WEEKLY MARKET OUTLOOK

15 - 21 December 2014

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WEEKLY MARKET OUTLOOK - An overview

Economics

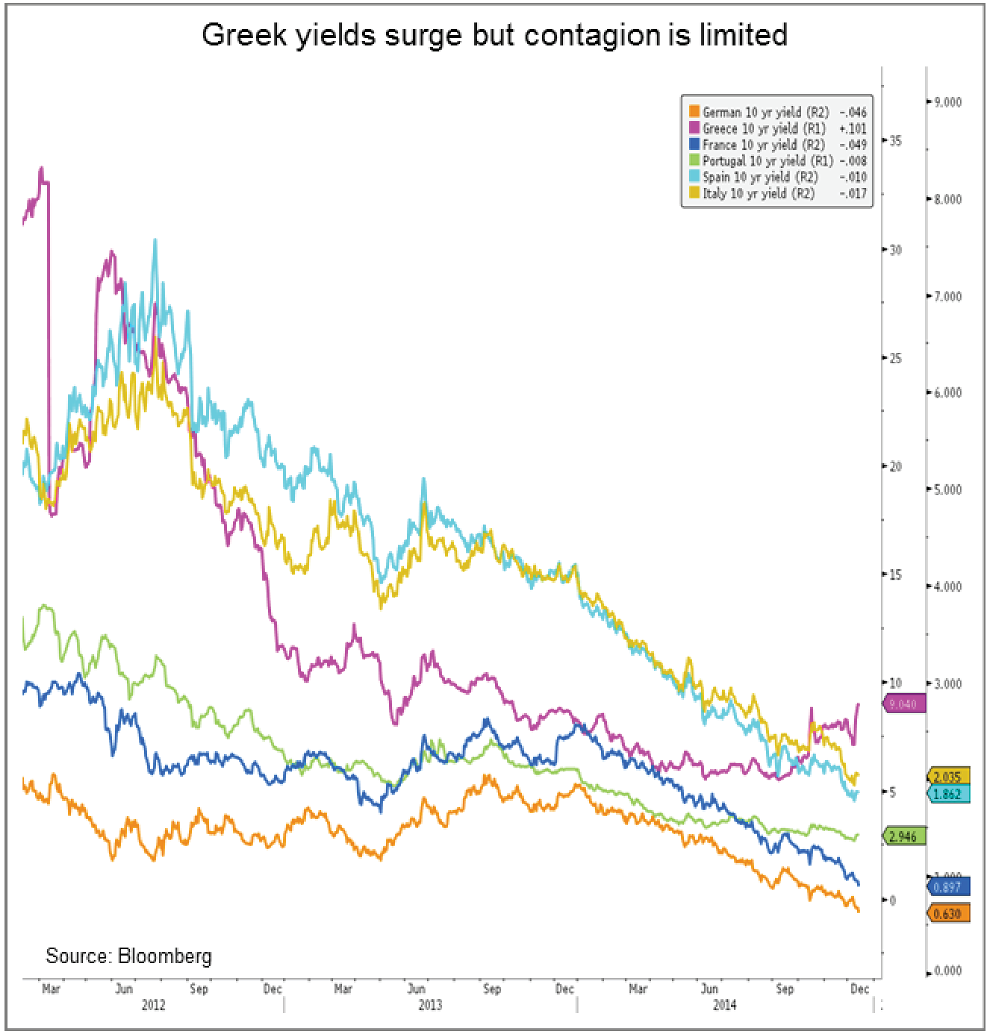
Euro-zone: The Greeks Awaken

“Grexit” return to traders vernacular

Investors searching for answers to the current sell-off in equity markets need to look no further than our favorite sentiment killer – Greece. The adage “kicking the can down the road” was attached to the European debt crisis five years back. Now it looks as if we have caught up to the can once again. To be honest, the whole world, except European policy makers, understood that the lack of structural reforms combined with €240 billion in emergency loans meant that eventually Europe would be again heading towards the abyss. Political chaos returned on Monday when the Greek prime minister Antonis Samaras announced that he will hold a snap vote in parliament December 17th . While the move is to show confidence in the Samaras government, it is a high stakes gamble. Within the 300 seat parliament Samaras’s coalition has only 155 seats, making it likely that ceremonial president, Stavros Dimas would miss the 200-vote supermajority (also on second round on Dec 23rd). Should Samaras lose, an immediate national election will be called which could see the radical opposition Syriza party coming to power.

Stay Short EUR/USD

Despite some economic improvement in Greece, the troika is keeping the country afloat and Syriza has threatened to throw out the bailout. The market’s reaction to renewed uncertainly is clear to see. Greece and EU peripheral bond yields have surged and regional equity markets sold-off. As with past Greece political dramas, traders are just spectators powerless to provide convincing analysis to such a dynamic and localized situation.



FX Markets

The SNB stays on hold

Deflation: a solid reason to support the EUR/CHF floor

At December 11th monetary policy meeting, the SNB maintained the 3-month Libor target band unchanged at 0.00-0.25% and reiterated its commitment to defend the EUR/CHF floor at 1.20. The SNB communication revealed concerns on the rising risk of deflation by next year. Governor Jordan stated that "the appreciably lower oil price will push inflation into negative territory during the next four quarters". Additionally, the rising deflationary threat in the Euro-zone is another major concern for the Swiss price dynamics. The spill-over effect should further weigh on Swiss economy, which already struggles with deflation despite the zero interest rate policy. Therefore, the SNB rhetoric today has been a solid argument and a reinforcement of SNB's commitment to defend the EUR/CHF's 1.20 floor.

EUR/CHF sold-off below 1.2015 as knee-jerk reaction to no pro-active action on interest rates. Traders remain alert given that the aggressive ECB monetary expansion will continue being an important challenge for the 1.20 floor. The SNB may have to introduce negative interest rates on sight deposits, should the floor comes seriously at risk. However we expect the SNB to proceed in a reactive fashion to ECB actions rather than a pro-active move. There is no need to pull out the big guns, given that the SNB's maneuver margin is very tight and the ECB is about to proceed with a full-blown QE on next quarter.

At this point, the ECB is naturally the leading power and the main decision maker, the SNB is the follower. There is nothing surprising in this power balance given the respective size of the Euro-zone economy against Switzerland's. The ECB lent 129.84 billion euros via the TLTRO2 (vs 170bn exp.) on December 11th. The total amount lent over the two rounds sum up to a moderate 212.44 billion euro verse 400 billion targeted by the ECB at the launch of the program. The weak lending increases the probabilities for further ECB action.

EUR/CHF is very close to the SNB's threshold

Economics

The end of BRL swaps is not a big deal

Will Brazil stop the swap program?

In his speech on December 9th, the Brazil Central Bank President Tombini said the bank's intervention through the swap program has reached its goal and signaled the program may be paused until fresh demand in the future. The goal in swap operations is certainly not to stop the Real from depreciating, yet to temper the BRL-negative volatilities to make sure not to lose control over country's inflation and current account deficit. "Existing since August 2013, the currency swap program cushioned exchange rate fluctuations" said Tombini, "providing protection to economic agents". Indeed, the real danger behind heavy FX volatilities is the lack of visibility in the real economy via exports, imports, capital in/out flows and the inflation. The recent fluctuations in EM markets had raised the need for the BCB's swap program. It has not protected the economy from stepping into recession at the first half of the year with inflation crossing above the BCB target (4.5% +/- 2%), nor to improve the current account deficit which sits at -3.81% of the GDP, the largest since Q1, 2002. Yet it perhaps prevented Brazil from further economic damage especially during the period of above 25% volatilities before the presidential elections of October.

Now that the political tensions eased despite market discontent to see Dilma Rousseff at the presidential chair for another four years, the freshly designated Finance Minister Joaquim Levy will target higher growth with tighter fiscal policy, which clearly is a big challenge. And the BCB needs to stay financially solid to give the needed monetary support to the market, at needed time. According to Tombini, stronger fiscal policy "should facilitate convergence of inflation to the 4.5% target". Yet the first step will be to convince investors that fiscal consolidation will lead to growth. Tough job!

BRL depreciation is not the issue, volatilities are

Given the strong economic data from the US and therefore stouter expectations that the Fed will soon drop the "considerable time" rhetoric and announce a clearer schedule for rate normalization, we see unique direction for USD/BRL. The BRL is classified among the Fragile Five, the most sensible currencies to US-yields in other words (alongside with TRY, ZAR, INR and IDR) and will remain subject to Fed-related selling pressures. To go against this natural direction would only be costly and inefficient for the BCB, which needs to use its resources intelligently. In this respect, even if the BCB renews its FX swap auctions, the BRL should continue weakening. However is welcomed a well-defined BCB intervention to temper volatilities, which we see as the main obstacle to Brazilian macro-metrics. Also, it is noteworthy mentioning that the BCB will inevitably be brought to further hike its Selic as the Fed tightens its policy. We see room up to 12.50% at the first stage, highest level in 2011. Further upside depends on how aggressive the Brazil economy may get squeezed by internal and external dynamics walking into 2015 with new economic team and international challenges.

USD/BRL short-term technicals point the upside

USD/BRL has risen above 2.6500 on bets that the Real should depreciate without the support of the central bank, the MACD (12, 26) stepped in the green zone suggesting the extension of the broad bullish trend building since the beginning of September. We watch 2.50/2.75 range for the year-end in the continuation of the bull channel. Option bids are biased on the upside above 2.50/2.52 walking toward December 30th.

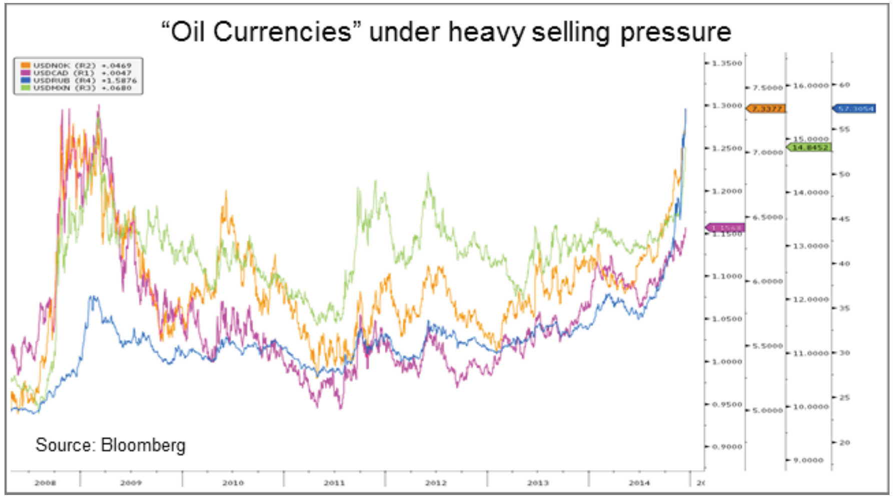
Commodities | Oil Collapses

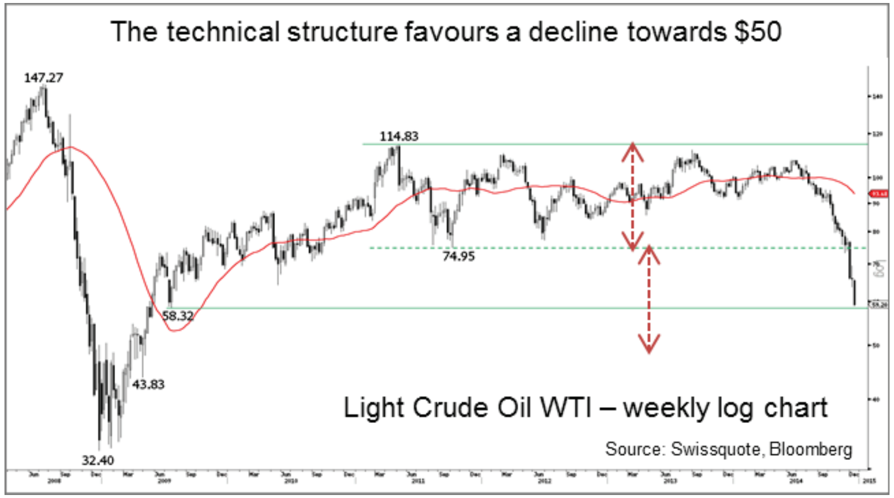
Oil Currencies aggressively decline

In FX markets, NOK, RUB, CAD and MXN, dubbed the “oil currencies”, have come under extreme selling pressure as they are the most exposed to sudden change in oil prices. Lower Norwegian yields combined with weaker oil prices has sent USDNOK to a multi-year high of 7.3674. The decision by the Russian central bank to increase rate 100bp to 10.50% failed to placate the market, as speculators today pushed USDRUB to 57.974 (small gap on the open). Potentially traders viewed the rate hike as an act of desperation and clear indication that the Russia economy is in trouble. USDCAD rose to 1.1500 (although the least aggressive sold in the group) as every $10 move in oil prices, the CAD makes a corresponding move of about 3-5 cents, highlighting the importance of the nation’s largest export. Finally, USDMXN is now above its five year high at 14.8359, nears Banxico’s 1.5% upper band, as a exceptions for lower foreign investment just as the Mexico opens its energy industry to private drilling. With OPEC basically stepping away from the management of global crude markets, widely understood supply glut and weak demand, we suspected further downside should be anticipated.

The technical structure favours lower prices

Looking at the chart of light crude oil (WTI), prices are close to the support at 58.32. Given the general oversold conditions, the odds to see a short-term consolidation phase shouldn't be overlooked. However, in the longer term, the bearish breakout in late November from a 3-year distributive phase implies a theoretical downside risk at $48.92. As a result, in the absence of any sign of capitulation or base formation, the technical structure favours a move towards the psychological threshold at $50.00. A resistance for a countertrend move can be found at $69.54 (01/12/2014 high).





FX Markets — The Fed needs to change its communication

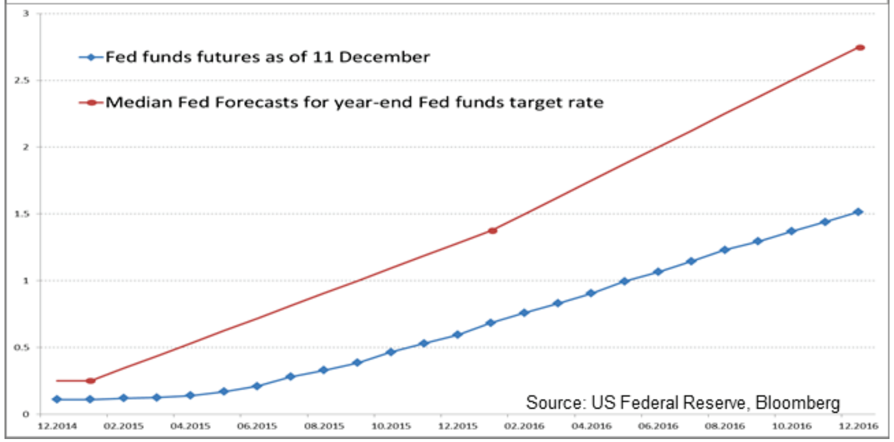
The Fed is likely to modify its forward guidance

During the 17 December FOMC meeting, Fed members are likely to keep in mind the significant spread between the FOMC forecasts and market expectations for the Fed funds. Indeed, the median of the FOMC forecasts made in September calls for a Fed funds target rate at 1.375% by the end of 2015, whereas market expectations still remains near 0.650%. The difference represents almost a three-meeting divergence. Furthermore, this spread increases for the year-end 2016 forecasts: the median from FOMC members is at 2.875%, whereas market expectations discount a rate lower than 1.600%, resulting in a spread bigger than 1.250%. Given that the recent labour market data continue to point towards a diminishing slack, the FOMC forecasts are unlikely to decline. However, as the Fed wants to avoid another "taper tantrum" scare, a reduced gap between Fed forecasts and market expectations would be a welcome development. In that respect, the Fed is likely to remove anything that could support too dovish market expectations. As a result, a drop of the "considerable time" is likely to occur in December. However, the new language should continue to stress that there is no urgency to raise rates and that the timing is highly dependent on incoming economic data.

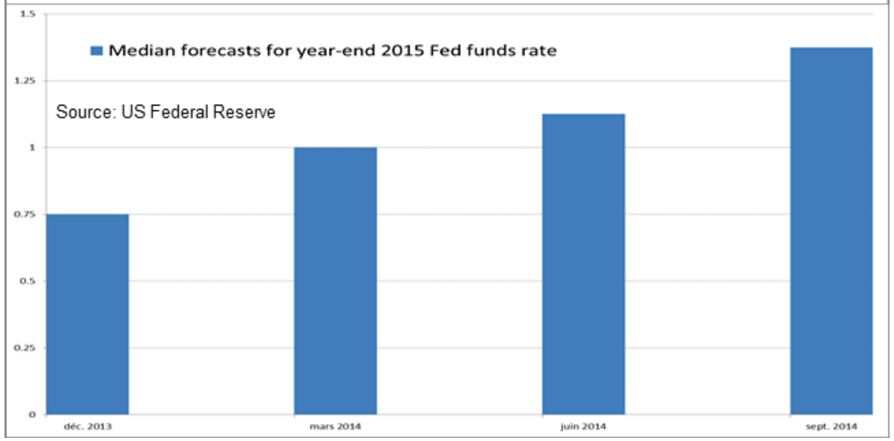
Market expectations are expected to inch higher

The removal of the "considerable time" sentence would likely strengthen the odds to see a June rate hike. However, if coupled with wording that signal patience and data-dependency, it should help to raise market expectations without unwanted high market volatility, especially as inflation pressures remains modest. Overall, the narrowing spread between Fed forecasts and market expectations should support a stronger US dollar, as the adjustment will likely be made by less dovish market expectations.

The Fed needs to narrow the spread between rates expectations



Fed forecasts have persistently increased since December 2013



FX Markets

Growth supportive Norges Bank supports a lower NOK

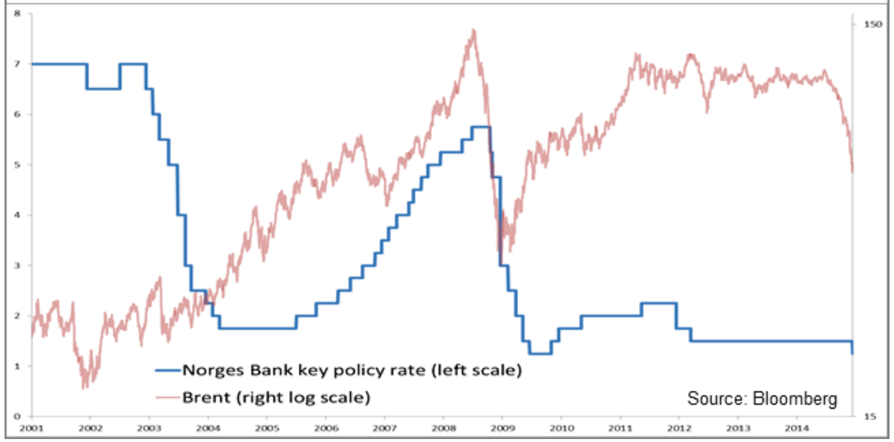
Norway's growth outlook hurt by its oil industry

The sharp decline in oil prices has hurt Norway's growth outlook, as the Nordic country heavily relies on its oil and gas industry. As a result, Mr Olsen, the Norges Bank governor has cut rate by 25 basis points to 1.25%, a level only reached once in 2009 for a brief period of time. This decision was accompanied by a downgrade of the growth outlook due to the potential spillover effects of the weakening petroleum industry on the wider economy. Indeed, the persistent decline in oil production is weighing on investment spending, which has already led to a reduction of more than 10% of the workforce in the oil industry this year, and the sharp decline in oil price is likely to lead to further measures to cut costs. As the Norwegian economy is becoming more dependent in non-oil sectors to support growth, the lower rate and the weaker krone should support these industries. Nevertheless, the rate cut surprised markets, as, contrary to most countries, inflation is close to the Norges Bank's 2.5% target and is expected to move higher, mostly due to inflationary pressures caused by NOK depreciation. As a result, the rates cut signals a clear shift in the central bank's stance as higher inflation is tolerated to support the Norwegian economy.

NOK breaches critical technical levels

Looking at USD/NOK, prices are moving above the key resistance at 7.3145 (December 2008 top), confirming a persistent buying interest despite the significant overextended rise. As a result, notwithstanding potential short-term corrective phases, further strength is expected. A resistance area is given by 7.8270 (August 2008 top) and the psychological threshold at 8.0000. A support lies at 7.1994 (intraday low). The technical picture in EUR/NOK is roughly the same, as prices are moving above the key resistance at 9.1483 (June 2009 top). The level at 9.5000 could act as a psychological resistance, while a major resistance stands at 10.16 (December 2008 peak).

Norwegian rates are at their lowest levels



Prices are moving above the strong resistance at 7.3145

FX Markets | Pause in EUR, AUD and CHF selling

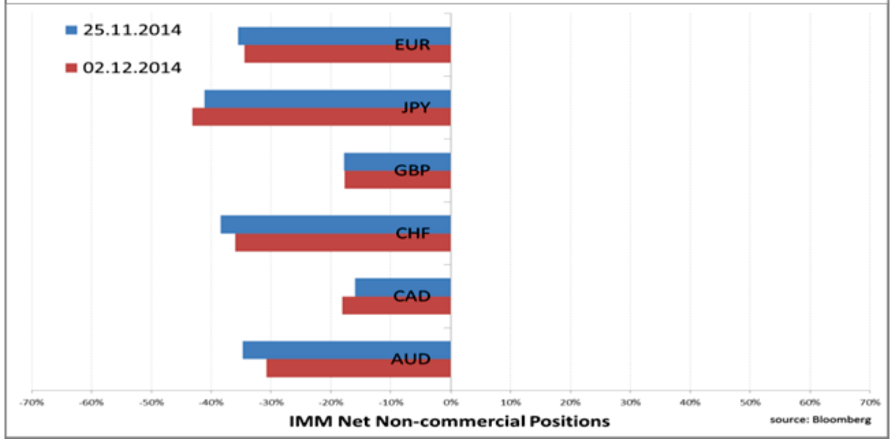
The International Monetary Market (IMM) non-commercial positioning is used to visualise the flow of funds from one currency to another. It is usually viewed as a contrarian indicator when it reaches an extreme in positioning.

The IMM data covers investors' positions for the week ending 2 December 2014.

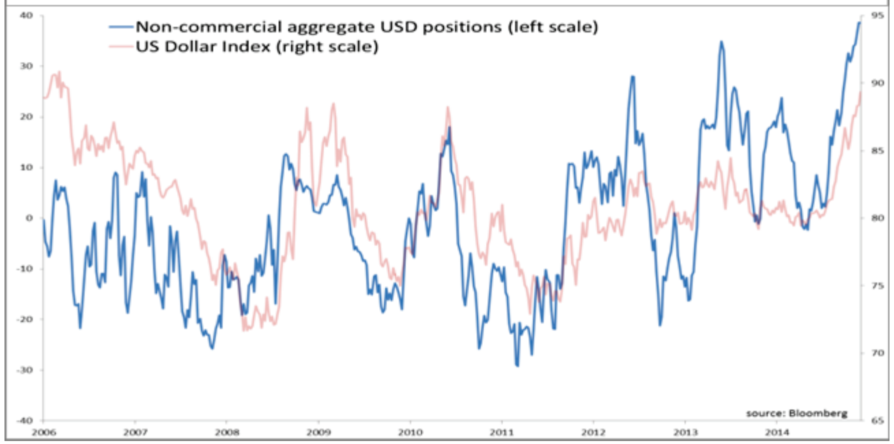
With the exceptions of the Japanese yen, there has been a pause in the accumulation of aggressive short positions in the Euro, the Australian dollar and the Swiss franc. Even if this unwinding in short positions can last longer, it is unlikely to change the underlying trend of price weakness against the US dollar. On the other hand, net short JPY positions continue to increase despite the already elevated levels. Overall, the aggregate USD long positions remain at record high, which, from a positioning standpoint, highlights a strong sensibility to any downside USD risks.

The net short GBP positioning has remained mostly unchanged after weeks of decline. Given the relatively dovish market expectations on the BoE's rate path, we see scope for an increase in long GBP positions given the relatively positive outlook of the UK economy for the next months.

Reductions in net short positions for EUR, CHF and AUD



Aggregated net long USD positions are at record highs



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