SWISSQUOTE

WEEKLY MARKET OUTLOOK

25 - 31 January 2016

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

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WEEKLY MARKET OUTLOOK - An Overview

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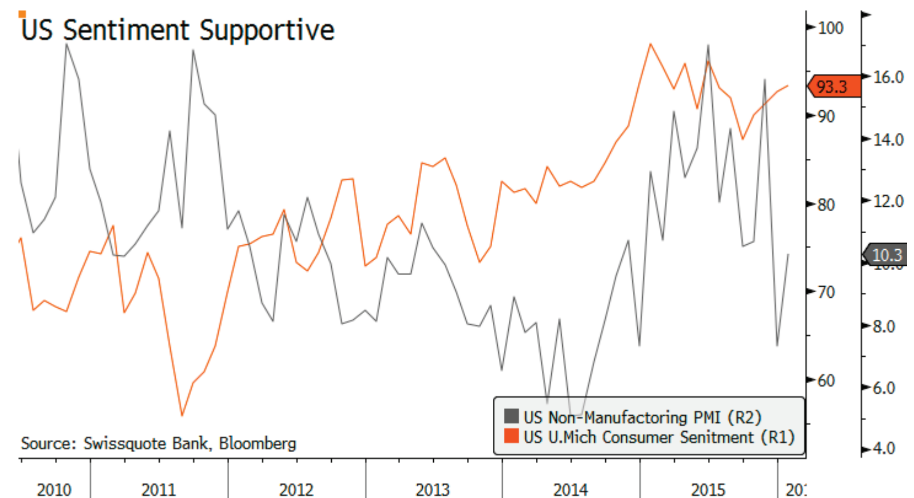
Economics

Don't Expect The Fed To Change Their Tune... Yet

There is growing concern that the Fed's interest rate hike in December has „killed" the US economy. Since the hike, market sentiment has weakened significantly, while US manufacturing looks to be suffering from the strong USD and weak oil prices. Following a brief post-hike calm, US stocks and long-end yields (critical for real-estate prices) have fallen sharply and oil prices have tumbled. This week, at the FOMC meeting, investors will look for any signal of regret by the dovish faction of the committee. We suspect that markets are confusing short-term external turbulence with a temporary soft patch in US economic data. That said, we have always indicated that the Fed "dots" were overly ambitions based on optimistic inflation outlook but never argued for a reversal of hiking path.

Manufacturing has been noticeably hurting due to the strong USD and spillover drag into real exports. The steady descent in manufacturing data, following the strong USD, indicates a worry trend. While recently, the downward trend has been exacerbated by slowing global trade as emerging in markets growth decelerates. The Fed has mentioned the effects of the strong US in their decision making process and will be monitoring developments. However, against the G10 the USD price is basically unchanged since December. It's important to remember that the US economy depends on manufacturing for only slightly over 10% of GDP. Meaning, while soft, is unlikely to derail the broader US economy. However, on the positive side, the US domestic economy is humming along. The robust labor market and low inflation environment suggests that the consumer sentiment remains strong. Which in turn, has supported private consumption and service sector (non-manufacturing PMI in expansion territory). The US expansion remains healthy and in a positioned to handle marginal higher interest rates.

A rate hike would also help to stabilise the currency and bring USD/BRL to below 4.00 - the pair is currently trading at around 4.12. However, the current backdrop of global market volatility and risk-off sentiment will keep investors away from EM currencies.



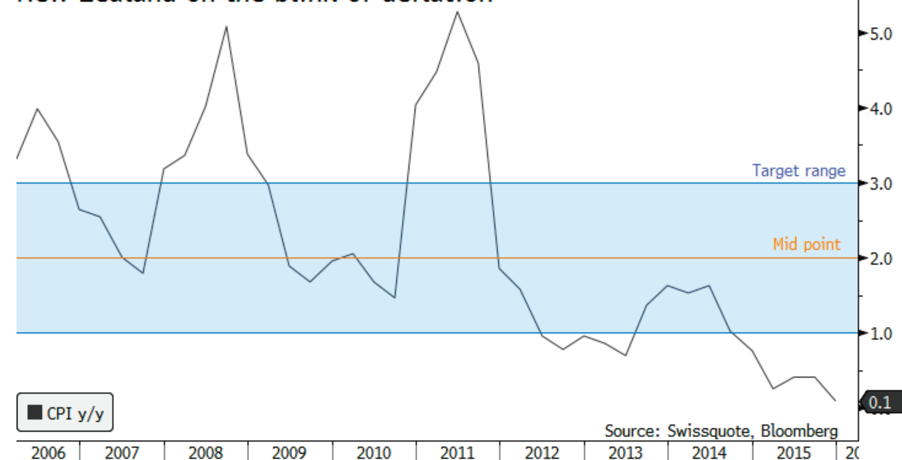
Economics

RBNZ May Be Forced To Cut Rate

During the first half of January, the commodity rout and mounting uncertainties about the China growth outlook has been weighing heavily on commodity currencies. The Australian dollar has suffered a hammering as it fell as much as 6.5% against the US dollar or 5.30% on a trade weighted basis. However, the Aussie showed signs of recovery, or at least of consolidation, over the last few days as the Australian economy seemed to have weathered relatively well the turmoil. Its closest neighbour, New Zealand, has also seen its currency being heavily sold-off. The Kiwi fell as much as 5.30% on a trade weighted basis while losing 7.50% against the greenback, back to the lows last seen in mid-November last year. However, unlike its big neighbour, New Zealand is facing a completely different situation, especially on the inflation side. New Zealand is on the brink of deflation while price levels moved at more comfortable levels in Australia - with CPI increasing to 2.00%y/y in December - while prices fell 0.5%q/q in the fourth quarter (up 0.1% on a year-over-year basis) in NZ.

Rate cut back on the table

This treat of deflation put the monetary adjustment question back on the table. Indeed, a cut in the official cash rate to 2.25% from 2.50% as early as next week looks more and more likely given the weak inflationary pressures. In the MPS from December, the RBNZ increased its growth forecast, betting on a pick-up in export prices and strong population growth, but pushed back the timeframe for reaching the inflation target by roughly one year compared to the previous forecast - the RBNZ expects headline CPI to reach the bottom of the target range in early 2016 and to move toward the mid-point at the very end of 2017. However, according to the latest data it may be delayed even further. Therefore, the central bank may have to come back into the play and cut the OCR to pre-vent the economy to head further into deflation. Obviously, this would add pressure on the New Zealand dollar, which is already at relatively low level. NZD/USD is currently trading slightly higher the strong support area lying between 0.64 - 0.6430 (Fibo 61.8% on 2009 - 2014 rally and low from mid-November last year), if broken the next target is $0.6235, then $0.60.



Economics

Oil Prices Keep On Collapsing

Downward trend

Petrol price war dominated last week's headlines. The Brent has slid below 28 dollars per barrel at the beginning of the last Monday Asian session before bouncing back around 31 dollars at the end of the week. Oil keeps on trading at levels unseen in the last 12 years in a major context of oversupply. OPEC members, which are concerned about keeping their markets shares, are pushing other oil producers out of the market by supplying more than a million barrel per day.

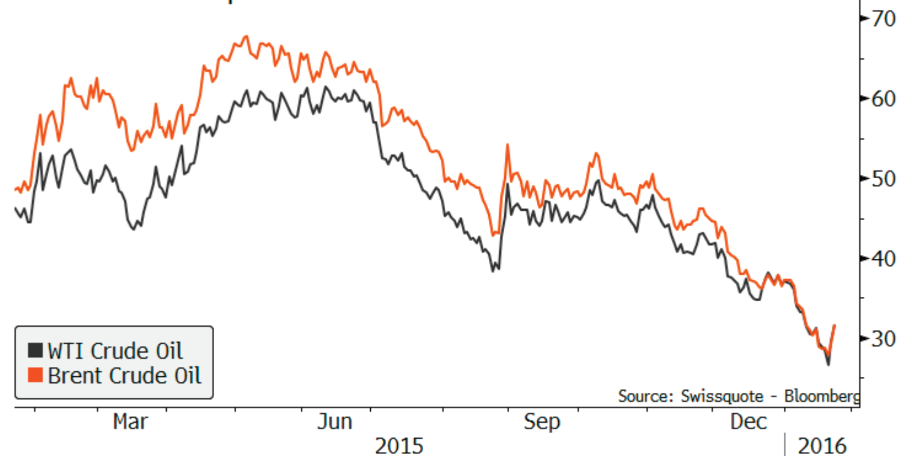
We believe that the crude oil downside momentum should keep going as sanctions against Iran have been lifted due to the recent compromises concerning the country's nuclear programme. Iran, under the deal signed last year with the International Community, will be authorized to return to the oil market. The lifting of these sanctions will result in an additional 500k barrels per day. Markets is also pricing in the next supply of American oil despite it will cost several dollars a barrel to ship WTI crude oil to European refineries.

Geopolitical risks

Any agreement between OPEC members on a possible supply in order to increase price and profits seems currently impossible. In particular, tensions between Saudi Arabia and Iran are preventing any such possible cooperation as it seems the key driver in this conflict is to become the leading regional power.

China's concern

Another key points is to see on the Chinese Slowdown which should weigh on the overall demand for the coming year. The oil price is set to remain low for the time being. Following last ECB's meeting, ECB President Mario Draghi has implied that more stimulus may be added because of the increasing downside risks on inflation due to falling oil prices. As a result, we target a price of $25 per barrel of Brent over the medium-term.

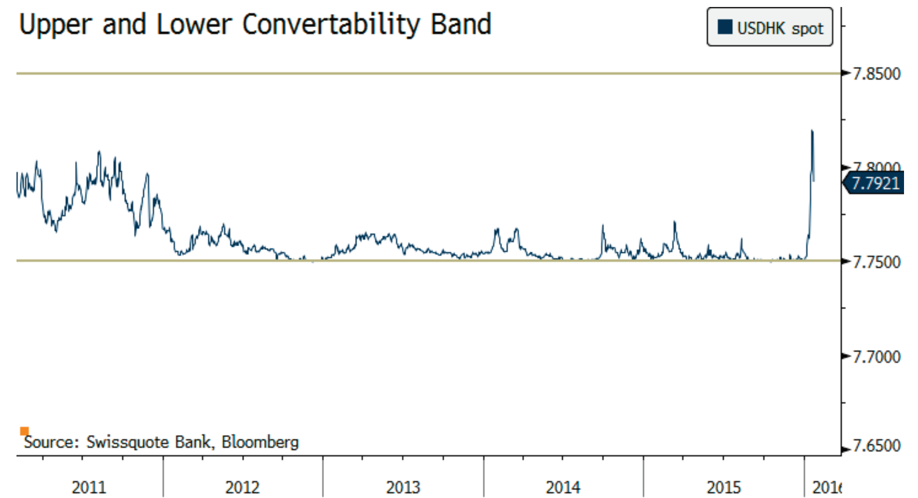


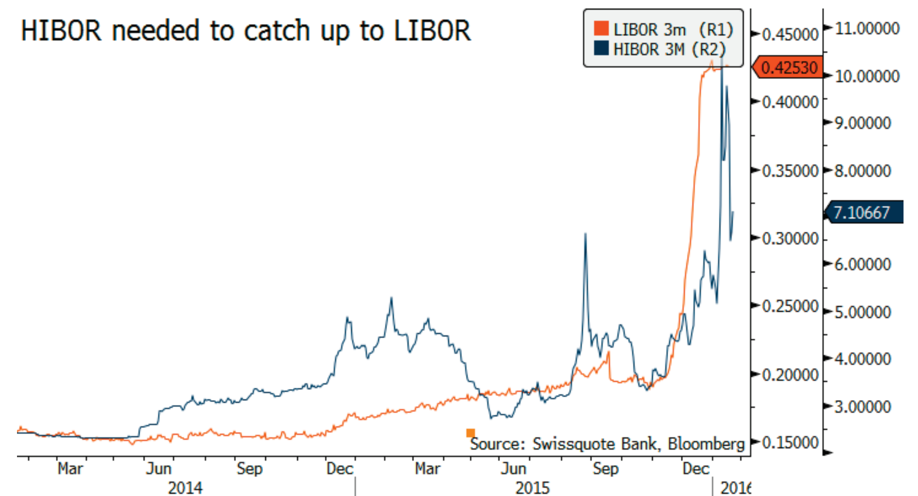
FX Markets

Hong Kong Dollar Peg Not Going Anywhere

USDHKD continues to rally reaching a 7.8093 high with forwards in the 6m tenors rising above the upper band. Aggressive selling for the HKD regained momentum after China announced that GDP grew 6.9% (in-line). Hong Kong's close ties with China have caused investors to link the two nation's currencies. China's weaker growth, expected capital outflows and devaluation are also expected to become Hong Kong problems. Within the three-decade old currency peg regime, the value of the USDHKD can fluctuate within a 7.75 to 7.85 band. This current move feels more like positioning rather than a shift in sentiment over Hong Kong economic fundamentals or change in policy. Monetary conditions in Hong Kong remain accommodating with the spread between US-HK interbank rates favoring the US by 17bp. This move, most probably, was merely a move by the Hong Kong rates to catch up to their US equal. Finally on a fundamental point, given the real HKD effective exchange rate and inflation differentials with the US, this does not warrant significantly higher USDHKD. Hence, we do not see the Hong Kong Monetary Authority abandoning the peg any time soon.

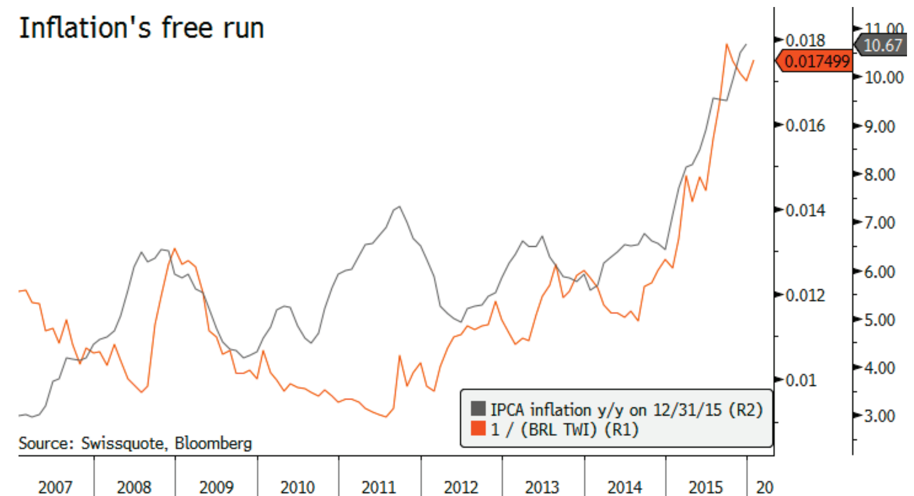
Furthermore, we suspect that the China proximity argument is weak and a devalued CNY should not necessarily trigger HKD selling. While the connection between Hong Kong and China markets will increase, HKD remains heavily influenced by the Fed and USD. The HKD peg has been extremely positive for Hong Kong's prosperity by providing stability and allowing the nations to become a hub of international finance. Further capital outflow (estimated at $300bn) will need to leave before liquidity conditions tighten and push up short-term HIBOR. Finally, Hong Kong's Monetary Base (MB) is fully backed by USD359bn in foreign currency. Should speculators continue to challenge the currency board, this massive "warchest" should provide credibility to Hong Kong's Linked Exchange Rate System.





Economics — BCB On Hold For Now

Last Wednesday, the Brazilian central bank decided, against the market opinion, to keep interest rates unchanged. As a result the Brazilian real depreciated further, gapping 1.50% at opening the following day. Indeed, most participants anticipated that Alexandre Tombini would have increased the Selic rate by 50bps to 14.75% to address rampant inflation and to try to anchor inflation expectations - let's recall that IPCA inflation measure reached 10.67%y/y in December and that economists keep adjusting their forecast to the upside. However, the BCB chose the other side, the "growth" side, and decided to not increase the burden on the economy, which is already suffocating for quite some time now. The situation in Brazil was already a nightmare before the commodity sell-off and renewed fears about China's growth outlook; but now that investors are dumping risky assets to seek safe-haven shelter, things have gotten a whole lot worse.



Not really a choice

In our opinion, the BCB will have to come back into play and raise interest rates this year to bring inflation back within the target range. It is just a matter of time as the constant pressure from the currency depreciation, the political chaos and widening fiscal deficit are pushing inflation higher, increasing the pressure on the central bank. Moreover, after years of work to re-gain market's trust and build credibility, it would be counterproductive to give up the fight against inflation at such a crucial moment.

A rate hike would also help to stabilise the currency and bring USD/BRL to below 4.00 - the pair is currently trading at around 4.12. However, the current backdrop of global market volatility and risk-off sentiment will keep investors away from EM currencies.

Economics

Markets Await ECB's Meeting In March

No surprise from the ECB

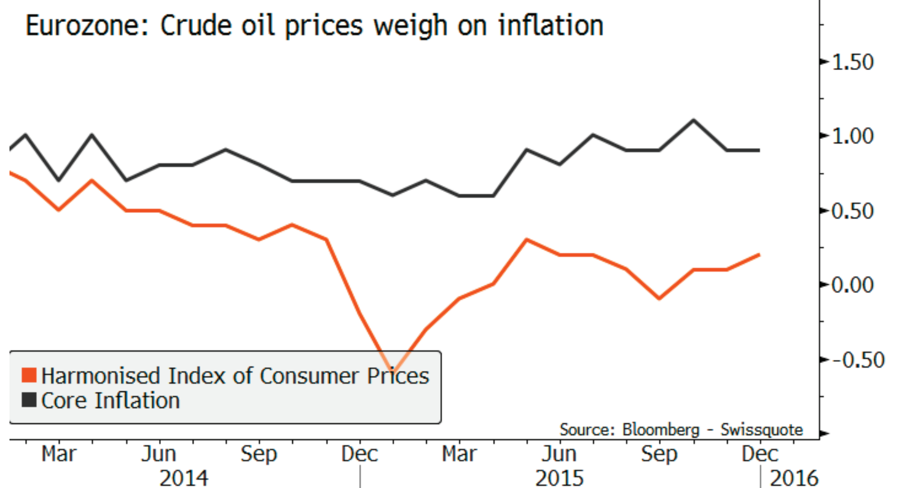
There was not much to expect from the EBC meeting last Thursday. President Draghi announced that current monetary policy remains unchanged since the last deposit rate cut in December from -0.2% to -0.3%. Yet, Draghi has hinted that further stimulus may be added if low crude prices linger as it keep pressure on the Eurozone CPI. Indeed, as we know inflation has not picked up since the beginning of the QE programme last year. Worryingly, the outlook appears even weaker than it did at December's meeting. Consequently, there is a good chance that the ECB's inflation expectations for 2017 will be lowered. In our view it will certainly be 1%.

Markets await next March's meeting

Next March's meeting seems already crucial as the Bank will "review and possibly reconsider" monetary policy. Draghi already stated that he ECB was ready to do whatever it takes to preserve the euro. We question the consistency of the ECB's long-term view. Indeed, Draghi's tone oscillates from hawkish to dovish. We consider that the continued decline of oil prices was predictable as the oversupply was not set to stop. We believe that Mario Draghi does not want go all-in as he wants to keep some room to act. Oil price is definitely not a good news for European policymakers.

A credibility issue

Last but not least, we also think that Draghi is taking a very measured approach to stimulus out of concern for the central bank's credibility. History has taught us that both QEs in Japan and in the US have proven to be less than 100% efficient. In any case, we feel that policymakers are currently waiting to collect more data, especially preliminary Q4 Eurozone GDP which will be released next week. Disappointing figures will pave the way for further stimulus at the next meeting in March. For the moment the EURUSD should not move much on today's meeting.



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