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Draghi talks up rate guidance

ECB View: Draghi seeks to cap rate hike expectations – ECB President Mario Draghi re-iterated the ECB's forward guidance on QE and interest rates on Thursday. This suggests that the guidance will very likely remain in place in the package that the ECB announces later this month. We expect the ECB to announce an extension of asset purchases (to September 2018) but at a slower pace (EUR 30bn per month versus EUR 60bn per month now). The QE guidance would leave the door open for a further extension or increase in the pace of QE beyond that, even though it would not be the most likely scenario in our view (we expect the programme to be wound down by the end of next year). The interest rate guidance (that interest rates would remain on hold 'well past' the horizon of QE) would signal to markets that interest rates would not rise before 2019. Indeed, Mr. Draghi especially emphasized the rate guidance, saying that the 'well past' terminology is 'very, very important'. We think capping rate hike expectations will be a key element in ensuring a benign market reaction to the slowdown in QE. (Nick Kounis)

Euro Government Bonds: Insatiable hunger from US hedge funds for Dutch debt - Yesterday, the Dutch Treasury launched for the first time a 7 year benchmark bond (DSL 0% January 2024) via Dutch Direct Auction, instead of issuing a 3 year bond. The Dutch Treasury said that it sold EUR 6.57bn at a spread of 12bps over the DBR 1.75% February 2024, which is equal to 0.05%. Furthermore, the amount sold was at the higher end of the target range of EUR 5-7bn and was somewhat higher than our EUR 6bn forecast. We judge that the high investor demand prompted the Dutch Treasury to issue more than was expected. Indeed, yesterday's book size was the largest since 2004, while the bid to cover was the highest since 2014. From the deal statistics we observe that both the allocation to investor type and the geographical allocation to country were almost identical to the issuance results of the 10 year benchmark bond which was sold last February. This could be driven by the unique issuance technique the Dutch Treasury uses and it could point to a relatively stable investor base. In addition, we observe a continued and high participation of hedge funds which are seemingly based in the US. It is now for the fifth time in a row that these fast money accounts have participated in the primary Dutch bond market. We calculate that on average in the last 5 Dutch deals, these hedge funds bought 16% of the total issued amount. This is an equivalent of EUR 4.7bn. The deal statistics do not reveal why hedge funds decided to participate. Usually these type of investors are only active in lesser creditworthy and therefore higher yielding bonds. The deal statistics do suggest that hedge funds do not have a maturity preference as they have been involved in 5, 7 and 10 year transactions. Finally, the statistics show that hedge funds started to participate in 2015, which could mean that there is a link to the ECB’s QE programme and the subsequent liquidity drain in the Dutch bond market. (Kim Liu)

Global FX I: US dollar recovery over for now - In the period between 8 September and last Friday, the US dollar recovered by 3% versus a basket of currencies. This was mainly the result of an upward adjustment of Fed rate hike expectations and higher US nominal and real yields. The US dollar set a peak last Friday after the US employment report. This report showed a higher-than-expected increase in hourly earnings and lower-than-expected US unemployment rate. Initially this report gave support to the US dollar. EUR/USD declined to a low of 1.670 but was unable to stay there. In a short period of time EUR/USD rose above 1.17 again, which was a strong signal that investors are not willing to buy the US dollar and sell the euro. Investors seem to buy the euro on dips and sell the US dollar on rallies. Indeed, the positioning in the futures market shows that net euro longs have barely been reduced. Overall, we think that the US dollar recovery is over for now and we expect renewed weakness in the near term. Investors have used the less hawkish-than-expected FOMC minutes this week as a reason to sell the US dollar again.

Global FX II: Risk of a euro correction remains there - In the coming weeks a test and possible break of the previous high in EUR/USD at 1.2092 is on the cards. However, the risk of a sizeable correction of the euro is still present in our view. The net-long euro positions are still very extreme and a trigger for a profit-taking wave can come from either direction. There are risk events such as the EU summit on 19 October, the elections in Japan on 22 October and the ECB meeting on 26 October. We expect US dollar weakness, yen weakness and euro strength to continue up to these events at least. Clarity about the recalibration of ECB policy could result in a “Buy-the-Rumour, Sell-The-Fact market reaction”, weakening the euro. Sooner or later, investors will probably take profit on a part of their euro longs resulting in a sizeable euro correction (not a trend reversal). We keep our target for the end of 2017 and 2018 at 1.20 and 1.30 respectively.

Precious Metals: Gold prices profit from dollar weakness - The developments in the US dollar and in US yields are directly visible in gold prices. From the moment that the US dollar recovery came to a halt (last Friday), gold prices have rallied. What is particularly interesting is that gold price weakness came to a halt just above the 200-day moving average (which is just below USD 1,260 per ounce). This is a positive signal because the longer term up trend remains in place. We expect gold prices to move above USD 1,300 per ounce again, but to stay relatively close to this level in the coming weeks. Our year-end target is USD 1,300 per ounce. Our target of the end of 2018 is USD 1,450 per ounce mainly a reflection of our view of that the US dollar will weaken significantly. (Georgette Boele)