WEEKLY MARKET OUTLOOK

27 October - 2 November 2014

Swissquote Bank SA | Ch. de la Crétaux 33, CP 319 | CH-1196 Gland | Switzerland
Tel +41 22 999 94 11 | Fax +41 22 999 94 12 | forex.analysis@swissquote.ch | www.swissquote.com/fx

DISCLAIMER & DISCLOSURES

WEEKLY REPORT - An overview

Economics

"Saving Switzerland's Gold" won't save the day

On November 30th, Swiss people will vote to decide whether
- The SNB should hold 20% of its reserves in gold,
- The gold reserves should be stored in Switzerland,
- The SNB should be allowed to sell its gold reserves.

The recent polls revealed 45% support for the campaign, while we believe that the likelihood of a "yes" vote is limited. Both chambers of Swiss parliament are heavily opposed to the "golden cage". One thing is sure: polls tend to be unstable and therefore should inject some volatility to relatively quiet Swiss markets in month ahead.

In a recent interview, Swiss Finance Minister Eveline Widmer-Schlumph said the current 1,040 tons of gold reserve is more than sufficient to taper risk-off periods. To which we add that the negative correlation breakdowns since 2007 crisis has proven that the gold is not a perfect hedge nowadays. Nor a source of stability. As the VIX index surged 80% in October 2008, the 1-month realized volatility in XAU/USD spiked to 56%, the 1-month implied vol neared 58%. This is certainly not a track record one seeks in a safe-haven investment.
In this respect, to condemn one fifth of SNB's balance sheet to a risk asset is not efficient from a portfolio point of view. Even if this was the case, there is no restriction preventing SNB from allocating 20% of its assets into gold.

The SNB currently holds about 8% of its reserves in gold (USD 43bn of gold holdings versus CHF 522bn balance sheet). Introducing the potential 20% bottom will therefore require a sizeable market operation, the necessity is somewhat uncertain. Especially regarding the quantities on table, a 1500-ton XAU-long operation (in five year period) can hardly be profitable for the SNB. Given that the annual mine production nears 3000 tons, this would mean that the SNB would buy 10% of world's mine production per year during the five next years. This additional gold demand can only push the gold prices higher and increase the cost of the operation. In addition, a "yes" vote will certainly boost speculative demand and provide an additional leveraged lift to the market, pushing the gold prices disproportionally higher! At the end of the game, the SNB would only constitute an expensive reserve in a quiet risky asset.

The gold initiative is therefore a heavy constraint on SNB strategy and would only limit the independence and efficiency of SNB's investment activities. In fact, the SNB, unlike its worldwide peers, has a meaningful maneuver margin on its activities. While the majority of its counterparts invest mostly in sovereign bonds, the SNB has the flexibility to hold 30% of its balance sheet in foreign assets, corporate or sovereign, which provides interesting geographical diversification and undisputable time advantage. In 2008, the SNB opened a branch in Singapore "to extend its coverage of markets in Asia", "to ensure a more efficient management of its assets in the Asia-Pacific region" and more importantly to "facilitate round-the-clock operations on the FX market".

It would only be dangerous and expensive to narrow SNB's maneuver margin. The SNB has already an important constraint: it should defend its 1.20 floor versus the euro. The situation in the Euro-zone remains alarming with the possibility of QE introduction in the close future. Although we do not see an immediate impact on the franc, the SNB clearly needs to keep the entire control at hand, and that rules out the sizeable 20% gold constraint that a "yes" vote would require.

FX Markets

BRL sell-off intensifies as polls favor Rousseff's victory

In Brazil, the second round of the presidential elections is due on October 26th. As the weekly closing bell approaches, the volatilities in BRL should remain elevated. USD/BRL's 1-month implied volatility spiked above 26% on week to October 24th as speculative trades, leveraged bets were the major source of vol. The event risk is very high and the sensitivity to election polls, surveys and political views/comments may trigger two-side volatility pre-weekend.

USD/BRL hit the fresh 6-year highs on week to October 24th, the direction post-election remains uncertain. We stand ready for a post-election relief rally in BRL, especially if the presidential course resumes with the opposition candidate Aécio Neves' victory. Neves program is mostly favored by investors as he is expected to run a market-oriented policy, to promote economic liberalization, to simplify Brazil's complex tax system and to fight the overheating inflation. Given sizeable leveraged bets, the USD/BRL has room to fall towards Fibonacci 50% retracement on September rally (2.36s) before the Real positioning stabilizes on macro-related allocations. A victory for Rousseff however will certainly let slip some disappointment on the market place. The Brazilian economy certainly needs to take a fresh breather. Given the macro fundamentals, another four years of Dilma Rousseff's interventionist regime is the scenario many wish to avoid, although Rousseff is expected to lean towards a less interventionist framework. The latest election polls showed Rousseff's advance on Neves. According to Ibope survey, Rousseff would collect 49% of votes versus 41% for Neves. Datafolha predicts 6 percentage points advance for Rousseff. The volatilities are expected to remain high before the closing bell as speculative positions should remain on the driver seat. The BCB sold 196.5 million dollar FX swaps today and rolled over 392.6b million dollar contracts to temper the BRL-sell-off. Should the selling pressures clear 2.50 offers on Monday, eyes will shift to 2.62s (almost 10 year highs, reached end-2008).

On a side note, we remind that the Brazil's CPI accelerated to 6.75% on year to September – above the BCB's 4.5% (+/- 2%) target band, while the GDP q/q contracted for the second consecutive quarter in 2Q (-0.6% q/q vs -0.15% in Q1). The current account deficit reached 3.77% of the GDP (largest deficit since 2002) rising the BRL-vulnerability to US dollar. The macro picture suggests a weaker BRL moving towards the Fed normalization. High UST-sensitivity should keep the downside pressures high in BRL vs. USD.

The Brazil Central Bank will announce policy on October 29th and is expected to maintain the Selic rate unchanged at 11%. Given the dovish shift in Fed's first rate hike expectations and lower oil prices (good for narrowing the current account deficit), we do not see emergency to proceed with rate action while the 3Q GDP expectations are not brilliant. According to a recent Bloomberg survey, the Brazilian GDP should contract by 0.3% in 3Q, followed by -0.1% in Q4 before getting back in positive territories. Despite inflationary pressures, the growth risk should push the BCB to maintain its rates unchanged for the year-end.

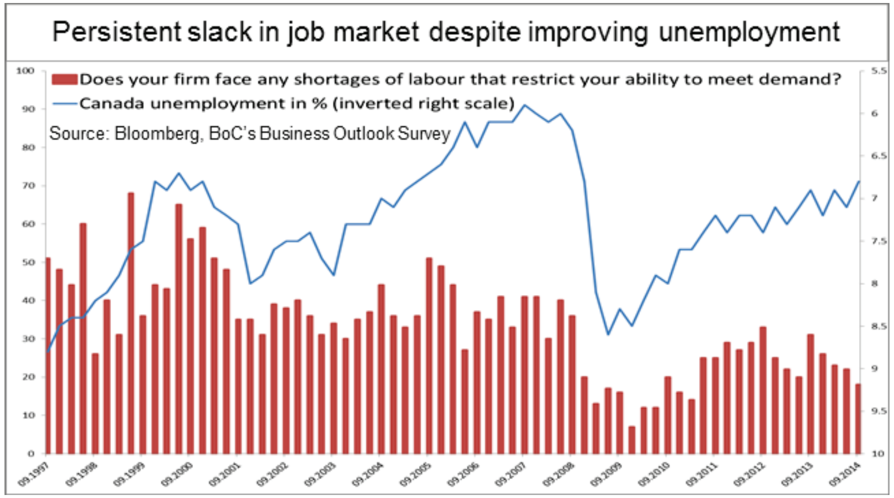
FX Markets | The Bank of Canada drops its forward guidance

Is the Bank of Canada no more neutral?

The Bank of Canada (BoC) has dropped its neutral forward guidance during its October monetary policy meeting. The removal of the forward guidance was hinted by Mr Poloz in his 10 October Discussion Paper. The BoC Governor stated in particular that forward guidances are most useful when the short-term nominal interest rate is at or near zero as it allows to flatten the yield curve even further, while dropping forward guidance allows to "shift some of the policy uncertainty from the central bank's plate back onto the market's place". As a result, the BoC is finding no net benefit to use forward guidances given the increasing caveats embodied in them and the current low levels in long-term yields. Nevertheless, a rate hike remains a distant prospect. Indeed, inflation pressures continue to be weak, business investments stay at low levels (despite improving exports) and excess capacity is considerable. On the other hand, the renewed vigour in housing market can be dealt with macro-prudential measures. As a result, even if the BoC is no more explicitly neutral, it should not be seen as a shift towards a more hawkish stance.

Further gradual rise favoured in USD/CAD

However, the change in BoC's communication suggests that the central bank is getting less aggressive in talking down the Canadian dollar. As a result, even if the USD/CAD is expected to move higher towards 1.1500 (psychological threshold), possibly 1.1725 (08/07/2009 high), the rate of ascend is likely to be slow. This can be seen by the recent lack of follow-through after the bullish breakout of the resistance at 1.1279. As a result, USD/CAD looks attractive on the long side only on weakness. Currently, a key support stands at 1.1072 (02/10/2014 low), as it is also close to a rising trendline.



FX Markets

Further rise in USD/JPY remains favoured

Japanese inflation expectations are declining

Hawkish expectations on US monetary policy have recently done the heavy lifting in USD/JPY. However, the Bank of Japan (BoJ) is likely to contribute more actively in the coming months. Indeed, as its monetary policy is highly focused on the inflation target, pressures are mounting on the BoJ to provide more support to inflation. This is especially true as inflation surveys do not match the BoJ's outlook.

Households surveys show that a huge majority expects a slight rise, mostly caused by increases in food and gasoline prices. More durable drivers like wages are not expected. Coupled with weakening growth potential expectations, household surveys indicate that the "Abenomics" effect is wearing off.

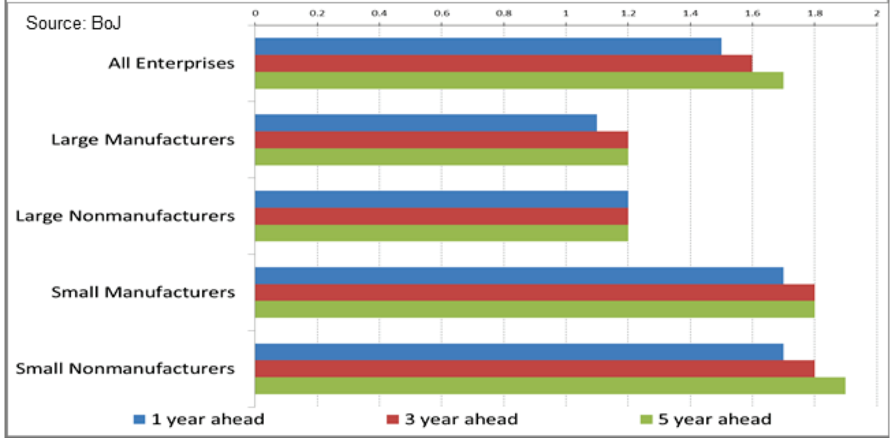
The inflation outlook from corporations, which was recently added in the quarterly Tankan, also highlights a more modest view on inflation than the BoJ. Indeed, none of the enterprises surveyed see inflation higher than 2% (excluding the VAT effect) even on a 5-year horizon.

Finally, economists surveys and market expectations (through the 5y5y inflation swap) also confirm a weakening outlook, suggesting that without additional easing from the BoJ, the 2% target is unlikely to be met.

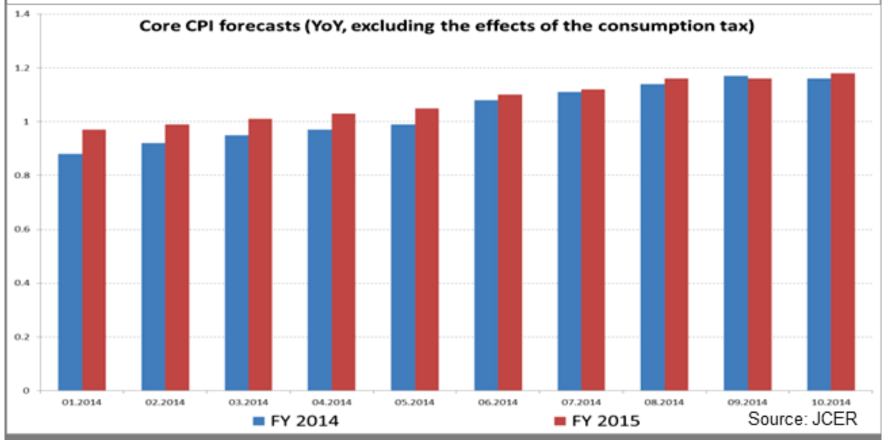
The second round of sales tax hike unlikely to be postponed

A postponement of the second phase of the sales tax rise is unlikely as it would further undermine the credibility of Abe's structural reforms while damaging the relationships with the Ministry of Finance and the BoJ, as both entity endorse a further rise. As a result, conditions are likely to be increasingly supportive (especially for the Nikkei) in the near future to favour the endorsement of the second sales tax hike and to cushion any negative effects caused by it. Among regional spending programs, a lower corporate tax and GPIF diversifications, stimulus from the BoJ is expected. As a result, any weakness in USD/JPY should only be temporary.

Corporates do not expect inflation to reach 2% in the years ahead



Economists' forecasts are rising but remains well below 2%



FX Markets

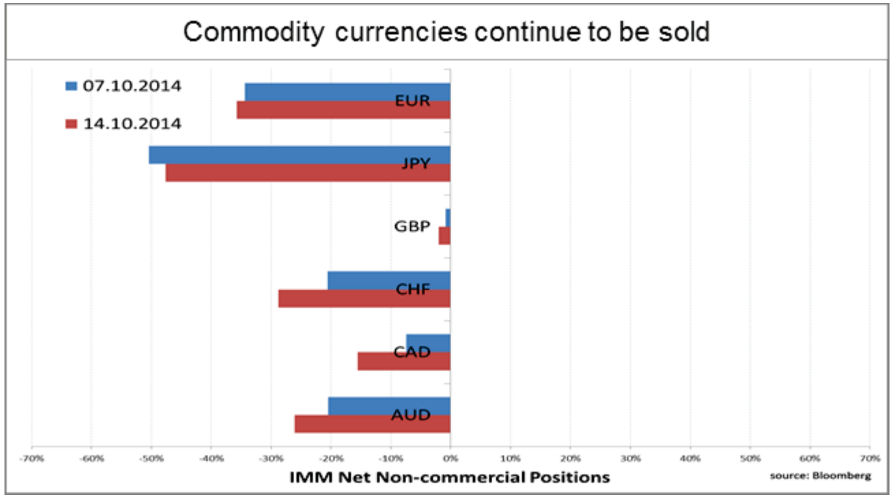
USD aggregate positions are near their historical highs

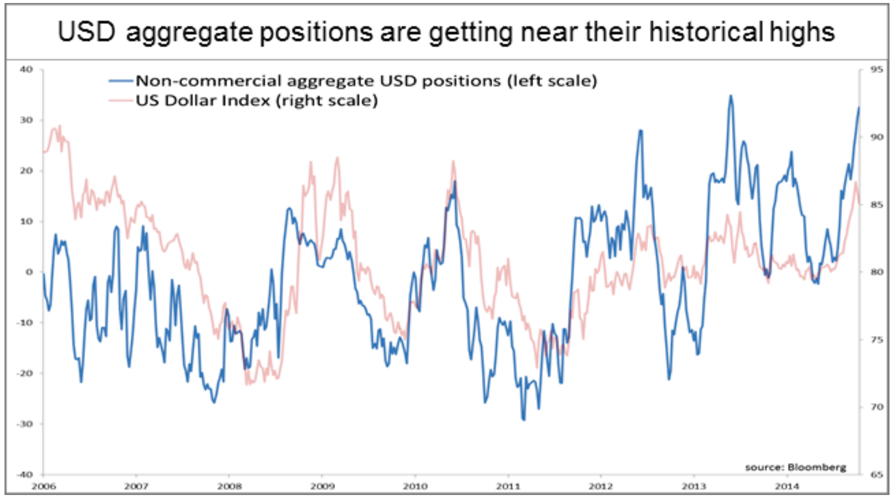
The International Monetary Market (IMM) non-commercial positioning is used to visualise the flow of funds from one currency to another. It is usually viewed as a contrarian indicator when it reaches an extreme in positioning.

The IMM data covers investors' positions for the week ending 14 October 2014.

The most recent data confirm the investors preference to the US dollar, as all major currencies remain net short against the greenback.
The net short EUR positioning has remained stable in recent weeks, suggesting that a new catalyst is needed to create a new wave of Euro selling. However, with the ECB implementing its recent easing measures (purchases of asset-backed securities and covered bonds) and given the increased Germany's resistances to a broad-based QE, the odds to see an imminent QE seems fairly low.

Net short positions in commodity currencies have significantly increased, pushing aggregate USD positions near their historical highs. Even if we continue to favour long-term USD strength, the current highly polarized market suggests risk of increased volatility. Long USD positions are currently best taken on price weakness.





DISCLAIMER

While every effort has been made to ensure that the data quoted and used for the research behind this document is reliable, there is no guarantee that it is correct, and Swissquote Bank and its subsidiaries can accept no liability whatsoever in respect of any errors or omissions, or regarding the accuracy, completeness or reliability of the information contained herein. This document does not constitute a recommendation to sell and/or buy any financial products and is not to be considered as a solicitation and/or an offer to enter into any transaction. This document is a piece of economic research and is not intended to constitute investment advice, nor to solicit dealing in securities or in any other kind of investments.

Although every investment involves some degree of risk, the risk of loss trading off-exchange forex contracts can be substantial. Therefore if you are considering trading in this market, you should be aware of the risks associated with this product so you can make an informed decision prior to investing. The material presented here is not to be construed as trading advice or strategy. Swissquote Bank makes a strong effort to use reliable, expansive information, but we make no representation that it is accurate or complete. In addition, we have no obligation to notify you when opinions or data in this material change. Any prices stated in this report are for information purposes only and do not represent valuations for individual securities or other instruments.

This report is for distribution only under such circumstances as may be permitted by applicable law. Nothing in this report constitutes a representation that any investment strategy or recommendation contained herein is suitable or appropriate to a recipient's individual circumstances or otherwise constitutes a personal recommendation. It is published solely for information purposes, it does not constitute an advertisement and is not to be construed as a solicitation or an offer to buy or sell any securities or related financial instruments in any jurisdiction. No representation or warranty, either express or implied, is provided in relation to the accuracy, completeness or reliability of the information contained herein, except with respect to information concerning Swissquote Bank, its subsidiaries and affiliates, nor is it intended to be a complete statement or summary of the securities, markets or developments referred to in the report. Swissquote Bank does not undertake that investors will obtain profits, nor will it share with investors any investment profits nor accept any liability for any investment losses. Investments involve risks and investors should exercise prudence in making their investment decisions. The report should not be regarded by recipients as a substitute for the exercise of their own judgment. Any opinions expressed in this report are for information purpose only and are subject to change without notice and may differ or be contrary to opinions expressed by other business areas or groups of Swissquote Bank as a result of using different assumptions and criteria. Swissquote Bank shall not be bound or liable for any transaction, result, gain or loss, based on this report, in whole or in part.

Research will initiate, update and cease coverage solely at the discretion of Swissquote Bank Strategy Desk. The analysis contained herein is based on numerous assumptions. Different assumptions could result in materially different results. The analyst(s) responsible for the preparation of this report may interact with trading desk personnel, sales personnel and other constituencies for the purpose of gathering, synthesizing and interpreting market information. Swissquote Bank is under no obligation to update or keep current the information contained herein and not liable for any result, gain or loss, based on this information, in whole or in part.

Swissquote Bank specifically prohibits the redistribution of this material in whole or in part without the written permission of Swissquote Bank and Swissquote Bank accepts no liability whatsoever for the actions of third parties in this respect.