WEEKLY MARKET OUTLOOK

24 - 30 October 2016

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WEEKLY MARKET OUTLOOK - An Overview

Economics

Russia: Higher Oil Prices Are Definitely Not Enough

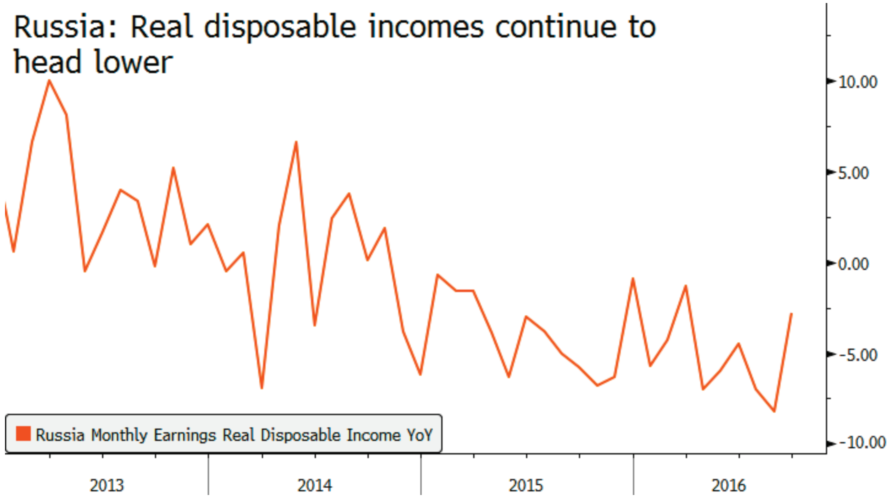
The path towards Russian recovery is tortuous. One may think that the higher oil prices was the answer to all of Russia's problems, it is actually deeper than that. Yet, evidently $50 a barrel is way better for Russia than $30. Obviously, the recent bounce certainly accounts for a significant part of Russia's expectations to return to growth by next year.

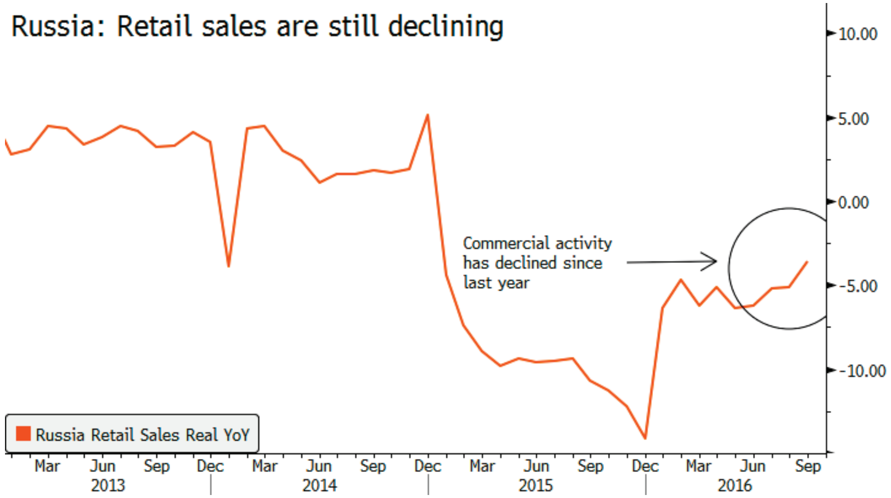
The latest fundamental data is not optimistic. The unemployment rate, remains unchanged at 5.2%, while inflation is also on its way down, reading only 4.2% YTD. One area of increasing concerning is retail, with September sales dropping to early 2015 levels at -1.4% m/m. Consumer activity is clearly at risk and this is confirmed by the fact that real disposable income has collapsed to -8.3% y/y in August.

Inflation is crushing the Russian middle class and this is having a clear, demonstrable impact on retail sales. Other data such as Industrial Production is also on the decline. The increase since last year has ceased and the data is now negative at -0.8% y/y. The Central Bank's dual mandate is therefore far from reach and it is going to be difficult for them to further lower the key rate before year-end in an effort to counter inflation upside risks. The next central bank meeting that will be held on 28th October should confirm the strategy. We believe that the Russian key rate is, very likely, going to be kept unchanged at 10%.

For now, the Central Bank of Russia continues to buy gold to back its currency. We recall that in 2015, Russia bought 208 tons, while adding 172 tons the previous year. For this year, Russia is planning to amass an additional 200 tons.

The medium-term future looks uncertain for Russia and reloading long USDRUB until the end of this year may be a wise bet.





Economics

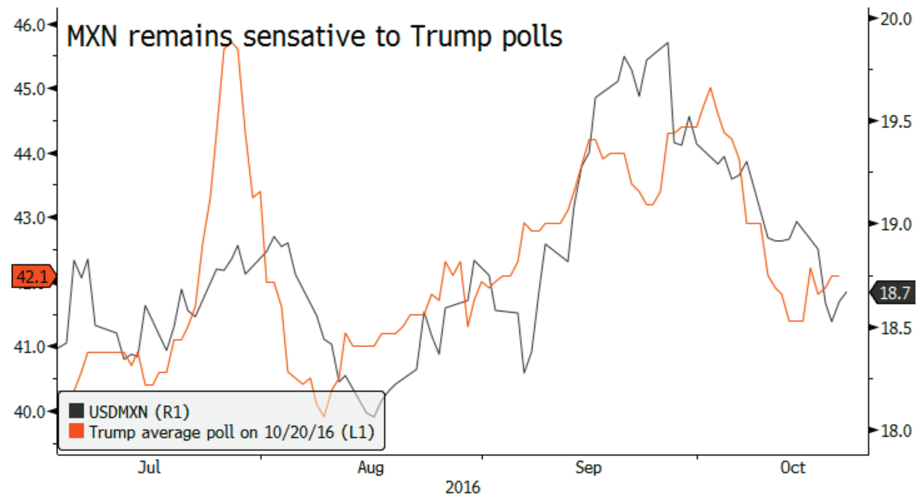
Election Volatility Ahead For Emerging Markets

With the final presidential election debate out of the way, there will be no more planned events with both candidates before Election Day on November 8th. On the surface it sounds as if it should be smooth sailing from here on in for financial markets. However, while it is unlikely that perception or polling numbers will shift organically, a treasure trove of skeletons in both candidates' closets raises the probability of a black swan event.

WikiLeaks continues to churn out new documents, on health issues, terrorist attacks, meaning that shifts in millennial voting habits and corrections in stock could all be easily imaged and would result in shifting polling data. The highly unfavorable rating of both candidates leaves both susceptible. In addition, the lingering elevation in EM FX implied volatility post-election, indicates that expectations for a disorderly transition of power remains high. We caution traders from becoming to compliant, especially vis-a-vis Trump's ability to shoot himself in the foot each time he gains momentum. Two things to remember are that all things considered the race remains tight and historically the tails are closer than we calculated.

From an FX standpoint, the correlation of EM prices with the Clinton/ Trump polling spread suggests that a Clinton victory will trigger a relief rally. Despite improving fundamentals and valuations, they remain subject to macro-conditions. Trump's anti-trade rhetoric has built a perception of higher risk to a Republican victory. Should Trump manufacture an election victory we will see a substantial sell-off in EM Asia. Mexican peso, Malaysian ringgit, Philippines' peso, Indonesian rupiah are all vulnerable to such an outcome. However, the recent declaration by Philippine President Duterte, that the nation's long-standing alliance was over, would put the pacific nation squarely in the sights of a President Trump.

Even with Trump's polling numbers in the basement it would not take a miracle to see a recovery. Should Trump stay on message, supported by a teleprompter, we should his polling numbers jump back. Pricing in positive Trump polls will drag on high beta EM currencies and increase broader volatility indicators.



Economics

Without Surprise, The BoC Kept its Rates Unchanged

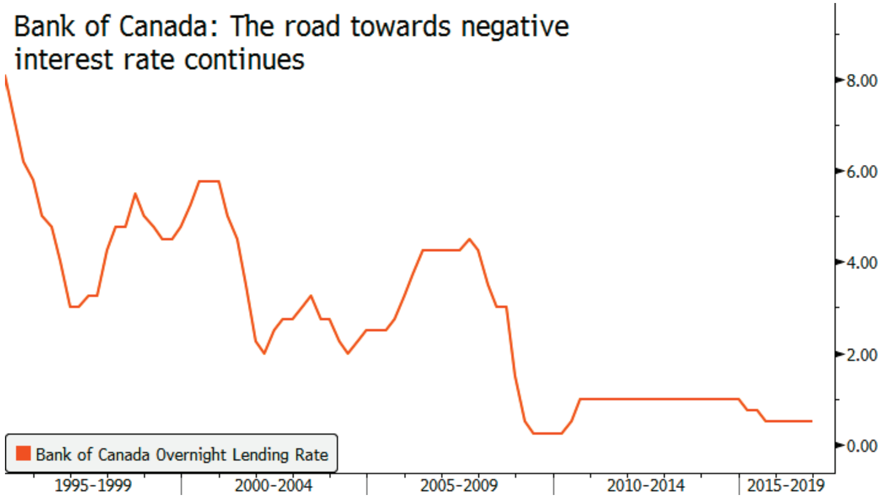
Last week, financial markets got it right. The Bank of Canada finally opted for the status quo by maintaining rates at 0.50%. But this does not mean that the central bank is back on the hawkish side. Indeed, the Central bank lowered growth expectations and inflation forecasts for 2017. The 2016 targets stand right now at 1.1% and 2% for 2017.

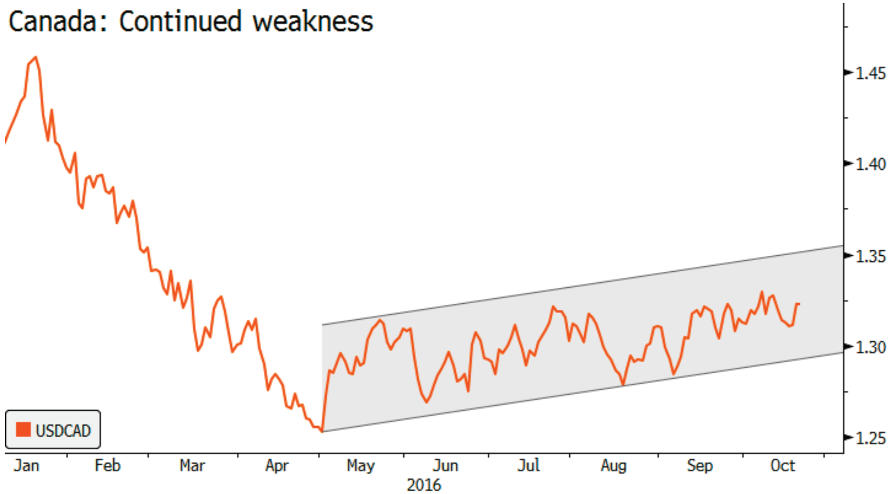
Global uncertainties remain and financial markets are also pricing in that there will be no change in monetary policy until the end of next year. The rebound in oil prices has not been sufficient yet to push the BoC to increase rates.

The Canadian economic data are on the soft side and there are nonetheless concerns about the true state of the economy. Unemployment is still lying on the 7% range and inflation is not picking up. Even worse, the CPI has slumped to its lowest in two years to 1.1% y/y. In addition, the latest retail sales for July have disappointed once more, printing at -0.1% m/m - the third straight negative month.

Canadian exports are also very fragile and despite it rebounded during the summer, it was clearly not enough to offset its large decline during the start of the year. The outlook is not very promising, the Bank of Canada has largely cut its targets regarding the US business investment, an important driver of Canadian export demand, to 3% from 4%.

Currency wise, the loonie should remain weak and we target the USDCAD to head higher until the end of this year. 1.35 represents a decent target over the medium-term. An unlikely upside move in oil prices would definitely provide with some relief to the BoC which rates should remain low for at least one more year.





FX Markets

What Happened At The ECB Meeting?

At last Thursday's ECB meeting, investors were expecting Mario Draghi to announce an extensions of QE beyond March 2017. No clear views were offered yesterday by Draghi but did hint at the extension of bond purchases. The dovish view still prevails and the tapering of the QE program does not seem even close. We maintain our view that QE will be extended and the amount purchases of €80 billion a month should remain unchanged for some time.

It appears very clear to us that the ECB December meeting will be the key meeting of this year. In order not to bring any further turmoil to the market, we believe that policymakers chose to opt this month for the status quo. It is also worth noting that Draghi is probably satisfied with the EURUSD level which is now stalling below 1.10. This largely benefits Eurozone exporters and is bringing some relief to ECB officials.

Eurozone inflation rate remains very low at 0.4% and also well below the inflation target of 2%. It cannot be said that the ECB program has been efficient so far. Indeed, no one can say that the Eurozone economy has been stimulated knowing that growth remains somewhat sluggish. In terms of interest rates, we hold our dovish view even though we believe that there is little room for other rate cuts. From our vantage point, rates cannot go much deeper into negative territory or the risk of triggering a bank run will increase. There is no upside to the ECB to add some pressures on the banking sector, which is already at stake. Some major banks such as Deutsche Bank or Commerzbank are making the headlines and this would only increase their difficulties.

Euro's false negative reaction

Interestingly, despite the fact that Mario Draghi provided no clear indication that additional easing is certain, today the EURUSD is -1.0% lower than prior to the ECB meeting. Our view is that the market is not listening to the ECB. They hear the words but show no comprehension of their meaning. Over the past ten years, markets have become so conditioned to get currency debasing easing every time that the inflation outlook deviates from the central bank's target rate (in this case the ECB's 2% target).

Despite Draghi's growing intellectual conflict, broader public disagreement on the effectiveness of the current monetary policy mix and the negative effect of distortion in financial markets, markets are still expected more easing. Financial markets are simply projecting that the ECB must do something and that the action will be euro-negative, as the recent experience with the BoJ has shown currency traders. However, we see central bank policy coming to a reflection point. Gone are the days when policy was expected to drive growth but has now shifted back to being a tool to support growth dynamics. Negative rates were just a step too far for most people. It is only a matter of time before central banks accept the fact that they are not in total control with Victorian-era precision and realize that the cost of doing something does not outweigh the cost of doing nothing.

In 2017, financial markets will need to learn to live in a world where central banks no longer pretend to offer economic salvation.

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