WEEKLY MARKET OUTLOOK

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WEEKLY MARKET OUTLOOK - An Overview

Economics

Yellen heads to Wyoming

Lack of trust in Fed communications

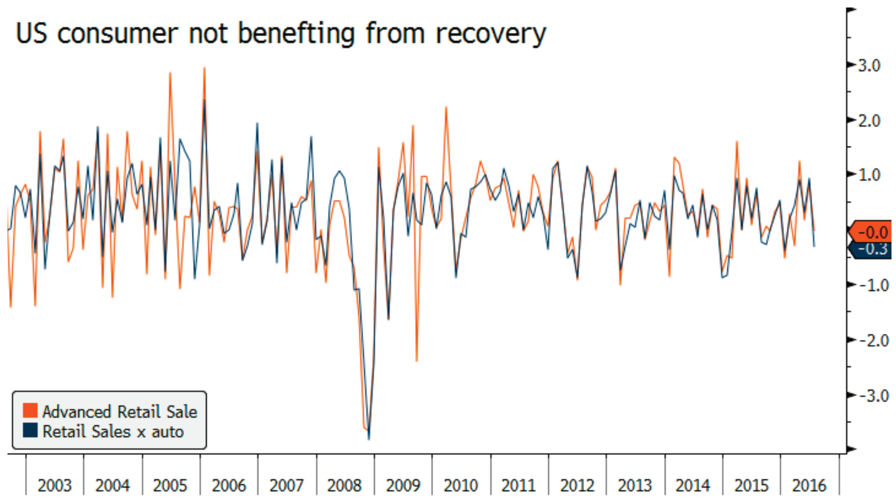
The Fed's communication strategy is suffering from a lack of credibility. This week, Fed speakers consistently provided a hawkish message yet, the USD and more importantly the US yield curve, failed to reprice a September rate hike. The rates markets estimate a low probability for a September hike at 20% and 45% for the December FOMC meeting. Clearly the markets don't trust the Fed's language (why would they considering the Feds track record?). New York Fed President Dudley has indicated that the US economy remains strong, supported by a healthy labor market and rising wage prices and suggested that the markets were underpricing the probability of a Fed tightening. Meanwhile, Dallas Fed President Kaplan suggested that there was room for the Fed to raise rates. These comments seem to be preparing the groundwork for Chair Yellen's speech at Jackson Hole to signal a rate hike.

A sudden shift in expectations would clearly catch the market flat-footed, quickly lifting US front-end yields and providing a boost to USD. However, we suspect those analysts calling for a hike are missing the global context and overestimating historically marginal US economic strength. The US economic momentum only appears robust when compared to sputtering global data. GDP growth remains a tepid 1.2% q/q which is hardly worth getting excited about. The Fed minutes released last week highlighted the sluggish US inflation outlook as July core CPI moderated to 2.2% from 2.3%. While evidence has increased that the consumer remains cautions as retail sales continue to decelerate.

Short USD on repricing confusion

In addition, a rate hike now, with global yields low and heading negative, would exceed tightening aim as capital floods into US assets stressing financial conditions.

In short we expect minor reduction in external risk to the US outlook and strong labor market will be sidelined for Fed members wait for further evidence activity is improving. We continue to fade USD rallies and see the current bullish momentum as closing long positions in illiquid markets (exaggerating moves), rather than a sentiment shift.



Economics

Economists Look Optimistic, German PPI Increases, But...

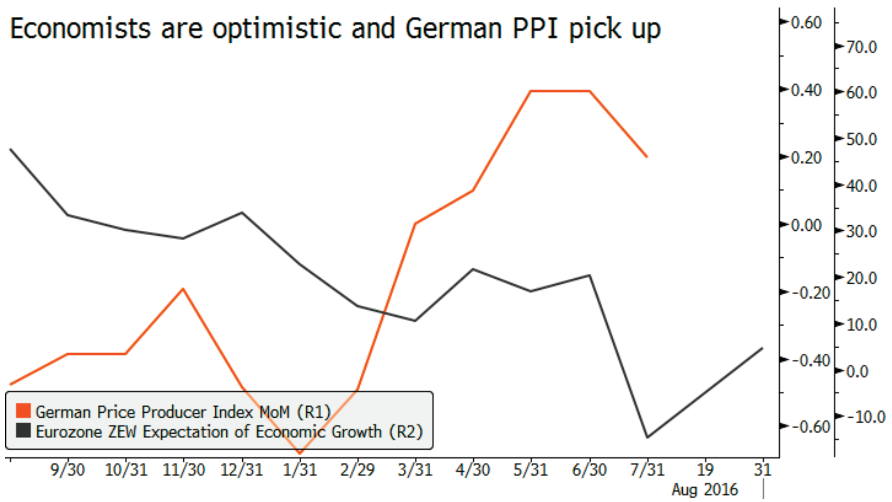
The ZEW indicator has been released earlier last week and consists in a survey of around 350 economists. Last month, it is clear that the Brexit vote added significant downside pressures according to those economists. Indeed, the July print uncovered the underlying difficulties of the Euro area. The indicator collapsed to a 4-year low to -14.7 and has bounced back to 4.6 this month. An indicator value above 0 indicates optimism while a negative value indicates pessimism.

From our vantage point, those difficulties were already existent and the Brexit has not revealed anything more. Since the vote, the BoE has eased and the ECB is also willing to expand (one more time) its monetary policy because of "mounting uncertainties surrounding the consequences of the Brexit". All of this was anyway widely expected by financial markets. If truth be told, the BoE was already struggling to save its GDP and ECB president Mario Draghi announced multiple times that the European Institution will do whatever it takes to get back towards the path of growth. In other words, the global economic slowdown has not been worsened by the Brexit vote.

The situation in Germany is being closely scrutinized by financial markets as a new impetus towards deflation would be a clear signal that the ECB is going to further ease in September. For the time being in Europe strong deflation pressures abound and markets are continuing to price massive intervention. Stocks and bonds markets are already way into a great bubble, with German 10-year government bonds for example currently yielding negative.

Last Friday, the German PPI index came in slightly above expectations at 0.2% m/m. Yet, on an annualized basis, the PPI is still negative with a -2.0% performance over the last year. The German indicator continues to increase and the short-term trend is rather positive. Additional pressure on consumer prices are now expected.

In our view, the rise of oil prices has certainly pushed PPI to edge higher. This increase however, remains somewhat limited. The PPI will only provide a clear indication of recovery when it is above a decent threshold on an annualized basis - above 2% would be ideal. In the meanwhile, there's really no other question to ponder other than how this massive stock and bonds bubble will end. As a result, we remain dubious that the ECB will manage to further weaken the single currency through its policy easing.



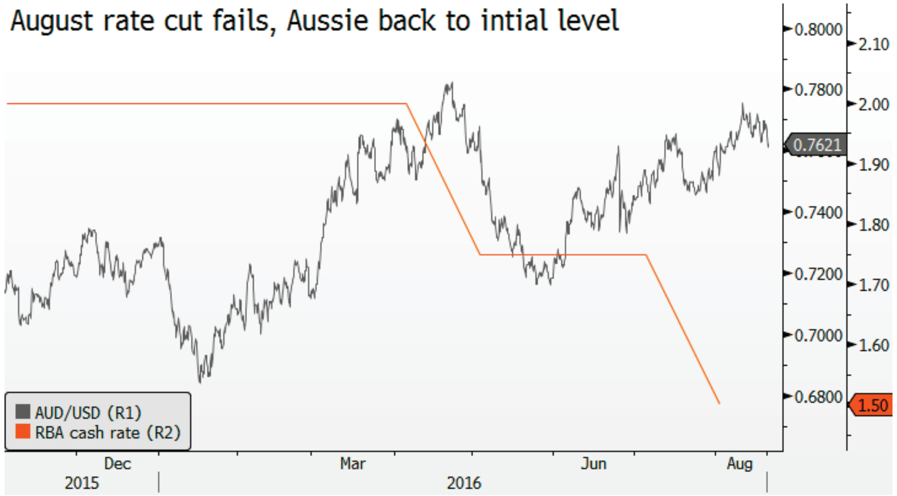
Economics

Is It Time For The Aussie To Weaken?

It has been a complicated year so far for the Reserve Bank of Australia. The central bank has had to deal with weak inflationary pressure, an economy that is at the mercy of slowing demand from China and a strong currency, which has been bolstered by investors desperately chasing higher yields against the backdrop of constant monetary easing from major central banks.

In spite of two interest rate cuts in less than four months (May and August), the Australian dollar remains under heavy buying pressure as monetary easing becomes the new normal amongst central banks. Back in May, the first rate cut had the expected effect as investors closed their long Aussie positions. At that point the market was still fearing the central bank, ready to play its game by staying away from the AUD. However, at the time of the second rate cut in August, the market already had plenty of time to question the central banks' ability to actually drive their respective currency. The failure of the BoJ to effectively weaken the yen has opened the door for a broader questioning of ultra-accommodative monetary policies. Therefore, the effect of the August rate cut was short lived as AUD/USD climbed back to its initial level in less than a week.

It is becoming increasingly evident that central banks are losing their grip on FX when they want to weaken their respective currency. However, mounting rate hike expectations still have the same effect, especially when the central bank has inflation expectations under control. Therefore, we would not be surprised to see the Aussie weaken in the next few weeks - especially against the greenback - as the market (again) anticipates the Fed to increase borrowing costs.



Economics

Russian Economic Data On The Rise

Ruble goes trendy

The ruble continues to appreciate and is now at a one-month high against the dollar. Of course there is room for further upside due to the ongoing Russian economic recovery. 62 rubles for one dollar represents a decent target in the short-term. This current strengthening is due to the fact that investors are looking for yields and while many western rates are negative or close to negative, the ruble is definitely a very good opportunity and looks still undervalued.

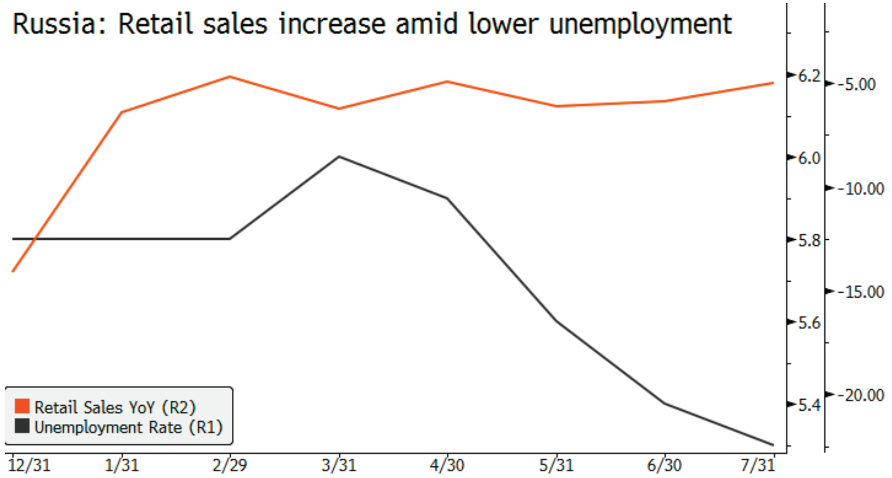
Oil prices but not only

The current rally in oil prices is driving investors towards Russia as its economy relies significantly on the black commodity. Last Wednesday, July retail sales have been released well above expectations at 4.2% m/m vs 2.9% m/m. On an annualized basis retail sales growth remains nonetheless deeply negative below -5% y/y because of last year's strong downturn and the collapse of oil. Unemployment data also improved and has also lowered to 5.3%.

Credibility is more and more on the Russian side

Russia is also attempting to back its currency with Gold. The Central Bank of Russia is approaching toward its objective of having $500 billion in gold and forex reserve. As a result the ruble is gaining credibility. And with rates at 10.5%. Credibility is even more attractive.

It seems that the Russian economy is recovering well. The Central Bank of Russia should now attempt to limit upside pressures on its currency and to increase revenues from exports. We expect a cut of the key rate towards 10% at the September 16th meeting. A deeper rate cut may also be anticipated.



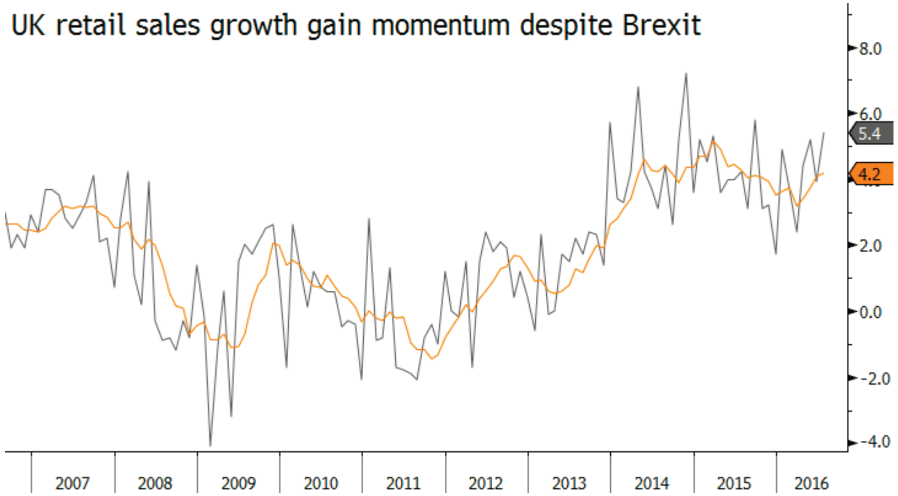
Economics

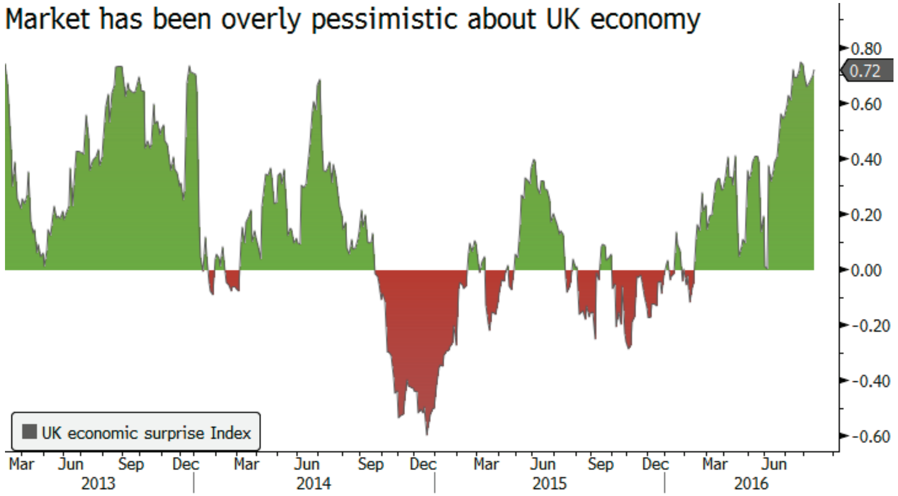
UK Data Surprises To The Upside

July UK retail sales came in much better-than-expected in spite of Brexit doldrums. Retail sales excluding auto and fuel rose 5.4%y/y, beating the median forecast and previous reading of 3.9% as the sales of textile, clothing and footwear increased 5.1%m/m, compared to a contraction of 1.6%m/m in June. The weak pound may have helped to boost consumers spending, however it also seems that the market has been overly pessimistic concerning the effects of the UK's decision to leave the European Union. A weaker pound is therefore a good thing as it will help the UK economy weather the expected contraction in GDP.

In its last report, the Bank of England held its GDP growth forecast steady at 2% for 2016 but revised its 2017 forecast sharply lower, from 2.3% to 0.8% in anticipation of a substantial slowdown in personal consumption on the longer-term. Perhaps July's solid retail sales are a once-off and the positive effects of the weaker pound will be short-lived. We are just starting to get post-Brexit data. Besides retail sales, the job market is holding ground despite gloomy forecast. Employment rate is above 74%, while the unemployment rate held steady at 4.9% while jobless claims fell 8.6k in July (versus +9k median forecast). Finally, headline inflation ticked up to 0.6%y/y in July from 0.5% in the previous month. Therefore, one thing is certain: the market has been overly pessimistic in the wake of the Brexit vote and clearly needs to better assess the lay of the land. The upcoming batches of data from the UK will be key in determining the medium to long-term effect of the Brexit.

After moving as low as 1.2866 in the wake of the BoE easing move, GBP/USD reversed momentum and climbed as high as 1.3185. The pound sterling was under selling pressure on Friday as US dollar bulls returned to the market, pushing the pair down to 1.3080.





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