SWISSQUOTE

WEEKLY REPORT

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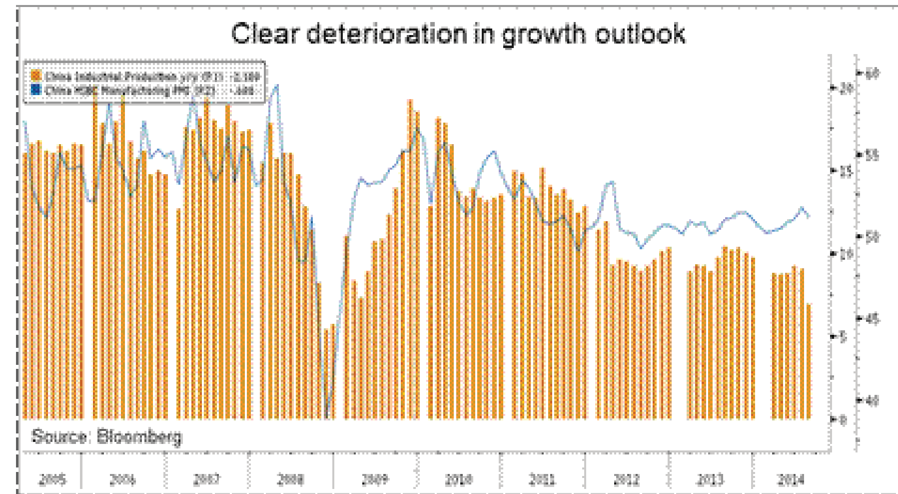
Economics

China begins an easing cycle

In a surprising move, China's central banks cut the interest rate on 14-day repurchase agreements by 20bps to 3.50%, a three year low. The decision to cut short-term borrowing costs of commercial lenders should be viewed as a clear signal that Beijing will aggressively attempt to offset slower-than-expected growth by guiding interest rates lower. Historically, parallel moves by the PBoC predicted adjustments in broader interest rates (in this case cuts). In addition, the central bank has pumped 500 billion yuan ($81 billion) into China's five major, state-owned banks. The unexpected moves follow signs of new deterioration in China's economic outlook and domestic demand.

Weak consumer growth

Since July, a clear trend of economic weakness has been developing in China. Last week, retail sales slight recovery evaporated as y/y sales printed at 11.9% verse 12.2% July read. While Industrial Production slowed to 6.9% verse 9.0% July read. This week's China manufacturing PMI will be important for the outlook on growth and prospects for additional stimulus. Given the backdrop of weaker global growth, in order for the government to hit their 2014 growth target of 7.5% GDP, further easing will be required. We anticipated 50bp of cuts to the benchmark interest rate by year's end. Direct cuts will assist in easing worries over financial risk, support demand through lending and lower increasingly worry debt burden. With China joining the easing game alongside the ECB and BoJ, the prospects for risky assets remain positive.



FX Markets

SNB keeps the negative-rate joker in hand

SNB prepared for immediate action

In its policy meeting on September 18th, the Swiss National Bank kept its 3-month libor target unchanged at 0.00-0.25% and renewed its pledge to defend the EUR/CHF peg at 1.20, saying it is ready to buy unlimited quantities of FX if needed. The SNB focused on the deterioration of the international environment in the recent months and warned that the Swiss deflation risks are higher again. Especially given the heavy ECB stimulus and the geopolitical risks favoring the franc strength, the SNB said to be ready to take immediate action if and when necessary.

At this point, we remain comfortable with the SNB policy. As the “floor” has not been challenged we did not expected the SNB to go on the offensive. The SNB understands that the effectiveness of policy tools might be muted when faced with a “wall of orders” or catalyst such as ECB actions or extreme geopolitical driven safe-haven flows. Therefore, the SNB will reserve action until absolutely necessary, in our view first with direct FX intervention.

SNB keeps negative-rate joker in hand as TLTRO miss expectations

We believe it a prudent decision for the SNB to keep the negative-rate joker in hand, as the ECB has not played all of its cards yet. The ECB lent 82.6billion euros to Euro-zone banks via the first round of TLTROs on September 18th. This amount falls seriously short of the already weak expectations (appr. 100bn). September TLTRO disappointment tip off that the total lending will probably remain significantly short of the maximum 400 billion euros foreseen for the first two operations (the second will take place on December). If this is the case, the ECB may be brought to reconsider a QE. This is where we would be happy to see the SNB pulling out its negative-rate joker.

USD/CHF correction underway

The USD/CHF hit a fresh year high (0.9433) as the hawkish Fed comments on September 18th pushed USD higher across the board. Given the oversold conditions, we expect a short-term bearish correction if 0.9284/0.9301 (post-Sep 4th rally on ECB’s additional stimulus announcement). The critical resistance zone remains solid at 0.9456/0.9500 (Sep 6th 2013 high / psychological level).

FX Markets

Scotland says "no" to independence

Sterling traders adjust strategy after "no" victory

The Scotland says "no" to independence, hence the 307-year-old union remains intact. This is good news for the UK economy as heavy consequences of a Scottish exit have been avoided, at least in the immediate future. This said, the yes-no gap has been tighter with only 55% of voters supporting David Cameron's "no" campaign. A non-negligible 45% wanted independence despite unanswered questions: independent Scotland's economic viability, a potential new currency (as the BoE clearly positioned against an EZ-like monetary union), the custody of health services and other social spending, the partition of North Sea oil revenue. As the "no" victory has been narrow, the risk of another Scottish referendum should persevere in the next few years and reduce the upside potential of the Sterling in the longer run.

In the immediate future however, the UK and the EU take a breather as the Scottish presence in the UK clearly moderates the risks of a national resurgence walking into 2015 General Election. In the aftermath of the Scots referendum, the fears of a potential rise of Conservatives (Tories) decline meaningfully. Although a conservative win implies the holding in 2017 of a referendum on EU membership, traditionally more pro-European Scots should continue balancing the fallouts.

Sterling can finally re-focus on fundamentals

The Sterling rallied across the board as the political uncertainties dissipated on September 19th. Now that the political risks have faded, the GBP-traders can re-focus on the fundamentals and on the BoE policy outlook. Especially, now that the speculations on Fed normalization gain traction.

GBP/USD recovered above Fibonacci 38.2% level on July-September drop (1.6487), yet failed to consolidate gains as "no" trades preferred cash in profit rapidly. The 3-month (25-delta) risk reversals spiked significantly to the beginning of September levels. The technical indicators turned positive and given the sharp sell-off on Scottish fears over the past weeks, the Cable has more room to recover. The next target zone is placed at 1.6644/90 (September 1st high & 200-dma). Regarding the mid-long term, the hawkish Fed expectations will likely keep the topside limited. The 3-month cross currency basis continues favoring a higher USD vs. GBP, despite the positive political outcome from the Scotland.

Against the EUR and the JPY, the outlook is positive. The EUR/GBP tumbled down to a fresh two-year low of 0.78102, and has clearly more to weaken. The ECB expanded its balance sheet yesterday via the first TLTRO lending. Despite weak interest in long-term lending to non-financial companies, the ABS and covered bond purchases to begin in November as well as the second round of TLTRO due on December, should weigh on the euro toward the end of the year, thus should favor the sell-side in EUR/GBP markets. Versus the Yen, the impressive GBP rally pushed the pair above 180.00 for the first time since October 2008. As we suspect that the rapid sell-off in Yen requires a short-term pause at the current levels, the divergence between BoE/BoJ should keep the bias on the upside in the first half of 2015.

FX Markets

The strength in US dollar has further to go

Recent USD strength is part of more structural trend

The recent appreciation of the US dollar has been impressive. However, a large part of the appreciation of the US dollar has been caused by the weakness of other currencies (EUR has been dragged by ECB's actions, GBP by uncertainties linked to the Scottish referendum and JPY by Abenomics). Still, many drivers hint that this is only the first part of a structural trend in favour of the greenback.

The US has one of the rare economy whose strength is backed by private sector demand. As a result, the inflation outlook is likely to deviate further from other developed economies. Coupled with the fact that the US is identified as better positioned to cope with the dis-inflationary effect of ageing population compared to other developed countries, the long-term interest rates are set to support a stronger USD.

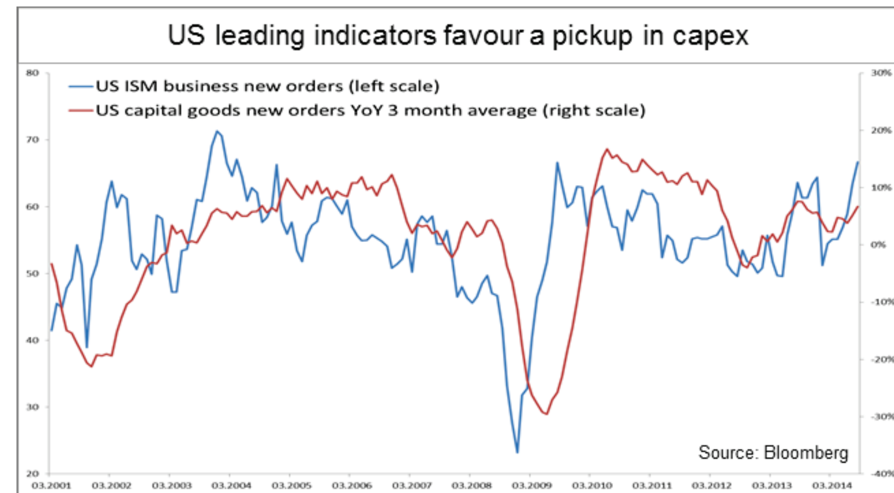
The US inflation outlook will also support the Fed's tightening cycle. As the short-term interest rates increase, USD buying interest is expected to increase significantly.

The prospect of energy independence in the US thanks to shale gas extraction has strongly improved the US trade balance, leading to a similar move in the US current account balance. Such betterment should support a stronger greenback.

The US dollar is not suffering from any over-valuation issues as can be seen by the proximity of the traded weighted index to its 40 year low. Furthermore, Purchasing Power Parity measures indicate that the USD is undervalued again all major currencies except the yen.

Potential long-term base formation in US dollar index

Looking at the chart of the US dollar index, the consolidation in place since 2008 has some resemblance with the one that occurred from 1991 to 1997. Even if the USD appreciation could be less spectacular than what happened after 1997, a rise towards 92.63 (2004-2005 high) is in all likelihood a very conservative objective.

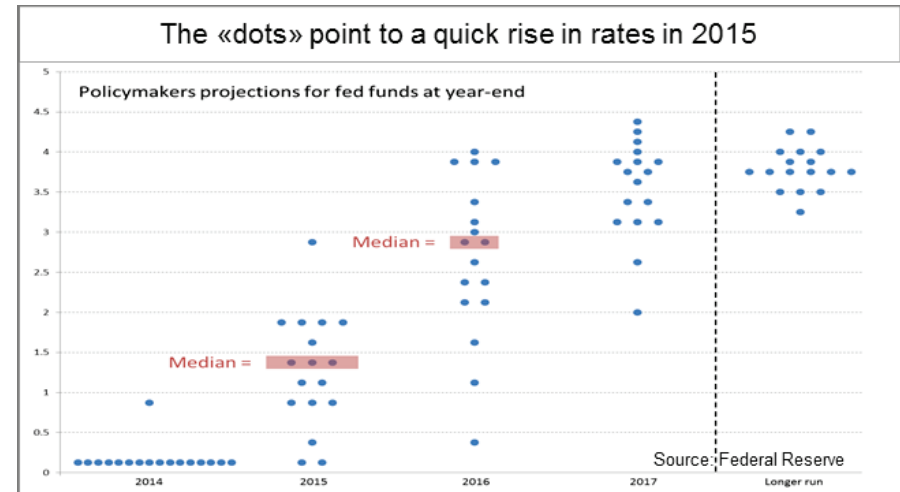


FX Markets

Short-term disappointments for EUR/USD bears

The Fed keeps forward guidance but hints at a faster rate cycle

Following the September FOMC meeting, the Fed left unchanged its forward guidance of a "considerable time" between the end of the asset purchases (October) and the first rate hike. However, the timing of the tightening cycle remains mostly data-dependent as highlighted in the "Policy Normalization Principles and Plans". Coupled with a slight downgrade in the description of inflation, there was no clear hawkish shift in the Fed's statement. On the other hand, the projections for the Fed funds were pushed slightly higher for end of 2015 (median at 1.375%) and for end of 2016 (median at 2.875%). As a result, should the Fed starts its tightening cycle in June, projections point to a rather steep rate path.



First TLTRO auction disappoints

On the maximum €400bn made available by the ECB across the two TLTRO auctions, only €83bn has been borrowed on 18 September. This result is much lower than expected. However, it has to be noted that despite the ECB made it clear that rates will not move lower, in order to signal that TLTRO rate (defined by refi rate plus 10bp) will not get more attractive, there were still reasons to wait for the 11 December auction. Indeed, banks can borrow cheaper money (at refi rate) through pre-existing 3-month LTRO programmes. As these LTROs expire on 29 January and 26 February, the 11 December TLTRO auction will be much more attractive. Furthermore, the ECB's asset quality review will be over, alleviating some resistances for banks to increase their borrowing.

A rebound in EUR/USD is getting more likely

The aforementioned developments, coupled with significant net short EUR positions and the strong support at 1.2755, increase the odds to see a rebound in EUR/USD. This could offer a chance to sell it at better levels.

FX Markets

GBP net positioning remains long

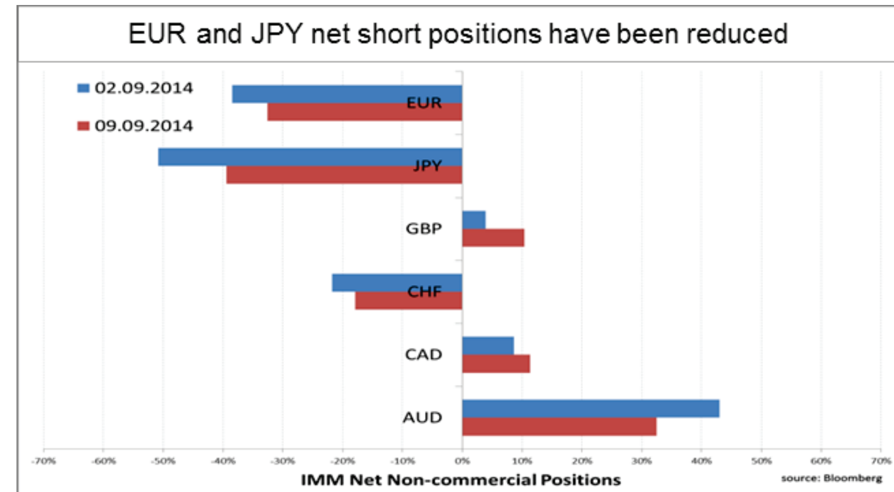
The International Monetary Market (IMM) non-commercial positioning is used to visualise the flow of funds from one currency to another. It is usually viewed as a contrarian indicator when it reaches an extreme in positioning.

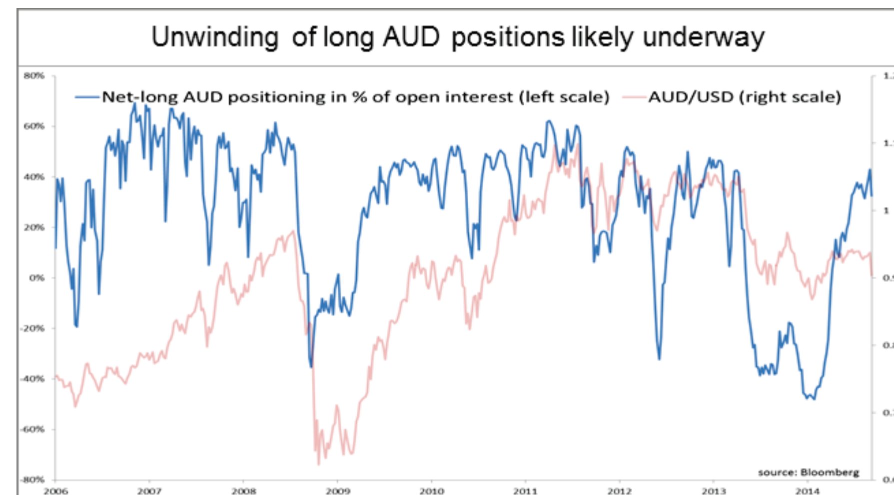
The IMM data covers investors' positions for the week ending 9 September 2014.

The significant net short positions in Euro and Japanese yen have been reduced. Even though it could spur some temporary countertrend moves in EUR/USD and USD/JPY, the underlying trend (bearish in EUR/USD, bullish in USD/JPY) is not expected to be reversed.

The British pound has been bought despite the high uncertainties linked to the Scottish referendum. This increase in net long GBP positions suggests that GBP/USD weakness looked overdone for investors 9 days before the referendum. It also suggests that any potential relief rally after the pro-union victory will not be fueled by short GBP unwinding.

The decline in AUD net long positions has likely fueled the decline in AUD/USD. Given the recent elevated levels reached by net long positions, this long unwinding is likely to weigh further on AUD/USD.





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