GLOBAL RATES & CURRENCIES: LIQUIDITY TRANSFUSION

"2015 is likely be another challenging year for the global rates and currencies market. The obvious trades such as the long U.S. dollar trade are already crowded. There also may be more volatility than trends, which means making money could require more frequent tactical maneuvers. With rates depressed everywhere, carry is unlikely to make a meaningful contribution to returns. In our view, beating the market will require careful analysis of global linkages between the major economies and market positioning."

– David Woo, head of Global Rates and Currencies Research

Our View

The burden shifts from the Fed: As the Federal Reserve begins to exit quantitative easing, we believe the burden of keeping the world economy afloat will shift to other major central banks. This means two things. First, rates outside the U.S. are likely to stay low or decline even further. Second, the U.S. dollar probably will have another good year. Among the likely results of this trend: five-year German government bond yields could fall to zero, and the Euro/U.S. dollar and U.S. dollar/Yen could reach 1.20 and 1.23, respectively, by the end of 2015.

China and the world diverge: The consensus is that global growth will accelerate in 2015, but that Chinese growth will moderate further to 7%. If either Chinese growth were to fall below 7% or Beijing had to resort to rate cuts to achieve 7% growth, it would have a depressing impact on global rates, including in the U.S. Meanwhile, the U.S. dollar should continue to be the prime beneficiary of slowing Chinese growth. U.S. exports to China are only 1% of U.S. GDP, versus 3% of GDP for Germany, 4% for Japan and 6% for Australia.

It is easier to trade the U.S. dollar than U.S. rates: The key lesson we see from 2014 is that, for the U.S. dollar to do well, all we need is for the U.S. to do better than other countries. However, for U.S. rates to go up, we need the other countries to do well, too. This means being long the U.S. dollar offers a better risk-reward profile, in our opinion, than being short U.S. rates. This is why it is preferable to view higher U.S. rates as a spread trade. Particularly attractive is paying US 5y against the Chinese 5y swap.

It pays to be contrarian: In 2014, investors found that the right trade, when it is crowded, often becomes the wrong trade. In other words, it sometimes pays to take the other side when positioning becomes too one-way. Attractive trades include buying U.S. break-evens versus eurozone break-evens and buying Portugal against Spain. The U.S. dollar/Yen, after its recent surge, appears vulnerable to a short-term pullback, especially if the market is overestimating the ability of Japan's Liberal Democrats to retain their two-thirds majority and Bank of Japan's willingness to increase quantitative easing again in the near future.

Oil volatility should drive global volatility: Year-to-date, oil prices have fallen 30%. Everything that has anything to do with energy underperformed in 2014, including currencies of oil exporters and short-dated inflation index bonds. A good hedge against the tail risk of a further plunge of oil prices is buying USD/CAD call option, given that Canada is one of the highest cost oil producing countries.

Key calls

Best directional trades:	Selling AUD/USD spot (spot reference 0.8710), targeting 0.78 with a 0.90 stop
	Pay 5y US swap rates versus 5y offshore China swap rates at 119bp, targeting 60bp with a stop at 145bp
Best European trade:	Receive Eonia 1y one year forward (entry -4 bp) with a -15 bp target and stop at 0bp
	Sell CHF/NOK (spot reference 7.00) with a target at 6.25 and a 7.42 stop loss
Best Vol trade:	Buy 1y-6m one-touch put spread in EUR/USD struck at 1.18 for 14.5% (spot reference 1.2425)
Best inflation trade:	Buy 30y US inflation versus 30y Euro inflation in swaps at a spread of +49bp, targeting +80bp with a stop at 35bp
Best contrarian trade:	Sell 3m USD/JPY ¥125 one-touch option to finance buying a 6m ¥125 one-touch option in U$10m/U$13m ratio payout (spot reference 117.80)
Best regulation trade:	Buy $200mm T 0.625% 11/15/16 vs paying in matched-maturity swaps. Entry 17.5bp, target 28bp with a stop at 12bp
Best relative value trade:	Buy 3y Portugal and 10y Bunds and sell 10y Spain (55%, 83% and -100%), targeting 115bp, with a stop at 93bp
Best tail risk trade:	1y USDCAD 1.27 digital call for 10.25% (spot reference 1.13)