WEEKLY MARKET OUTLOOK

15 - 21 February 2016

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WEEKLY MARKET OUTLOOK - An Overview

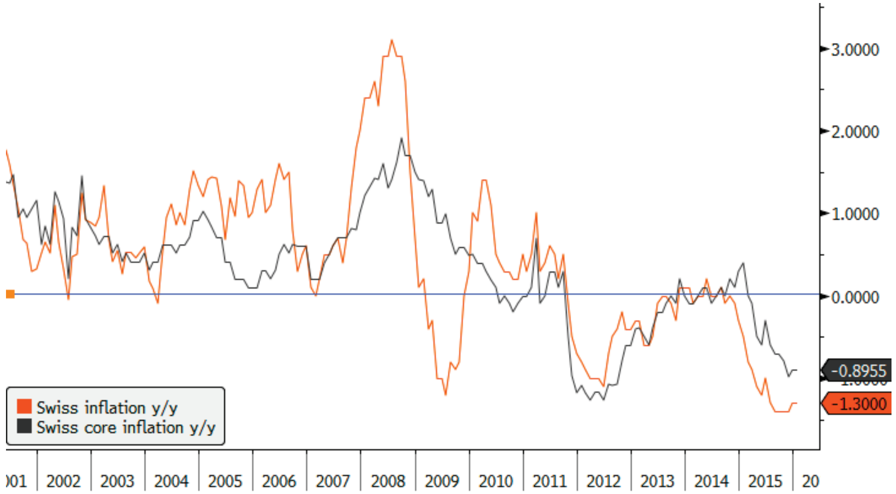
Economics

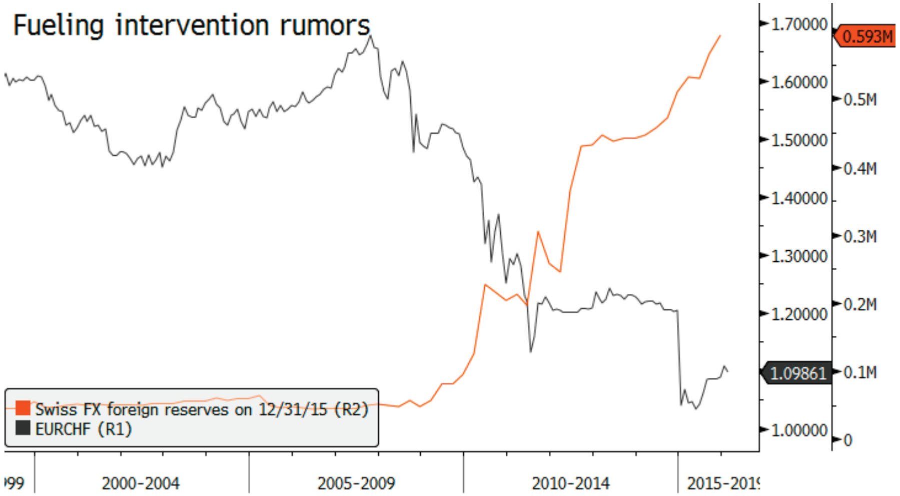
Swiss Deflation Entrenches Yet CHF Strengthens

Switzerland's inflation data for January remained deep in deflationary territory, as was universally anticipated. Swiss CPI held at -1.3% y/y, -0.4% m/m, while core CPI -0.9% yet m/m fell -0.4% from -0.1%. CHF was stronger against the USD and EUR as a function of deteriorating risk sentiment rather than domestic developments. The weak price outlook reported today will only fuel market expectations for SNB action. Recent jumps in official sight deposits (575.4bn from 559.5bn), combined with a steadily weaker CHF had traders speculating on FX interventions.

We thought it was unlikely that the SNB had any involvement based on consistent CHF valuations effects and already bloated balance sheet. However, steady safe-haven trading has reversed the CHF strength. Yet, faced with a soft economic backdrop and strong CHF, the probably has increased significantly that the SNB will act. This said, direct FX intervention is less likely than further reducing already negative rates (although both have received the SNB's blessing on a steady basis). SNB President Thomas Jordon has clearly indicated his view that the CHF is overvalued and that the rate can be “lower than it is where we are now” (lower band currently at -0.75%). Interestingly while negative interest rates have not been enormously effective at reversing capital inflow, it has slowed CHF accumulation plus we are now seeing other central banks adopt the strategy.

In FX markets global safe haven currencies were in demand as fear over the health of global banks, fall in oil prices and rising expectations for CNY devaluation all caused investors to deleverage risk. With monetary policy divergence which drove the USD strength now fading, expectations for the ECB to increase stimulus in March and global uncertainty driving capital back into CHF, the SNB is once again in an uncomfortable situation. The SNB needs to make the CHF unattractive to foreign and domestic buyers but realistically have limited tools. However, it's too early too act, so expect the CHF to continue to gain against G10.





Economics — Mixed Feelings For Australia And Canada

A difficult context

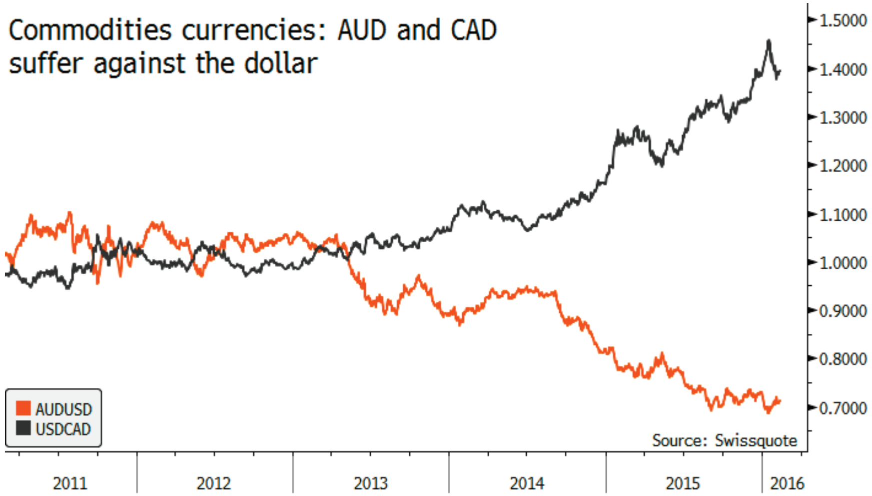
As long as the current oversupply by OPEC members continue, downside pressures on oil will continue. It seems that this overproduction period is far from being over. The Brent crude oil is trading around $31 a barrel and several countries such as Australia and Canada are suffering from those low prices. Unfortunately, their weakness should continue. For the time being, their economies are declining in particular their current account which are both in deficit. Australia has recorded an amount of $21.2 billion and Canada is lying at $11.5 billion for the third quarter of 2015. Their economies are mostly reliant on financial inflows coming from their commodities industries and as long as the global environment, especially geopolitical aspects remain uncertain, the situation is not going to get any better. Current Middle East issues in Syria, the Iran-Saudi Arabia issues as well as the ruble collapse are elements where oil is the sinews of war. Current commodity war is set to continue.

Entering into negative rates territory

In Australia, the Reserve Bank announced it is keeping its interest rates at 2% amid strong recent unemployment data for the last quarter 2015. The unemployment rate has declined over the last year to 5.8%. Yet, Australia is very dependent on China which represents its main partner. There is growing evidence that the Chinese slowdown is not over (lower gas consumption growth for example). As a result, aggregated demand for Australian's goods should keep on weakening and this will increase the impact on Australian revenues. Then the Aussie should remain under significant pressure despite trading above the psychological level of $0.70. This is why Governor Steven is now envisaging to further ease monetary policy. Current inflation data are also giving the necessary room for the Reserve Bank of Australia to act.

Cutting rate is also something that we believe the Bank of Canada will decide. US' neighbours are also largely suffering because of low commodities prices. Even "better", negative rates may be implemented to force businesses and consumers to start spending. Fundamentals are clearly not picking up. Canada's trade deficit is still very important, accounting for around $427 million. Last but not the least, the weak imports of industrial machinery is a clear indicator that business investments in Canada is slowing down.

For the time being, there is one silver cloud for Australia and Canada. Gold has soared by 16.74% since the beginning of the year. This should provide some additional revenues necessary for these two countries. Yet, we remain bearish on the Aussie and on the Loonie over the medium-term.



Economics

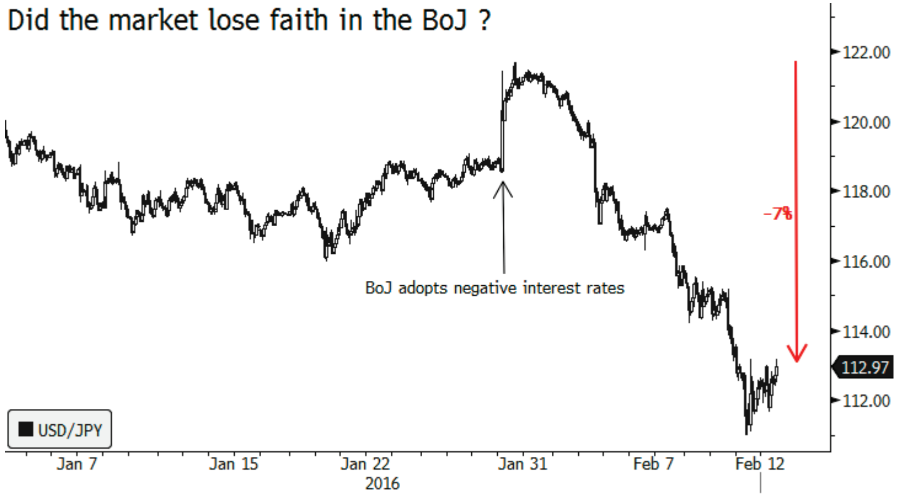
JPY Strengthen Amid Faltering Confidence In BoJ

As usual during a period of high uncertainties and growing fear of recession, investors pile into safe-haven assets, such as the Japanese yen, sovereign bonds and the Swiss franc, while dumping riskier assets such as equities and EM currencies. Unfortunately for the Bank of Japan, this situation is far from being convenient as it goes completely against what the Central Bank has been trying to achieve since it decided to implement its Quantitative and Qualitative Easing back in 2014. Since the beginning of 2016, the Japanese yen has appreciated almost 8% against the US dollar. Besides its safe haven property, the rise is mostly due to the combined effect of the market's fading confidence in the BoJ's ability to create a weaker yen but also the belief that the Fed will be unable to go on with its rate hike cycle as the global growth outlook worsens - Yellen has hinted that market turmoil may further delay the rate hike cycle.

However, it is worth noticing that the BoJ has a share of responsibility in the strengthening of the yen. At the end of January the Bank of Japan voted to adopt a negative interest rate policy (NIRP), hoping that it would help to keep the yen at low levels and even increase pressure on currency. Initially, the market reacted accordingly by pushing USD/JPY to 121, up 2.5%. However, when market participants realised that the -0.1% interest rate was going to be applied to a ridiculous part of the total current account balances (the policy rate balances), while the two other main parts (basic balance and macro add-on balance) are not subject to negative rates (+0.1% and 0.0% respectively), they piled into the yen even more than before.

The BoJ's decision to implement a half measure, which was clearly seen as a sign of weakness by market participants, adds to the concern that central banks across the globe are struggling to bring inflation to their respective inflation targets. In addition, the ECB council's refusal to massively increase the QE back in December and now the BoJ's decision to just cut rates suggests that central banks across the globe began to question whether the implementation of new stimulus would allow a return to sustainable positive inflation and solid economic growth.

A fresh batch of economic data from Japan is due next week and will shed more light on the health of the economy. For now, USD/JPY remains stable, between 112 and 113. We believe there is still some downside potential for the pair; however traders are still trying to understand what happened on Thursday, when USD/JPY spiked two figures in less than 5 minutes.



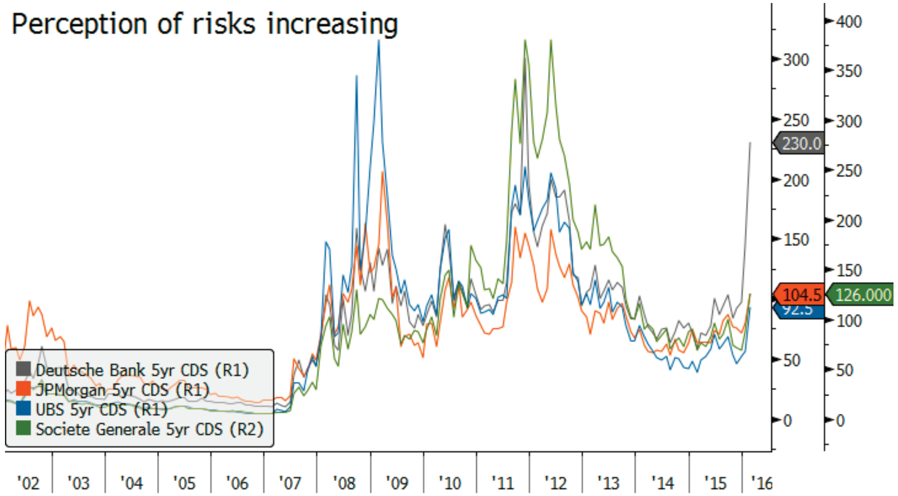
Economics

Banks Credit Risk Surge

Deutsche Bank's (DB) shares fell to a 30-year low this week, with the initial blame revolving around broader equity selling and fear of global economy, prompting investors to dump risk assets. The decline was so steep that CEO John Cryan was forced to issues a statement to assure investors that the bank was "absolutely rock solid" on Tuesday and would continue to make planned payments. While the initial market response was positive, markets quickly reversed direction, as addressing the issues brought fears to the forefront of investors' minds. On the surface it seems as if DB stock is suffering from widespread risk aversion. However, Cryan's statement comes on the heels of an early DB statement which raised some eyebrows. “Based on the preliminary 2015 financials, we believe we have sufficient ADI and payment capacity under the German GAAP to pay AT1 coupons,” said Chief Financial Officer Marcus Schenck on the company's earnings call January 29th, according to a transcript. Markets are increasingly unnerved by the uncertainty of DB derivative holdings.

Outside this idiosyncratic risk seen in DB, bank credit spreads in developed markets, specifically the Eurozone, have been the focal point of current market volatility. Europe's weak bank earnings, growing disappointment with the ECB's ability to manage risk and potential, arbitrary process of determining payouts has caused credit spread widening. Heavy positioning in credit markets, broader worries over macroeconomic backdrop, China's market volatility and unexpected consequences of a rapid collapse in commodity prices have all put investors on a knife's edge. Interestingly, recent moves have not been mirrored in EM credit spreads. CDS index of European banks have blown out from a relatively benign 100bps in December to 207bp at Friday's close. While these levels are not near the peaks reached during the financial crisis, any sudden moves should be monitored.

One haunting similarity between the 2007-2008 Financial Crisis and today's events, is the sudden appearance in the media of a new complex instrument. Contingent convertible bonds, dubbed CoCo bonds, were developed in response to “too big to fail policies, to protect lenders in case of a crisis by turning debt into equity. CoCo has complicated and untested features that allow the bond to be converted into equity or dissolved, should the issuing banks' capital drop below a pre-determined threshold (a simplistic description). While reported exposure remains low, fears of unaccounted for liabilities on banks' balance sheets during a time of high volatility consistently adds to investors anxieties.



Economics

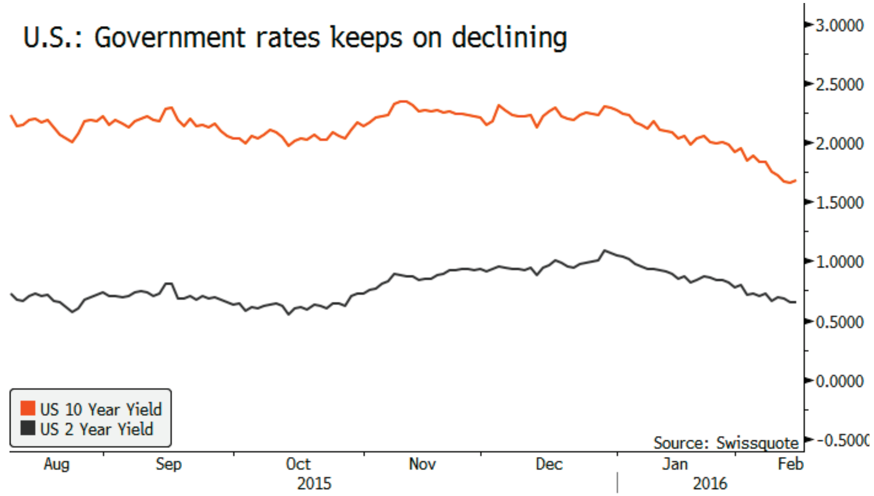
Janet Yellen Admits Negative Rates Are Not Off The Table

Markets are now excluding a Fed rate hike for March as inflation is clearly not picking up despite low unemployment rates. 2015 CPI is stalling at 0.7% y/y, far away from the Fed's target of 2%. A rate hike in April seems also very unlikely with a likelihood of 2%. The dollar has sharply weakened as a result of those expectations. Fed's Chairwoman Janet Yellen has spoken last week in front of the congress to deliver the Fed's semi-annual Monetary Policy Report.

Janet Yellen had been a little bit surprising at this session. She mentioned for the first time negative interest rates. Logically she announced that the Fed is ready to delay hikes but she has, of course, refused to admit that the current Fed strategy to achieve a normalized monetary policy has so far proven inefficient. She mentioned that overall financial conditions have become less supportive of growth. In particular that unemployment rates have lowered but better job conditions have not provided the awaited effect of a decent wage growth necessary to spur inflation toward the Fed's target.

Yellen also claimed that she is wary of increasing rates too abruptly in case this pushes the economy in recession. The real truth is that American debt is way too large ($18 trillion) and interest on this debt would explode if interest rates increased too much. This is why, Yellen is now considering negative interest rates to avoid this from happening and especially to prevent a recession. Yet, at some point inflation is needed to destroy debt, but this is not on the cards anytime soon because in our view job market conditions are largely overvalued. As a result, we think that there is a strong possibility of a QE4 which would be synonym of fresh money to save GDP. We are no longer in the era of monetary policy divergence or normalization. We are now firmly in negative interest rates territory and Yellen is considering this option despite the fact that she "is not sure if Fed can do it".

For the time being, stocks markets are suffering from such an unclear monetary policy and we consider that the Fed is not in full control of the situation. As we have been mentioning since last year, rate hikes seem more and more unlikely this year. Currency wise, we now expect a temporary surge of the dollar against the single currency as European uncertainties are not over. Pressures on the EURUSD will still remain bearish over the medium-term.



FX Markets

IMM Non-Commercial Positioning

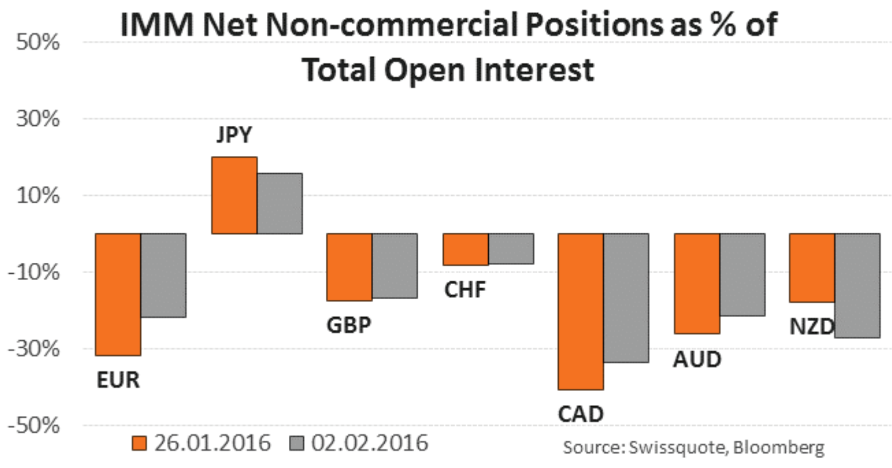
The International Monetary Market (IMM) non-commercial positioning is used to visualise the flow of funds from one currency to another. It is usually viewed as a contrarian indicator when it reaches an extreme in positioning.

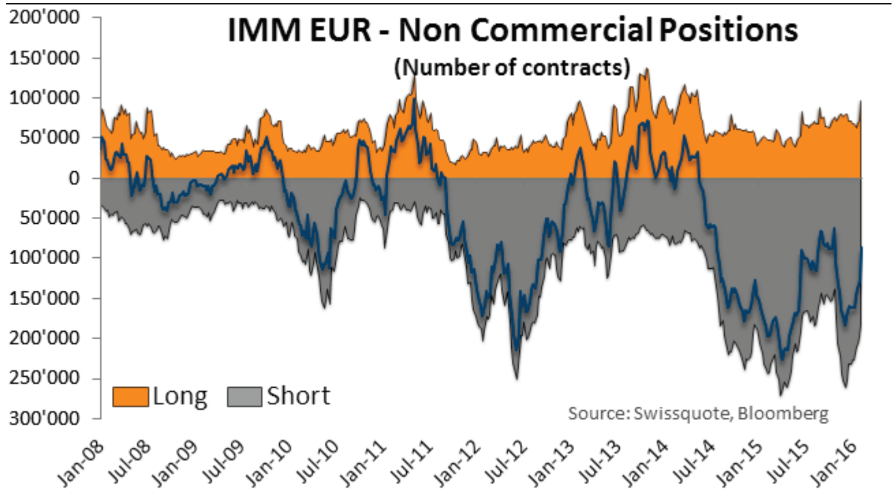
The IMM data covers investors' positions for the week ending February 2nd 2016.

Net short EUR positions have decreased substantially, after reaching more than 40% of total open interest in late December, as traders lowered substantially the odds of an interest rate hike by the Federal Reserve. Short EUR positioning should continue to decrease as the policy divergence's story is losing strength.

Net GBP short positions have decreased moderately after reaching 17% of total open positions in the previous week. The political uncertainty stemming from the potential Brexit together with the low interest rate environment will likely continue to weigh on the pound sterling.

Net long gold positions continued to increase. The environment of global uncertainty and fears of recession have brought a renewed interests in the yellow metals as investors take shelter from the market turmoil.





Themes Trading

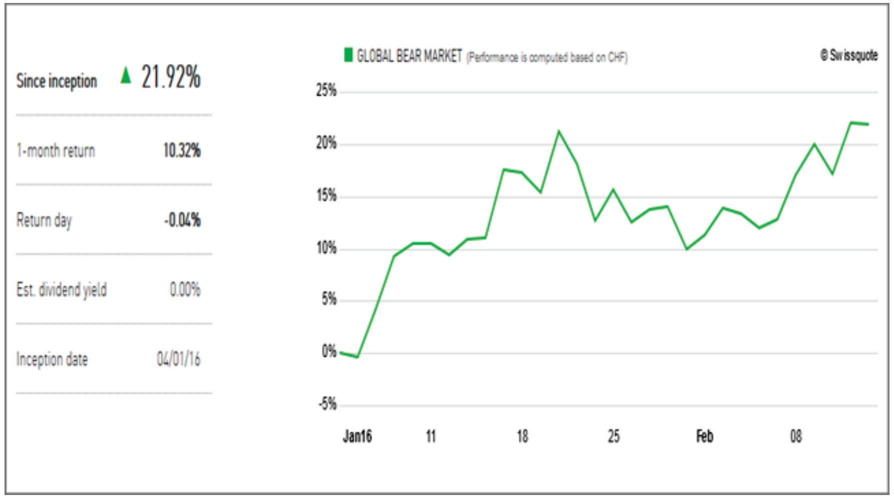
Global Bear Market

Global equity markets have not reacted well to the advent of 2016, with volatility expected to become the new "normal" for stock markets and central banks shifting monetary policy. The lack of corporate profit growth, the scary decline in oil, China's sharp economic slowdown, high multiples and weakness in credit markets all suggest that further downside in stock markets is a distinct probability. Perhaps the strongest argument is that the current bull market has been fueled by the Federal Reserve's massive bond-buying programs, which have propped up equity market prices and stimulated growth in emerging markets. With the Fed on course toward normalization, artificial growth in asset prices will unwind.

With US interest rates rising, investors are increasingly likely to rotate out of risky emerging market assets and into safe havens. In addition, the Chinese manufacturing sector is struggling with overcapacity after years of over-investment; its only option is to slash prices and flood the global marketplace. This disinflationary dynamic will hurt earnings and create a spillover effect for consumers, further weighing on stock prices. We are unsure whether this is the "big one," but having a bit of protection in your portfolio never hurts.

We have built this theme using ETFs (Exchange-Traded Funds) with a broad sampling of large cap stocks globally. Using ETFs allows us to effectively short (or sell) stocks in order to benefit from price depreciation.

Analysis & Portfolio - Swissquote Bank Strategy Desk



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