

# WEEKLY REPORT

**29 September - 5 October 2014**

**WEEKLY REPORT - An overview**

<b>p3</b>	<b>FX Markets</b>	Dynamics behind the recent XAU sell-off - Ipek Ozkardeskaya
<b>p4</b>	<b>FX Markets</b>	RBA/RBNZ gap tightens on Australia's hot housing market - Ipek Ozkardeskaya
<b>p5</b>	<b>Stock Markets</b>	Technical take on the US stock market - Luc Luyet
<b>p6</b>	<b>FX Markets</b>	Lack of buying interest in Sterling - Luc Luyet
<b>p7</b>	<b>FX Markets</b>	Commodity currencies hurt by long unwinding - Luc Luyet
<b>p8</b>	<b>Disclaimer</b>	

## FX Markets

## Dynamics behind the recent XAU sell-off

### XAU at risk as Fed exits QE?

The broad based USD strength continues weighing on gold. XAU/USD extended losses to an 8 month low of \$1,208.40 on September 22nd in the continuation of steep downtrend channel building since September 2nd. Since the month began, the XAU/USD lost more than 5% and the bearish momentum has not slowed yet. What is the downside potential in gold prices?

Optimism on US recovery and hawkish Fed expectations will certainly keep selling pressures tight in XAU/USD. The significant surge in gold prices has started in 2007-2008 as the Fed launched its first QE. The inflationary fears due to massive liquidity injection lifted XAU/USD above \$1,000 toward the end-2009. The gold hit \$1,920 on September 2011. As the Fed intervention did not result in irrepressible inflationary pressures, the gold prices are seen stabilized at \$1,200-1,500. However as we approach the lower band of past 4-year trading band, multiple factors enter the game and the price direction becomes difficult to predict. Today, the market sentiment improves regarding the US economy. The Fed will end its third QE program in October 2014, bringing us to the new era of policy normalization. The Fed's 4.5 billion dollar balance sheet will start contracting. Will follow the first Fed fund rate hike. Although the timing remains uncertain, the first Fed hike is estimated by the second half of 2015. From a technical perspective, the Fed normalization could stimulate normalization in gold markets and possibly shift the gold levels toward \$680-1000 (2008-2009 trading band) should the critical \$1,150-80 support breaks. This said, markets are not pricing in the coming ECB expansion yet. Should the ECB liquidity partially counter-balance the Fed tightening, the normalization in gold markets will certainly be delayed.

### Risk of correlation breakdown

On the opposite side, the geopolitical tensions and the safe-haven demand keep the XAU/USD bid above this critical support. Yet if the US

economy is ready for normalization, it should be good news for risk lovers. As the risk appetite improves, the gold allocation in investment portfolios should automatically decrease, thus further weigh on gold. Following this reasoning, we can also explain why the SPDR Gold Trust holdings retreated to 774.65 metric tons, the lowest since end of 2008. At this point, we still need the hedging/risk-diversifying characteristic of gold in investment portfolios, simply because the end of cheap liquidity can temporary hit the stock/bond values, increase volatilities and keep the demand in gold sustained before the tighter Fed policy becomes the new standard. However, we see a fresh breakdown in negative correlation between S&P 500 and XAU since the September Fed meeting. The 40-day correlation between US stocks and XAU turn positive for the first time this year, fueling doubts that portfolio managers cannot safely count on gold hedging mechanism. Should this situation persist, the \$1,150-80 support will come under higher pressure.

### Is the sharp reversal in correlation dynamics temporary?

As the ECB expansion is poorly priced in, a tangible explanation is perhaps the gold demand ex-investment/hedging purposes and the lower gold supply. In fact, prices falling towards \$1,200 elicits strong demand in physical gold markets as Asian and Middle East markets are highly price sensitive. The gold demand in China and India, world's biggest gold buyers, are expected to accelerate in the fourth quarter, while the latest reports show that the scrap supply will drop 17% in 2H. The classical supply-demand mechanisms should thus sustain the gold prices before the year-end as the festive/wedding season is expected to have significant boost in physical gold. This seasonal effect clearly distort the short-term shift in correlation dynamics. Hence it is too early to talk about a long-term impact on gold prices. Walking into 2015, we will be monitoring a break below the \$1,150/80 support, as the Fed/ECB dynamics concertize.

## FX Markets

## RBA/RBNZ gap tightens on Australia's hot housing market

### RBA reacts to hot housing market

The Australian policymakers have finally voiced their discomfort regarding the distortion in the housing market. In its semi-annual Financial Stability Review, RBA said "The composition of housing and mortgage market is becoming unbalanced, with new lending to investors being out of proportion to rental housing's share of the housing stock". New measures are needed to be discussed to make sure the lending conditions become more rigorous than what we currently see. In fact, the overheating housing prices have long been tolerated due to structural transition that Australia is favoring from mining to construction sector. However, the speculative dimension of the hot real estate market now raise the question of how stable is this growth, what is the potential of an amplified sell-off in the future and what would be the implications on household wealth stability once the RBA will lift its rates to "normal" levels from the current historical lows. "Banks need to ensure that loans generated in the current environment can still be serviced by borrowers in less favorable circumstances" said the RBA "for instance, at higher interest rates or during a period of weaker economic conditions". According to the IMF, Australia has one of the highest house prices –to-income ratio (after Belgium and Canada). The slow growth in wages is clearly a concern for the worsening of this proportion. The introduction of macro-prudential measures is perhaps what the RBA is preparing for to cool down the overheating housing prices. On a side note, we remind that the RBNZ has been brought to raise its rates first among the leading central banks mostly due to unsustainable house price inflation (other than introducing restrictions on lending).

Externally, the concerns on weak Chinese recovery, the softening commodity markets and the broad based USD strength should keep the pressures tight on AUD. The long-term underlying downtrend and the lack of base formation on January 2014 keeps the AUD/USD bias on the downside. A critical support is seen at 0.8660 (Jan'14 low).

Versus the Kiwi, the unwind in Kiwi positions continue favoring the AUD/NZD on the upside, now that the RBA/RBNZ outlook gap took a fresh turn after the recent developments.

### Quick follow up on NZ election

The New Zealand's National Party won its third term in September 20th general elections. The pressures on RBNZ dissipated alongside with Labour Party's hopes to win. The Labour Party's Parker was aiming to set new monetary policy challenges to counter the strength in the Kiwi, such as a policy target for the current account deficit and the use of pension contributions as additional monetary policy tool. Parker's defeat scattered political risks on the NZD, yet the softer commodity markets (especially the tumbling export revenues from dairy products), USD strength and limited high-beta appetite should continue weighing on the NZD-complex. NZD/USD broke its key support at 0.8052 (04/02/2014 low), a fresh year low, as Fonterra cut its milk payout forecasts on September 23rd. The negative pressures continue. Supports can be found around 0.7840 (long-term rising channel) and 0.7684 (24/06/2014 low).

## Stock Markets

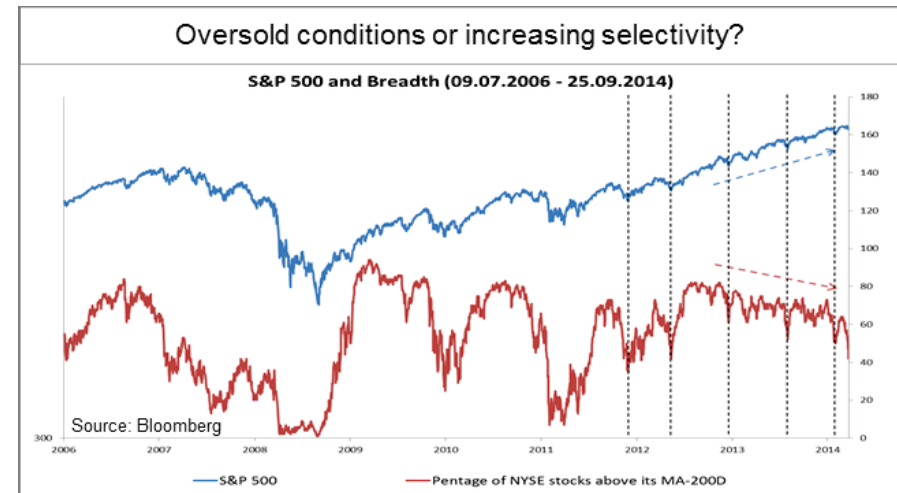
## Technical take on the US stock market

### Increasing selectivity in US stock market

The S&P 500, which encompasses the largest listed US companies in term of market capitalisation, is close to its all-time highs. However, looking at the broad US stock market, the strength in large caps has not recently been confirmed by US mid cap and small cap indices. Indeed, looking at the S&P 400 Midcap and the S&P 600 Smallcap, these indices have not made new highs since July and are not as close to their previous highs than the S&P 500 (around -5.2% for mid-cap and around -8.0% for small-cap). Furthermore, the percentage of stocks (traded in NYSE) above their 200-day moving average has recently moved below 50% and is at its lowest levels since November 2012. All these developments point towards increasing selectivity in the US stock market (the same is true for the German stock market).

### Half-empty glass or half-full glass?

Increased selectivity means that the stock market relies on fewer stocks to advance and is left with a more fragile base to withstand any pickup in selling pressures. However, breadth indicator are not useful in providing a precise timing to exit the market. For example, the decline in the percentage of stocks above their 200-day MA is in place since May 2013. As a result, price patterns remain key for timing issues. The underlying trend and the lack of distributive pattern in mid-caps or small-caps suggest that selectivity issues remain premature. In that respect, it is worth monitoring the support at 1356 (01/08/2014 low) in S&P 400 Midcap, as a break would invalidate the succession of higher lows and validate a double-top formation. On the other hand, should small and mid cap start to strengthen again, this could lead to a new broad-based market rise. Looking at seasonality, the end of year is historically the most bullish period for stocks, confirming that a significant decline till the end of the year is unlikely. So selectivity is a worry, but it is likely too soon to get out of the market.



## FX Markets

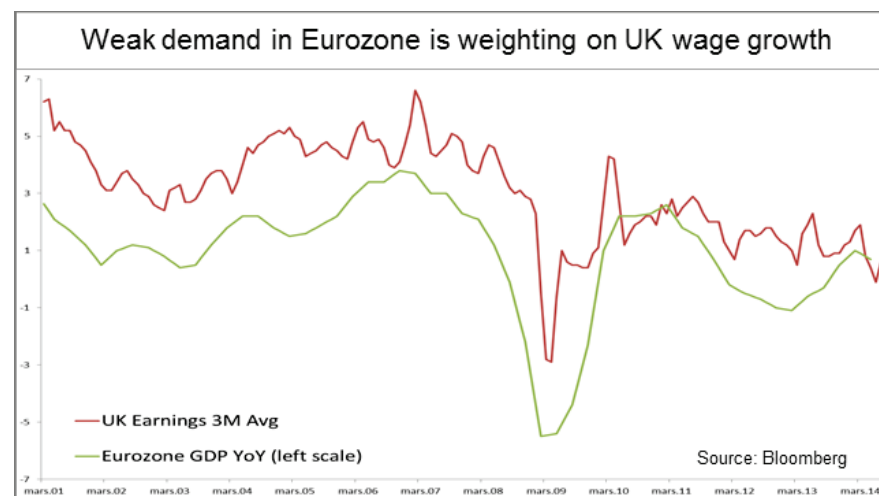
## Lack of buying interest in Sterling

### Subdued buying interest in British pound

With the uncertainties linked to the Scottish referendum behind us and the comfortable margin of the pro-union victory, a short-term pickup in Sterling demand was expected. Even though the British pound did strengthen, the scope of its appreciation suggests a limited buying interest. Part of the reason likely stems from the policy outlook from the Bank of England (BoE). It remains likely that the BoE will be the first major central bank to raise rates. However, compared to the US, this early hike is not as important as the subsequent path rate. Indeed, the BoE is in no position to follow a path rate as aggressive as indicated by the Fed's projections. Furthermore, although the relative monetary policy favours a weaker EUR/GBP, the disinflationary pressures in Eurozone could slow the BoE's normalisation process. Indeed, persistent weak demand from UK's main trading partner is likely to lead to margin erosion (as prices are lowered), causing weaker wage growth (which is a key input in BoE's monetary policy) and weighting on inflation and GDP. Finally, as explained in a previous report, UK's large current account deficit is likely to be an obstacle for sustained GBP appreciation. As a result, the GBP supporting driver stemming from the proximity of the first BoE's rate hike is unlikely to have a lasting effect as wage growth and GDP are likely to stall unless the Eurozone economic outlook improves (which would then also reduce selling pressures in Euro).

### Technical take on GBP/USD and EUR/GBP

Looking at price behaviour, GBP/USD is unlikely to rise higher than the resistance area between 1.6644 (01/09/2014 high) and 1.6739 (18/08/2014 high). On the other hand, EUR/GBP is getting nearer to its strong support area between 0.7755 and 0.7694. Even if a break lower is favoured, the subsequent decline will likely be more gradual. As a result, the low of the long-term declining channel is unlikely to be broken.



## FX Markets

## Commodity currencies hurt by long unwinding

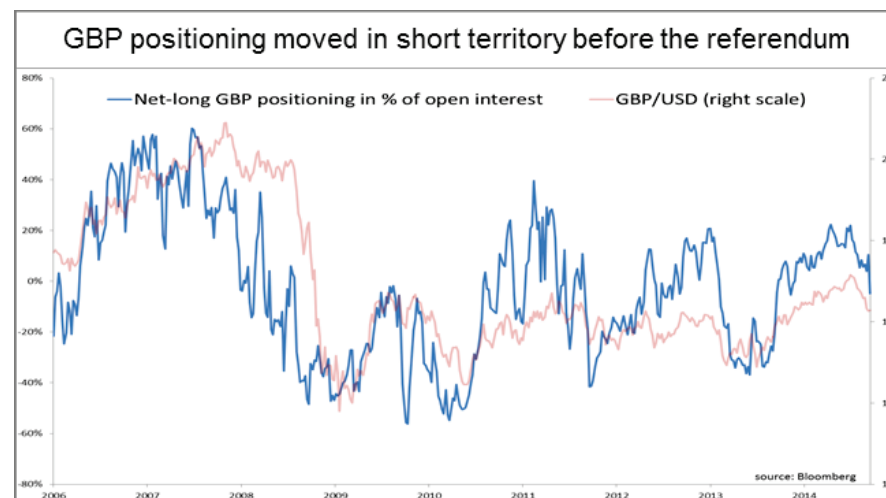
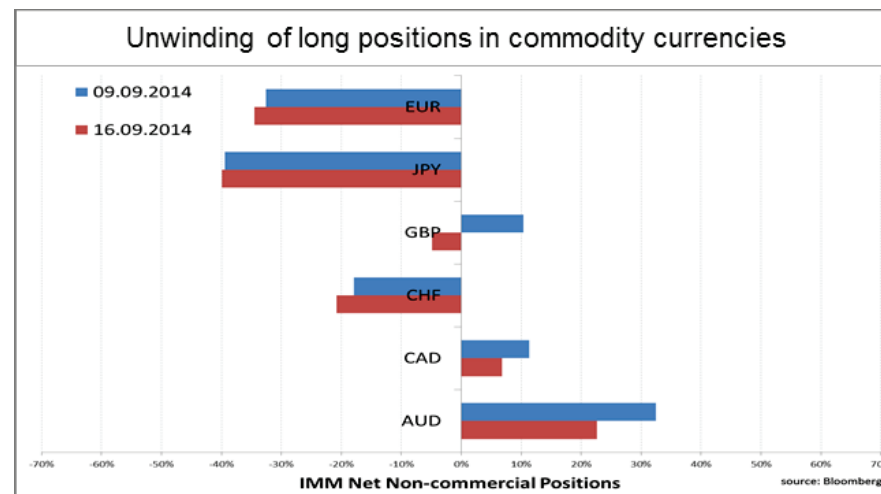
**The International Monetary Market (IMM) non-commercial positioning is used to visualise the flow of funds from one currency to another. It is usually viewed as a contrarian indicator when it reaches an extreme in positioning.**

The IMM data covers investors' positions for the week ending 16 September 2014.

The positioning in Sterling two days before the Scottish referendum was slightly short. Even though the 1-week change in positioning was significant, the current net short GBP positioning (-4.89%) suggests that short unwinding is unlikely to have any significant effect on a potential rebound in GBP/USD.

The main moves in positions have occurred in commodity currencies. Australian and Canadian dollar net long positions have been further reduced. Given the recent elevated net long AUD positions, the recent weakness in AUD/USD has likely been fueled by a sharp unwinding in AUD positions.

The Euro and the Japanese yen continue to display high net short positions. Even if it can lead to short-term volatility, the underlying USD bullish trend is likely to support a persistent large net short exposure in EUR and JPY.



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