CURRENCY CURRENTS
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BLACKSWAN

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Quotable
"There is no danger of the public ever finding any key to the secrets of winning. The crazy gambling urge and speculative hysteria makes that a certainty. But if the public play ever did get wise to the facts of life, the principle of ever-changing cycles would move the form away from the public immediately."

--Robert Bacon, *Secrets of Professional Turf Betting*

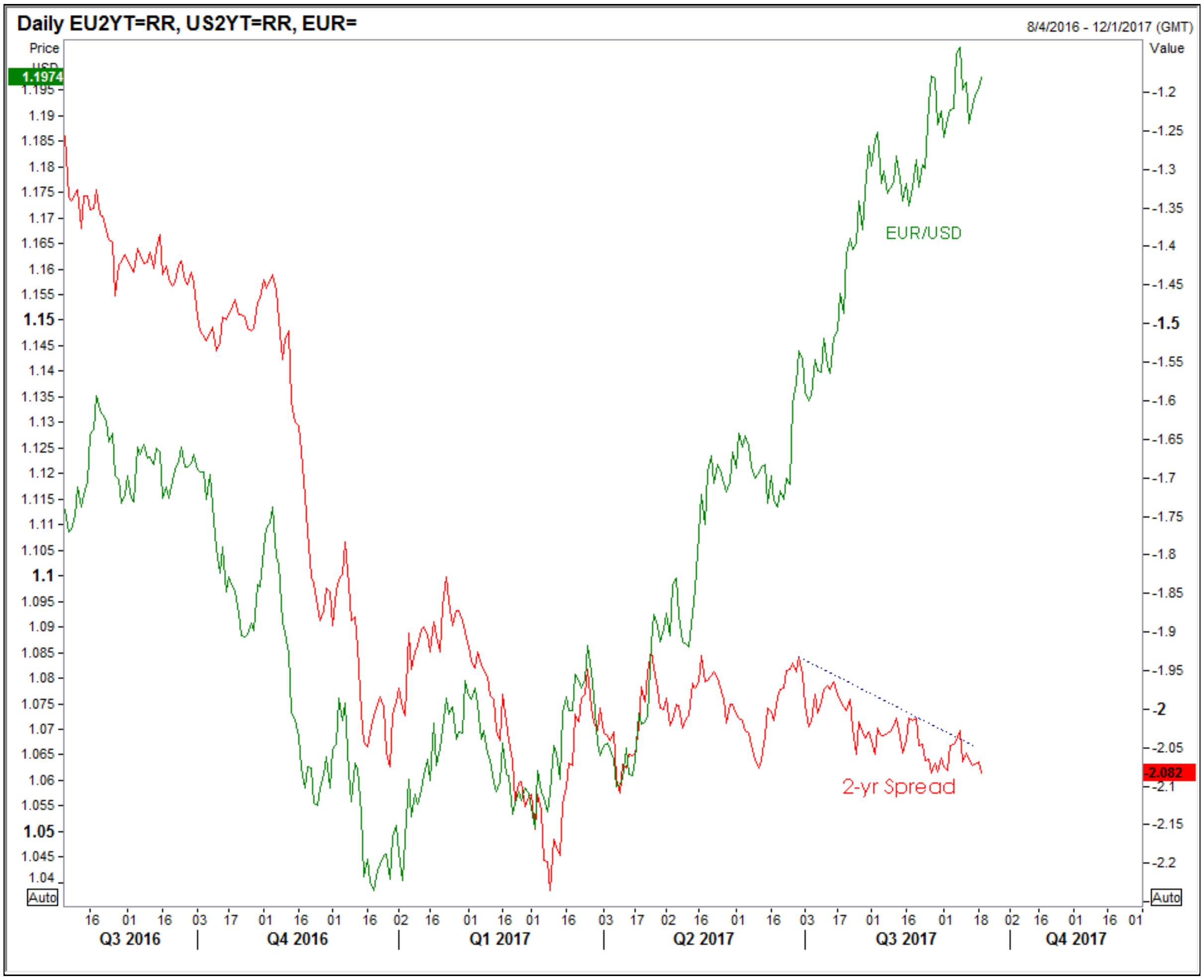
Commentary & Analysis
Three scenarios in front of the Fed and horses to ride…

As I sit in my office here in southeast Florida, I wait impatiently for the arrival of two pending storms—hurricane Maria (hoping the forecasts are correct this time) and Janet (aka the Federal Open Market Committee interest rate decision tomorrow). Below are our three best guesses of what the Fed will do (couched as plausible scenarios) and associated currency trade ideas.

1. **A 25-basis point hike—a surprise!** From a currency perspective, it would most likely lead to a sharp rally in the US dollar.

Our favorite horse to ride under this scenario would be short EUR/USD. Rationale? Lots of positioning already long the euro based on: An expectation the European Central Bank is going to play catchup on interest rates given the improvement in the Eurozone economic fortunes.

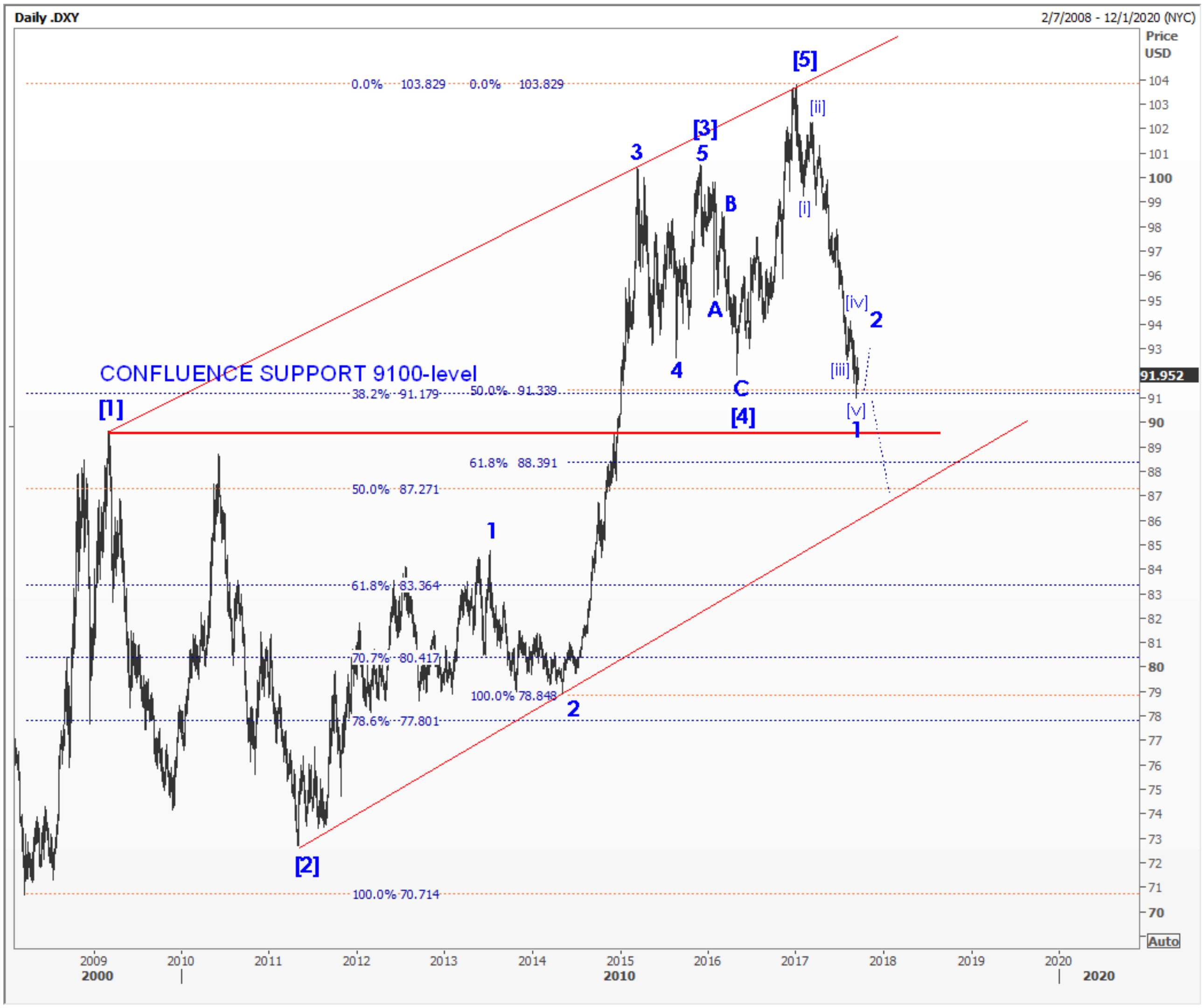
But what is interesting is the fact **despite these improved sentiments for the eurozone and the euro currency, the spread between the EU and US is still very much in favor of the United States** and there is a huge divergence between the once correlated two-year rate spread and EUR/USD currency pair, as you can see clearly in the chart below. *[Most analysts have written off any chance of a Fed hike tomorrow—most analysts wrote off the chances of the Bank of Canada hiking rates on September 6th, only to be surprised.]*



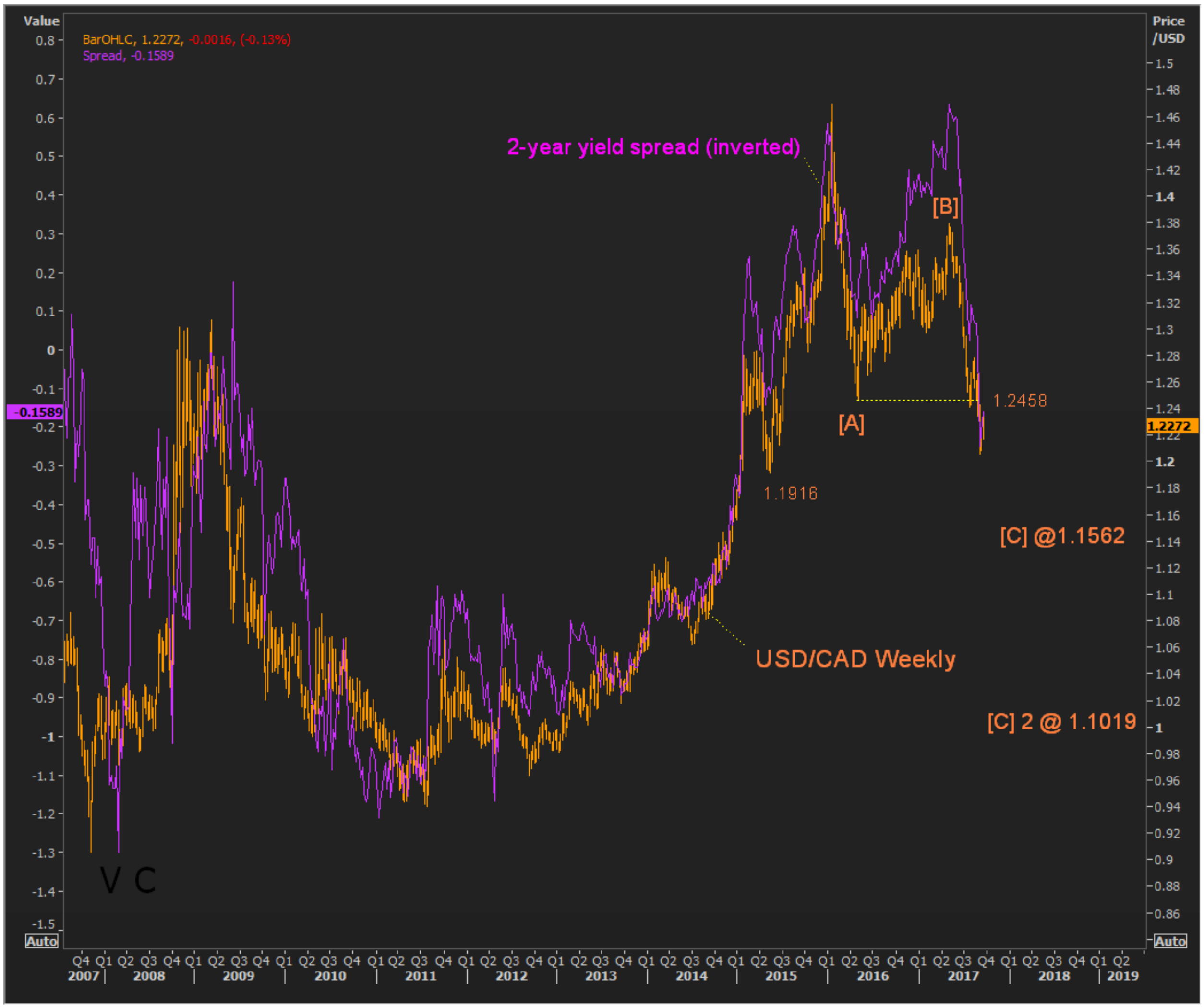
A Fed rate surprise tomorrow would blowout the already huge relative yield spread to the advantage for the US dollar; that we suspect would likely lop off about 500-600 pips from the EUR/USD price quickly.

2. **Fed Chair Yellen channels her inner dove.** "So…given that inflation still hasn't materialized, and increasingly we are losing confidence in our core model—the Phillips Curve; and given what seems a slowdown in forward momentum in the US economy, we are going to revert back to the old catch-all phrase 'data dependent' and give the economy time to digest our prior hike in rates before looking at our tarot cards again."

This would likely be a "phi-slama-jama" moment for the US dollar; the index would likely blow through what appears to be a confluence of support at 9100 and not look back until it sees the 8700-level; confirming a new cyclical bear market in the US dollar is underway.

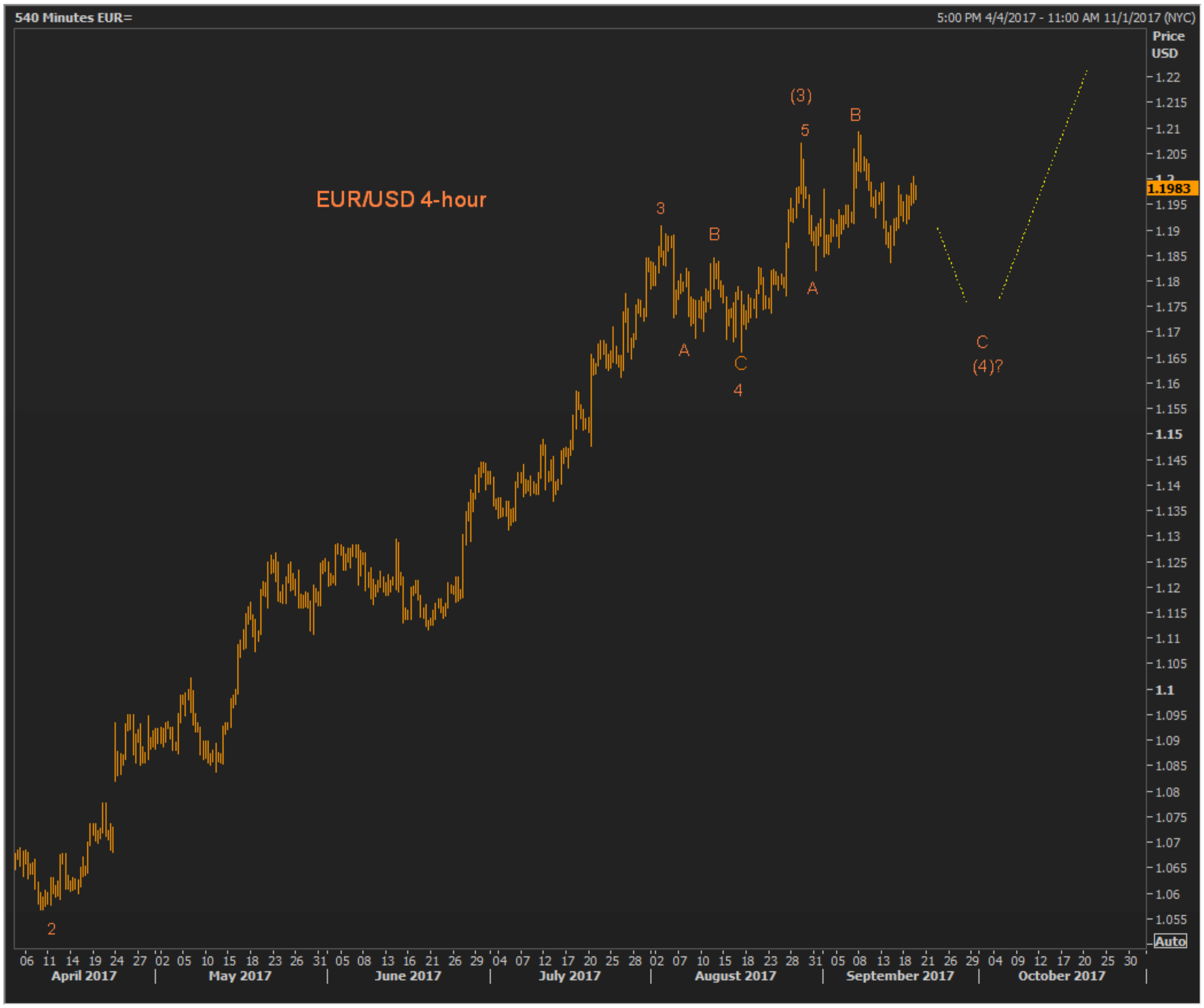


Our favorite horse to ride under the Yellen "inner dove" scenario would be the Canadian dollar. Three reasons: 1) already rising relative yield spread in favor of Canada; 2) more liquidity to drive both risk assets and commodities; and 3) expectation the BOC rate hiking campaign will remain on track. The weekly chart below comparing **USD/CAD to the two-year spread between Canada and the United States** (spread inverted below so you can see its correlation with USD/CAD).



3. **Rate hike for December on track and balance sheet reduction to proceed as planned.** Under this scenario we believe the US dollar stages a correction higher against the pack; i.e. Wave 2 rally as you can see in the US dollar index chart above.

   Our favorite horse to ride here, for a "correction" lower, would be the euro. And we would be looking for a move back to 1.1600 level; possibly extending to 1.1400. As you can see in the chart below, there are lots of gain to digest given the powerful rally we have seen in EUR/USD this year.



There are many more plausible scenarios—there always are. So be careful out there.

Of note: I will be speaking at the [Traders Expo in Las Vegas on November 3rd]. More information on my presentation to follow in the next Currency Currents.

Regards,

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