# WEEKLY MARKET OUTLOOK

## 23 - 29 May 2016

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# WEEKLY MARKET OUTLOOK - An Overview

# Economics | Banxico Watching Market Developments

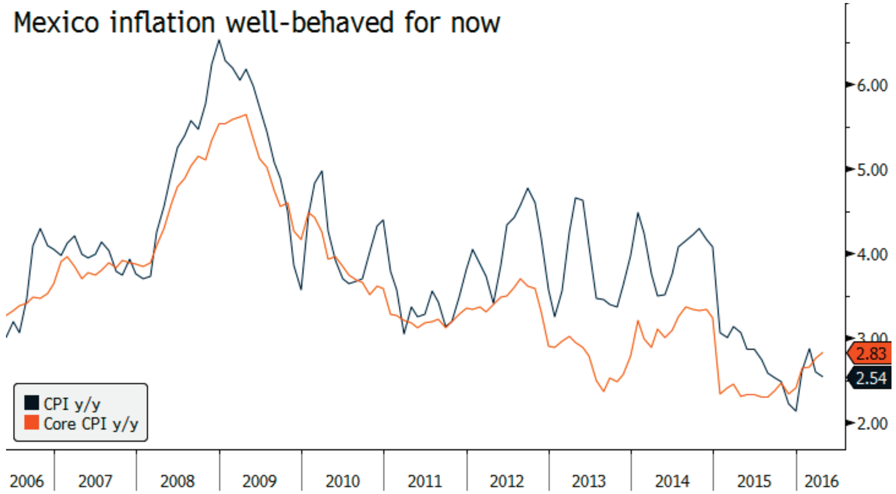
With expectations for a Fed rate hike increasing, and EM currencies increasing sensitivity to changing US yields, our focus turns back to the potential reaction in EM currencies. Mexico's Banxico published the policy meeting minutes from 5th May. As expected the board voted unanimously to hold the reference rate steady at 3.75%. The members clearly indicate that other risks (Brexit, US elections, China economic recovery) have faded into the background with general market volatility and MXN price the dominate concern.

We suspect that the overall tone indicates the central banks will maintain a defensive stance, especially given the threats of MXN driven upside risks to inflation and market volatility due to Fed policy.

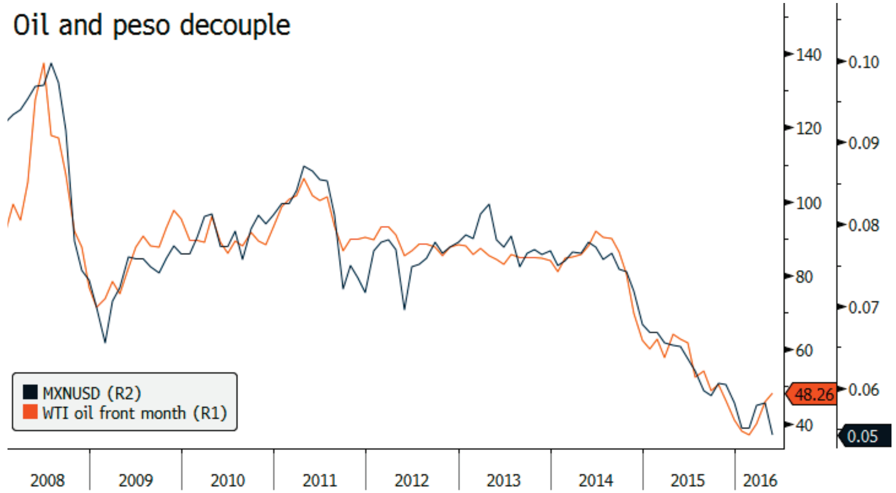
Last week Mexico's CPI decreased 0.32% m/m in April driven by a fall in perishable food prices and FX pass-through. Moving forward, we see a stabilization of food prices consistent with a year-end inflation forecast of 2.8%. With inflation well mannered, the Banxico seems satisfied to wait-and-see what develops with Fed policy path and commodity prices rather than moving forward with further policy action. Earlier, a surprise 50bp intra-meeting interest rate hike and heavy FX intervention provided the effect of slowing MXN depreciation, without derailing economic activity.

However, should the rally in US yields continue the closer we get to June, weakness in MXN (along with much of the EM space) might demand greater action then just unscheduled FX intervention. Yet, the fear of FX intervention does not seem to be worrying MXN bears. While we do not have a level should the market converge into another "Taper Tantrum" pattern we should see Banxico react with both barrels blazing (surprise FX intervention and interest rate hikes). We could see a pre-emptive strike with a 50bp rate hike and FX intervention ahead of the 30th June meeting.

Mexico inflation well-behaved for now




Oil and peso decouple



## Economics

# Fed Minutes Took Markets By Surprise

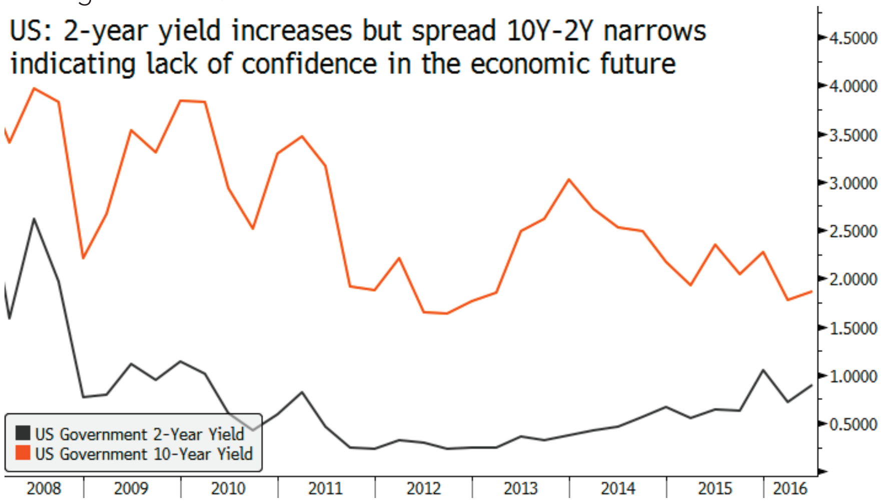
The Fed's April meeting minutes released last Wednesday have shown that most members of the US central bank are ready to raise rates at the next June meeting. The EUR/USD reacted sharply by declining to 1.1220 before consolidating. Surprisingly, the Fed is again taking a hawkish stance while financial markets practically ruled out a June hike. Before the minutes the likelihood of a raise next month was estimated at 4%, now it is up to 32%.

On the back of this release, short-term Treasury yields have increased to a 2-month high to 0.89%. However, in contrast US stock markets ended almost flat as fears of a possible end to the free money era have increased. Nonetheless, we should remember that a raise will only be possible if the economy picks up. The markets which, up to now were firmly focused on global conditions are now thoroughly scrutinising the true state of the domestic economy. Consumer spending, which is on the soft side will be closely monitored in particular within the next few weeks. We feel that markets have overestimated any June action and that the dollar should continue to suffer in the run-up to the June FOMC meeting.

### US Existing Home Sales much awaited

After the Fed's minutes that surprised financial markets, the US domestic situation is then definitely back in the spotlight. Until now, the global economic slowdown, in particular the oil price collapse, has been thought to be behind the delay in a Fed rate hike, much more so than the actual state of the US domestic economy. It is now time to decide if data is supportive enough to trigger a further rate hike. Last Friday has seen the release of existing home sales data for April which came in above expectations at $5.45 million. Over the past few years, this indicator has traded mixed but in March it rebounded sharply. The trend was anyway expected to continue as financial markets priced in a $5.40 million release from $5.33 million a month before. In April, rate hike expectations declined so it is reasonable to assume that sales went up as both mortgage prices were expected to remain weak and housing prices to strengthen.

From our vantage point, we think that the true state of the US economy is overestimated, especially the labour market, even if the unemployment rate is very low and NFP is still at a decent level. We believe that new jobs creation is more about part-time jobs than full-time jobs and that the ability to purchase a home will weaken. Downside pressures should soon appear on the housing market. The recent March pick up in new home sales and existing homes sales is due, in our view, to a diversification concern from large institutions. Indeed, US housing homeownership rate continue to decline currently at around 63.70% - this figure was 66% in 2011.



# Economics

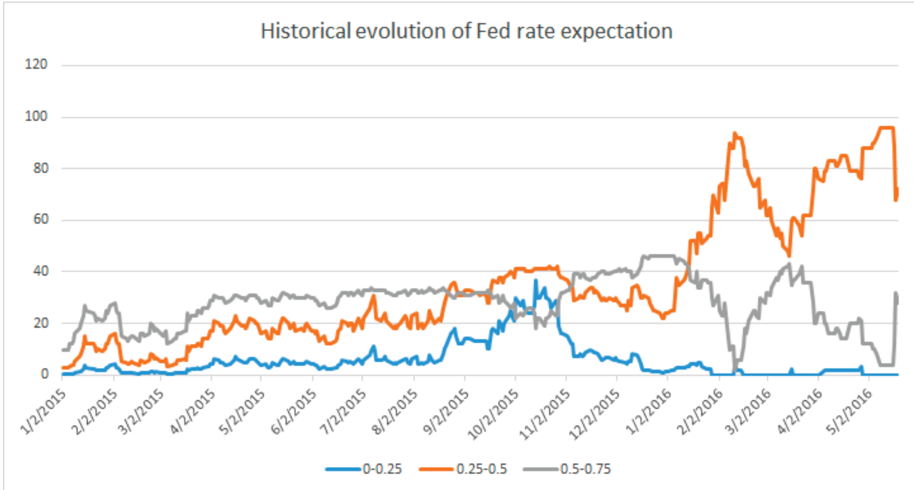
## Return Of "Amexit"

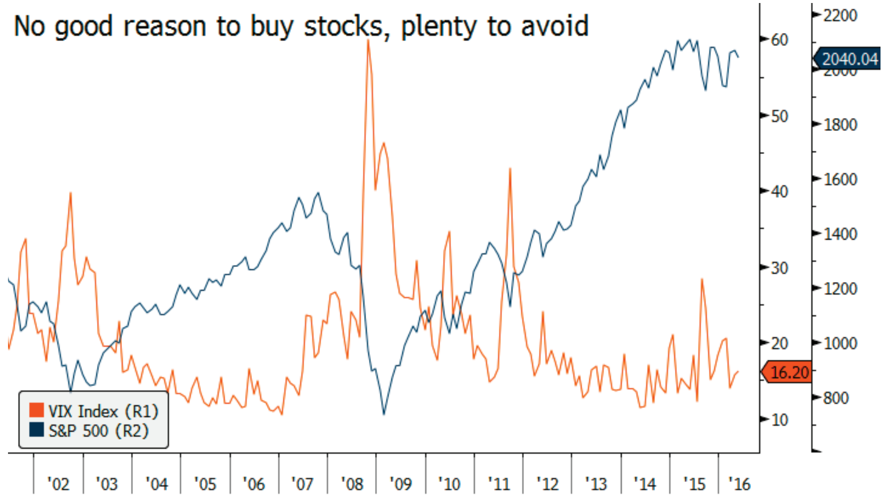
The FOMC minutes indicated that June meeting was "live", combined with good US data and hawkish Fed comments have increased the probably of a rate hike next month from near zero to 35%. We are already seeing the all too familiar symptoms of a pre-hike tantrum. Symptoms include the preemptive sell-off in commodities, equities, steeping of the US yield curve and safe-haven USD buying. There are a series of events that if triggered would lead up to an event we are calling "Amexit". The first horseman would be growing probably of a June rate hike.

**A series of events which would make us cringe**

Should Fed Fund futures increase pricing from current 35% to a meaningful above 60% probability, its likely, once again that the markets would suffer through another "taper tantrum." The reaction to higher US rates can be exemplified by the rotation of capital into safe-haven assets, the liquidation of risky global equities. A correction in equities will make presumptive US Republican presidential candidate Donald Trump sound prophetic (remember his amateurish sounding call on bubble and recession?). Then being emboldened by a Fed induced equity correction, Donald J. Trump would likely gain significant political capital heading into the Republican convention in 18th-21st July and into the presidential election. Presumptive democratic candidate Hillary Clinton, with her long connection to Wall Street, will find it difficult to defend her positions should the stock market's collapse, while it would play right into Trumps bully pulpit.

According to campaign trail promises, Trumps goal as president is to redefine nearly every social, political and economic pact America has made both domestically and international. Markets will need to begin pricing in America's removal from the international stage or what we call "Amexit".



# Economics

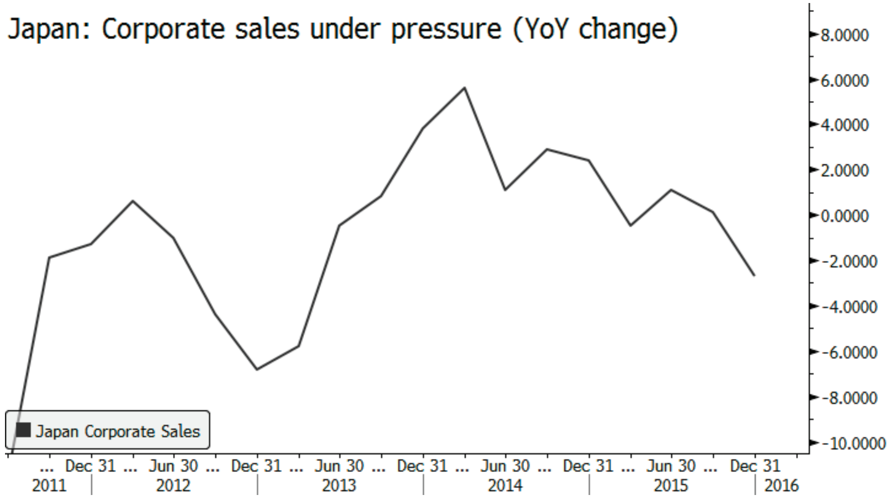
## Q1 Japan GDP Is Giving Breathing Space To The BoJ

The first quarter Japan's GDP has printed in above expectation at 0.4% q/q when markets expected a slight increase at 0.1% q/q. The good figure is providing good hopes that inflation may one day be back. The rebound in private consumption to 0.5% q/q at the start of the year certainly helped. Markets have barely reacted as the JPY did not strengthen on the release and remains below 110 yen for one dollar note. Indeed GDP deflator is its lowest level in two years and it reflects the increasing deflation pressures that the country is facing. In the same time corporate sales are at a very disappointing -2.7% y/y.

**Is more intervention the next step?**

For the time being, we are still thinking that the Bank of Japan may further ease. Fundamentals are not better as when policymakers were adding stimulus. In our view we think that the yen will remain attractive as global uncertainties persist. One major key driver for the USD/JPY is also the current Fed monetary policy which is very difficult to follow. Recent declaration from Fed's Lockhart mentioned that three rate hikes will happen this year when Fed members have been so reluctant to add rates from a quarter point. On our side, we do not believe that raising rates are still on the table this year and markets should start price in one day or another the monetary policy convergence between the US and Japan. This would necessarily trigger more intervention by the BoJ.

This is clear for us that the yen is still largely overvalued and there are growing rumours that the central bank may add further stimulus at next meeting that will be held the 15th and 16th of June. Downside pressures on the Japanese currency due to its safe haven status make even more difficult any monetary policy to succeed.

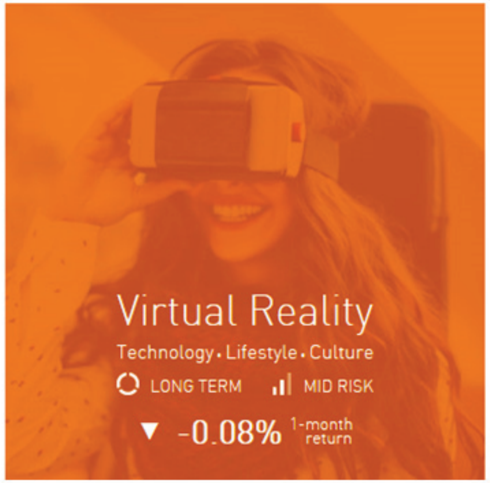



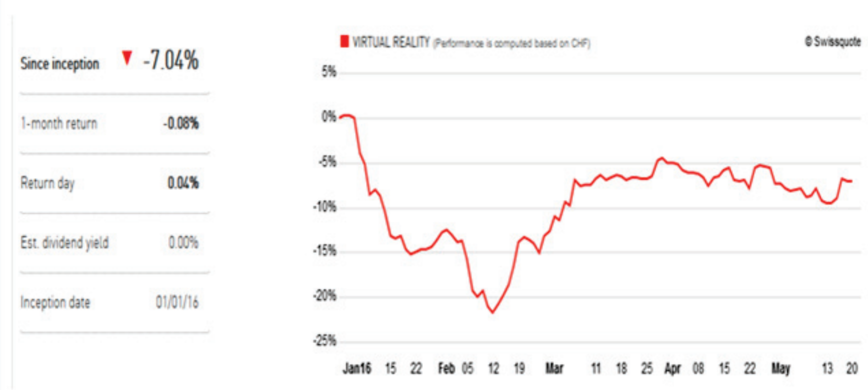
# Themes Trading — Virtual Reality

Is this a simple gadget, a new tech bubble or a revolution? It's hard to say at the moment, but one has to admit that the concept is fascinating. Virtual reality takes users to simulated worlds. It might sound like a new generation of video game consoles at best, but we believe it's going to be much more than that. For example, visiting a potential new home or looking for a doctor's advice from the comfort of your home could become a new normality. Features could go well beyond mere play or entertainment: in fact, we believe this technology could represent the same kind of step change as the introduction of smartphones and PCs - a whole new way to seek out information and interact.

According to a recent survey by statista.com, the user base is also set to explode, rising to 171 million users from 43 million this year. Forbes is also saying that revenues could reach CHF 21.2 billion in 2018, compared with around CHF 150 million this year. Suffice to say that potential growth may be immense.

For this theme, we have chosen companies that are either mainly focused on virtual reality or have adopted a strategic stance towards this new technology. For example, AMD and NVIDIA have designed a full range of graphics cards ready for virtual reality, while Qualcomm is developing virtual reality applications. The selected companies are also investing significant amounts, demonstrating that things are moving apace. Facebook bought Oculus for $2 million in 2014, while Qualcomm and AMD invested $30 million in Matterport for virtual reality real estate tours. There will not be any half-and-half results: either the market will explode or it won't!



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