

## MNI Market Analysis: Risk Reward Profile Skewed To Dollar Weakness

10 February 2022, Yvan Berthoux

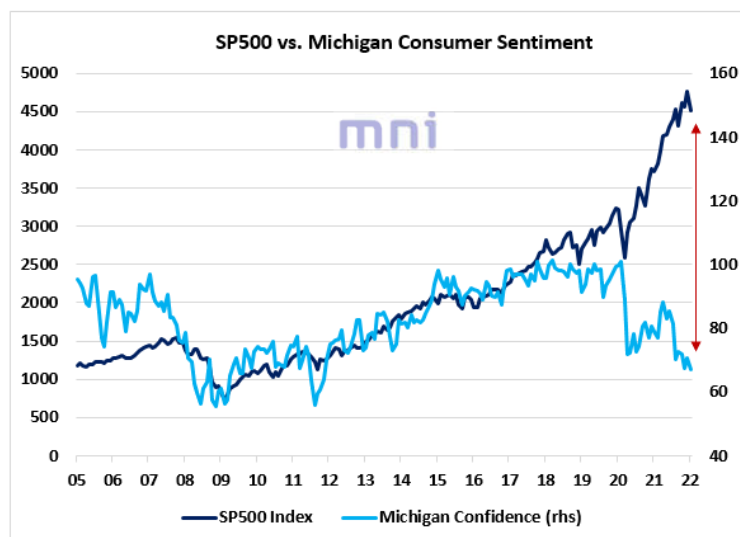
### Executive summary

- With a rising number of economic and sentiment indicators pricing in a significant deceleration in the economic activity, Fed may disappoint investors this year by delivering fewer hikes than the market is currently expecting.
- In addition, souring fundamentals leave US risky assets vulnerable for 2022.
- A less 'hawkish' Fed stance leaves room for some USD depreciation this year against EM FX and the Euro.

### Consumer sentiment standing at depressed levels

- In the past two years, US confidence indicators have not followed the strong recovery in equities and continue to remain at depressed levels, having fallen to a 10-year low in January. Figure 1 shows the strong divergence between US equities and the Michigan consumer sentiment survey in the past 2 years.
- US economists have historically used consumer confidence surveys as one of the key predictors when forecasting consumption growth. The simplest OLS model generally regresses changes in real PCE on changes in consumer confidence at previous periods, using two lags. Hence, growth expectations could continue to be reviewed to the downside.

Figure 1



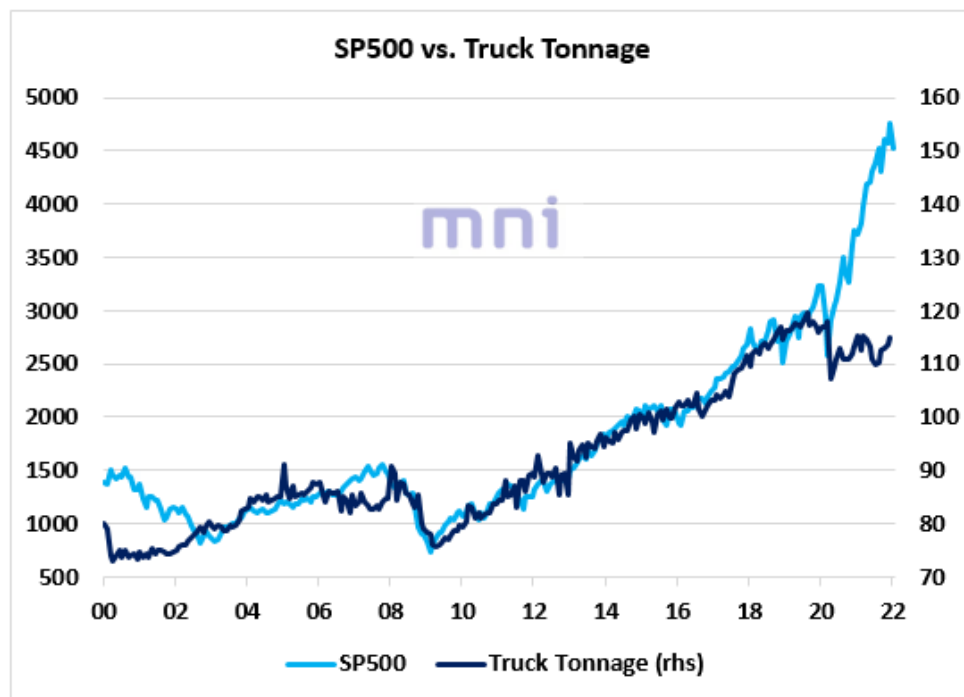
Source: Bloomberg/MNI

This adds up to the numerous charts that are currently indicating that US risky assets, especially equities, remain fragile for 2022.

**SP500 vs. Truck Tonnage**

- Figure 2 shows another interesting divergence that has been occurring between SP500 and Truck Tonnage, which some investors consider as a good proxy for the physical size of the US economy, since the Covid shock.
- While US equities have been constantly reaching new all-time highs, the Truck Tonnage Index has been gradually recovering but is still standing far below its all-time high reached in August 2019.
- One explanation is that the Covid19 shock has just accelerated the rotation from retail to 'e-commerce' that we have seen in the past cycle, implying that American are simply shopping more online.
- The second explanation is that the sharp liquidity injections from central banks that led to a significant rally in the mega-cap growth stocks, responsible for most of the rally in the SP500.

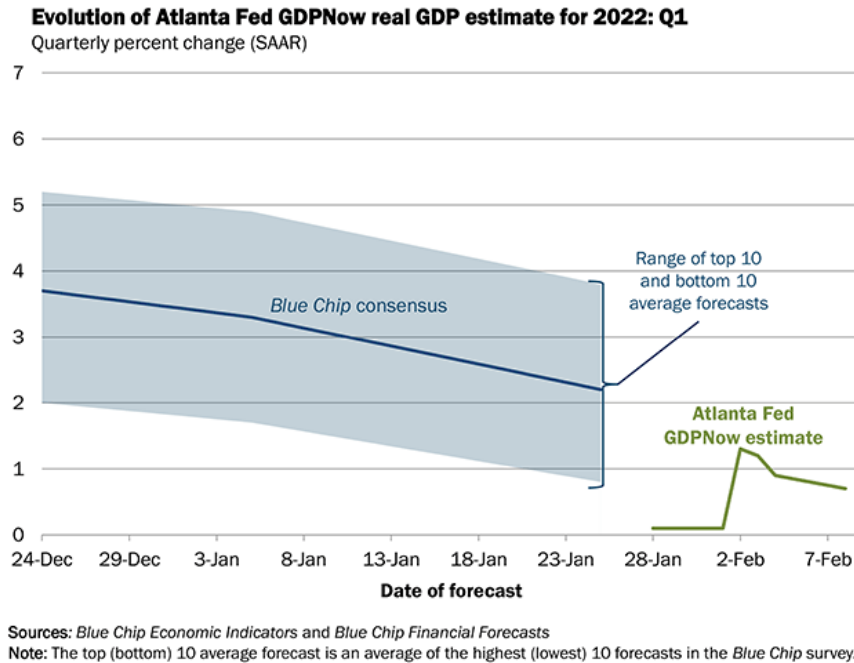
Figure 2



Source: Bloomberg/MNI

We have seen that sell side firms have been constantly reviewed Q1 real GDP to the downside in recent weeks, with Atlanta Fed GDPnow currently estimating real growth to be at 0.7% QoQ (figure 3).

Figure 3

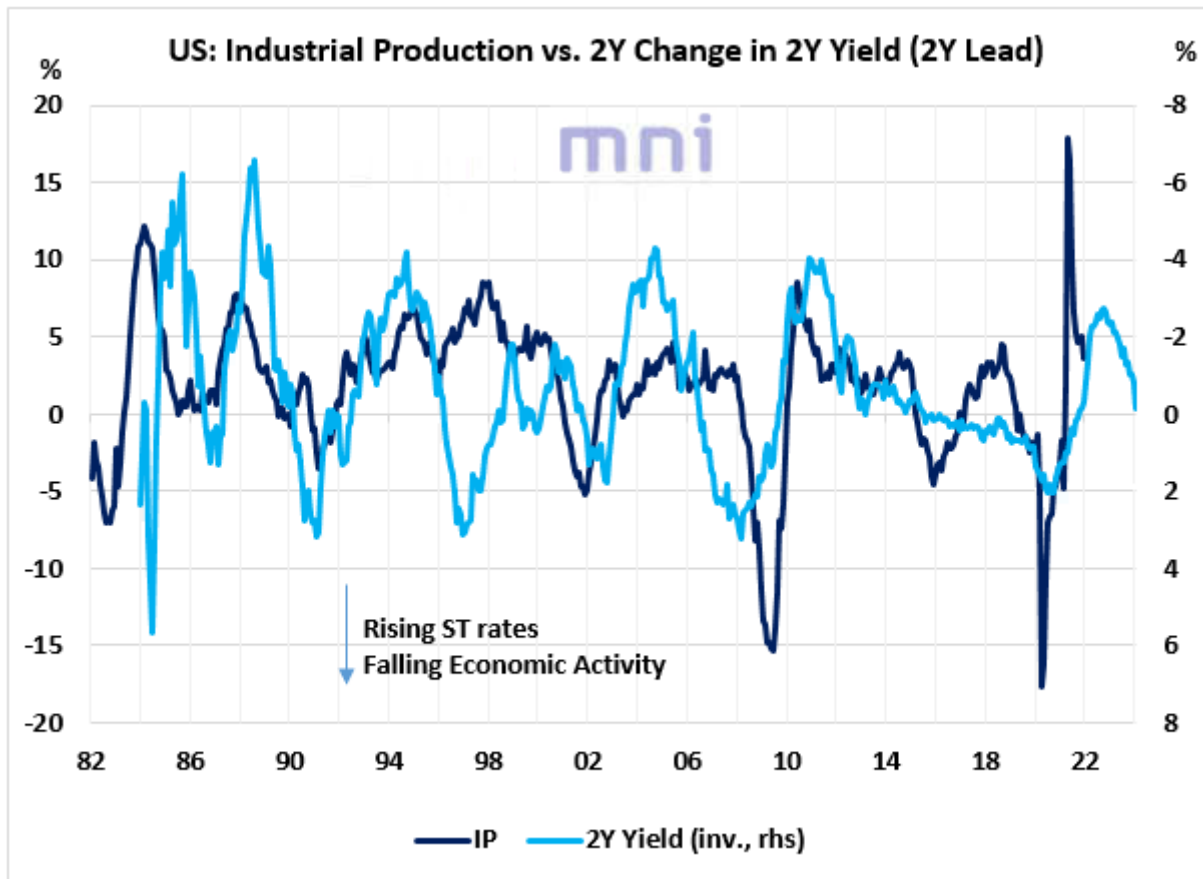


Source: Atlanta Fed

### Sharp Tightening Generally Leads To Slower Growth

- One of the most important charts that has been ‘neglected’ by some economists is the effect of a sharp tightening cycle on the economic activity.
- Figure 4 shows that the 2-year change in US 2Y bond yield has strongly led the business cycle in the past few decades (by 2 years).
- In the EM world, we have seen that the effect of rising rates aggressively on the economic activity is much quicker; the 2Y change in 2Y yield usually leads the business cycle by 6 months.
- Therefore, rising rates in the short end of the curve could accelerate the economic slowdown in the coming months, leaving US policymakers in a difficult position.

Figure 4

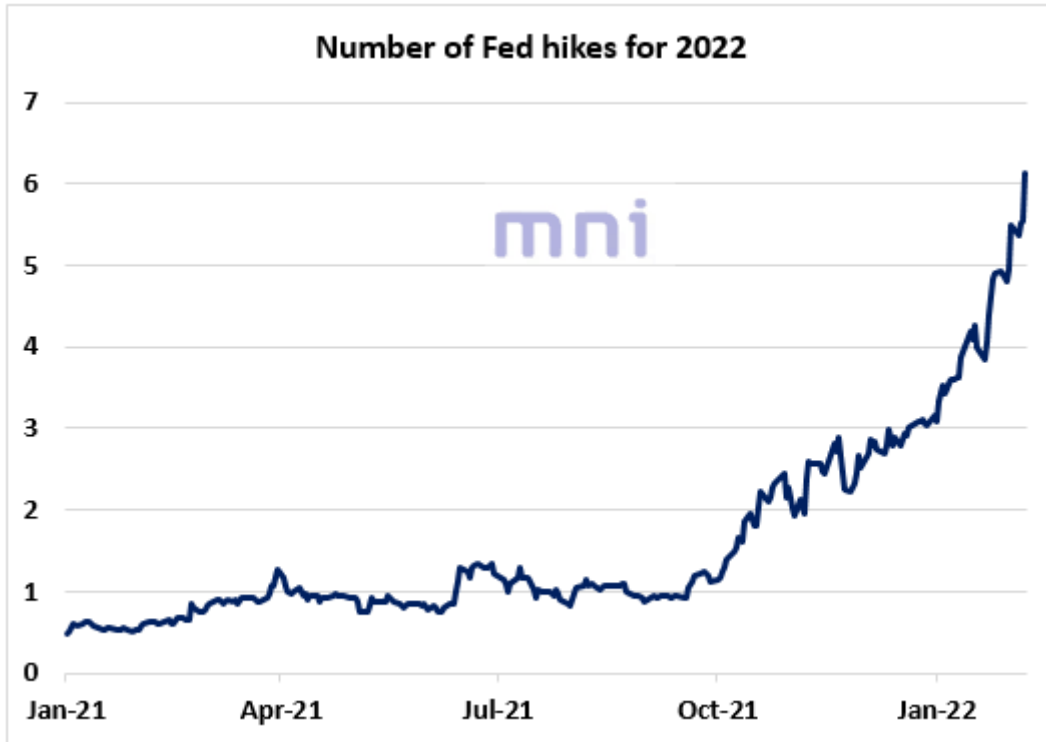


Source: Bloomberg/MNI

**How much can the Fed realistically tighten this year?**

- With the FF futures Dec 22 trading at 98.46, the market is now expecting more than six 25bps Fed hikes for this year.
- Some sell-side firms are even expecting up to 7 hikes for 2022.
- With the economy expecting to continue to decelerate, it will be difficult to see 6 to 7 hikes this year, and US policymakers are likely to disappoint the market with less hikes, especially if we start to see market frictions going forward (i.e. another important consolidation in US equities).
- Hence, this shows that the risk/reward on the US Dollar is currently skewed to dollar weakness, and therefore could create interesting opportunities in EM markets going forward.

Figure 5



Source: Bloomberg/MNI

**Risk reward on US Dollar Is Skewed To Dollar Weakness**

- The DXY Index found support at its 100DMA last week after consolidating sharply lower from its local high of 97.44 reached in the end of January.
- ST support to watch on the downside stands at 95.28, which corresponds to the 100DM and the LT upward trending support line.
- A break below that level would open the door for a move down to 94.4790, the 38.2% Fibo retracement of the 89.21 – 102.98 range.
- On the topside, resistance to watch stands at 96 (50DMA).

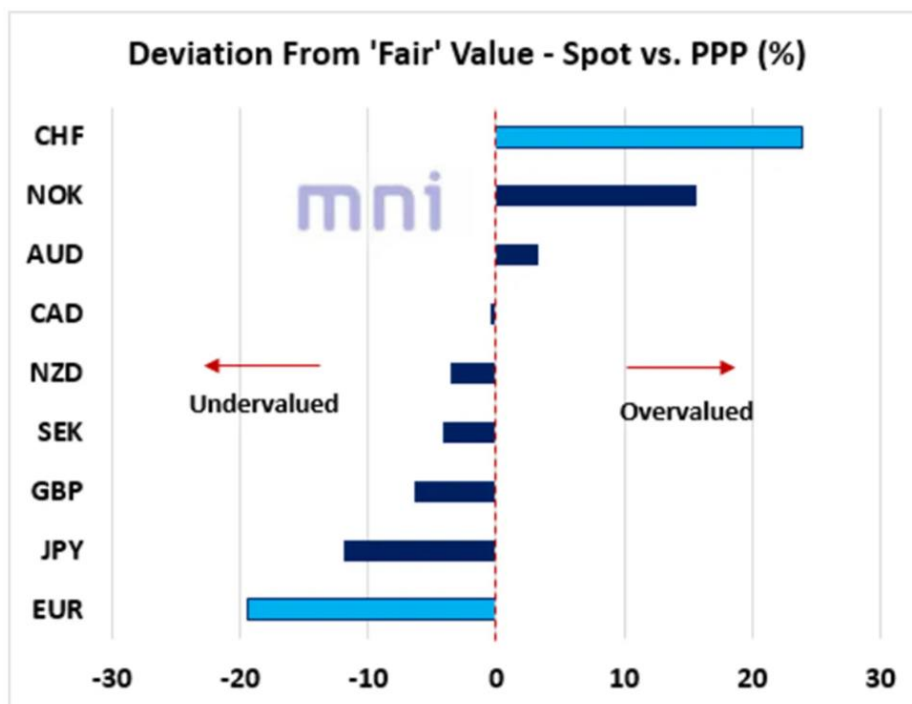
Figure 6



Source: Bloomberg

In addition, 'cheap' Euro could also move significantly higher this year. Figure 7 shows that the single currency remains significantly undervalued against the greenback (nearly 20%) according to our BEER model (using terms of trade, inflation and 10Y interest rate differentials as explanatory variables).

Figure 7



Source: Bloomberg/MNI

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