WEEKLY MARKET OUTLOOK

11 - 17 July 2016

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WEEKLY MARKET OUTLOOK - An Overview

Economics

Australia Between Political and Global Uncertainties

RBA keeps its cash rate at 1.75%

Financial markets widely expected last week the Reserve Bank of Australia to keep its cash rate at 1.75%. The RBA's decision is among the first to come from central banks since the Brexit vote and due to the unknown consequences of the referendum, the RBA decided to remain on hold. Yet, we should take note of the fact that precious metals have surged to levels unseen over the last two years.

A rate cut is now looking very likely (probability: 50%+) at the next RBA meeting in August, as calculated on the basis of Australian Cash Rate Futures. The Australian GDP still looks decent, Q1 GDP printed at a solid 1.1% q/q, while on an annualised basis, GDP is hitting 3.8% y/y. The main concern remains the inflation outlook and the greater demand for Aussie which could weigh on the economy and pave the way for further easing.

In the short-term, political worries abound. The Australian federal election's outcome, which will determine all 226 members of the Parliament of Australia - is still uncertain at the moment as no party has won enough seats. The country could stand to lose its triple-A rating as there are concerns that the new government would not be able to decrease debt.

Nonetheless, most of these possibilities are already priced in, or in our view, largely overestimated (elections) and as a result we should see continued strengthening in store for the Aussie.

S&P very likely to downgrade Australia

Last week S&P decided to reduce its credit rating outlook for the Australia. The country's coveted triple-A rating is now at stake, in fact, there is a decent probability (33%), that a downgrade will occur. The rating agency underlined housing debt as cause of major concern and we know that Australian banks are indeed massively invested in a well-inflated real estate bubble. In fact, mortgages represent a significant percentage of the balance sheet of major Australian banks. Next week we will get the unemployment rate for June, which is expected to come in at 5.8%, up from 5.7%. Full-time employment creation is another major issue for the country. Over the last three months, most added jobs have been part-time.

Against this backdrop, the continued increase of gold and silver should largely benefit the Australian economy. China, Australia's major trading partner is reducing its overall commodity demand from Australia. Globally, the overall decline in iron ore demand, which accounts for around a quarter of total Australian exports, is weighing heavily on the Australian economy. As a result, precious metal set aside, the situation in Australia looks tougher. This may trigger deeper rate cuts by the RBA.

Economics

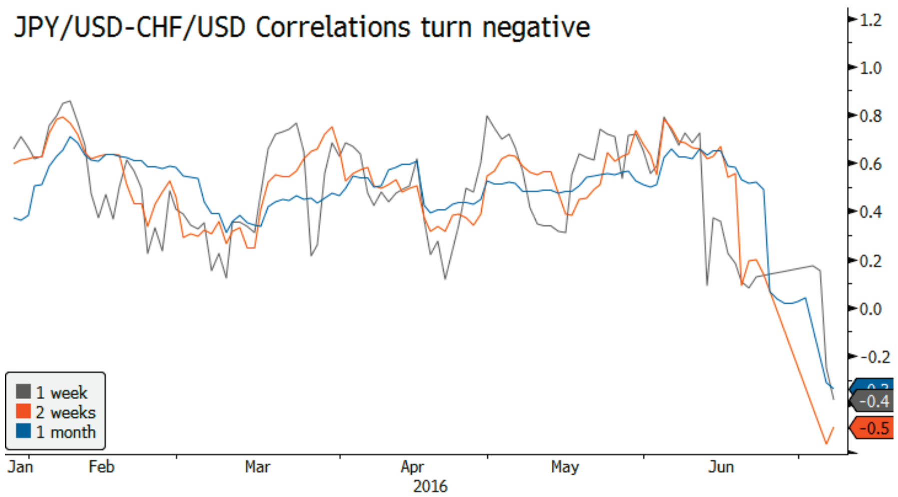
Safe Haven Battle

In the wake of Britain's decision to leave the European Union, financial markets behaved as expected: investors fled risky assets to buy safe havens ones - nothing new or revolutionary. In the FX market, it translated into a substantial rush towards the Swiss franc and the Japanese yen, while the pound sterling, the single currency and all commodity currencies saw a rapid slide in price. However, since mid-June the Swiss franc and the Japanese yen have begun behaving differently.

Historically, the correlation between CHF/USD and JPY/USD is typically between 0.4 and 0.6 (weekly, bi-weekly and monthly correlation). However, since the Brexit vote, the dynamic between the two safe haven currencies has altered dramatically. In fact the correlation is now negative - at around -0.40 on average - meaning that the Swiss franc has, to a certain degree, managed to shake off its safe haven status. The question is: why has the dynamic changed quite so dramatically?

Well, at the heart of the answer lie both central banks. The BoJ has failed to keep traders at a good distance in inspiring fear among speculators. On the other hand, the SNB, which still has a high credibility, successfully repel the waves of investors willing to take shelter in the Swiss franc and traders speculating it won't be able to hold its position. Directly following the Brexit vote, the SNB made clear that it had intervened in the FX market and that it would continue to do so to protect the franc against further appreciation. A few days later the Swiss franc returned roughly to its pre-Brexit levels, while, in contrast the Japanese yen continued its massive appreciation against all currencies.

Last week, the CHF lost 0.60% against the US dollar, while the JPY surged 2.25%, clearly showing that the correlation is now negative. All in all, it appears that no matter what the BoJ does to devaluate the yen, the market will likely not buy it. This is reminiscent of January this year when the BoJ cut rates to negative territory and the yen surged 4% in less than three days. Unfortunately for the BoJ, it seems that the SNB has succeeded in preserving its credibility, while the Japanese central bank will now have to stand alone against a growing tide of worried investors looking for solutions to protect their capital.



Economics

Is FX Intervention The Only Card Up The SNB's Sleeve?

A growing balance sheet

The Swiss National Bank is expanding its balance sheet in an effort to mitigate upside pressures on the Swiss currency. The size of the total sight deposits increased significantly during the week ending July 1st. These grew by CHF 6.3 billion to 507.5 billion just a week after Brexit. What we now find concerning is the size of the balance sheet which is over 100% of the annual Swiss GDP. The pace of the increase has not been so fast since the abandoning of the peg in January 2015.

We feel that the negative rates policy and FX intervention are not likely to be sufficient to relieve pressure from the uncertain economic and market conditions. The CHF should continue to suffer from its traditional safe haven status. It remains largely overvalued and deflation pressures should persist. In fact, we do not believe that current monetary policy will increase inflation.

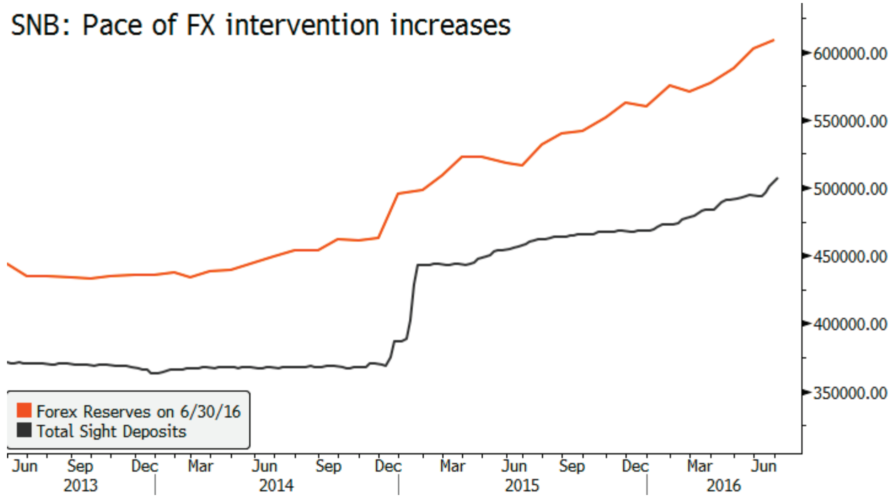
Forex reserves are also on the rise

Earlier last week, the June foreign currency reserves were revealed showing that it has increased by CHF 6.7 billion to CHF 608.8 billion. This of course indicates strong action from the Swiss National Bank to protect the domestic currency. We believe that the SNB will continue to intervene in the FX market in order to maintain the EUR/CHF above 1.0800. From our vantage point, this will require significantly large balance sheet increases to keep the currency stable.

EU uncertainties are weighing on the EUR/CHF

The SNB is also on high alert for further EU developments in particular the risk of an EU dislocation. This possibility is growing, Finland has now also launched a petition to signal their intention to leave. It is also important to note that the current European turmoil and European bank issues are increasingly driving money towards safe havens, especially the CHF. From our vantage point, the 1.0800 level seems to be a strong level of intervention especially as we can see that selling pressures on the CHF are stronger around that level. More significant SNB measures are on the cards as the central bank stands ready to protect its currency and economy.

Intervention should continue to be the main tool of choice to weaken the Franc at least for the time being as this will cause less disruption to the economy, even though, a rate cut towards -1% would not be such a big deal. To conclude, the SNB has been successful in preventing the CHF from appreciating too strongly post-Brexit. Yet, the central bank continues to remain largely under pressure.



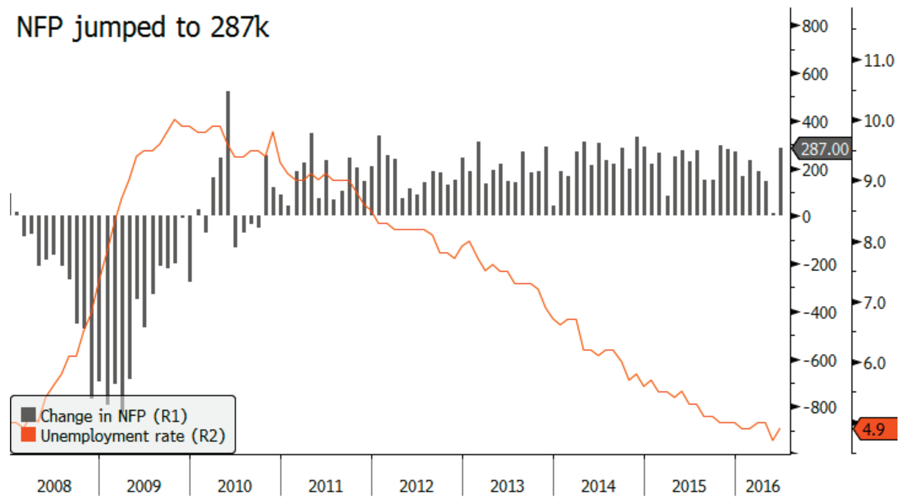
Economics

US Data To Remain On The Backburner

Amid the release of better-than-expected June NonFarm payrolls (+287k versus 180k expected and 11k last), EUR/USD dropped 0.70% down to 1.10 but quickly returned to around 1.1050 as traders realised the implications of the NFP are fairly limited in the wake of the Brexit vote. Indeed, market participants have been paying less attention to US data since June 23rd. The ADP report, released last Wednesday had almost no effect on the greenback, even though it surprised to the upside (+172k jobs versus +160k expected and 168k previous). Similarly, the publication of the June FOMC minutes has been largely ignored by investors but not for the same reasons. These discussions and the subsequent interest rate decisions were made prior to the Brexit vote and are therefore obsolete in that they do not reflect the Fed's mindset since this event. The market will have to wait for the next FOMC meeting, which will take place at the end of the month of July. However, there will be no press conference, only a statement will be released.

Nevertheless, the minutes released last week offer a few hints, for example, that the committee was reluctant to proceed with further monetary policy tightening ahead of the Brexit vote and were also willing to hold out for additional data from the job market, especially after the weak May NFP report that painted a gloomy picture of the US job market (38k private jobs created an expected 160k expected).

Even though the latest job report is rather encouraging, it will not affect the Fed's thinking in the same way as it would have before the Brexit vote. The market is now singularly focussed on this story and has put the general state of the US economy on the backburner. With good reason, according to the latest probabilities extracted from the Fed funds futures, the market does not expect the Fed to hike rates before the end of 2017. We therefore believe the release of US economic data will have less impact on the USD compared to the pre-Brexit environment.



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