SWISSQUOTE

WEEKLY MARKET OUTLOOK

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WEEKLY MARKET OUTLOOK - An Overview

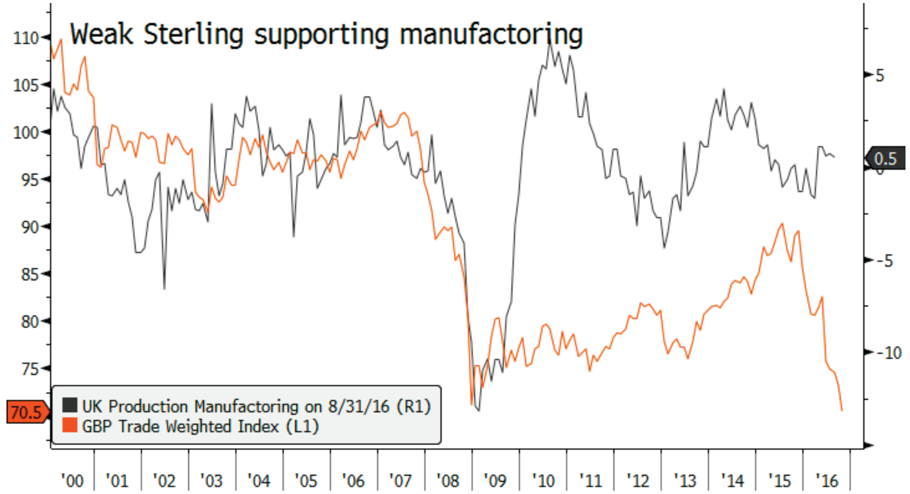
Economics

Don't Believe The Hype... Buy GBP

Just when the market had nearly forgotten about Brexit uncertainty the radical break up has come roaring back. UK Prime Minister May comments emboldened "hard Brexit" backers by suggesting that she would prioritize British control over immigration break-up negotiations. She went on to indicate that Article 50 would be delivered to Brussels by April 2017. The stark comments were widely seen as the first tangible move away from a "soft Brexit", which would maintain EU membership in the single marketplace in exchange for allowing free movement of workers. Then French President Holland demanded tough Brexit negotiation. The reality of a potentially messy Brexit slammed into the GBP, triggering a liquidity event, with the GBPUSD falling to all-time lows. As with pre-Brexit, there is a feeling that the negative hype around the economic repercussion has hit panic proportion. "Flash Crash", "Perfect Storm" and "Currency Crisis" are now being thrown around the sterling. Now is the time to investigate the contrarian trade.

Incoming economic data is not suggestive of a hard landing. The services PMI for September slipped marginally to 52.6, from a reading of 52.9 in August, above market consensus for a 52.2 print. Regardless of the marginal decline, the details of the services survey were relatively solid. The index for new business, increased to 53.7 while the employment index climbed 0.9 to 51.7. The strong read indicates that services PMI could move higher in October. This follows an impressive trend of construction and manufacturing PMIs, which improved in September. Last week's report highlights the resilience of the UK economy. The healthy PMI reports suggest that the conventional consensus and the Bank of England's own growth forecast to low. In addition the weak GBP is having an impressive spillover effect into manufacturing, export and tourism. It is even likely that the weaker sterling will attract international real estate investors willing to overlook immigration issues for a bargain.

The UK-US short term yield differential has widened significantly and unlikely to widen further without a surge in the US economic outlook. We anticipate that GBP selling is likely to slow as the Brexit hype dies down, UK economic data remains resilient and the probability of a Fed December hike decreases. Or the US presidential election cycle becomes a news "black hole" becoming the only thing that investors are focused on.



Economics

EUR/CHF Under Pressure As Brexit Fears Rise

Inflation slumps

In Switzerland, consumer prices increased less than expected in September, rising 0.1% month-over-month, versus an expected increase of 0.2% as the period of the summer sales ended. On a year-over-year basis, the inflation gauge contracted 0.2%, well below median forecast of 0.0%. The lower reading is mainly due to the downside pressure of transport (-1.9%y/y), goods & furniture (-2%y/y) and alcohol & tobacco (-0.9%y/y) components. Overall, the strength of the Swiss franc will continue to weigh on prices as international investors are not yet ready to give up on the security embedded in the Swiss currency.

Sight deposits

Two weeks ago the SNB had to intervene in the FX market to defend the Swiss franc. This assumption is strongly supported by the sharp increase in domestic sight deposits in the week ending September 30. Domestic sight deposits rose by more than 8 billion CHF to 452.9 billion, the largest increase since the removal of the floor back in January 2015. Last week, EUR/CHF dropped sharply towards the 1.08 level before bouncing to 1.0975, up 1.50% on the move.

FX Reserves

Swiss FX reserves hit another all-time high reaching CHF 628bn in August, up 1.1bn compared to July. This is a rather small figure especially after last week's sharp increase in domestic sight deposits which occurred after the suspicious EUR/CHF spike. This modest expansion in foreign currency reserves could however be explained by the broad base appreciation of the Swiss franc during September.

Indeed, on a trade-weighted basis the Swiss franc appreciated more than 1.40%. Looking at the details, we noticed that during September the CHF appreciate roughly 1.50% against the EUR, 3% against the GBP and roughly 2% against the greenback. All in all, the situation remains the same as the Swiss National Bank has to stand react to act, especially now that fears of a hard Brexit are spreading across financial markets what would trigger a rush into safe-haven assets such as the Swiss franc. The next few months promise to be a hectic period for the SNB.

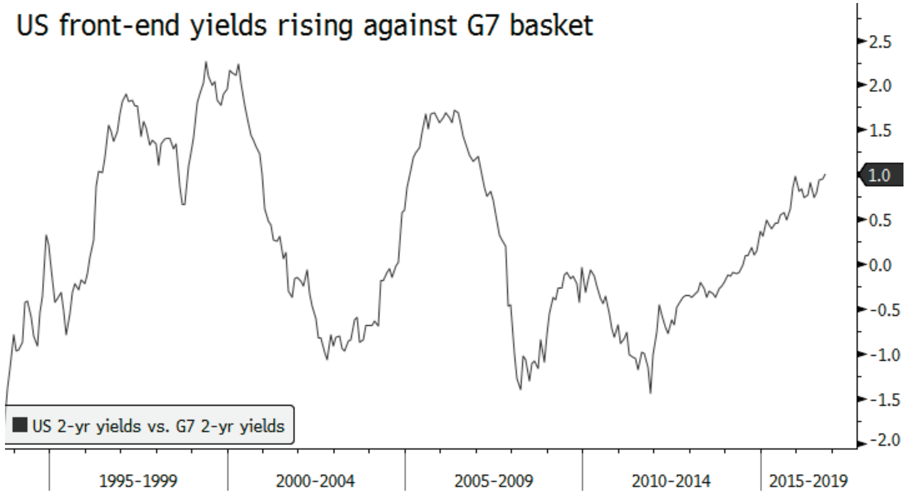
Economics

USD Rally Nearly Complete

USD traders have been focused on other drivers outside of US economic fundamentals and Fed policy (DB, Brexit) since the last meeting. Better than expected US economic data and hawkish Fed speak has reinforced view that a 25bp interest rate hike could come in December. Both Richmond Lacker and Chicago Evans stated there was a solid argument for the Fed to raise rates once by year-end. While ISM non-manufacturing, factory orders and rebound in exports highlighted an economy accelerating. Even the September ADP employment report which showed considerable deceleration in private jobs gains, due to weakness in service-providing sector, 154k from 177k prior read was not the collapse many had forecast. While weaker NFP at 156k also we not terrible but should not increase hike probability. Yet overall, the net results have been a rapid increase in Fed fund expectations to 65% for December while US front-end yields have rallied. The move has not been drastic enough to unhinge high yielding positions (ie wide real yield differential). However, those assets low yielding assets have come under selling pressure.

Within the currency space JPY, CHF and GBP have been victims of steady liquidations. Should we continue to see US yields increase the exodus will only escalate. However, we don't see US economic data providing a conclusive indication of economic strength but rather a mixed-uncertain picture which will constrain further pressure on December rate hike expectations. While Asia EM growth remains an encouraging story, the rest of the global outlook has stagnated. Besides slowing global growth, decelerating investments, the turned of globalizations has reversed. This external pressure should continue to drag on any real acceleration of US growth. Despite warning by global leaders contraction of world trade is expected to further weigh on a developed markets recovery. Europe, specifically Germany, is highly exposed to slower trade; especially since GBP collapse now give the UK a competitive advantage.

Even if a Fed rate hike gets fully price in, the tepid economic outlook will limit a steeper interest rate path. In regard to the Fed making 2017 look very much like 2017. So in this scenario we continue to see high yielding high beta currencies as attractive trades.



Economics

BRL Doomed To Weaken Again

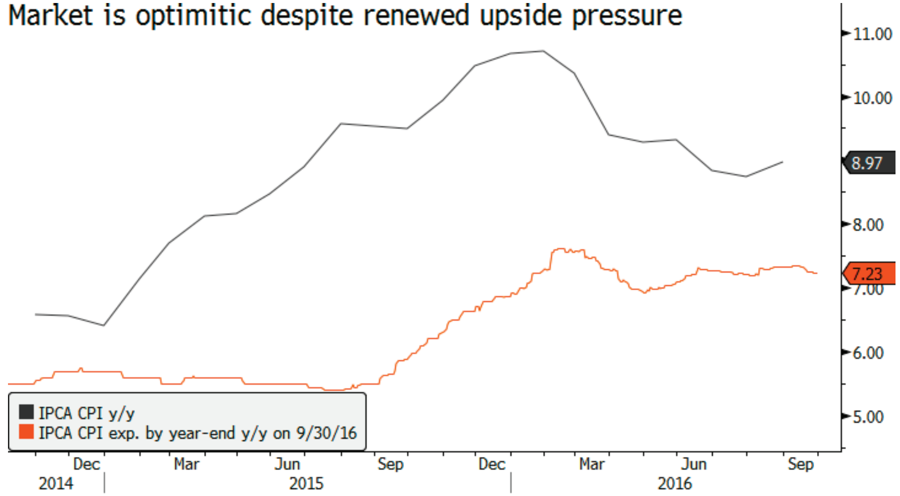
After rallying strongly for the first seven months of the year - rising more than 30% against the USD - the Brazilian real has started to reverse those gains as the excessive optimism surrounding Dilma Rousseff's removal fades away. Michel Temer is now Brazil's new head of government and has plenty of work ahead to put the country back on the growth track and fix fiscal problems. The issue is that the market has put the political aspect of Brazil on the backburner and is now more sensitive to the economic data and the risk embedded in Brazilian assets. Since mid-August, the stock market has been losing momentum with the iBovespa stuck below the 60,000 level. The spread for five-year credit-default swaps has reversed trends and turned north, rising 18% from 245.5bps to 285.74bps during the month of September as rating agencies cut Brazil's credit rating to junk.

On the data front, good news has been pretty thin lately. The industrial output, released last Tuesday, contracted 5.2%y/y in August after a contraction of 6.4% in the previous month. The manufacturing sector is still under substantial pressure as the PMI printed well below the 50 threshold that separates expansion from contraction, coming in at 46 in September versus 45.7 in the previous month. Finally, on the inflation front, the latest report showed that the BCB should not drop its guard as inflationary pressures remained elevated during the second half of the summer with the IPCA gauge ticking up to 8.97%y/y in August from 8.74% in July. In September, inflationary pressure are expected to ease slightly, with the market anticipating the IPCA measure to ease to 8.60%.

All in all, we expect the Brazilian real to remain under pressure over the coming months as investors continue looking for other high yielding assets, especially now that the Federal Reserve has made it clear that it is on the path to lifting lending rates.

CDS on the rise again

Market is optimitic despite renewed upside pressure



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