am FX

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Home Holoportation technology has arrived

Current Views

Long NZDUSD @ 0.6692
Stop loss 0.6614
Take profit 0.6818

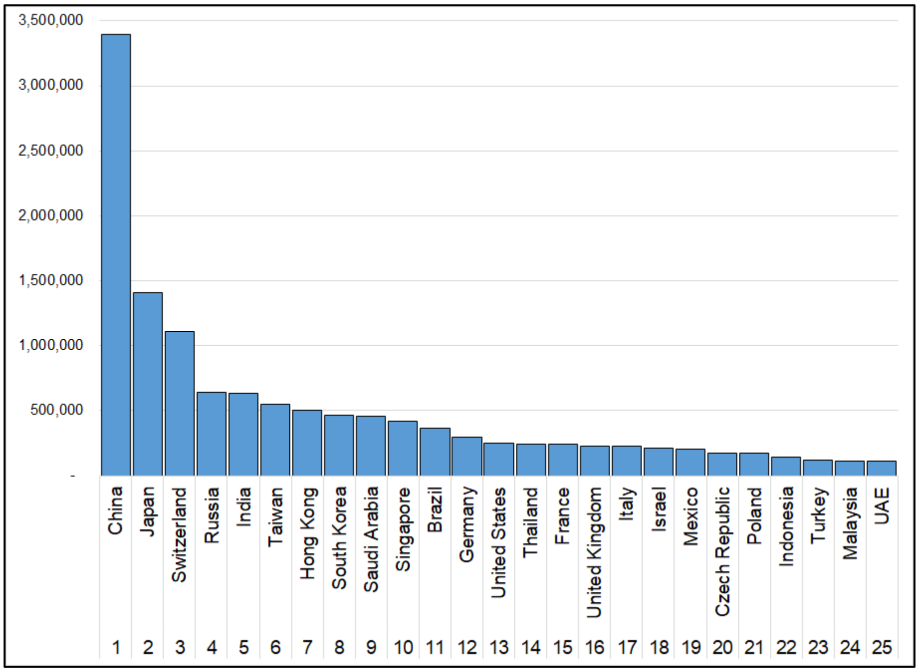
Long BTC @ 38220
Stop loss 31400
Take profit 49900

Bullish EURGBP
Long 18MAR 0.8550 EURGBP digital call at 24% (spot ref. 0.8426)

Where to stash all the cash?

Interesting delayed reaction in yields and bitcoin today as the market processes the historic moves by the EU, US and other nations to freeze or seize the proceeds of Russian oil. Everyone is now trying to figure out who might want to move money whereas the global financial system is officially more and more weaponized.

Here are the largest FX reserve holders in the world:



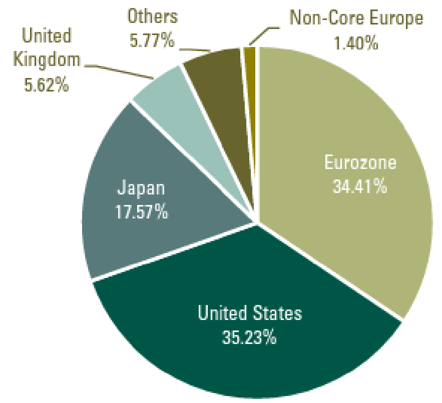
In a cooperative game, more global trade and the accumulation of FX reserves makes sense.

In a competitive game, where your currency holdings are issued by an adversary and can be frozen or vaporized at that adversary's discretion… Global trade and the accumulation of FX reserves makes… Less sense.

China currently holds about 2,000,000,000,000 USD (That's trillion, with a T) in its big fat electronic wallet. It also holds many, many euros. One might reasonably think that those numbers will go down from here, not up, as the PBoC hedges future sanctions risk.

But where can all that money go? At right you can see there are not a lot of options. If you want to buy liquid fixed income, you pretty much need to buy the debt of a US / EU ally.

So, what *can* China do?



Investment grade debt outstanding

Here are four options. None of them are great.

1. No more USDCNH buying. Easy for USDCNH to go down, hard for it to go up. This may already be happening. The easiest way to shrink the USD reserves is to let US bills and bonds mature, QT-style, and reinvest the proceeds elsewhere. As long as China does not buy USD, their USD proportion will slowly grind lower. It was 79% in 2005 and it's now 60%.
2. Sell USD and buy Asian currencies, EM, or gold. The list of currencies China can buy is short because China's list of allies is short and the countries on that list are not rich in liquid fixed income offerings. Russia, Pakistan, and North Korea, for example, do not offer liquid bond markets suitable for parking trillions of USD. Brazil, perhaps? Even Switzerland has gone with the sanctions and is not a safe haven in the event of a cataclysmic series of sanctions against China.
3. The Reset? China bails from the current global monetary system and starts a parallel system. Fun to talk about but seems highly suboptimal for a country known for its ability to play the long game.
4. Diversify into bitcoin? That's not happening but it's not the worst idea in the world. They could probably deploy half a trillion in crypto if they went slow.

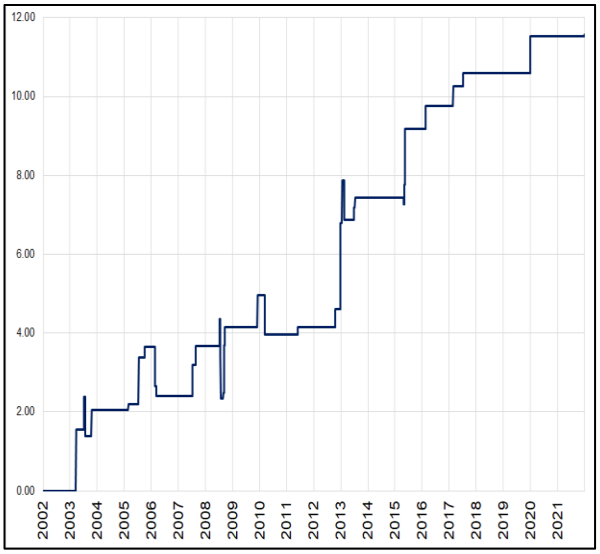
Anyway, this is all super big picture but worth thinking about. USD and EUR, as China's largest reserve holdings, are less attractive today than they were a week ago. The paucity of options is the biggest impediment to any sudden move, but the bitcoin maximalist view of fiat is coming true bit by bit.

The definition of "fiat" contains the word "arbitrary" and actions in Canada and against Russia show this is probably a somewhat valid descriptor! Especially as the Fed expands its balance sheet with CPI at 7%--despite advertising a 2% inflation target. That feels pretty arbitrary too.

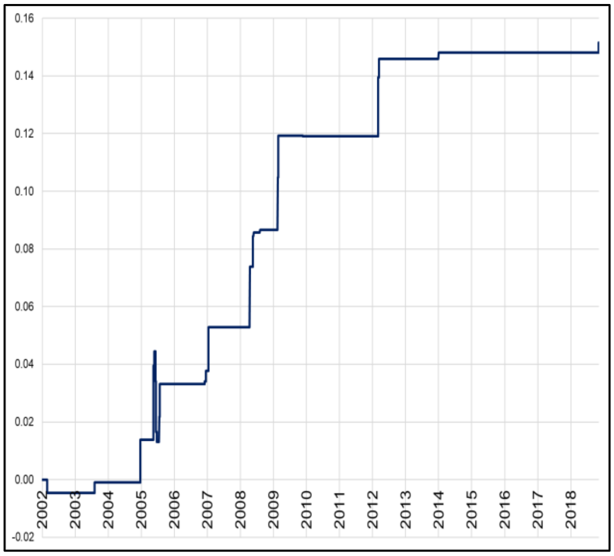
20 years of evidence

Sunday night, the market piled into short EURUSD and short USDJPY on the weekend sanctions news. This never ceases to amaze me because there is so much evidence over so many years showing that going with a Sunday gap pretty much never works. I have done studies on this in the past and decided to update my data. Here are the results:

P&L of going against a Sunday gap in EURUSD



…and USDJPY



The chart shows what would happen if you bought every gap down and sold every gap up and covered at 5pm NY Monday. The minimum gap to qualify is 75 pips in EURUSD or 50 pips in USDJPY. The hit ratio is about 80%. In other words, the hit ratio of selling EUR gaps lower or buying gaps higher on Sunday is about 20%. This is true in all currencies, including EM (even Turkey!). There is no alpha in going with Sunday gaps and there is a ton of alpha in fading them.

The reason for this is behavioral / structural. When scary news comes out on the weekend, there are no buyers. The price probes lower and lower, sucking up all small bits of liquidity until finally it finds a huge pocket of bids and that's the extreme point / brick wall.

The trade is hard to do systematically because it goes against every instinct in your body.

"Russia cut off from SWIFT? Buy euros!"

"Greece vote fails and they are going to get booted from the EUR? Buy euros!"

They are stupid trades that make no sense and that is why they almost always work. There is a section in my first book on these Sunday gaps; I have included it as an appendix today. Key excerpt:

> Precisely because it is so incredibly scary and difficult to trade, the Sunday Gap is one of the most profitable setups in currency trading. Watch for it and take advantage if you dare! This is a double black diamond setup and not for the faint of heart.

Is it weird for me to quote my own book? I'm not weird—you're weird.

Final thoughts

State of the Union tonight. Possible event risk into it and after it. For example:

- SPR release or Iran announcement just ahead of it or just after.
- Russia major escalation right before or during (to steal the spotlight / send a message).

Bank of Canada tomorrow. Hawkish 25bps I think.

Have a somewhat transparent day.

good luck ⇅ be nimble

Excerpt from "The Art of Currency Trading"

Sunday Gaps

The Sunday Gap pattern is one of the most reliable patterns in foreign exchange but also one of the most difficult to trade. The pattern arises when there is major news out over the weekend and the market reopens at a new level on Sunday. There are dozens of examples in the past 20 years, including the weekend Saddam Hussein was captured (bullish USD), the weekend Greece voted against the IMF bailout (bearish EUR) and the weekend Recip Erdogan declared that financial markets were at war with Turkey (bearish TRY).

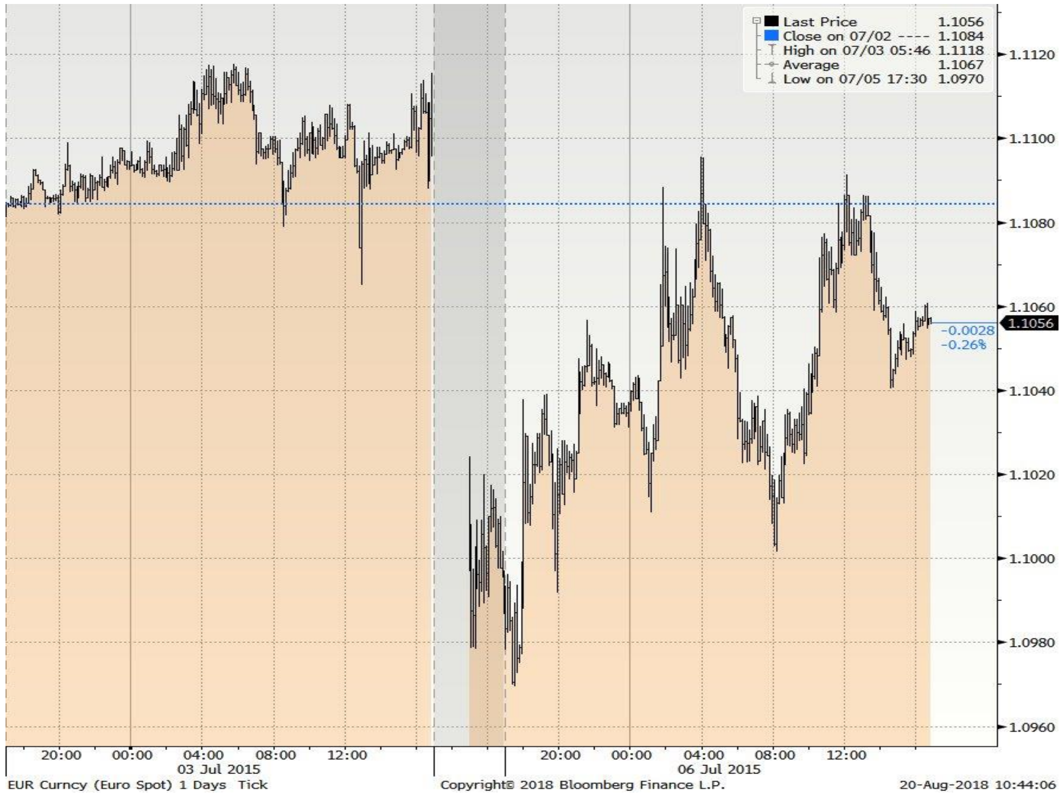
The stunning feature of Sunday gaps is that they almost always fully reverse within 48 hours. In 2012 I did a study of 20 different Sunday Gaps and found 85% of them reverse to the prior Friday close within two days. This happens because the market gets overextended and out of balance as it attempts to find a new equilibrium in a thin market where there are only buyers or sellers (depending on the news) and nobody to take the other side. This huge opening order imbalance makes the market move much more than it would have otherwise and this overextension then corrects substantially as liquidity returns to normal in the Asia session.

Example 1: Greek Referendum 2015

In July 2015, Greek voters went to the polls to vote on whether or not to accept bailout conditions imposed by the European Commission, IMF and ECB. The vote was a resounding no (61% to 39%) and this was viewed as a negative outcome for the European Union and EUR. Here is what EURUSD did on the Sunday open:

Tick chart of EURUSD the Friday before and Sunday after the Greek referendum in 2015

July 3 to 6, 2015



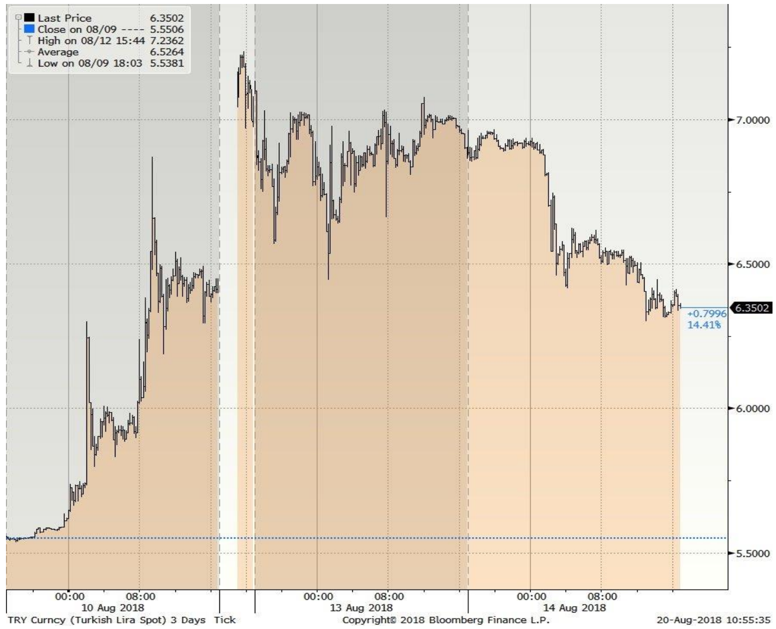
This is a classic Sunday gap. The market closed at 1.1084 on Friday and then gapped much lower to open at 1.0980 on Sunday (see gray area in the middle of the chart). EURUSD probed the downside one more time (1.0970 is the low) and then rallied all the way back to the Friday close of 1.1084; this happened even though the news was unambiguously bad. Let's look at another more recent example. Note that I could fill 25 pages with examples like these—it's a common and powerful pattern.

Example 2: Turkish Lira Crisis 2018

In August 2018, investors were on edge about Turkey's massive current account and corporate financing deficits. The story escalated as President Erdogan refused to allow the central bank to raise interest rates. Friday, the market expected things to get better as President Erdogan was scheduled to speak on Saturday and he would almost certainly make positive remarks to soothe nervous markets.

Instead, Erdogan made a fiery anti-US speech and said that Turkey would not back down from this "Economic War". Investors watched with bated breath as markets opened on Sunday and here is what happened:

Tick chart of USDTRY around the August 10, 2018 weekend gap



USD/TRY closed at 6.40 on Friday and then opened more than 10% higher at 7.10 on Sunday afternoon (see white vertical section). Over the next 12 hours, the market proceeded to fill the gap and trade all the way back to 6.40. Once again, even with terrible news (bullish USDTRY news), the Sunday gap reversed completely.

These gaps are <u>extremely</u> difficult to trade because in order to fade the gap you need to take the opposite side of what looks like very important news. The strategy is simple: Take the other side of the gap in the opening hour of trading in a position size that makes you feel comfortable. Put a stop loss one average daily range away. Cover (take profit) when the gap is 90% filled.

Precisely because it is so incredibly scary and difficult to trade, the Sunday Gap is one of the most profitable setups in currency trading. Watch for it and take advantage if you dare! This is a double black diamond setup and not for the faint of heart. **END**

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