WEEKLY MARKET OUTLOOK

2 - 8 Mai 2016

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WEEKLY MARKET OUTLOOK - An Overview

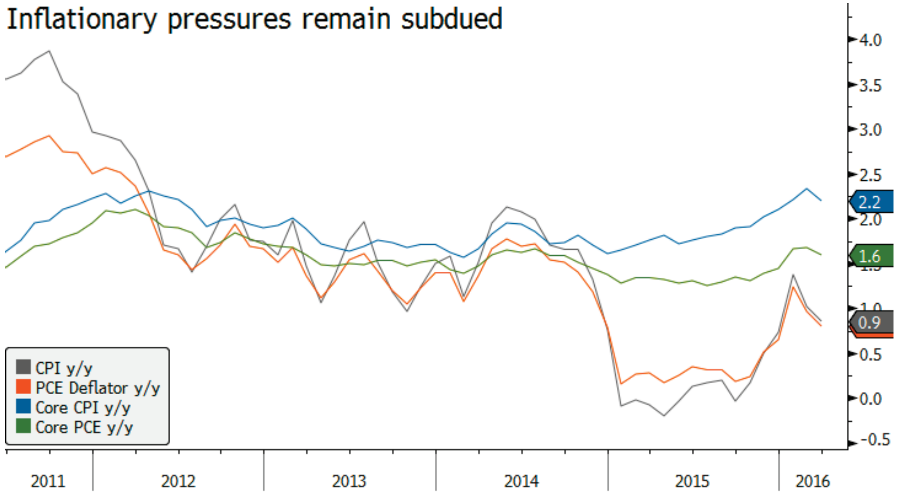
Economics

One Fed Hike In 2016

The results from last week's FOMC meeting and the subsequent market reaction, including solid sell-off in yields and USD, has strengthened our belief that the Fed will raise interest rates by 25bp only once in 2016. We see the highest probability of a hike being in December and only a slightly lower chance of the single hike happening in November. In trading terms, this indicates that the monetary policy divergent theme will be pushed out further. The overall tone of the FOMC meeting was cautious in terms of domestic and international conditions. While the Fed did not close the door on a June hike, continued reference to the downside risk to inflation, combined with a deceleration of US economic activity (and still subdued international backdrop) suggests that a slowing pace to price pressures has lowered expectations (realized in reduction of FF pricing). The Fed forecasts still suggest two hikes in 2016 but we view this as being unlikely. The issue is this: should the forecast for two interest rate hikes prove accurate, the Fed will need to immediately signal that a June hike is possible, otherwise they risk driving extreme market volatility. Our view is partially due to less confidence in the US/global recovery story but more to events overshadowing potential policy paths.

It is unlikely that the Fed will fire off multiple rate hikes in subsequent meetings as comments indicate a patient, 'gradual' path to tightening. This implies a hike-then-pause will be the strategy of choice. Therefore, to safely push the Fed Fund target rate to 1.0% in 2016, the June meeting must be live. The July and September meetings are less ideal options for volatility inducing policy action. The July 26-27th FOMC meeting is stuck between the Republic and Democratic National Convention plus a week before the critical 'brexit' referendum. The September 20-21st meeting is too close to the US Presidential Elections where any adjustment could have significant political consequences and therefore deemed political.

Unless we see an acceleration in inflation, potentially triggered by higher oil prices, or evidence that the US housing market has become unstable, we will see a single 25bp hike at the December 13-14th or potentially November 1-2nd meeting. Given the uncertainly in US data we do not see the Fed risking their credibility to get ahead of the market and jumping in June. We remain bearish on USD and view pullbacks as an opportunity to reload on EM and commodity linked currencies. Tellingly, FX implied volatilities have been declining in recent days. Should our view prove correct, then we still have a solid four to five months to run the carry fuel trade.



Economics

Japan: Holding Off Further Stimulus

Japanese stock markets need more cash

Japanese stock markets suffered last Thursday. Both the Nikkei and Topix index closed largely in negative territory, losing more than 3%. The reason behind this is simple: the current perfusion from the Japanese central bank will not be increased. The deposit rate is unchanged at 0.1% and Governor Kuroda announced that the asset purchase target is kept at 80 trillion yen per year. The Bank of Japan has decided not to add additional stimulus despite recent weak data and financial markets adjusted lower their expectations on Japanese stocks.

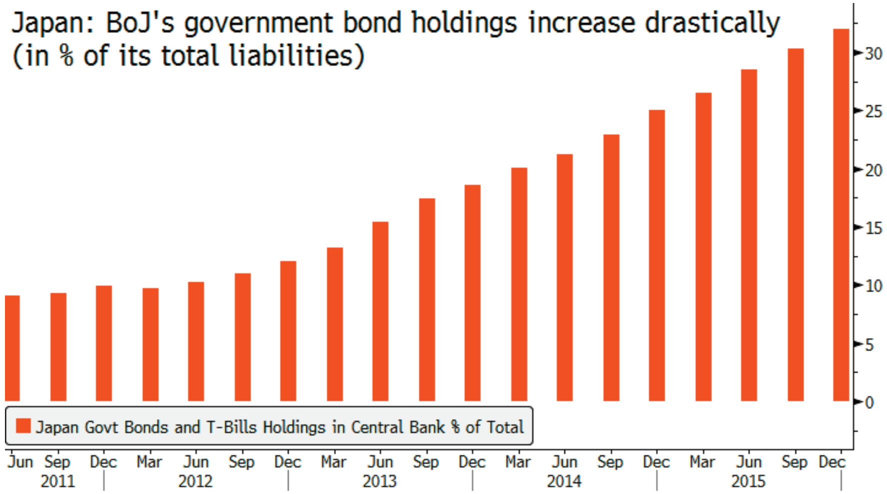
The Japanese economy keeps on giving us false hopes. Firstly, the BoJ's fight against deflation seems endless and the surprise introduction of negative interest rates in January has not yet managed to foster inflation. Japanese policymakers are now claiming that the 2% CPI target should be achieved by fiscal 2017. Secondly, amid global uncertainty, the yen is attracting investors due to its safe haven status and thirdly, recent domestic data are concerning, especially as April PMI fell further to 48.0 from 49.1 a month previous. February Tertiary Industrial Activity edged down 0.1%. Most recent All Industry Activity Index also declined by 1.2%.

Time, time and time...

At the following press conference amid the rate decision, Kuroda mentioned that the central bank needed more time to assess the effect of negative interest rates. Currency-wise, the yen is growing stronger against the greenback and the pair is now heading toward 107. The yen is still much stronger against the greenback than it was at the start of this year when the pair was around 118/120.

Yen should appreciate until further action

There is a decent likelihood that the BoJ's wait-and-see approach would drive the yen towards 100. A major driver of the USDJPY is the monetary policy divergence between the Fed and the BoJ but we consider that the US path to higher rates only exists, for now at least, in the heads of Fed members. For the time being, we believe that there should not be any further easing until after this summer. Only a deeper economic slowdown within the next few months would push the BoJ to add more stimulus. For this reason we remain bearish USDJPY in the medium-term horizon on growing US uncertainties. The BoJ will then be condemned to ease further. Governor Kuroda, despite his current patience stance, will soon be back to the ECB President Draghi's "whatever it takes" attitude.



Economics

AUD To Suffer As Iron Ore Rally Loses Steam

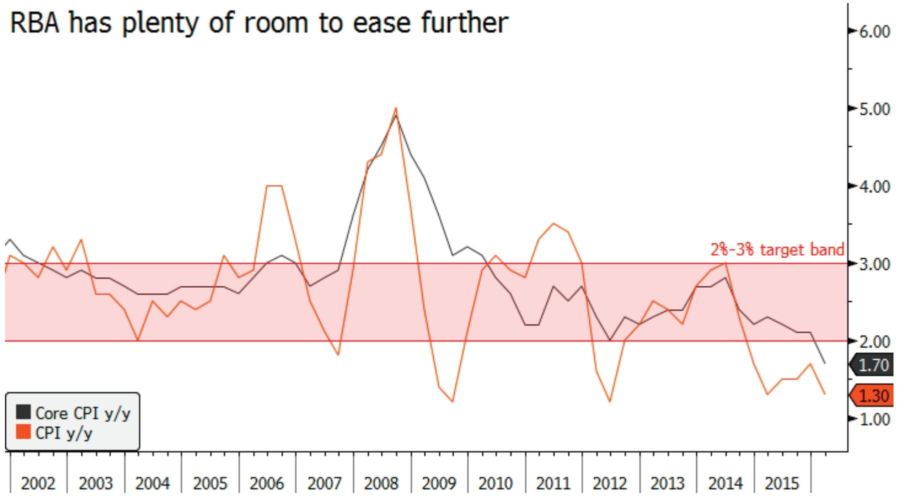
AUD up 12% since January

The Australian dollar has had a nice bull run since the beginning of the year against the backdrop of fading rate hike expectations in the US and rallying commodity prices, especially iron ore, gold and crude oil. Iron ore prices have surged as much as 60% since the beginning of the year with the most liquid future contracts on the Dalian commodity exchange (China) trading at CNY 500 a metric ton, which corresponds to roughly $74, the highest level since January 2015. The wave of optimism over the prospects for China is one of the major causes for this sharp increase in iron ore prices. Gold is on its way to test last year's high at $1,307 an ounce as investors take shelter from highly volatile financial markets, while oil prices are finally recovering with the Brent crude trading at around $46.50 a barrel.

Iron ore rally running out of steam

However, we believe that the rally in iron ore prices has had its day as nothing justifies further appreciation. Indeed, iron ore ports inventories continued to rise steady over the first quarter while the production of crude steel kept decreasing. This situation suggests that the rise in iron ore prices has been mainly driven by massive speculation on the futures market and that there is no solid foundation behind current prices. In addition, China's construction sector, one of China's largest consumers of steel, remains in the doldrums in spite of early signs of recovery. We therefore anticipate that iron prices will correct to the downside as speculators take profits home. In so doing, this would add pressure on the Australian economy, the world's largest exporter of iron ore (50% of the world's total production).

In such an environment the Australian dollar should come under renewed pressure. However, there is one thing that could delay a correction in the Aussie: the Federal Reserve. Indeed, fading rate hike expectations in the US should keep the dollar lower, which would help commodity prices and therefore commodity currencies. On the other hand, the recent (very) disappointing inflation data from Australia - negative inflation quarter-over-quarter in 1Q 2016 (-0.2%q/q or 1.3%y/y) - could encourage the RBA to further ease its monetary policy to boost prices level. All in all, we anticipate the Aussie will correct to the downside, with the $0.74 level as the next target.



Economics

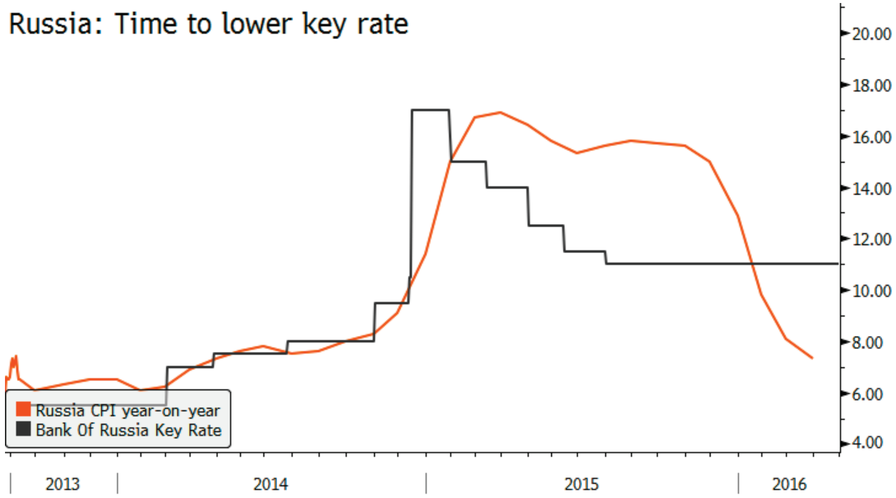
The CBR Missed The Opportunity To Cut Its Key Rate

The ruble has continued to appreciate ever since it reached its all-time low against the dollar in early January. At that time, more than 82 ruble could be exchanged for a single dollar note. Now, the USDRUB has weakened below 65 and even more upside pressures on the currency should continue as the rebound in oil prices persists. The outlook for Russian oil revenues is more positive despite the global supply glut. Expectations for increased oil demand over the coming years and the fear of peak oil are driving the commodity price higher.

We still believe however that the ongoing RUB's flight is of concern in the medium-term as exports will likely suffer further. A stronger currency offset the positive effects of the oil rebound. As a result, the Central Bank of Russia has missed the opportunity to weaken the ruble, at last CBR meeting on Friday 29th, by 0.5% as we firmly believe that current ruble levels represent an opportunity to normalize monetary policy. The adverse effect on inflation will be, in any case, balanced by the stronger currency and higher oil prices.

Inflation, which is being closely scrutinized, is rapidly declining. The date has declined to around 7% y/y, which is still a too high level. Yet, there's a dearth of high-yielding assets in the world today. So investors snap up Russia. Certainly, keeping a double-digit key rate does not help the situation. Long-term investments are bearing the brunt of this rate and the premiums required for an investment to be profitable are, as a result, very high.

Our view on the USDRUB is bearish. The dollar should drive the pair even lower as the dovish stance of the Federal Reserve reveals the true, underlying difficulties of the US economy. 60 ruble for one dollar represents our 3-month target.



Economics

Switzerland’s Economy Stabilises

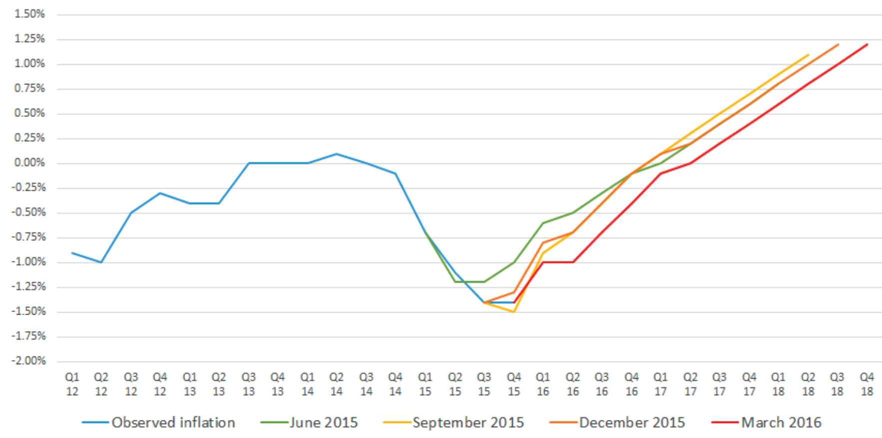
The KOF economic barometer eased slightly in April, printing at 102.7, above the median forecast of 102.5 but below the previous month’s upwardly revised figure of 102.8. The report suggests that Switzerland weathered the first quarter of the year relatively well as the barometer remained above its long-term average. However, the country is still in the hot seat as it main export partners are less eager to import Swiss products. Indeed, the weak global demand and the strength of the Swiss franc continue to weigh heavily on the country’s exports and especially on the watch industry.

Swiss watch exports fell 8.9% in the first quarter (-16% in March only!). The demand for Swiss watches collapsed in March due to a decrease in demand for almost all of its main trading partners. Demand from Hong Kong fell 37.7%y/y in March, demand from the USA decreased by 32.9%y/y, while the Chinese appetite for Swiss watches contracted 13.7%y/y. Overall, the resilience of the industrial sector limited the damage as total real exports contracted 1.1% y/y in March compared to a downwardly revised increase of 2.1%m/m in February.

All in all, we expect a delay in Switzerland’s economic recovery, as the world’s largest economies are set to grow at a slower pace than expected, which would main alive the investors' appetite for safe haven assets such as the CHF. For Switzerland, this would translate into a longer period of low inflation and we therefore do not expect inflation to move into positive territory before the second half of 2017. At its March meeting, the SNB anticipated inflation to reach 0.1% in the first quarter of 2017.

On Friday last week, EUR/CHF continued to trade lower after hitting 1.10 on Wednesday as investors rushed from riskier assets for the safety of gold and the CHF.

SNB to delay further the rise of inflation in positive territory

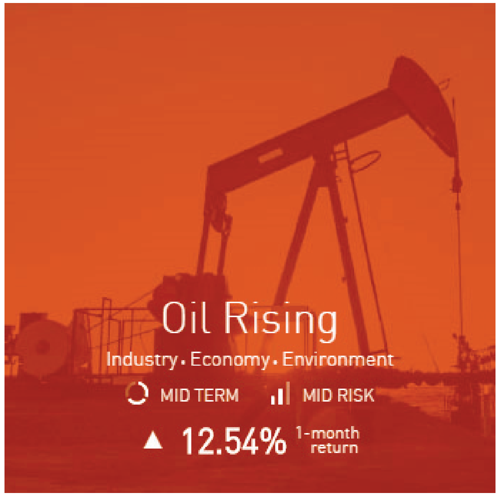


Themes Trading | Oil Rising

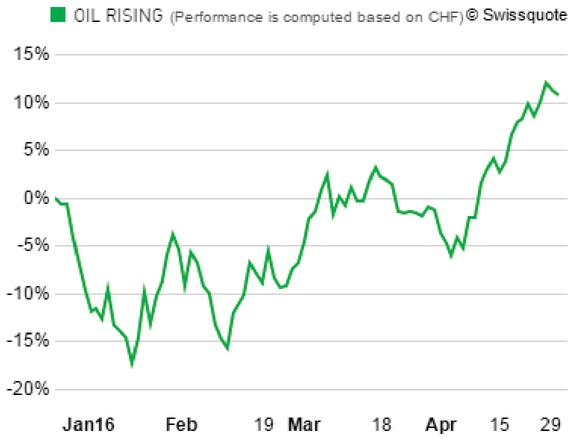
If you are anything like us, you probably believe that an oil price of $30 a barrel is unlikely to be sustainable. Expectations of higher oil prices should provide excellent opportunities in equity markets. The supply glut that has pushed oil prices from $100 down to $30 a barrel remains a reality. However, fundamental changes are now occurring that increase the probability of a price surge.

First, despite the weak global backdrop, demand has consistently grown (though it has not outpaced growth in supply). Second, production is steadily slowing as unprofitable wells are taken offline and OPEC finally shows signs of coordinating a decrease in oversupply. Lastly, oil prices have been resistant to geopolitical realities, yet with 80% of the world's oil produced by countries actively engaged in military conflict, it would not take much to threaten key supplies.

We suspect crude prices have now bottomed out. As oil prices increase, the earnings outlook and profit margins for much-maligned oil stocks should quickly improve. We created this theme to capture the equity opportunity as oil prices steadily increase.



Since inception	▲ 10.76%
1-month return	12.54%
Return day	-0.39%
Est. dividend yield	0.65%
Inception date	01/01/16



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