WEEKLY MARKET OUTLOOK

22 Dec 2014 - 11 Jan 2015

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WEEKLY MARKET OUTLOOK - An overview

Economics

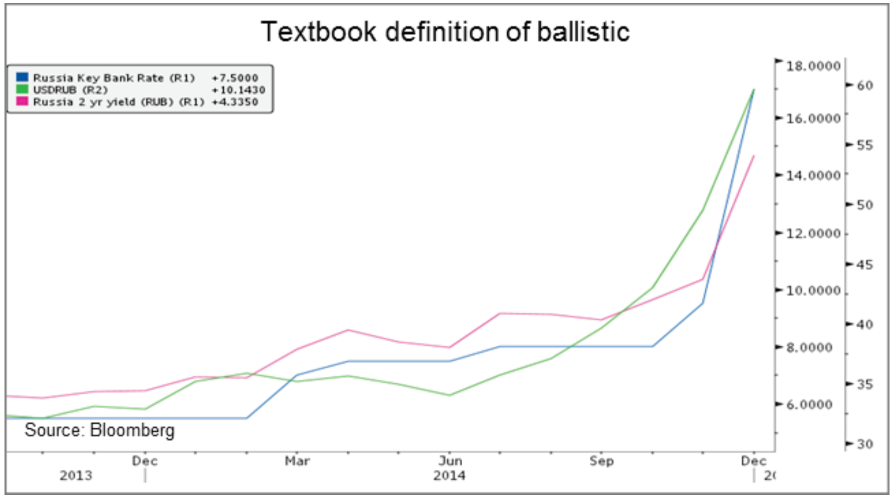
No problem in Russia?

Russia Crisis

So what do you do when investors' confidence has drained and your currency has collapsed? If you're Russian president Putin, you hold a town hall style meeting where an ex-KGB agent reassures everyone that everything is under control. Yet when the smoke cleared and all the "questions" were answered, traders were left with no major measures with which to address the current crisis. Just a short recap of the events surrounding the ruble collapse. The ruble has been under selling pressure as oil prices sank and US yields rallied. This massive exodus of capital and confidence, forced the Russian central bank to remove the managed float which had been keeping the ruble price action within a controlled fall. Things really started to get bad when the central bank forecasted that oil below $60 would send Russia into a severe recession. Rapidly declining oil prices and sanction induced lack of foreign reserves, created a mad dash liquidation out of Rubles. In a desperate attempt, the Central bank of Russia unexpectedly hiked the main interest rate from 10.5% to 17%. A decision which provided stability for only a few hours before traders panicked causing the USDRUB to peak at 79.16 (-43% in three-months). Since Tuesday's rout, the Ruble has recovered to 60 verse the USD.

No change of Political Regime

So far the only solutions have been trivial, side stepping the real issues. Exporters have in-theory agreed to limit foreign reserves to Oct 1st level and Russian central bank First Deputy Governor Ksenia Yudayeva said they were prepared to pump 1trn rubles into domestic banks to ensure financial stability. While buzz of more radical options, such as harsh capital controls are making the rounds. The Russian economy is stagnating, illustrated by weak industrial production data and slow retail sales, while investments by domestic companies are falling as western sanctions begin to bite (forecast contraction of -4.5 percent in 2015). There are additional worries that heavy leverage companies may not be able to repay debts and that there are possible rating downgrades on the horizon. On the political front we are skeptical that these events actually poise a threat to President Vladimir Putin's popularity. As with any politician, stability and economic growth is critical for control, yet Putin has framed the current events as an attack on Russia by the west not a failure or misguidance of his leadership. This is yet another media war which Putin has won again.



FX Markets

No rate action till year end despite higher TRY volatility

Volatility spike in TRY hurts sentiment

The massive volatility spike marked the lira markets on week to December 19th. Both internal and external factors have been responsible for the volatility pick-up in TRY. The Turkish journalist arrests, the oil race to the bottom, the heavy RUB sell-off, the surprise CBT rate intervention and the FOMC jitters contributed to USD/TRY's rally to record high of 2.4146 on December 16th. The 1-month implied volatility spiked to 15% for the first time since March. EUR/TRY tested 2.9488 / 3.00 resistance zone (Fib 38.2% on January-November ease / psychological level). The sell-off in Turkish bonds recorded on week to December 12th (USD 718mn) seemingly accelerated, pushing sovereign yields higher across the curve with higher front-end impact due to mounting anxieties. The interbank lending hit the Central Bank's upper corridor of 11.25%.

Oil drop couldn't help the lira longs

The significant drop in oil prices did not profit to TRY, although lower energy costs is favorable for narrowing current account deficit, and lower inflation. The reverse carry flows have significantly depressed the appetite for high yielders. Especially given that the rate differential should also compensate for above 9% inflation in Turkish holdings.

The 3-month cross currency basis in TRY verse EUR and USD rebounded sharply alongside with the FX volatilities, confirming that the appetite in rate spread is now being fully offset by TRY-negative vols. We believe that the volatile environment will ease toward the year end given the cautious Fed stand before rate normalization and the ECB preparing for a full-blown QE.

Turkey gives verdict on December 24th

The Central Bank of Turkey will give policy verdict on December 24th. On December 12th, the President Erdogan said the rates should fall further to sustain the economic recovery. Despite the recent turmoil in the markets, we believe that the political pressures will keep the CBT away from any rate action before the year end. The CBT should feel more comfortable using unconventional tools to temper FX volatilities at this point. The accompanying statement should however remain strictly hawkish.

FX Markets

Swiss National Bank pulls out the rate weapon

SNB introduces negative rates sooner than expected

In a surprise action, the Swiss National Bank pulled the interest rate on sight deposits to -0.25% on December 18th and reiterated its commitment to defend the 1.20 floor on EUR/CHF. The target CHF libor has been widened to -0.75%/0.25%, its usual width of 1%. While the aggressive cut in libor target lower bound will certainly not impact the interbank market, as banks will place their excess liquidity at the better -25bp therefore defining the interbank floor at this level, the extent of the action is seen as a concrete signal to the market: the SNB will dare lower rates, if needed. The euroswiss interest rate futures spiked to 100.200, highest since mid-2011. The anxiety on the Swiss rate markets has just begun. On a side note, the negative rates will be applied to sight deposits above an exemption threshold: for accounts subject to minimum reserve requirement (RR), this threshold stands at twenty times the statutory minimum RR, for the others the threshold is set to 10 billion francs, effective from January 22nd. Domestic authorities are not subject to new measures for the time being. There is no direct implication for the general public as customer deposit rates are fixed by the commercial banks, which however may need to "adjust their lending and deposit conditions to changes in money market interest rates."

The SNB action, itself, has not been a massive surprise, but the timing was. We would expect the SNB to pull out the rate weapon as reaction to a potential policy action across its borders in the Q1 of 2015, certainly not before Christmas! This is why, with no guidance regarding the timing of the unexpected cut, we suspect that the week to December 19th has cost the SNB plenty protect the floor. With the ECB signaling full blown QE, "grexit" coming back into traders vernacular, the heavy sell-off in ruble and the FOMC's cautious stand regarding the timing of the first FF rate hike, it was clear that the SNB's already bloated balance sheet was poised to expand again. "The Swiss franc has been experiencing renewed upward pressures vis-à-vis the euro in the last few days" stated the official communication, "The worsening of the crisis in Russia was a major contributory factor in this development."

The SNB's negative rate action will temporary ease the selling pressures on EUR/CHF, especially on the speculative camp. Yet more steps will certainly be needed as the ECB hasn't said its last words yet. The correlation between EUR/USD and EUR/CHF is now null. The 1-month 25-delta EUR/CHF risk reversals switch to positive territories for the first time since end-October. With better volatilities, we expect the put sellers to pull the balance back to negative.

In the FX markets, the reaction could have been stronger. EUR/CHF spiked to 1.20974 before rapidly easing below 1.20500. For CHF-lovers and risk-heaven trades, EUR/CHF close to 1.21 has certainly been a good long Swissy entry price in the current risk-off setting. We see little follow through above the reaction high of 1.20974 in the absence of fresh intervention.

FX Markets

The Fed paves the way for a mid-2015 rates hike

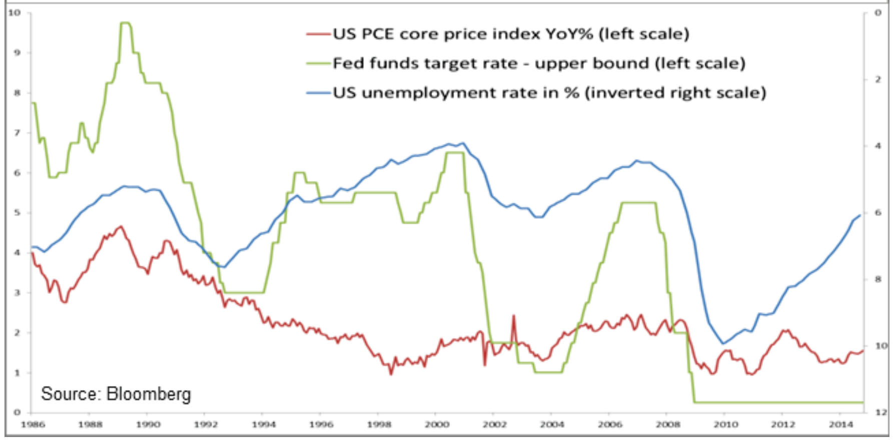
The Fed has changed its communication

As expected, the Fed transitioned away from its "considerable time" guidance for its rates outlook in a message stressing patience and data dependency. Indeed, the FOMC statement mentioned that the Committee "can be patient in beginning to normalise". Fed Chair Yellen gave more details by saying that normalisation is unlikely to begin before the April meeting. Furthermore, the statement stressed that economic conditions could alter the timing and the pace of the tightening cycle. Concerning economic projections, the growth outlook was left unchanged, whereas the job market outlook was revised higher and core PCE inflation was modestly lowered (despite significant downwards revisions for headline PCE in 2014 and 2015).

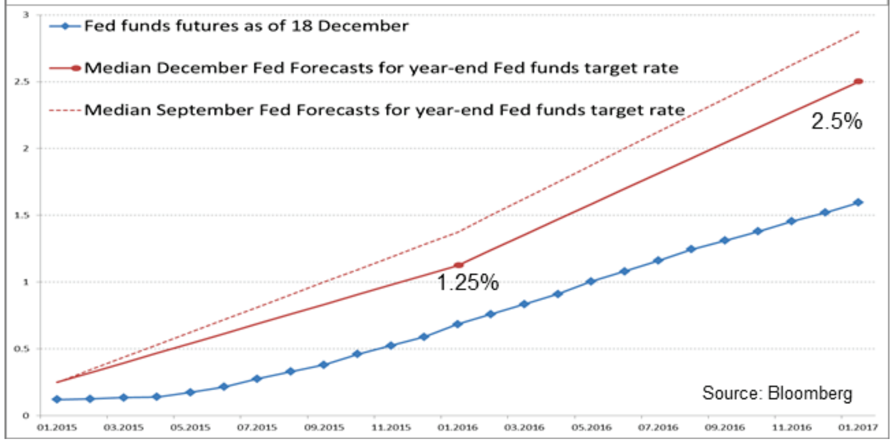
Job market seems more critical than inflation in rate hike timing

The health of the labour market and the inflation outlook will be critical to assess the Fed actions. However, Fed Chair Yellen hints that the normalisation process should be more driven by improvements in the labour market than in inflation. Indeed, she mentioned that most participants want to have a feeling of reasonable confidence that when normalisation begins, inflation will be moving up over time. She added that if labour market conditions continue to improve, that is likely to occur. As a result, without a significant decline in the inflation outlook, which is not expected by the Fed as inflation impacts from the decline in oil price are deemed transitory, the job market will be the trigger for the start of the tightening cycle. Overall, as the April FOMC meeting is not followed by a press conference by the Chair, the Fed is strongly hinting at a June hike. Concerning the pace of the rate hikes, the disinflationary pressures linked to the oil decline has led to more accommodative Fed forecasts, reducing the gap with the more dovish market expectations. However, as the US job market continues to improve, market expectations should be revised higher, supporting a stronger US dollar.

The health of the labour market favours higher rates



The new Fed forecasts suggest four rate hikes in 2015



FX Markets

Additional easing measures favour a weaker SEK

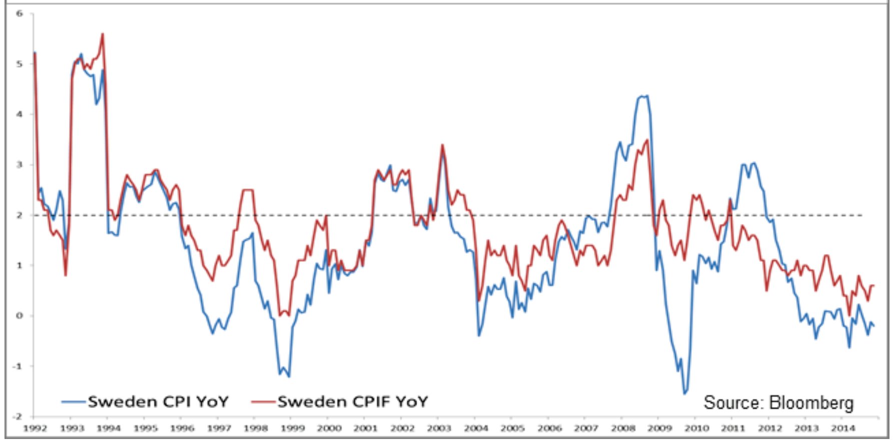
Riksbank paves the way for additional easing measures

The Swedish central bank (Riksbank) kept its monetary policy unchanged on 16 December, leaving the repo rate at 0.0%. However, the Riksbank slightly postponed its forecast for the first rate increase to the second half of 2016 as monetary policy needs to be more expansionary for CPIF inflation to rise in a timely fashion towards its 2% target. Indeed, despite ongoing improvements in the Swedish growth outlook, inflation should remain somewhat lower for a time, mostly due to falling oil price, increasing the risk to see further decline in long-term inflation expectations. The Riksbank also announced that it was ready to engage in further measures (other than postponing the timing of the first rate hike) if needed. In that respect, the expected upcoming ECB's sovereign QE, in order to quickly expand its balance sheet, and the recent sharp depreciation of the Norwegian krone are expected to further increase the downside risks to the Riksbank's inflation projections (as Eurozone and Norway represent roughly 57% of Swedish Imports). Coupled with a persistent low inflation environment, additional unconventional measures to curb disinflationary pressures are likely to be launched in the next months. Given that FX interventions remains a "last resort" solution for the Riksbank, negative rates seem the most likely scenario.

Further strength in store for USD/SEK

As the Riksbank is likely to react to any additional easing measures from the ECB, we do not see long EUR/SEK positions as particularly attractive. However, USD/SEK should continue to strengthen given increasing divergences in the respective monetary policies. Looking at price behaviour, we continue to favour a further rise towards the strong resistance at 8.1372 (08/06/2010 high). A key support stands at 7.3258 (31/10/2014 low).

Swedish inflation remains far away from its 2% target



USD/SEK expected to rise towards the strong resistance at 8.1372

FX Markets

Long USD/CAD attractive from a positioning stanpoint

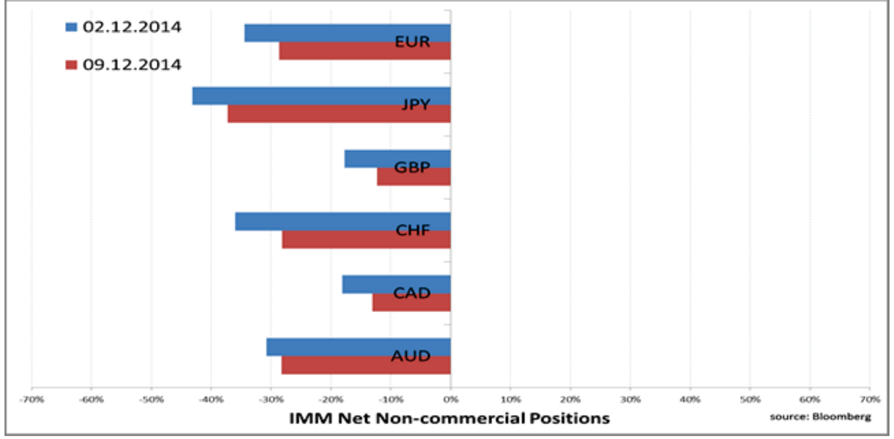
The International Monetary Market (IMM) non-commercial positioning is used to visualise the flow of funds from one currency to another. It is usually viewed as a contrarian indicator when it reaches an extreme in positioning.

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

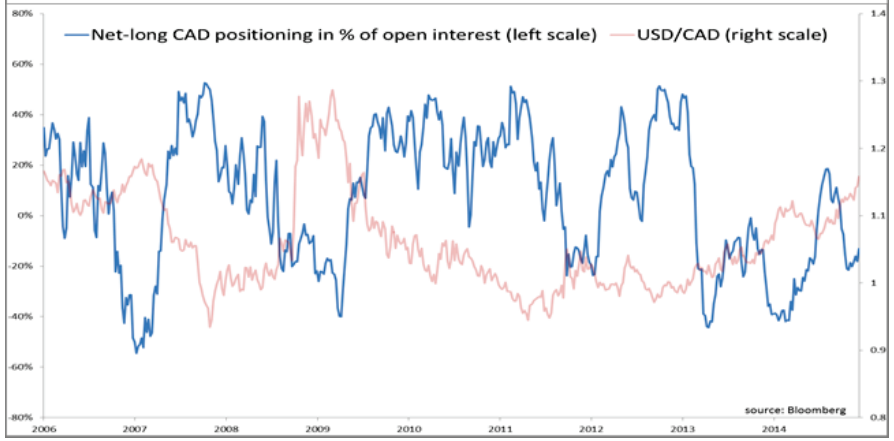
The data displays a general reduction in long USD bets. Indeed, all currencies have seen a decrease in their net short exposure against the US dollar. Part of this development has been motivated by the lack of action of the ECB after its December meeting. This disappointment is likely temporary as the ECB is likely on its way to launch a broad-based QE early in 2015 in order to quickly expand its balance sheet.

From a positioning point of view, the new highs in the Canadian dollar coupled with a reduction in its net short positioning suggest that a long USD/CAD position remains quite attractive.

Global reduction in long USD positions



Small reduction in net short CAD positions despite USD/CAD highs



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