WEEKLY MARKET OUTLOOK

4 - 8 May 2015

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WEEKLY MARKET OUTLOOK - An Overview

Economics

FOMC Recap

Members not so dovish

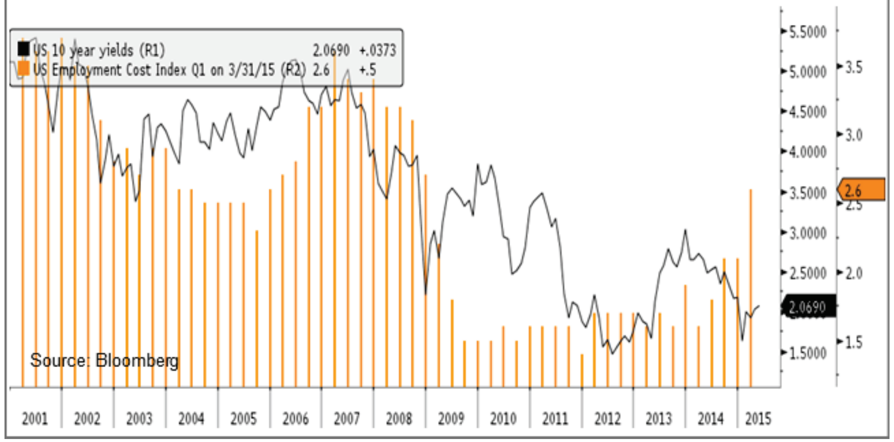
Recent USD decline has been the direct effect of investors pushing out the timing of the FOMC's first interest rate hike - views which were only amplified by the extremely weak Q1 GDP report. Yet when one examines the FOMC statement, there is a clear concern over the weak inflation level but the growth outlook seem more stable. Despite the soft patch in US economic data, there is no evidence that a June rate hike has been completely ruled out. However, our base scenario is that September's FOMC meeting will see the first rate increase.

The statement indicated that the current weakness in inflation is due to falling energy costs and a vague reference to the strong USD. The statement suggests that members believe inflation is "expected to rise towards 2% over the medium term as the labor market improves further and the transitory effects of declines in energy and import prices dissipate". The US labor market remains a bright spot, which should lead to a acceleration in wage growth to support the Feds mid-term inflation outlook. Surge in the US Q1 Employment Cost index, released this week, also reinforces the trend of higher wages and potential inflationary impact.

Regarding growth, the Fed doesn't seem too concerned with the slowdown. Winter weakness was attributed to "transitory factors" such as harsh winter weather, low oil prices, and lukewarm foreign demand. The overall feeling for the Fed was summed up with the final statement, indicating that "the risks to the outlook for economic activity and the labor market as nearly balanced." While the Fed presumes the economy will rebound after a lethargic Q1, market expectation of a rate hike continue to pivot on incoming data.

As to clarity on the timing, the Fed maintained its mildly dovish stance on the rate hike. It stated that members "anticipates that it will be appropriate to raise the target range for the federal funds rate when it has seen further improvement in the labor market and is reasonably confident that inflation will move back to its 2% objective over the medium term." Clear as a muddy puddle. Bloomberg Fed funds implied probability indicates that there is over 50% chance of a rate hike in September. It also suggests that steepening in the US yields curve could be due to the adjustment in longer term expectations for rates. Given our hawkish view, we remain constructive on USD and expect current corrective pullback to fade.

Employment Cost Index and rates getting jumpy



FX Markets | UK General Election

Hung parliament

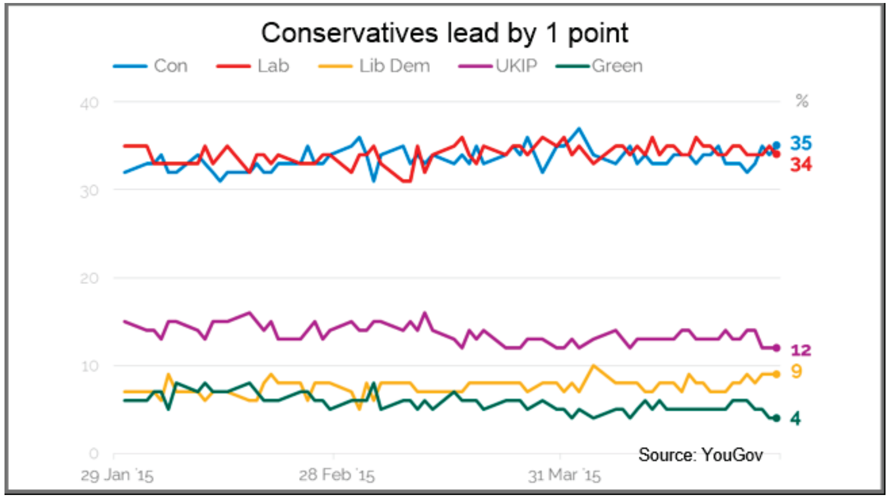
The general election will be held on May 7-8th and the least we can say is that it will be tight with no clear majority. According to the latest poll provided by YouGov, Labour party leads the Conservatives by a marginal 1 point lead at 35% versus 34% for David Cameron's party while the UK Independence party is far behind, polling at about 12%. A hung parliament seems one of the only certainty as no party will achieve the 326 seats needed to form a majority government.

European Union membership on the table

A multi-party coalition will cause uncertainty in FX markets as each decision on economic policy will be fiercely negotiated. Conservatives and Labour have different views about public spending, taxation and the place of UK within the European Union. Conservatives have made the promise to propose a referendum on Britain's membership within the European Union by 2017 while a EU referendum is unlikely under Labour. The "EU membership" subject is of prime importance vis-à-vis developments of the sterling pound as investors may give up on starting or supporting UK businesses in case the UK voters choose to leave the European Union, dragging down the pound sterling.

GBP/USD technical point

GBP/USD broke the 50dma on April 23 and appreciated sharply afterwards to test the next key level at 1.5412. So far, the sterling didn't validate the break and is currently trading lower around 1.5235. Going forward, the next resistance stands at 1.5539 and the pound will also need fresh boost to break the 200dma. On the downside, the cable will find support around 1.52 and lower around 1.50.



FX Markets

BCB Fights Inflation

BCB increased the Selic rate

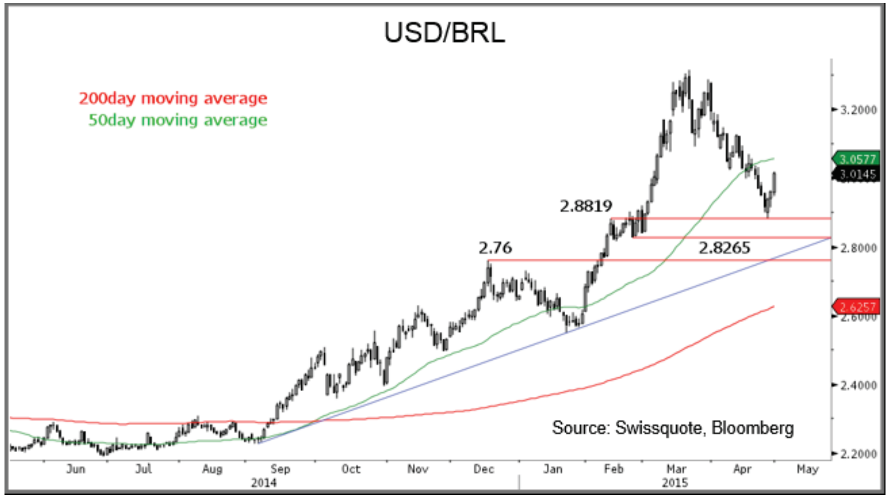
On April 30, the BCB increased the Selic rate by 50bps from 12.75% to 13.50% in an attempt to curb inflation and to restore markets confidence in the central bank ability to steer the economy. Inflation rose massively over the last year, reaching 8.13%y/y last month - far away from the 4.5% target the BCB set for 2016. We expect the BCB to keep raising rates as inflation expectations are way above target (5.8% so far for 2016).

Nevertheless further rate hikes will probably not help the Brazilian economy to recover as the gross national product is expected to contract again in Q1 2015 by -0.2%y/y - last time Brazilian GDP expanded was in Q1 2014). President Tombini will therefore monitor closely the effects of increasing borrowing costs on the Brazilian economy while keeping increasing rates on the other side. However, a deepening recession would add more pressure on the job market and would therefore mechanically ease inflation pressure, allowing the central bank to lower interest rates again in 2016.

USD/BRL

The Real's appreciation accelerated over the last weeks on growing carry appetite. However, the uncertainty over the Fed rate hike timing and poor Brazilian data have pushed carry traders to take their profits and dragged down the Real. On the short-term, we expect traders to rush again into the higher-yielding currency as further rate hikes from the BCB are highly likely. On the medium-term, the US economy should have recovered from the harsh winter and traders will start to price in the upcoming rate hike from the Fed. All in all, there is still room for further Real appreciation but it may not last long.

USD/BRL will need fresh boost to move above the 50dma - standing at 3.0577 at the moment. On the downside, the first support stands at 2.8265 and the following one lies at 2.76.



FX Markets

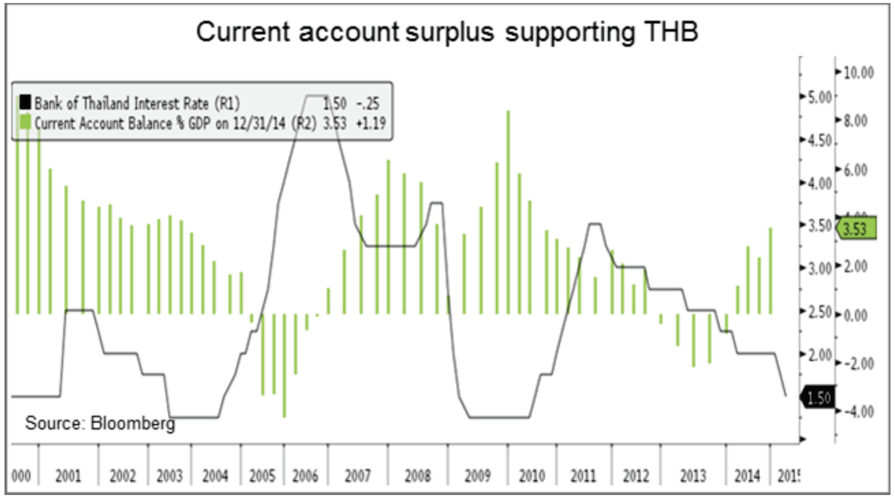
THB To Weaken On BoT Action

This week, the Bank of Thailand (BoT) unexpectedly cut its policy rate a further 25bp, bringing interest rates to 1.50%. Interestingly, despite clear fundamental reasons for Thai baht weakness, the currency has remained ominously resilient. In fact, the THB has been one of the only currencies to appreciate verse the USD, allowing it to remain one of the strongest regional currencies. Yet after a long wait, change in BoT bias suggests that further THB weakness should be expected.

The government, has struggled to create political legitimacy, support economic growth and to lift domestic confidence since taking power. Yet the THB continued to appreciate. A primary rationale for the strong THB has been the improvement to the current account, driven by lower imports. A sizable fall in imports can be attributed to lower oil prices and the slowing economic growth has limited the demands for automotive and capital goods. In addition, yield starved foreign investors have reinvested capital into Thai assets this year to take advantage of higher government debt.

The central bank's decision to cut interest rates was directly geared toward offsetting the negative impact of the THB. This cut had more support, with a vote of 5-2, with two dissenters preferring to hold rates. The accompanying statement was noticeably more dovish, with a heavy emphasis on the effect of a strong THB. It was clear that the BoT is now knowingly worried that exports and inflation would be effected by 'pressure from recent Thai baht appreciation'. Core inflation fell to 1.31% in March which is a 1 one-year low. Given the explicit mention of the THB strength, our suspicions that the risk of interest rate cuts will put rates below the all-time low (1.25%) has increased significantly.

Despite the fact that domestic demand and inflation data remain fragile, we expect that the THB will outperform regional peers unless the BoT acts. To help limit THB strength the BoT announced relaxation measures on capital flows. These measure will make it easier for both domestics capital to flow outwards and investment inwards. Given the timing of the announcement we suspect the measures are aimed at relieving pressure from the strong THB. Further easing should weaken THB moving forward.



Stock Markets

Sell In May And Go Away

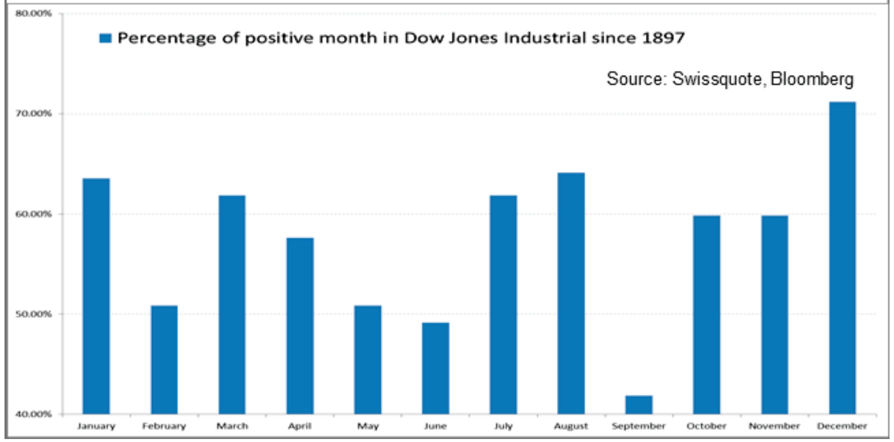
Seasonality is now less supportive for US equities

A rather well-known adage in the stock market is "sell in May and go away". It is based on the idea to hold US equities at the beginning of November and to liquidate them at the end of April. It does not mean that the stock market will decline from 1 May to the end of October, only that the performance during that time has been found empirically lower than the rest of the year. Although part of the difference in performance comes from a reoccurrence of major market declines near September (e.g. 1987, 1998 and 2008), it shouldn't overshadow some recurrent facts. The month of September is by far the worst month to hold US equities, as it is positive roughly only four times out of ten (41.88%). The only other month to be on average more often negative than positive is June but only by a small margin (49.15%). On the other hand, the month of December is by far the best month to hold US equities, as it is positive more than 7 times out of ten (71.19%).

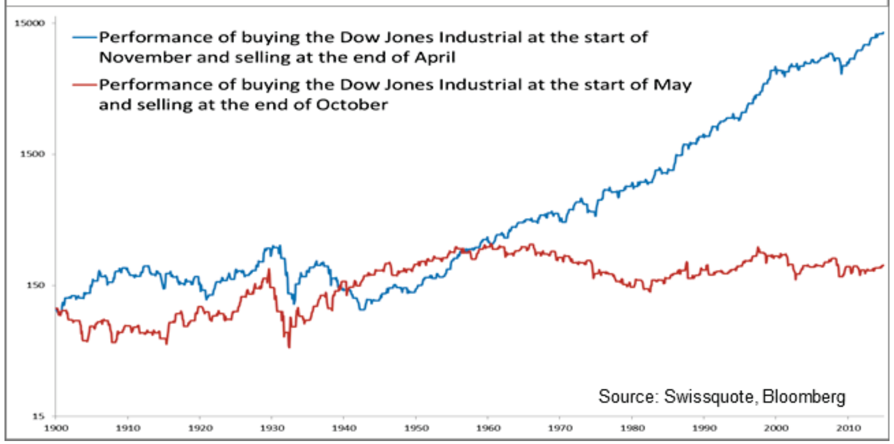
What does it mean for 2015?

Although the S&P 500 has not been able to make significant new highs since February yet, the upcoming less supportive seasonality does not call for a major decline in the near-term. Part of the reasons are that the recent rally in US equities is broad-based (mid and small caps are confirming the strength in the large cap) and that the current technical configuration (ascending triangle) favours a short-term bullish bias. However, with the Fed looking to start its tightening cycle this year (probably in September), we suspect that the trading period around September is likely to be rather volatile. As a result, we would not be surprised to see some profit taking in the next months as we approach the end of the summer, confirming subdued returns for the period of time from May to October.

September is by far the worst month to hold US equities



Since 1950, seasonality has added significant outperformance



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