SWISSQUOTE

WEEKLY MARKET OUTLOOK

8 - 14 February 2016

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WEEKLY MARKET OUTLOOK - An Overview

Economics

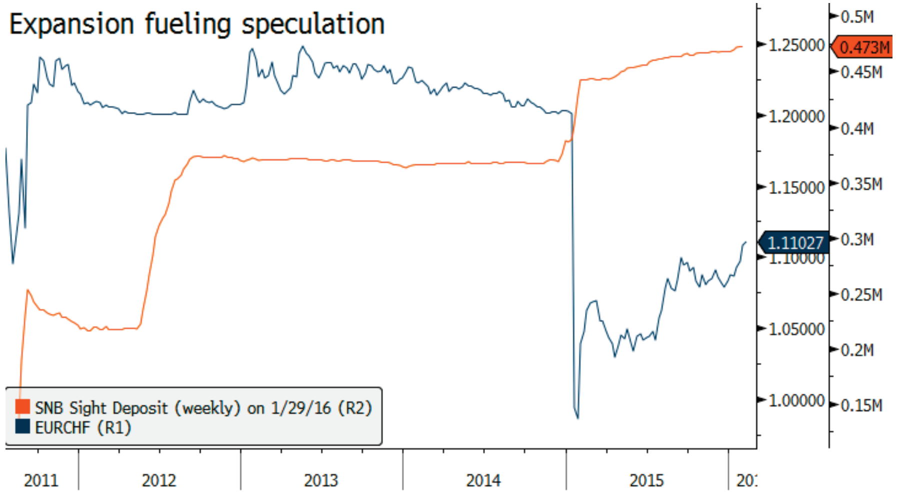
Speculation Over SNB Intervention

Weak domestic data

The volatility in the recently yawn inducing EURCHF has fueled speculation of SNB intervention. We remain skeptical despite the fact FX intervention would be justified as Swiss inflation remains in deflationary territory and the economic outlook is gloomy. Swiss retail sales contracted for a fifth consecutive month in December; the real gauge fell 1.6%y/y in the last month of 2015 as spending for clothes and footwear shrank 9.3%. When excluding fuels real retail sales contracted 1.5%y/y. Clearly the warm winter weather has restrained traditional heavy spending on recreation in the Alps. The combined effects of a strong Swiss franc and gloomy global outlook continued to weigh on broader retail trade turnover and consumer sentiment. Nevertheless, with the ongoing stabilisation - and even improvement - of EUR/CHF, we should see a slow recovery of the retail sector as we head further into 2016; but nothing significant however. The threat of the ECB is always in the back of the investors' mind and should prevent any substantial improvement of the Swiss economy as long as the euro zone remains on the edge of deflation. So far, EUR/CHF reacted positively to the news and is on its way to test the next resistance standing at 1.1150.

No evidence of SNB intervention

It's more likely that macro events, including Euro strength are having a natural effect of sending EURCHF higher, then SNB intervention. We understand that the franc provides a safe-haven during geopolitical turmoil rather than central banks driven volatility. As expectations for the ECB to ease further (despite verbal comments), investors have rotated back into Europe from Switzerland. Perhaps the strongest suggestion that the SNB is actively trying to weaken the CHF has been the sudden jump in sight deposits by approximately CHF4.5bn since the start for the year and monthly SNB FX reserves for January rose to CHF 575.4bn from CHF 559.5bn. However, as major Swiss bank correctly points out that seasonality has a significant effect on sight deposits which can easily account for the variation. In addition, the weakness in CHF indicates that increase in FX reserves is more likely the effect of valuation. Given the worrying domestic fundamentals, the franc should continue to weaken making a rationale for a preemptive SNB dubious. Baring a risk "shock" we should see CHF weaken further and EURCHF trending higher.



Economics

Russia: Still Willing To Increase Its Forex Reserves

A worrying situation

Russia's economic situation is concerning. 2015 GDP fell to 3.7% y/y, down from the slight rise of 0.6% in 2014. Global turmoil are largely affecting the country which has also had to deal with a weakening currency, mostly due to the lingering low oil prices and with a massive inflation that is lying around 10%. The USDRUB is trading at a few figures from its record-high of 82 rubles versus the greenback, meaning that gold in the Russian currency is very expensive. On top of that, the price of gold and metals have recently improved to a 3-month high.

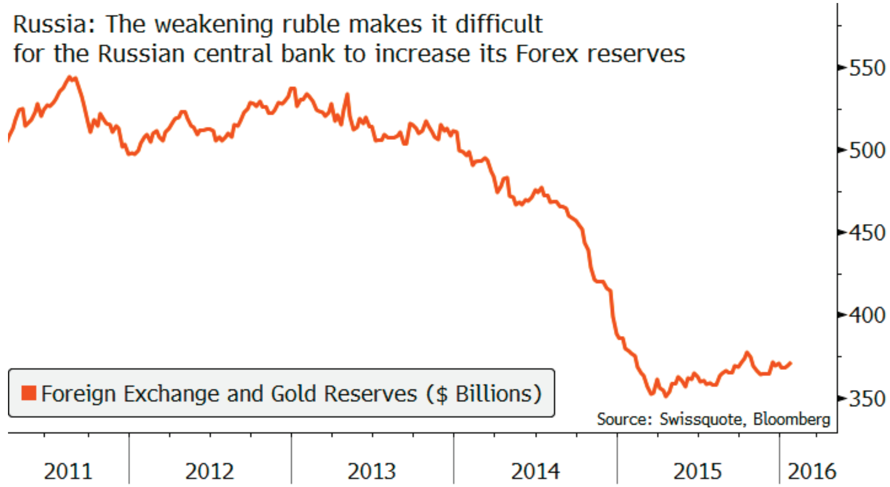
Target: increasing the Forex reserves

The currency war is definitely on and in an effort to stabilize the ruble, Russia is looking for to expand its Foreign-Exchange reserves (which includes gold). The precious metal would definitely bring some stability and confidence toward Russia. Last week, the Russian central bank has disclosed this amount for the period ending 29th January. It has increased by $2 billion from a week before. Russia's Central Bank head, Elvira Nabiullina has already made it clear that one of its primary objectives is to increase these reserve holdings up to $500 billion. For the time being, holdings only amount to 371.3 billion.

Inflation remains way too high

Another key point is the growing inflation in the country. Central bank's inflation target of 4% looks difficult to achieve in the medium-term because of the international sanctions and the oil prices collapse which drives Russia's revenues much lower. There is not much room for Russia as high inflation and negative growth prevents any change in interest rates rates which should remain stuck at 11%. Yet any further weakening of the currency should drive the central bank to increase rates as it happened late 2014 when rates increased by 17%.

The challenge is to know whether Russia (and also) China are in fact capable of entirely backing their currency with gold. There is a deliberate strategy from Russia to remove the dollar from the Russian international exchanges. And this is why Russia needs more gold in order to gain credibility. Gold definitely represents confidence in a Central Bank. It would appear that the currency wars are still blazing!



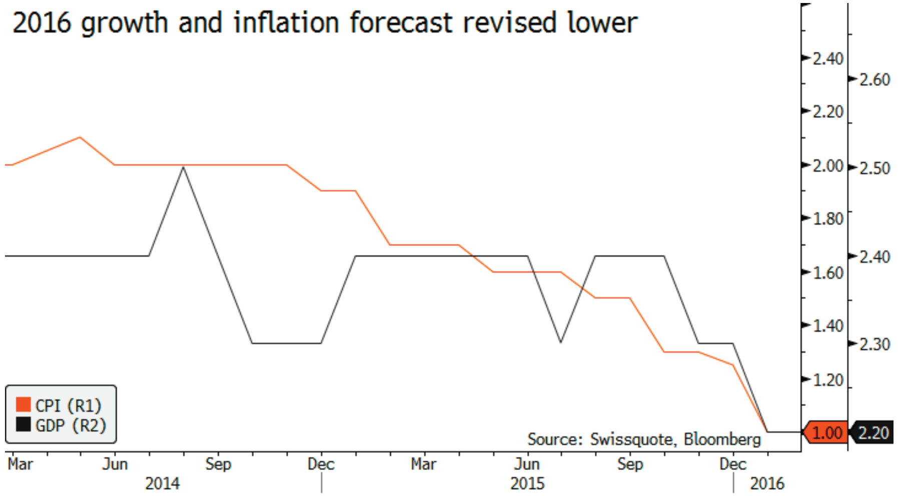
Economics

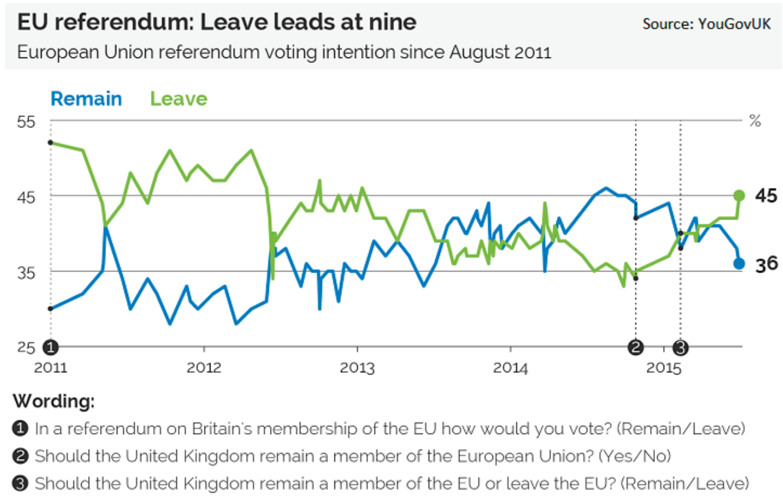
Dovish BoE Will Weigh On The Pound

The Bank of England held its quarterly meeting last Thursday and released its interest rate decision together with an update of its inflation and growth projections. As widely expected by the market and us, the Monetary Policy Committee voted to maintain the benchmark rate at record low 2% and the stock of purchased assets financed by the issuance of central bank reserves at £375 billion. Ian McCafferty, the unique hawkish dissident, shifted away from its usual stance and joined the dovish camp; it was therefore a unanimous vote (9-0) to maintain the benchmark interest rate at record-low 0.5%.

The MPC also provided an updated version of its growth and inflation projections. Both projections were unsurprisingly revised lower as the rout in crude oil prices and mounting uncertainties about China's growth outlook, and more broadly about the weak global demand, worsened the UK's outlook. The MPC revised down its growth projection to 2.2% from 2.5% for 2016 and to 2.4% from 2.7% for 2017 and also trimmed the inflation forecast to 0.4% from 0.7% for 2016 and to 1.2% from 1.5% for 2017 as wage pressure remained subdued and energy prices continued to weigh. Overall, the committee appeared to be relatively confident about the growth outlook and is still thinking that the next move is going to be an increase and not a cut. However, Mark Carney's comments were less dovish than anticipated by investors, which helped the pound to bounce back to its pre-announcement levels.

The cable was on fire last week as traders pushed back the timing for more Fed rate hike. GBP/USD surged more than 2% during the week, hitting 1.4650 on Friday. However, the party is over as the pound will most likely head lower as the BoE will remain sidelined for a longer period of time. Moreover, the pound's weakness will also be exacerbated by the lingering Brexit threats that will take the front stage as we are heading into 2016.





Economists

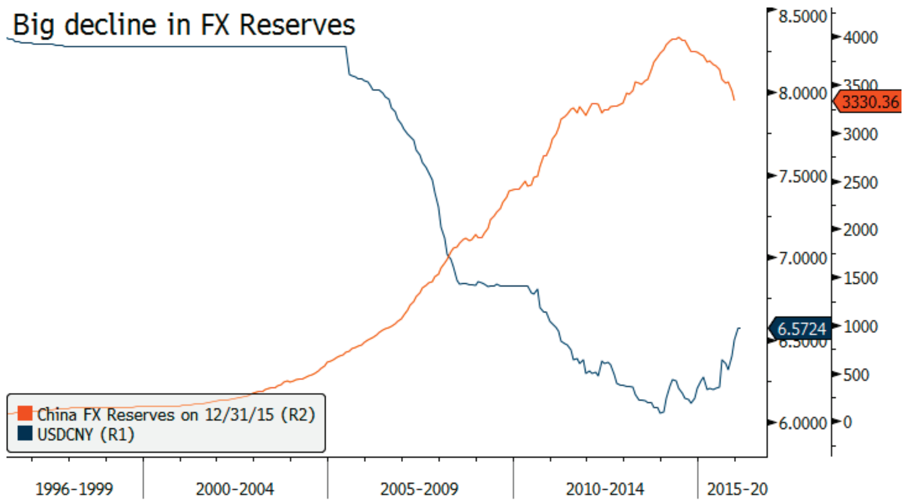
China’s Slow Motion Currency Crisis

We are unmistakably watching a currency crisis unfold in slow motion. While the crisis end-game is not preordained in our view, we are heading in that direction. Lines have been drawn and positions are being built. The Chinese State Administration of Foreign Exchange (SAFE) has gone on the offensive this week to offset damage done by RMB speculators. Recently public comments by well-regarded and significantly funded asset managers indicate their expectations for further RMB devaluations. SAFE's new head, Pan Gongsheng (old PBoC deputy Governor) confidently stated that FX reserves remain sufficient and anticipates a current account surplus in 2016. He continued to say that there was no basis for continued yuan devaluations and yuan rates will remain stable, and finally, suggesting that the Chinese economy is in reasonably solid shape. This is a very different narrative than what is circulating in financial communities. Global investors are increasingly uncertain about China's economic strategy and its ability to manage rebalancing and therefore halt capital outflows.

Despite policy miss-steps in 2015, we remain cautiously optimistic that China has the firepower to stimulate domestic demand while managing capital outflows (without the nuclear options of stricter capital controls). Vice Premier Wang Yang comment to US treasury secretary Lew that China was able to keep the RMB at a “balanced level.” We anticipate that policy makers currently will focus on RMB stability by injecting capital rather than targeting growth and cutting interest rates (which might exacerbate outflows in the short term).

However, in the near-term capital outflows are undoubtedly mounting, potentially getting out of control. It is estimated that outflows have reached $676bn in recent years. To combat the pressure on RMB, the PBoC has had to dig deep into foreign reserves ending in a $140bn intervention in December.

On Sunday, ahead of the Chinese New Year holidays, China will release data on FX reserves. Bloomberg estimates are expecting a significant $120bn decline yet our expectations are for an even deeper fall of $145bn. This would mark the largest decline in FX reserves ever and rapidly intensify investor’s skepticism surrounding China’s capabilities (including ability to manage peg). Further devaluing in RMB will have a profound disinflation impact on an already fragile global economy while sparking regional competitive devaluations. However, a smaller decline in FX reserves could trigger a short position squeeze.



Economists

U.S: Hoping For Stronger Data

Markets have been awaiting the release of the U.S. personal income and spending data since the FOMC decided late January to keep interest rates unchanged at 0.5%. The first one has printed in line versus the last available data in November while personal spending has declined. Last first estimates of the Q4 GDP print did not take us by surprise when it came in at a poor 0.7% q/q, the weakest since winter 2015, with the U.S. economy still struggling to enter a path of sustainable growth. Chinese economic slowdown and collapsing oil prices should lead to less investment and more job cuts. The Fed is definitely overly optimistic on its rate-rise path. Why would the institution succeed now where it has failed over the last ten years?

Recent soft US data will again put in question the Fed's tightening strategy for this year. All other central banks are currently easing (except for the Bank of Mexico, which is actually carefully following the US rate path in order to avoid any capital outflows that would result from a smaller rate differential). The Fed is therefore alone. We believe that hiking rates too prematurely would have a massive impact on the American economy and drive it again into recession. Yet, the astonishing amount of U.S. debt needs inflation to be reduced over the long haul. If this does not happen then, we are not afraid to say that a QE4 could be in the pipeline. Knowing the Fed's situation this would be very contradictory but we believe that rates have been raised because the central bank needed to show that it still has control of the situation.

The Fed's baseline forecast calls for four rate hikes this year and markets are pricing in that a continued strong trend of jobs creation this year should normally be sufficient to trigger those four raises. Yet, there are more than a hundred million Americans without a job so it leaves us some year before we see a relief in labour shortages.

Consequently we believe that there are too many workers on the sidelines, which adds downside pressures to wages. Despite official lower unemployment data that printed last week, including lower unemployment rate which declined to 4.9% and significant jobs creation, NFPs released 152k new jobs in January, wages growth remains somewhat sluggish. We are highly skeptical of inflation picking up towards the Fed's target of 2% The Fed's dual mandate is far from being achieved despite massive intervention over the past decade. Weak data is the new normal for the U.S economy.

If inflation does not clearly pick up very soon, then the Fed will not have much room to act to achieve its targets. Fed Chair Yellen has recently announced that she is not very convinced about negatives rates and their effectiveness. Then, she should also admit that massive QEs are also far from being efficient. But passivity is not an option so negative rates, or QE4, or both seems to be the direction in which we are heading. We are bullish EURUSD as we believe that policy divergence is coming to an end for 2016.

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