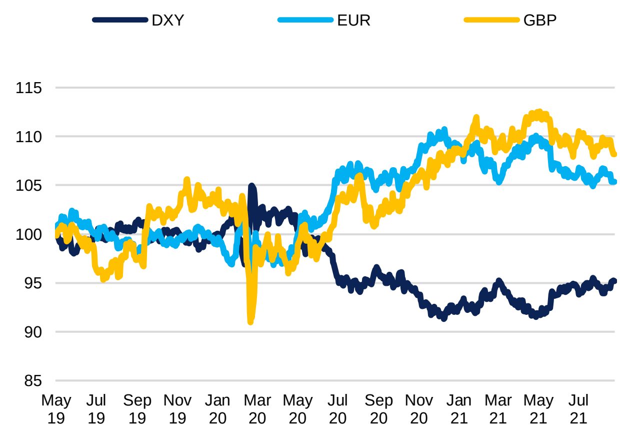
Source: Bloomberg

USD Desk Comments

The Fed indicated in August tapering will not necessarily lead to rate hikes, leading to a bout of USD weakness. However, through September the USD has been somewhat rangebound until the news of a potential default by Chinese property developer Evergrande Group sent fear among investors of a contagion effect as they looked to the safe-haven of the USD, lifting vol from their sombre. In addition, the Fed meet again this Wednesday and we expect the event to add even more impetus to FX markets after a period of low vol. Market participants will be looking for indications on when they are likely to begin tapering and any changes to Fed's dot plots. We believe tapering will begin in November (in line with consensus) but given the recent timid Labour market growth data and inflation numbers we expect tapering to be at a slower pace, therefore we expect no change in the dot plots for 2022/23 during this meeting. We expect the USD to continue trading in a broad range till end of year, before a stronger appreciation cycle develops; especially against high beta ccy's.

The Dollar vs Euro vs Pound

Both Euro and the Pound weakened against a stronger Dollar.



Source: Bloomberg

GBP Desk Comments

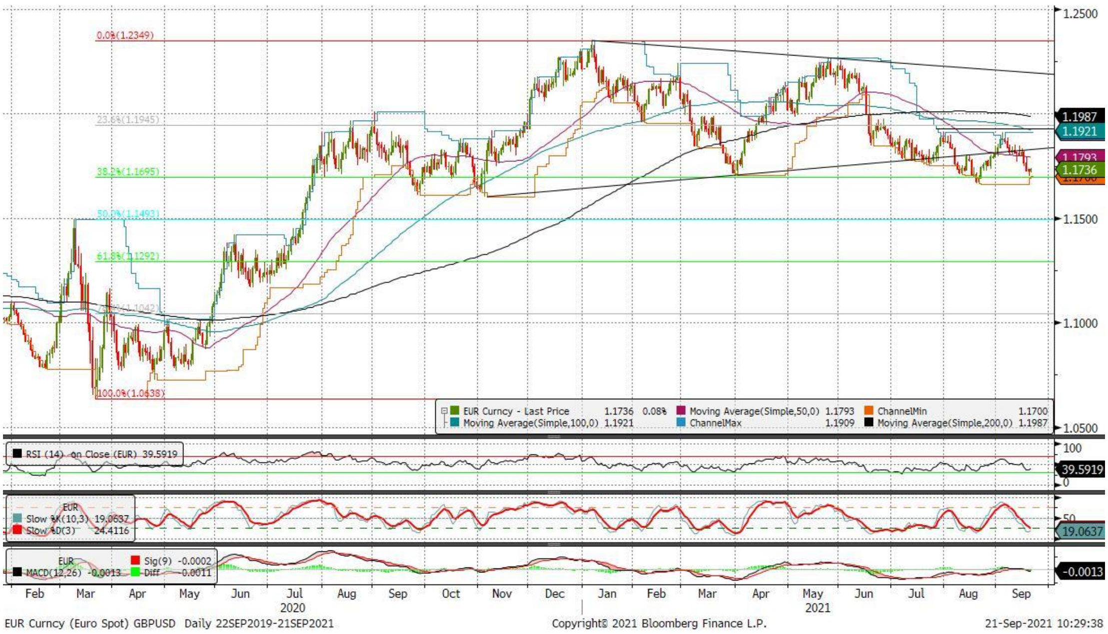
GBP has been on the back foot lately down 4.2% from the highs in June as an increase in taxes and energy price rises threatens to lead to a decline in real incomes and hurt consumer and business confidence. Despite the economy fully opening, this is likely to lead to slower than expected growth momentum. However, with inflation surging to its fastest pace in 20 years, BoE will have no choice but to raise rates sooner which should provide GBP with some stability. Our core view is for a stronger pound next 6-12 months amid expectations of the BOE reacting sooner than their counterparts and an increase in foreign investment will help provide support for sterling. However, there are serious risks to this narrative if supply disruptions persist and higher than expected inflation could leave the UK economy in a period of stagflation.

Technical Analysis

GBPUSD

GBPUSD has been consolidating between 1.4 and 1.3572 after finding support at 23.6% fib level. We could now see a period of consolidation between 1.35 and 1.43. Within this range a triangle pattern has formed, and break could indicate which level will be tested first in the consolidation range. On the upside, a break above resistance @ 1.43 (50% fib of the move from 03/16 to 03/20) and at 1.4382 (High from April 2018) will lead to the next leg higher towards 61.8% fib / 1.50 psychological level. This view remains intact while downside support @ 1.35 holds. A sustained close below 1.35 would lead to a larger pullback to 1.32/1.3165 (38.2% fib).

EURUSD



EURUSD tested and failed to break 1.1909 high from 30th July, after failing to make a sustained close below our level @ 1.1702. Our biases remain to the downside after EURUSD broke the downside of the triangle / neckline of the of head and shoulder pattern. On the downside we expect market to test support at 1.16 and 1.15. A close below 1.15 could pave way for a deeper correction to 1.1292 which would also be the target area from the Head and shoulders patterns. On the upside, a close above 1.1909 could see market test the down trend.

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This report drills down into the detail of the coffee market and is produced three times a year, we also produce shorter more concise updates. We undertake a macroeconomic assessment of major consuming and producing regions before analysing the recent earnings reports from Starbucks, Nestle, Luckin Coffee, Dunkin Donuts, and Costa. This helps us highlight new sales and marketing techniques and any consumption changes, which has been particularly popular during COVID-19. The largest chunk of this report is where we assess the Supply and Demand outlook using our primary data for the coffee market and where we apply our fundamental models. We showcase our crop forecasts and highlight any changes before providing prices forecasts and trading strategies with futures and options.

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