Scotiabank
Global FX Strategy

FX QUICK NOTES

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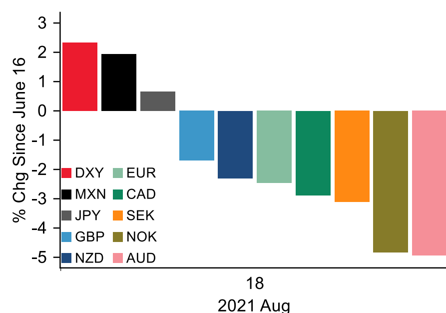
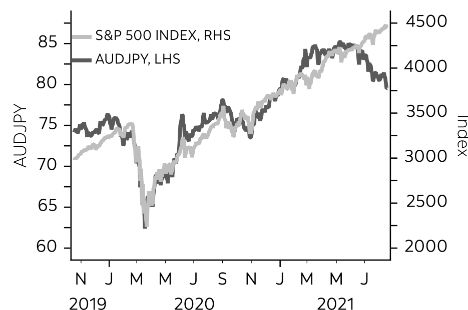
High Beta FX Weaker After June FOMC



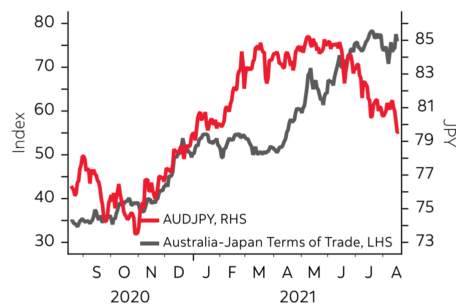
Source: Macrobond, Scotiabank FICC Strategy

AUDJPY Decouples from S&P 500



Source: Macrobond, Scotiabank FICC Strategy

AUDJPY Drops, Terms/Trade Steadies



Source: Macrobond, Scotiabank FICC Strategy

Regime Shift Since June Favours Havens over Commodity FX

The FX market has experienced a regime shift since the June 16th FOMC meeting revealed a more hawkish bias among policy makers than markets were anticipating. Since the middle of June, the USD and the JPY have tended to strengthen whereas high beta FX—with the notable exception of the MXN—have underperformed, reversing trends that had been evident in the first half of the year. The move away from riskier, commodity-related FX has not been reflected in other markets, prompting a clear—and unusual in recent years— decoupling in the AUDJPY cross from US equity markets.

The June 16th FOMC meeting revealed a clear shift in tone among the collective thinking of Fed policy makers. This was most apparent in the change in the dot plot which revealed more policy makers expected at least two rate increases through 2023. Markets moved abruptly to factor in higher chances of Fed tightening—albeit in the still distant future—while longer term market rates moved decisively higher, with 2Y bond yields advancing from 0.16-0.18% in the lead up to the meeting to a peak near 0.27%. Yields have since consolidated but remain markedly higher than in the first half of the year.

The impact on FX has been quite marked. The USD, which underperformed broadly in the first half of the year, has turned into an out-performer since mid-June. The JPY, which dropped 7% against the USD in H1 and under-performed all the major currencies in that period, has gained a little under 1% against the USD and is now a broader out-performer. Meanwhile, the CAD—which was the top-performing G10 currency in the first half of the year—has weakened nearly 3% since mid-June. The AUD and NZD have added to early year losses, with the AUD down nearly 5% as FX investors tilt away from "riskier" currency plays. A notable exception is the performance of the MXN which has maintained a firm profile as domestic interest rates have pushed higher and stock markets have moved steadily higher.

While other factors certainly come into play to some extent, the turnaround in the JPY crosses has been significant and highly unusual in that these cross plays typically stick fairly close to the broader trend in risk appetite. This is particularly the case with AUDJPY which is something of an FX "bellwether" for the overall market risk mood. The 5.6% drop in the cross since mid-June contrasts with the steady rise in US equity markets over the same period.

Over the same period, commodity prices are little changed in broad terms although iron ore and crude oil have weakened significantly. This may account for some of the CAD and AUD under-performance (as well as the JPY out-performance) via the relative shift in respective terms of trade but the change does not appear to be sufficient enough to explain all of the movement in the commodity/JPY crosses. However, we rather think the clear structural break between AUDJPY and equity markets reflects more defensive positioning among FX investors.

The trends in the JPY/commodity currencies look poised to extend in the short to medium term on the charts, at least. In our technical reports, we have noted the proximity of major support for CADJPY at 85.45 (and little support below here until the 80 area). Meanwhile, AUDJPY has broken below its 200-day MA for the first time since May 2020 and is pressuring a broad band of long-term support between 79.20/70. Losses below here would suggest more weakness towards 75/76. Note that we suggested AUDJPY long as one of our top trades for 2021 and while the cross had appreciated well through the first half of the year, returning more than 6% at one point, we are now out of that trade with a small, 2% gain all in.

August has—so far—not delivered the seasonal spike in volatility that sometimes emerges around this time of year. Equity markets are taking indications that the Fed punchbowl might be taken away shortly in their stride. However, equity market gains are being driven

by narrower leadership (the NYSE stock market breadth indicator continues to deteriorate) which is a sign that we should be wary of some deterioration in the broader risk backdrop. Investors should consider opportunistic CADJPY or AUDJPY shorts as a hedge against higher market volatility.

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