GLOBAL RATES AND CURRENCIES 2016 YEAR AHEAD: The great divorce

"We think the question is not whether the U.S. economy can live with higher interest rates and a higher U.S. dollar. The question is, given the semi USD/RMB peg and China's increasing open capital account (which come at the expense of China's monetary independence), whether China can live with higher U.S. interest rates and a higher U.S. dollar. We are skeptical. This why we think the USD/RMB peg, a marriage of convenience that has been the anchor for the global growth model for the better part of the last 15 years, is headed for a divorce."

– David Woo, Head of Global Rates and FX Strategy

Our view

The U.S. and the rest of the world on a debt seesaw: The economies of the U.S. and the rest of the world have diverged, at least partly because of U.S. policies exporting its problems – such as debt. In our view, five years of quantitative easing drove both U.S. interest rates and the U.S. dollar to the ground, pressuring other nations to adopt interest rates that were too low for their own good, so that countries such as China, Brazil, Australia, and Canada went on a borrowing binge. In a sense, the U.S. de-leveraged by pressing the rest of the world to leverage up, with global debt growing $57 trillion since 2007, up 40 percent, per McKinsey.

China is at the greatest risk from higher debt: Because of its relatively inflexible foreign exchange regime, we believe China effectively adopted U.S. monetary policy more absolutely than most, and has acquired far more debt. McKinsey estimates that Chinese debt has quadrupled since 2007, and its debt-to-GDP ratio has risen above that of the U.S. The August 11 RMB devaluation was the defining event of 2015, forcing the markets to recognize China's challenges. We believe China could depreciate the RMB as much as 10 percent against the dollar in 2016, reshaping the outlook for the rates and currencies market and weighing further on already beaten-down emerging market and commodity currencies.

The rest of the world is a mixed bag: We believe that further easing by the European Central Bank should help support peripheral debt and give way to outperformance of eurozone rates versus their U.S. counterparts, especially at the long end of the curve. In contrast, we are concerned that the scope for further easing by the Bank of Japan is limited, and believe that the market is underpricing the risk of a potential backlash against the yen.

Key calls

- **Buy USD/CNH 6m forward outright:** Our favorite FX trade for 2016
- **Buy U.S. 30y real yields:** Further RMB depreciation could slow Chinese selling and lower the real terminal Fed Funds rate
- **Buy EUR/USD 3m 1.10 call with a 16 Dec 1.1050 window KO:** History tells us that

the first Federal Reserve rate hike often leads to short-term profit taking in U.S. dollar longs

- **Buy 1y EUR/USD<1.00, USD/JPY<120 dual digital (for only 7 percent):** A cheap way to play the 2016 euro down, Japanese yen up theme
- **Long EUR versus U.S. rates in 5y5y:** This is still our favorite monetary policy divergence trade
- **Long 6m5y U.K. versus U.S. rates straddles:** The so-called Brexit – possibility of a British exit from the European Union – and much more
- **Buy AUD/KRW:** This is an attractive RV proposition insulated from RMB risk
- **Sell TRY/JPY:** Our technical team’s favorite FX trade
- **Sell 3y Fannie Mae debt versus Treasuries:** Our favorite U.S. election trade
- **Long 12m Treasury bills against OIS:** Money market reform should ultimately trump Chinese FX interventions