WEEKLY MARKET OUTLOOK

26 January - 1 February 2015

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WEEKLY MARKET OUTLOOK - An overview

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RBA to follow the easing trend

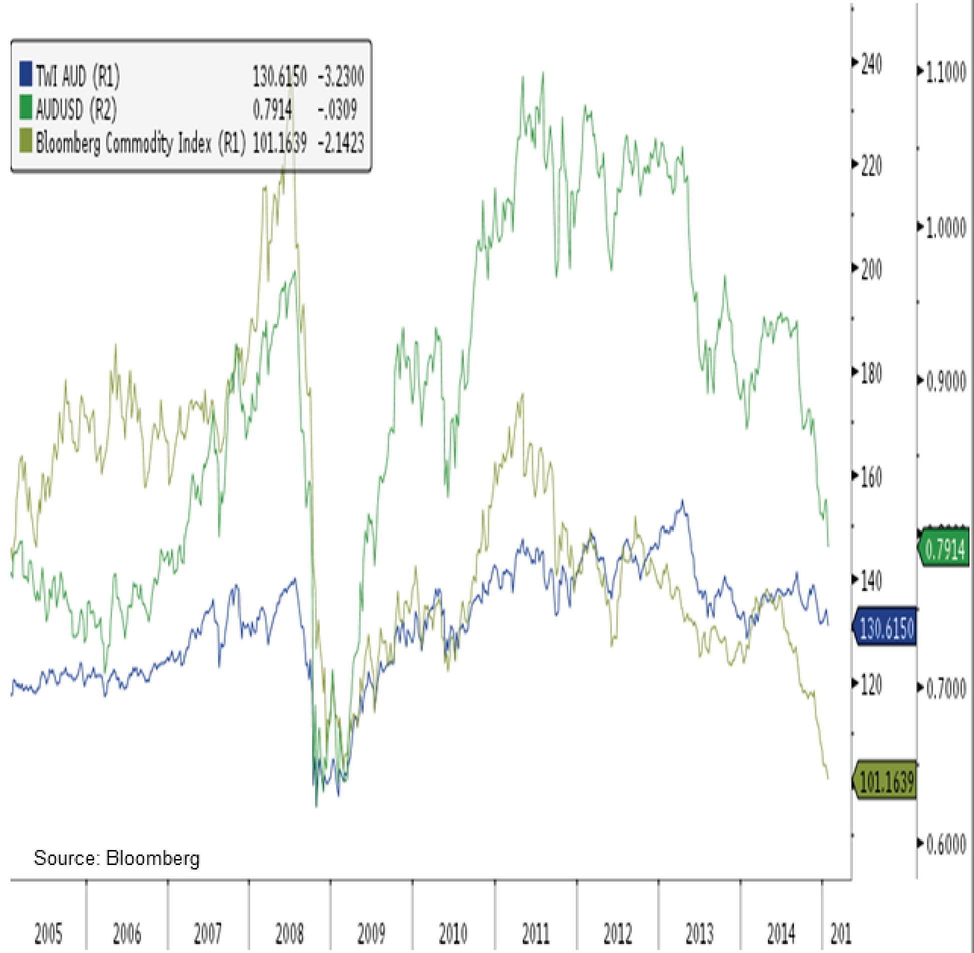
Dovish Central Bank actions all the rage

There is a new easing fad in central bank circles making the rounds and RBA stands ready to hop on the bandwagon. Recently a slew of central banks have decelerated their hawkish outlook with meaningful policy adjustments. Surprise rate cuts from the BoC, CBT and RBI, combined with the massive ECB stimulus and SNB abandoning the EURCHF floor, has shifted global expectation for policy to profoundly dovish, with a sprinkle of unwelcome drama. The willingness for the central bank to suddenly shift gears seems to have fashioned into a trend, which more central banks will exploit. Markets are now anticipating that the RBA will be the next major central bank to act.

Cut to protect AUD weakness

It seemed that growth and inflation levels remains supportive of Australia current monetary policy, yet the fact is that its cash rate target is substantially higher than other G10 nations (except New Zealand). And given the search for yields triggered by the renewed round of policy easing, marginal buyers will begin to emerge, potential pushing AUD higher. A rate cut will make Australia bonds and currency less attractive to speculator and potential commodity exports more competitive. RBA governor Steven has been vocal in his desire for a weaker AUD and now is compelled to act. This week's Q4 CPI should print well below the RBA inflation forecast, while weaker outlook for commodities will be a continued drag on growth, providing justification for action. We suspect that the RBA will follow the herd by lowering the cash rate next week by 25bp to 2.25% (new record low). We remain bearish as the break of support at 0.8030 indicates a near term target of 0.7700.

AUD needs to trend lower



Source: Bloomberg

Economics

ECB unveils the QE package

ECB announces 60 billion euro QE per month

The ECB announced the much expected QE package in addition to TLTROs and private debt purchases programs launched in the last quarter of 2014. The new QE program consists of 60 billion euros worth government bonds and European institutional debt purchases per month from March 2015 to September 2016. This sums up to 1.14 billion euro package, higher than the market estimates of 750 billion - 1 trillion euros expected in case of a risk sharing framework with the National Central Banks (NCBs). The Eurosystem will carry the 20% of the risk and the rest will be on individual NCBs' shoulders. The ECB will buy investment grade bonds only, and the purchases will not exceed 25% of issuer's debt issue, and 33% of issuer's total debt. The operation will be "conducted until [...] sustained adjustment in the path of inflation which is consistent with aim of achieving inflation rates close to 2% over the medium term". This means that this QE program should bring the ECB's balance sheet toward 2012 levels as declared formerly. While more stimulus is not overruled to push the inflation toward 2% targeted further than September next year.

The inflation outlook required forceful policy response, said Draghi at his speech in Frankfurt yesterday as the 5y5y inflation swaps fell below 1.5% mid-January. The efficiency of the ECB program remains uncertain however, given that healthy transmission toward the real economy is crucial to push the liquidity to enhance economic activity. This requires structural reforms and growth-friendly fiscal consolidation. Draghi warns it would be a big mistake if countries use the program for fiscal expansion.

The Greek puzzle

The Greek bonds will, in principle, be eligible after the 2010-2012 SMP redemption, meaning by July. However, the political situation in Greece remains quite uncertain before January 25th elections with the anti-European Syriza's leading the election polls. The PM Samaras said in his speech in Thessaloniki that the country risks exclusion from the QE program if the bailout review stalls. Greece needs to agree on the extension of the aid program by February 28th in order to receive 7.2 billion euros aid payment and also to become eligible for the QE. We believe that at this stage a coalition with Syriza will be set amid Jan 25th elections and temper the Grexit speculations.

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TRY: attractive carry trades with moderate volatility

The cheap liquidity enhance carry demand for TRY

No one was surprised as the Central Bank of Turkey cut the benchmark repo rate by 50 basis points to 7.75% at January 20th MPC meeting. The overnight corridor has been kept unchanged at 7.50% - 11.25%. The lower oil and commodity prices, the expectations for further cool-off in inflation, the negative rates in Switzerland, the anticipations for further expansion in the Euro-zone, the surprise action in India (based on similar motives), combined to political pressures have played big in CBT decision to cut rates. Indeed, the leading central banks diverge from the policy normalization as the global slowdown in inflation – or dangerously nearing deflation – push the policymakers away from any tightening in rates. In contrary, the surprise Canadian, Danish rate cuts this week, the sharp dovish shift in the BoE combined to the sizeable ECB QE keep the liquidity conditions very favorable for market players. The risk-on sentiment encourages carry traders to take advantage of the rate differentials. The step toward a growth-friendly policy given the favorable macro conditions should be welcomed by investors. However, all above-stated factors (justifying reasons) are external to Turkey's fundamentals and we remain skeptical on the stability of the environment in the mid-term. This being said, the CBT kept its cautious tone on the accompanying statement, stating that the upcoming decisions will depend on inflation outlook, while the policy should remain tight via near-flat curve. Turkey Minister of Science, Industry and Technology Isik said the rate cut did not meet expectations as the government's will is to push the real rates to zero. Given the upcoming general elections however, we believe that the risk premium that investors will demand on TRY investments due to political jitters should certainly limit the downside potential on TRY rates. The zero interest rate frame is therefore difficult to achieve as it would not reflect the risks that Turkish economy carries at least in the first two quarters of 2015. Investors should remain vigilant to trend reversals. As proven in the past, the lower rates are welcomed only until considered suddenly inconvenient. There lies the risk.

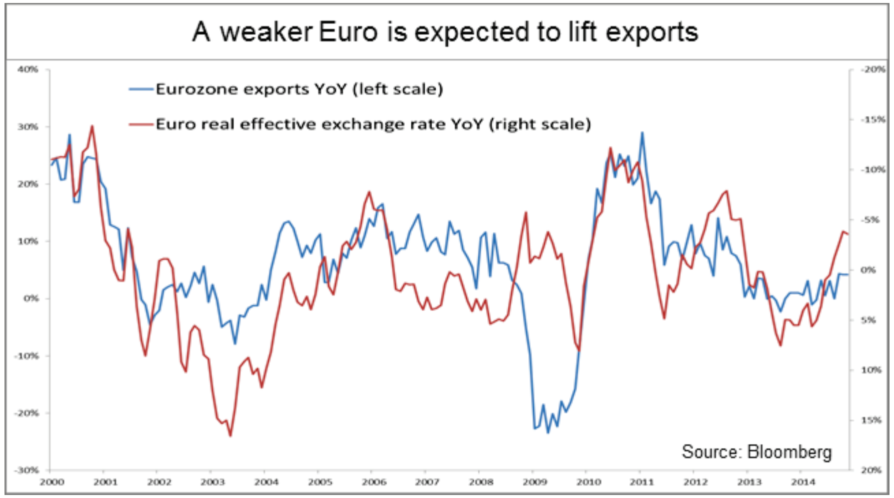
The broad sell-off in EUR triggered fresh sell-signal in EUR/TRY after the ECB QE announcement on Thursday, January 22nd. The cross should further challenge 2.5848/2.6673 supply zone (2011 double top / Fibonacci 38.2% on May'13 – Jan'14 rally). We look for interesting entry opportunities on short EUR/TRY, yet remain alert on volatility spikes given the risky nature of the carry strategies.

Stock Markets

ECB's QE expected to lift European stock markets

ECB's QE should boost European earnings

On 22 January, Mr Draghi announced the a €1.14tn broad-based QE with monthly purchases until at least the end of September 2016 (see page 4 for details). The Euro dived on the news as expected. The Euro weakness will further boost European nominal GDP, as exports and inflation will rise. Furthermore, corporate profits will improve as their base currency is depreciating supporting significant higher European earnings on a year over year basis. As a result, European stock markets are likely to rise on the back of a more favourable earnings outlook.



European stocks expected to move higher

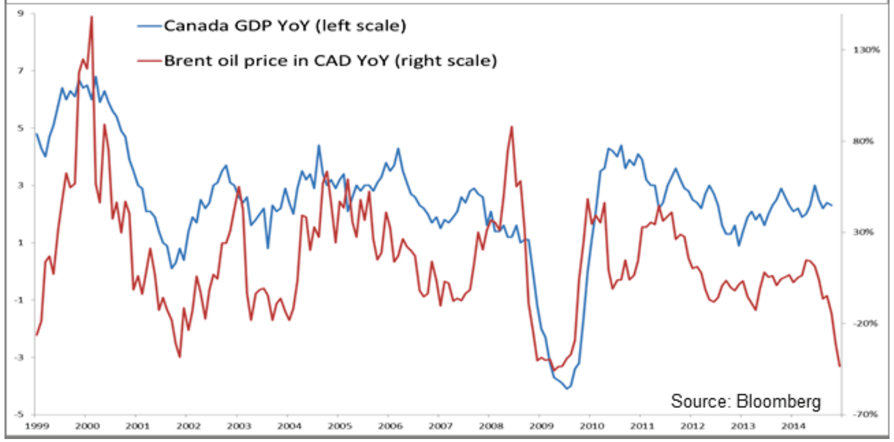
Looking at the STOXX Europe 600, the recent highs after a 6 months consolidation confirm the ECB's QE positive effect on the European stock market. Indeed, the recent break of the resistance at €350 validates a bullish head and shoulders continuation pattern. The implied target calls for a rise towards the 2007 highs at €401.

Relative European underperformance to reverse?

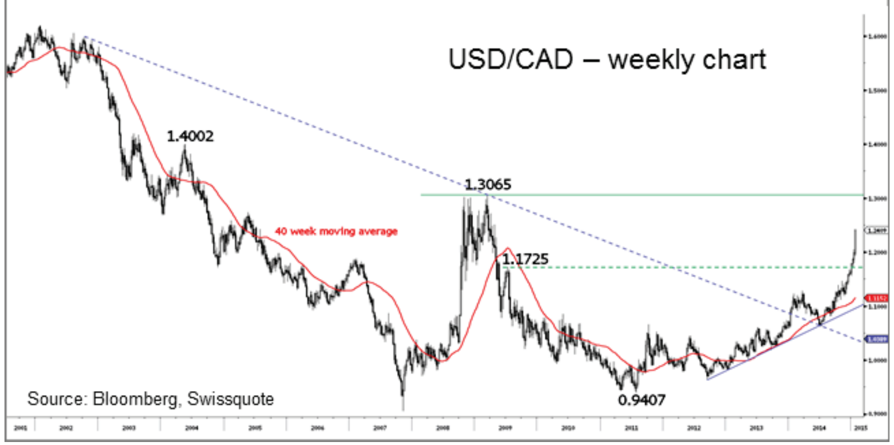
One of the key trend in stock allocation has been the European stocks underperformance compared to their US counterpart. Even if we do not suggest a long-term reversal of this trend, months of outperformance could be about to start. A decisive break above the steeper declining trendline would confirm such scenario.

FX Markets | BoC cuts rates to cushion negative impact from oil decline

Declining oil prices are weighing on Canada GDP



USD/CAD expected to rise towards its strong resistance at 1.3065



The BoC cuts rates following a weaker Canadian growth outlook

On 21 January, the Bank of Canada (BoC) cut interest rates to 0.75% (from 1%) and lowered its growth forecast on the domestic economy from 2.4% to 2.1%. This is a direct response to the significant negative impact of the decline in oil prices on the domestic economy. Indeed, most of Canada's proven oil reserves are in tar sands located in the Western province of Alberta. As tar sands require high costs for extraction, the break-even oil price is much higher than current prices (CERI estimates it above $80 WTI levels). Therefore, even if the current decline in oil prices could prove temporary, investment in the Western provinces are likely to be unattractive for more than a temporary period (the BoC oil prices projections are around $60). Given than these provinces have strongly contributed to Canada growth in the recent years, the resulting slowdown in this area will likely generate serious headwind for growth. Meanwhile, exporters, the backbone of the Canadian economy, have thus far not much benefited from the US recovery, as they need a longer rebuilding phase after their destructive business cycle.

Given the potential magnitude of the shock caused by oil prices, the BoC has decided to strengthen the defences provided by a lower CAD and an improving US economy (notably thanks to the oil decline) by cutting rates.

Further rise likely in USD/CAD

The surprise rate cut and the fact that the BoC will not trail the Fed's rate hike (as the economy will need more time to narrow the output gap) call for further rise in USD/CAD. Looking at the chart, the long-term rounding bottom formation favours a move towards 1.3065 (March 2009 peak). A key resistance now lies at 1.2506 (21/04/2009 high), while a support stands at 1.2063 (21/01/2015 low).

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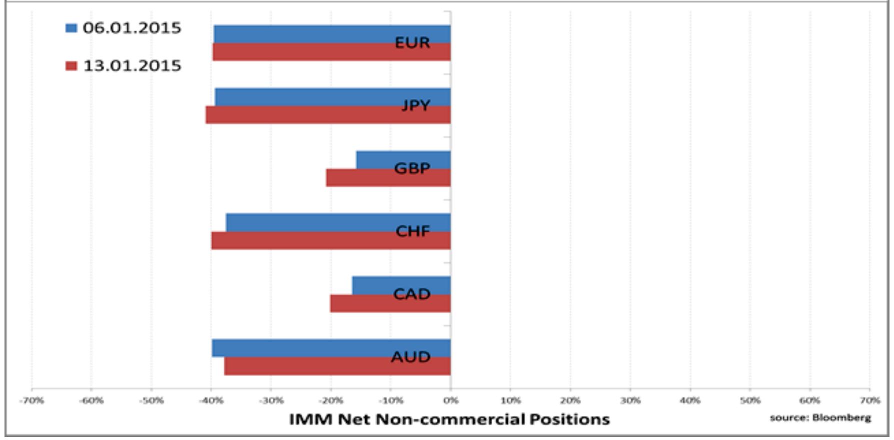
Elevated long USD positions leave room for disapointment

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.

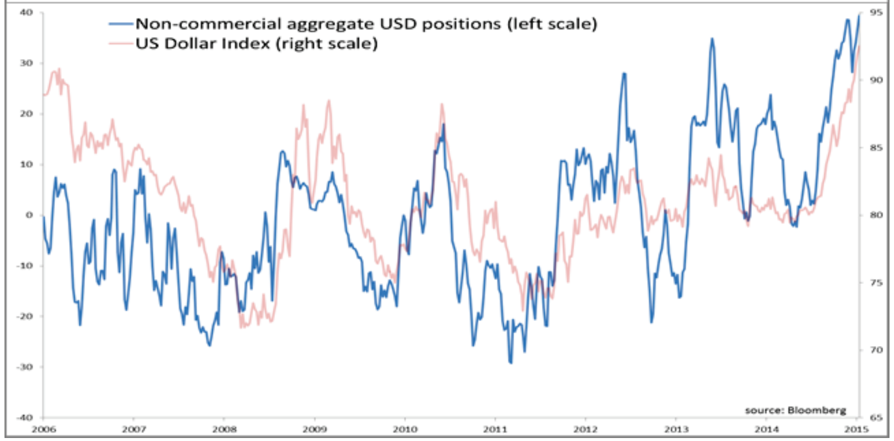
The IMM data covers investors' positions for the week ending 13 January 2015.

Swiss franc short positions was at very low levels (-39.90%) before the SNB's decision to remove the EUR/CHF floor. This elevated positioning can explained part of the massive sell-off that occurred after the SNB's announcement.
Euro short positions are roughly at the same levels (-39.74%) than CHF short positions. As a result, Euro remains very sensitive to any upside risks. Looking at the new record highs in long USD positions and the recent unimpressive US data (labour wages and retail sales), the USD buying interest could weaken in the short-term. However, given the massive ECB's QE programme, the medium-term trend continues to be in favour of a lower Euro.

AUD was the only currency to be bought against USD



Long USD positions at new record highs



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