WEEKLY MARKET OUTLOOK

25 - 31 July 2016

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WEEKLY MARKET OUTLOOK - An Overview

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Economics

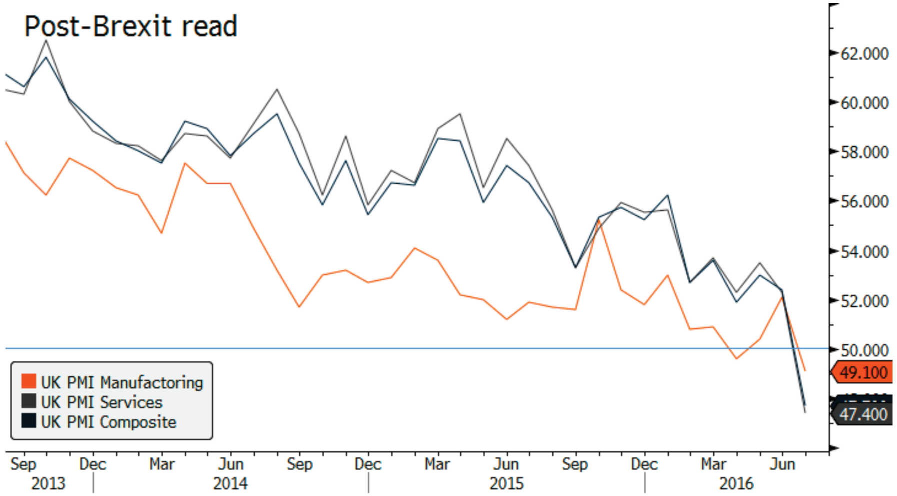
Grim Post-Brexit PMI Read

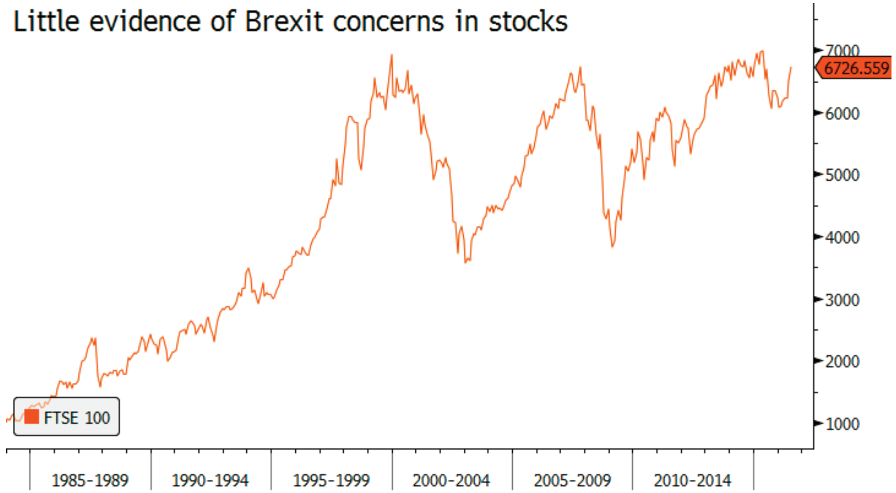
Markets which have been bracing for the Brexit fallout, begin to get data last week. UK PMIs declined across the board indicating a significant post-Brexit weakening and signaling a potential economic contraction. UK flash PMIs manufacturing, service and composite declined to 49.1, 47.4 and 47.7 respectively (from 52.1, 52.3, 52.4 prior read), marking one of the sharpest drops in UK PMI history. This unsettling read comes on the back of yesterday's soft retail sale, which dropped -0.9% m/m on both core and headline numbers, driven by pre-vote concerns and poor weather. At this pace the composite PMI is reflective with GDP growth declining 0.5% q/q.

Unfortunately for the UK economy, until clarity regarding the UK post-Brexit vote relationships with the EU and the world begins to take shape, the uncertainty will weigh on growth. While the UK consumer might function as usual, businesses are likely to proceed cautiously with investment decision, hiring and spending. This retrenchment in business activity will likely send the UK into a recession in 3Q 2016. Should the economic data continue to deteriorate; expectations for a more dovish BoE in August will weigh heavily on GBP. Market expectation for a rate cut jumped on the weak composite PMI read, with market pricing in an 88% implied probability the BoE will lower the benchmark rate 25bp to .25%.However, weakness in sterling could drive inflation expectations past the BoE target, and keep the central bank sidelined. Yet, in our view, positive inflation evolution is a low probability scenario.

In addition given the evidence of weakening in the UK, we can assume that there are real risks to Eurozone growth (especially exposed is Germany), despite Eurozone PMIs in July falling less than expected.

We remain bearish on GBPUSD, with upside capped by 1.3500, and target Brexit reaction lows at 1.2798.





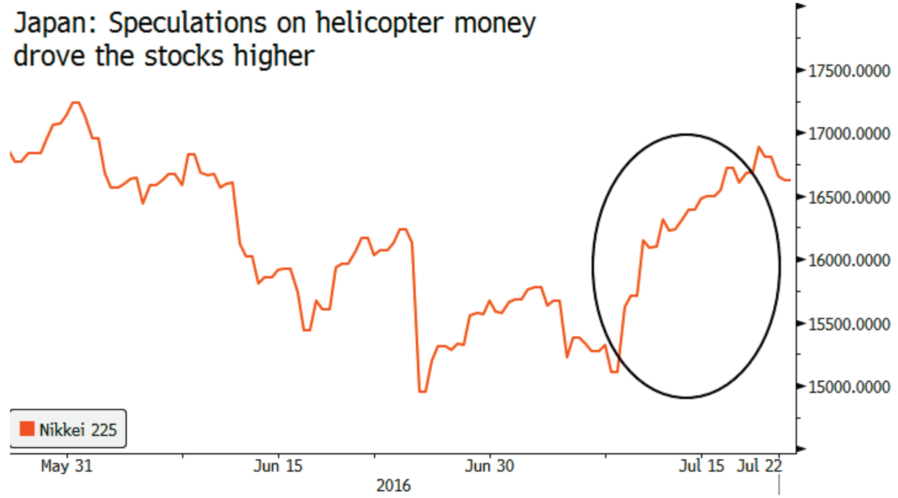
Economics

BoJ's Kuroda Rules Out Helicopter Money

The yen strengthened later last week on comments by BoJ Governor Kuroda that helicopter money is not on the agenda. Japan's constitution in fact prevents the central bank from using such stimulus. In any case no one is fully aware as to what exact form such a measure would take. Would it involve the issuing of perpetual bonds or even the distribution of actual cash to Japanese citizens?

Despite financial market disappointment, the Nikkei has not suffered from these comments. We believe that whatever officials are saying, markets remain confident that further stimulus will be added. In other words, if it is not helicopter money, it will be something else. The fact remains that Japan is running out of options and will be obliged to, at least experiment with this monetary tool. Quantitative easing has failed and is now reaching its limit. The next logical step to stimulate the economy is helicopter money. Japan needs inflation, at least to kill its massive debt. It seems contradictory to be reluctant to use this new tool knowing that massive stimulus was pumped into the economy over the course of the past decade with no decent results to show for it.

Until the next steps are clarified, Japan will of course continue to stimulate its economy. We expect further easing at the next meeting to be held at the end of this month. The government should announce that a yen 20 trillion (around $180 billion) fiscal stimulus package will be implemented. The huge current monetary stimulus of yen 80 trillion stimulus has not supported a pick-up in inflation - in fact, inflation forecasts are now skewed to the downside. As a result, Japan recently slashed its projections on the belief that consumer inflation will not go higher than 0.4% for fiscal 2017. It seems that the same old saga continues for Japan. Why expect different results when the method does not change?



Economics

RBNZ To Cut OCR

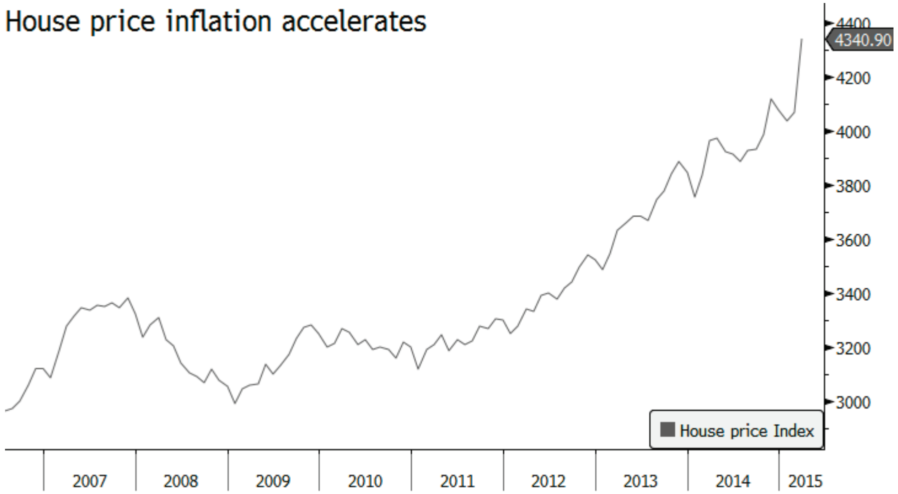
It has been another tough week for the New Zealand dollar as it fell almost 3% against the greenback. After dropping 2.30% in the previous week, NZD/USD ended the second straight week with significant losses amid mounting evidence that the RBNZ will cut further the Official Cash Rate.

The Kiwi's debasement came on the back of a disappointing inflation report that showed headline CPI dropped unexpectedly in the second quarter, sliding to 0.4% on both a quarterly and yearly basis, missing projections for both the market and the RBNZ. The market was expecting a read of 0.5%y/y, while the central bank forecast CPI to rise 0.6%y/y during the June quarter. Tradable inflation (i.e. domestic inflation) fell 1.5%y/y, reflecting the unexpected rise of the Kiwi over the last few months, while non-tradable inflation increased 1.8%y/y as housing market prices continued to gain momentum.

On Thursday, the Reserve Bank of New Zealand released an economic update. The statement was very dovish and clearly set the stage for a rate cut in August. The RBNZ highlighted the diminished prospect for growth in spite of a very stimulatory monetary policy, the "fragility of global financial markets" and persistent uncertainties about the outlook. Most importantly, the central bank appeared to be quite unhappy with regards to the strength of the Kiwi as the trade-weighted exchange rate was 6% higher than assumed in the June statement.

As a consequence, we expect the RBNZ to cut the official cash rate by another 25bps at its August meeting, which would bring the OCR down to 2%, in spite of the negative effects it would have on the housing market. Indeed housing prices have been fuelled by the low price environment and another rate cut would definitely increase the upside pressure on these prices. However, the Reserve Bank had clearly indicated its intention to take separate measures to stem the housing bubble by using lending restrictions and tightening the LVR.

On the technical side, the Kiwi stabilised above the strong support that lies at around $0.6950 (low from June 24th and 50dma). In the longer term, NZD/USD is still trading within its uptrend channel and a break of the 0.69 threshold would send a strong sell signal that would open the road for further decline.



Economics

US Stocks: Is The Sky The Limit?

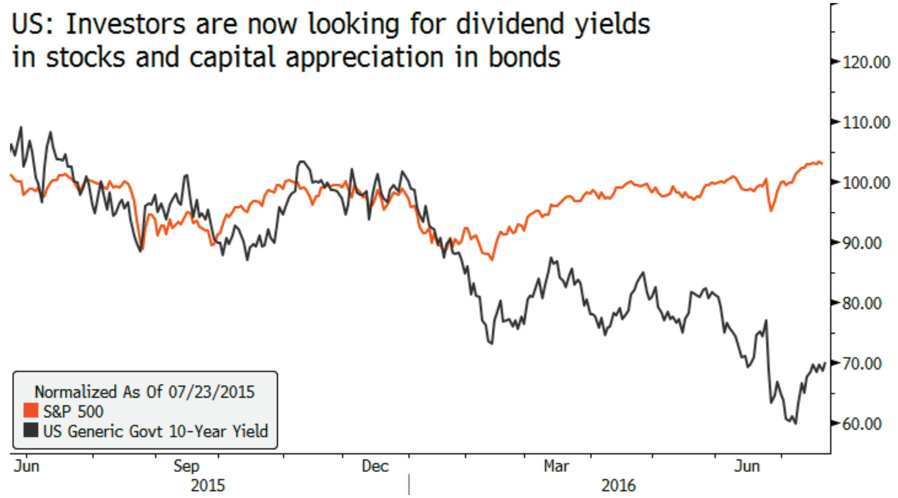
The S&P 500 is trading at a record high, closing at 2173 points last Thursday. While global uncertainties are important, it appears that US stocks may be overvalued. We remain cautious on the true assessment of the US economy. In fact we believe that US fundamentals are overestimated (in particular labour data). In other words, a stronger US stock market would clearly mean that the American economy is expanding. We are skeptical of this.

Our view is to look at the unlimited liquidity central banks may be willing to offer. Stock markets are no longer driven by fundamentals but by central bank policymakers and quantitative easing. Two weeks ago, Ben Bernanke's visit to Japan and rumours of BoJ helicopter money pushed the Nikkei higher, around 8% in three sessions, even though we know that Japan is struggling for sustainable economic expansion and fighting against deflation.

There is, and we have been saying this for some time, absolutely no monetary policy divergence. Investors understand that rates will remain low for some time. According to Fed Fund Futures, a US rate cut before the end of 2017 is now possible - yes, even if right now the probability seems extremely small. As we have written several times, the path to US rate hike is largely overestimated and should continue to underpin the stock market.

It is also true that the current S&P 500 P/E ratio (Share/ Earnings - incl. dividends) is not at its 2009 level. It is around 25. We recall that this indicator being way higher in 2009 at 123.73. Most earnings for Q2 declined and we should see the P/E ratio increasing again.

There is no reason why US stocks would decline right now as easing should continue. 2200 on the S&P 500 represents therefore a decent target on the 1-2 month term horizon. Yet, a risk off move or panic may trigger a sharp downside move on US stocks. The US election is the new market focus and a QE4 should be expected.



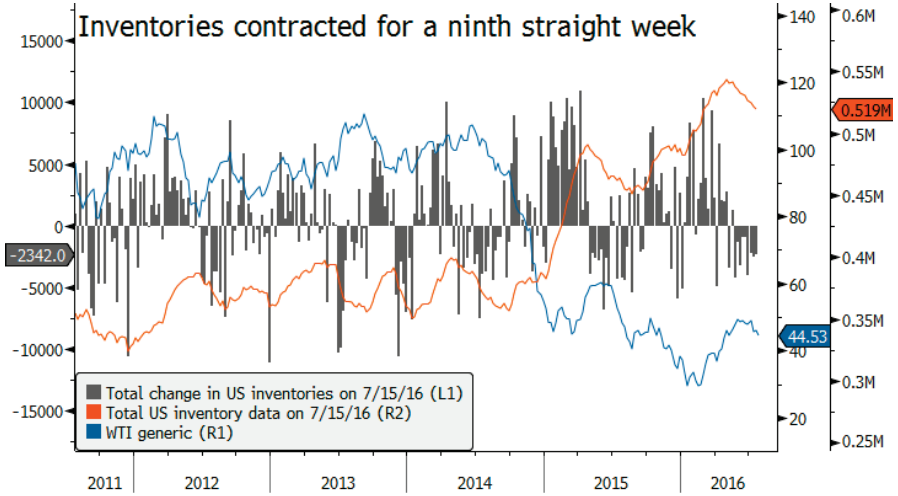
Economics

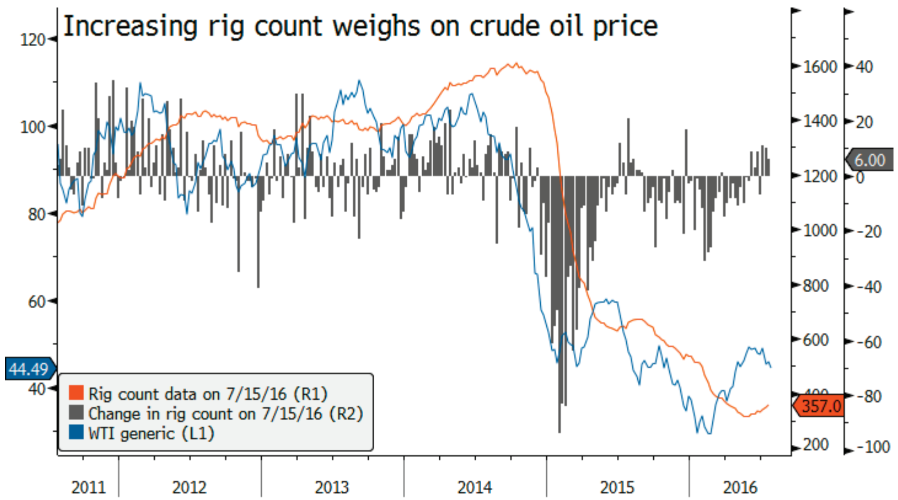
Further Crude Oil Gains Unlikely

It has a been a hell of a year for crude oil so far with the price of a barrel of West Texas Intermediate almost doubling in less than six months. The price of the US crude oil gauge rose from $26 to as high as $51.50 a barrel on June 9th. However, since then the rally has lost steam in response to a strengthening US dollar, which gained momentum in the wake of the Brexit vote, and against the backdrop of mounting uncertainties about a supply glut. The WTI has been trading in a downtrend channel since mid-June and has erased roughly 13% of its previous gains to return at around $45 a barrel.

On Wednesday, the Energy Information Administration released its weekly US crude oil inventories report. US stockpiles contracted for a ninth consecutive week, down 2.34mio barrels on the week, while the market expected a decrease of 1.3mio, which brought total inventories down to 519.46 million barrels from 521.8 million in the previous week. Even though the continuous decrease in oil inventories could provide a boost to crude oil prices, the market is increasingly focused on the substantial increase in the number of US rig counts. Indeed the count of active US drilling rigs gained 7 units up to 447 during the week ended July 15, making this the sixth increase in the last seven weeks. Since May 20th, rig counts have risen by 47 units in response to strengthening prices. It is therefore increasingly likely that the rally has come to an end and that we are most likely heading towards a period of consolidation, if not one of downward adjustment.

The WTI broke its 50dma to the downside in early July and is now heading toward the following support that lies at $43.03 (low from May 10th). Further south, a strong support can be found at around $40.85 (200dma).





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