

# WEEKLY MARKET OUTLOOK

20 - 26 October 2014

**WEEKLY REPORT - An overview**

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## Economics

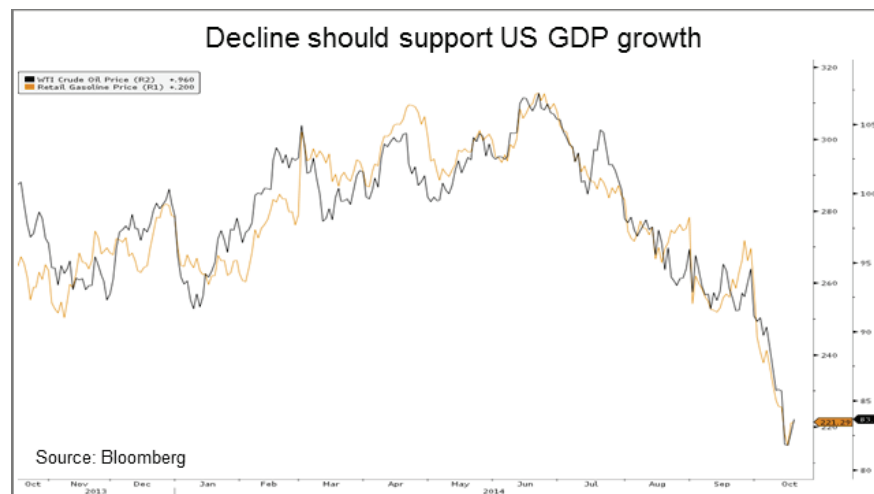
## Growth fears overdone

There is clearly a growing nervousness in financial markets. The sharp decline in equity markets and rally in US treasury bonds this week had an overall impression of panic. While the outlook for the Eurozone continues to deteriorate (supported by weak German industry data), the overall view for global economic growth remains stable, although moderate. We suspect that growth in the US, assisted by lower oil prices (see chart on the right), will allow asset prices to recover.

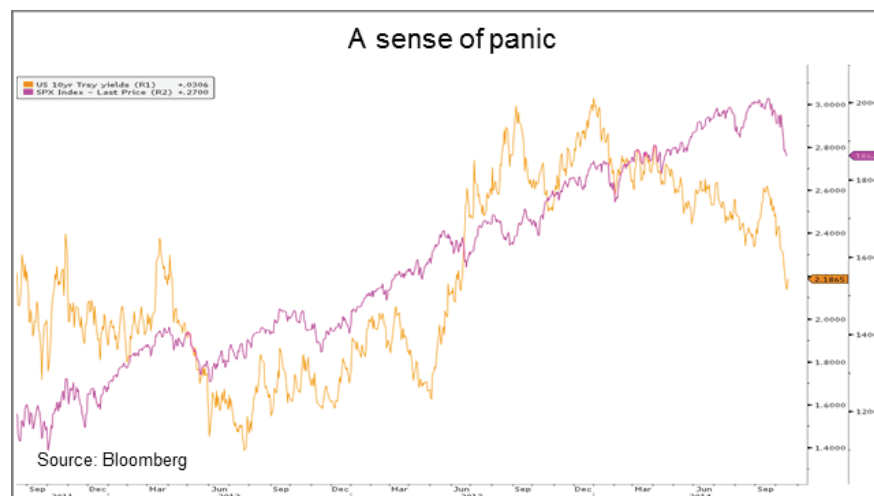
The weak US retail sales triggered an unbalanced reaction, as trader's speculated on the collapse of US domestic demand. However, with further investigation, it is clear that the underlying sales growth remains upwards. Slump in retail sales was majority the result of a steep drop in auto sales but only after reaching a nine-year high in August. In the broader context, by adding 200,000 jobs for the majority of 2014, personal spending and real income is on a gentle upwards trend (also helped by fall in retail gasoline), GDP growth remain on a 3.0% path for 2014.

With hysterical analysis grabbing the headlines, we suspect that the concept of delaying the end of QE3 or launched QE4 is the most absurd. Inflation is heading in the wrong direction, due primarily to a fall in commodity prices. The generally hawkish St. Louis Fed President James Bullard grabbed the headlines by suggesting the Fed should discuss delaying the end of asset purchases given the soft inflation expectations. Yet, we think the spillover from commodities is transitory and a majority of members understands that. The drop in August headline CPI was abrupt yet with y/y 1.3% a strong disinflation threat is unlikely. Finally, with US treasuries heading lower (see chart on the right, yellow line) now is exactly the time the Fed should wean the financial markets off cheap liquidity. We expected after this minor dip, US data will steadily improve into the New Year, with the Fed moving to hike in early Q2 2015.

### Decline should support US GDP growth



### A sense of panic



**FX Markets****Loonie extends losses on alarming slide in oil prices****WTI crude hit 80\$ / barrel**

As the global economic slowdown story gains traction, the spillover into oil prices has been acute. Since WTI crude's 2014 peak at \$104, the price has fallen over 22% (\$24 decline), a four-month downtrend. The decline was amplified by an overabundance of supply hitting the market and an inability of struggling Asian economies to absorb the surplus. Brent crude has followed a similar pattern of weakness slipping below \$83 - the lowest level since 2010. Commodity correlated currencies such as the CAD, RUB and NOK have been hit hardest by the lower oil prices. The IEA revised lower its demand projections by 250 barrels per day, citing easing slowing global economies. The cut forecast sent oil prices further down, the WTI crude hit \$80.00. Moving forward, the direction of oil prices (risk of further downside) remain uncertain. Traders are eyeing OPEC's next meeting on November 27th. In normal circumstance, we should expect OPEC to react but due to geopolitical issues we believe OPEC will allow further weakness oil prices.

**BoC-doves in charge**

USD/CAD extended gains to the fresh 5-year high of 1.1375 on week to October 17th, due to concerns on falling oil prices. The oil prices are now at alarming levels, as the oil industry will get a serious hit below the \$85-profitability-threshold for some oil sand projects, according to International Energy Agency. If this is the case, lower prices can only hit Canada's most important export business and thus impact the already fragile Canadian recovery. Autumn Business Outlook Survey showed signs of firmer foreign demand, yet the slight improvement in business outlook failed to strengthen investment intentions for the next 12 months (source: BoC website). The trend in oil prices will perhaps not be helpful to push investor appetite higher.

Technically, the USD/CAD extension over the 1.1280 resistance suggests the bullish momentum remains on track, with a medium target of 1.15.

Although in the longer run yield spreads have a greater influence. The divergence between BoC and Fed policy further support the upside in USD/CAD. In addition, the 3-month currency basis print significant preference for USD vs. CAD. The BoC should remain dovish as long as the macroeconomic conditions (especially the inflation) allow supporting export growth through currency depreciation. This should let the USD/CAD short term spreads to further widen, pushing USD/CAD higher.

**Economics****Cold Winds in the Euro-zone****Heavy sell-off in peripheral bonds**

The risk sentiment in EUR remains limited as Greek 10-years climb to 9% for the first time since October 2013. Traders seek exit from peripheral risks and fast, as fading liquidities increase anxiety; Portugal (+50 bp), Italian (+35bp) and Spain (+20bp) 10-year yields rise significantly. The 40-day rolling correlation between Spain-German 10-year spread extends above 50%, partially explaining EUR/USD holding support even after soft CPI release yesterday. As fragmentation in the Euro-zone surge, EUR/USD increases as traders need more hint on a potential ECB QE (as support). Although the short-term bullish momentum strengthens, top seller strategies dominate pre-1.30 as the EUR-negative risks prevail. Markets are very sensible to QE-related comments as the Euro-zone recovery remains very fragile.

**Political tensions escalate between core and periphery**

On the other hand, the discrepancies between policy makers increase tensions at the heart of the Euro-zone. ECB President Draghi insistently asks political support to establish fiscal reforms (lower taxes, lighter fiscal consolidation) to avoid a dangerous deflationary spiral to install in the Euro-zone. The Euro-zone aggregate CPI accelerated 0.4% in month to September; the CPI y/y remained stable at 0.3%, the core CPI advanced from 0.7% to 0.8%. Given the alarming macro-metrics, peripheral countries ask for more easing to step out of recession, while German politicians and Bundesbank have enough of monetary stimuli and the ongoing financial chaos. German Chancellor Angela Merkel said yesterday that economic aid was underused, adding "We in Germany are showing that growth and investment can be strengthened without leaving the path of consolidation". Cold winds blow in Europe.

On October 21st, Eurostat will publish Euro-zone's government debt ratio in 2013 (as % GDP). In 2012, the total EZ government debt reached 92.60% of the GDP (vs. 66.2% in 2007). The release may revive discussions

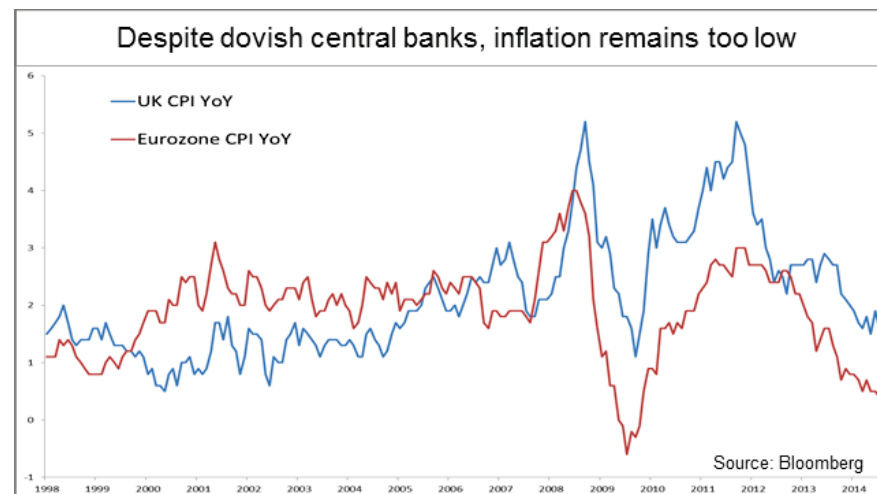
on whether or not the EZ countries should further tighten their belts.

## FX Markets

## EUR/GBP to stall near 0.8034/0.8066

### Inflation remains globally low

The persistent decline in oil prices is a reminder of the dis-inflationary pressures that are plaguing the global economy. For the European Central Bank (ECB), this is particularly bad news as inflation expectations are de-anchoring from their 2% target. As a result, it is likely that the ECB will have to do more in terms of monetary policy. In the UK, inflation data are also weakening. However, the labour market continues to improve, although at a slow pace, while growth should remain supported by a strong UK service sector. As a result, the Bank of England (BoE) is likely to continue to discuss when raising rates. Meanwhile, market expectations for the first rate hike has drastically been pushed back (August 2015), which should limit the scope for negative surprises on that front going forward. Furthermore, limited excess capacity in the UK and a tighter job market should allow a continuous slow rise in rates after the first hike.



### EUR/GBP is near a strong resistance area

Looking at EUR/GBP, prices have risen after having successfully tested the key support at 0.7755. However, the FX pair is now close to the strong resistance area defined by 0.8034 and the long-term declining channel. Furthermore, the proximity of the 200-day moving average should act as an additional barrier for any further strength in EUR/GBP. On the other hand, a new test of the support at 0.7755 is seen as a conservative downside risk. Indeed, the economic outlook between the Eurozone and the UK continues to favour further divergence in relative monetary policies, which should keep on weighting on EUR/GBP.



## FX Markets

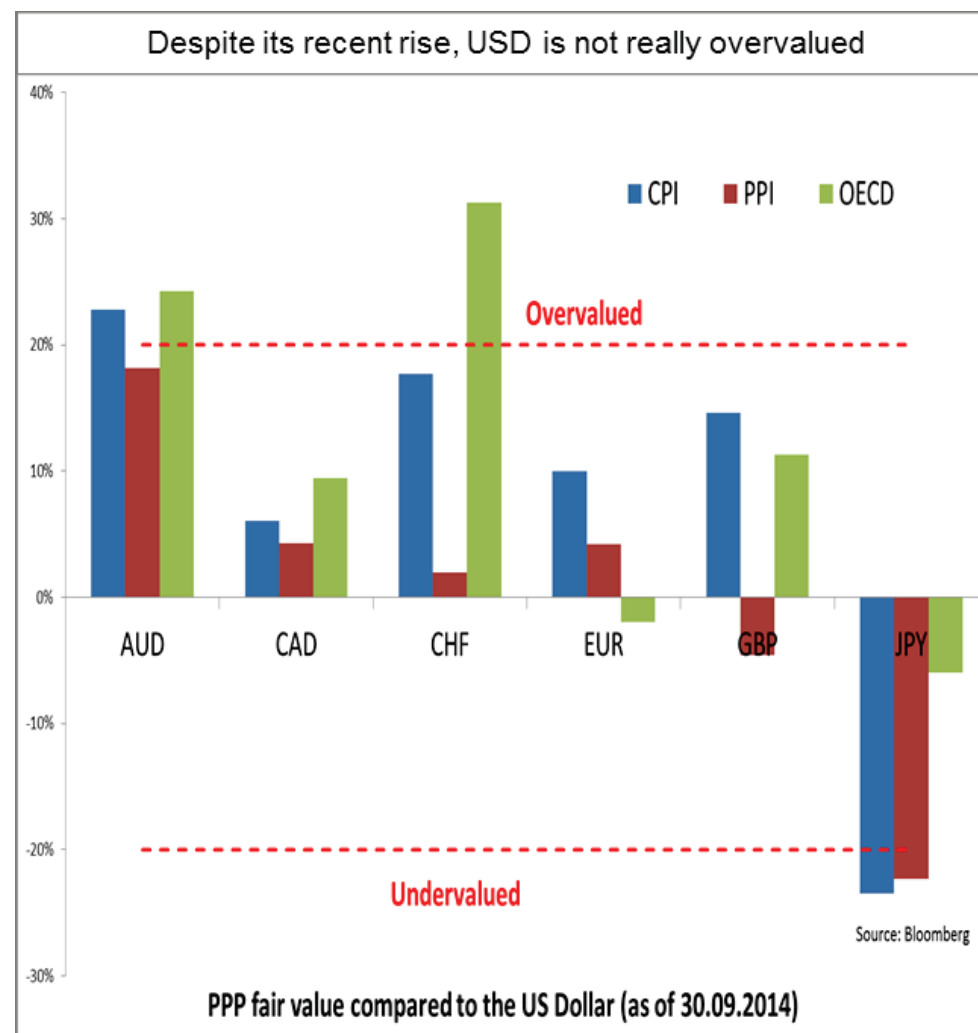
## Long-term valuations not overstretched in USD

### US dollar is not overvalued

Given the recent broad-based appreciation of the US dollar, it is interesting to look at long-term valuation measures like the purchasing power parity (PPP) to see if the greenback has moved too far. Barring the Japanese yen, all major currencies remains above their long-term "fair-value" against the US dollar. In other words, in aggregate, the US dollar is de facto below its long-term "fair-value". As a result, given the long-term positive drivers in favour of the appreciation of the USD (divergent monetary policy, shrinking US current account deficit), it would be very unlikely that the end of the US dollar appreciation occurs without being broadly overvalued. Furthermore, as the US dollar index is highly sensitive to the performance of the Euro, the fact that the single currency is nowhere near undervalued territory suggests that long-term valuation measures are far from signalling the end of the USD appreciation.

### The Australian dollar is the most overvalued currency

Looking at PPP valuations, the Australian dollar is the most overvalued major currency. These long-term valuations should act as a barrier for sustainable strength in AUD/USD and suggests that a bottom in AUD/USD has likely not been made yet. The Swiss franc is significantly overvalued looking at OECD calculations. However, selling EUR/USD remains more attractive than buying USD/CHF as it does not bear the tail risk of a break of the 1.20 threshold in EUR/CHF. The undervaluation in yen (at least in two calculations) is likely to create headwinds, suggesting that any rise in USD/JPY is likely to be more gradual than what has occurred between August and September.



## FX Markets

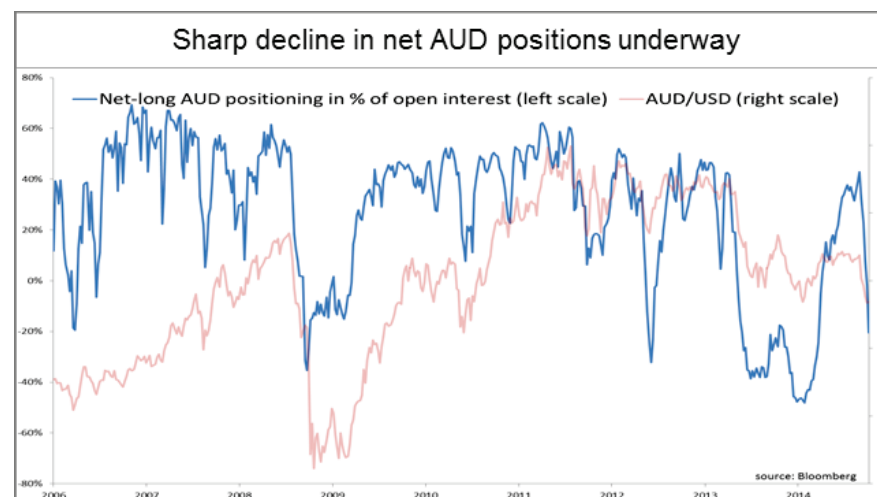
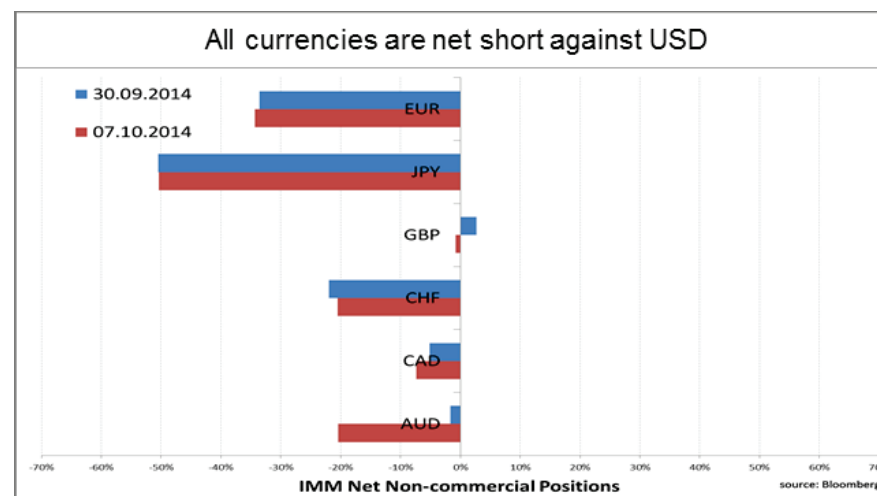
## Major currencies are now all net short against the USD

**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 7 October 2014.

Looking at net positions, all currencies are now net short against the US dollar. As a result, the aggregate long USD positions have further increased and are getting closer to their May 2013 high. Even if short-term downside risks could be magnified by this elevated long USD positioning, we continue to believe that the underlying long-term USD bullish trend is not over yet.

Compared to last week data, the major change in positioning occurred in the Australian dollar. This confirms the sharp reversal in non-commercial positions as they have moved from 42.97% (2 September 2014) to -20.44% (7 October 2014). Monitor the strong support at 0.8660 (24/01/2014 low) in AUD/USD, as prices are getting increasingly sensitive to any temporary countertrend move.





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