WEEKLY MARKET OUTLOOK

16 - 22 January 2017

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WEEKLY MARKET OUTLOOK - An Overview

Economics

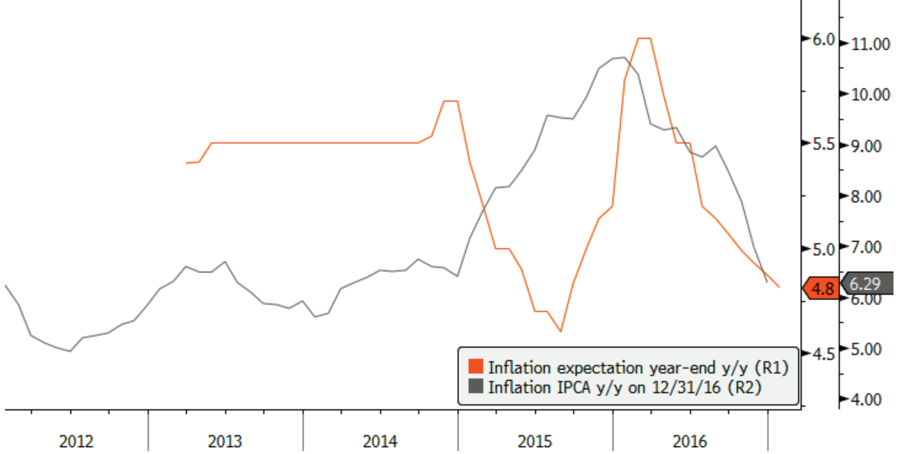
BRL: Carry Traders Back In Business As Fears Ease

As expected, the Brazilian central bank eased its monetary policy last Wednesday as it cut the Selic rate. However, the BCB surprised market participants by lowering its benchmark interest rate by 75 basis points, while the market was expecting a cut of 50bps, which brought the Selic down to 13%. The market's reaction was rather muted as the upcoming Trump's investiture remains the biggest driver, especially for EM currencies. On Wednesday it was more about digesting Donald Trump's statements at his first press conference as President-elect.

The Brazilian real, just as most emerging market currencies, appreciated sharply against the dollar as The Donald took the stage to outline his presidential programme. The market's expectations were maybe a little bit too high but the reality was that Trump's conference did not provide further details over the much discussed fiscal stimulus package. Investor's disappointment translated into a sell-off in the dollar, which also beneficial for the real. In addition, the rate cut was actually be welcomed by investors as it gives a much-needed breath of fresh air to the economy, which is facing one of its worst recessions. Indeed, the GDP is expected to have contracted 3.5%y/y in 2016 after having shrunk 3.8% the previous year. The country should get back on its feet as soon as the first quarter 2017, with a growth consensus of +0.3%q/q.

Against the backdrop of decreasing volatility and easing fears regarding the negative impact on EM of a Trump presidency, the environment for carry trades should continue to improve as investor risk tolerance increase. In the short-term, the Trump story will remain the main driver in the FX market, meaning that event risk is definitely something to monitor. USD/BRL should continue heading toward the 3.10 threshold that was reached last October.

Market expects inflation to reach 4.8% by the end of the year



Economics

ECB Minutes Reveal Its Political Concerns For 2017

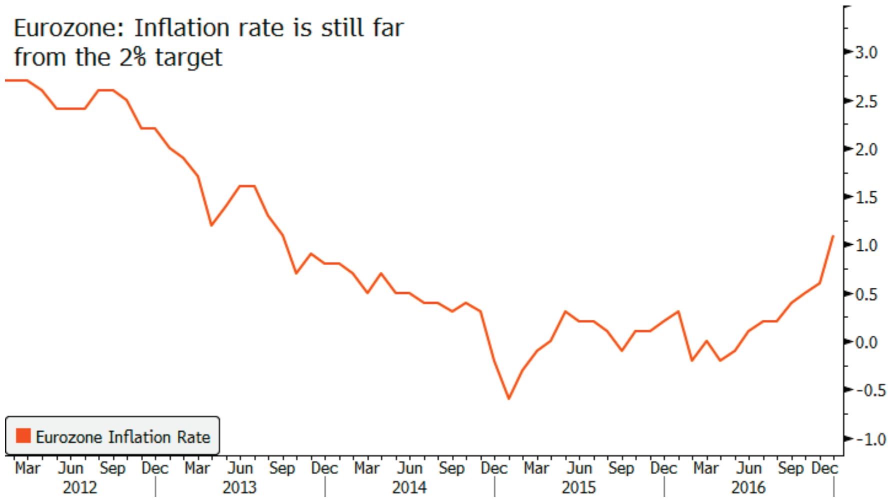
Following the release of the much-awaited Fed minutes, earlier last week the ECB released its account of its December Monetary Policy Meeting. These minutes clearly indicate that economic and political uncertainties are now important central bank drivers. Indeed, the result of the Brexit and Italian referendums are definitely straining EU unity. However, we consider that those uncertainties, as long as they are controlled, are helping to the ECB by lowering the single currency's value. Indeed, a strong euro would not be beneficial for economic growth in the Eurozone, which is currently stalling below 2%.

We recall that the central bank has extended its asset-purchase program by nine months, adding around €540 billion to the economy until next December when markets was expecting only an extension of 6 months. In our view, the reduction of the amount of the asset-purchase program is mostly due to address the scarcity of the bonds. Hence, this reduction should rather be viewed as an effort to show some kind of hawkishness in their monetary policy. In other words, the ECB feels its credibility may be at stake as an open-ended QE like in Japan would threaten the efficiency of its action.

On top of that, some ECB members are ready, in case the economic outlook disappoints, to raise back the asset-purchase program to €80 billion bond a month. This would definitely not be a good idea as it would rapidly show the limits of the ECB monetary policy. At some point, it is likely that the institution could not find enough bonds to buy.

The minutes also indicate some concerns regarding inflation, which is not picking up even though higher energy prices should be adding upside pressures on consumer prices. All in all, no major surprises from the ECB. Eurozone reflation will be the yardstick of the ECB's monetary policy this year.

In the short-term, there will be the rates decision next week on the 19th. No press conference will follow and no changes should happen.



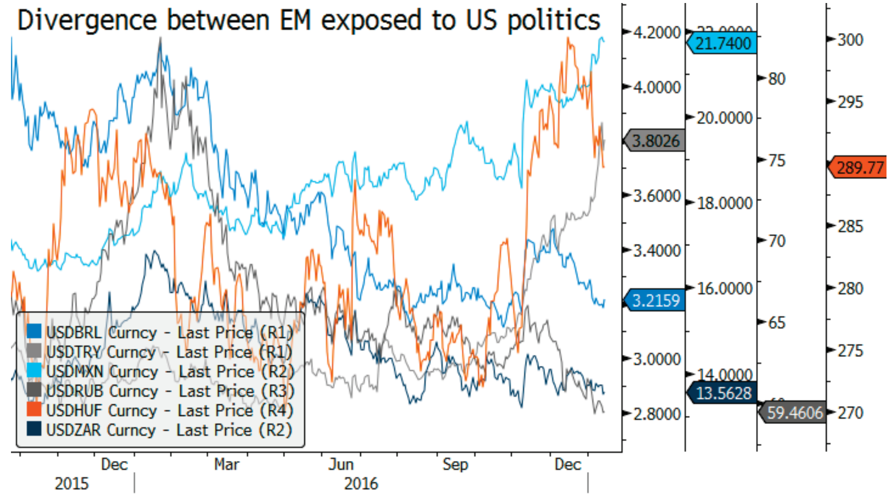
Economics

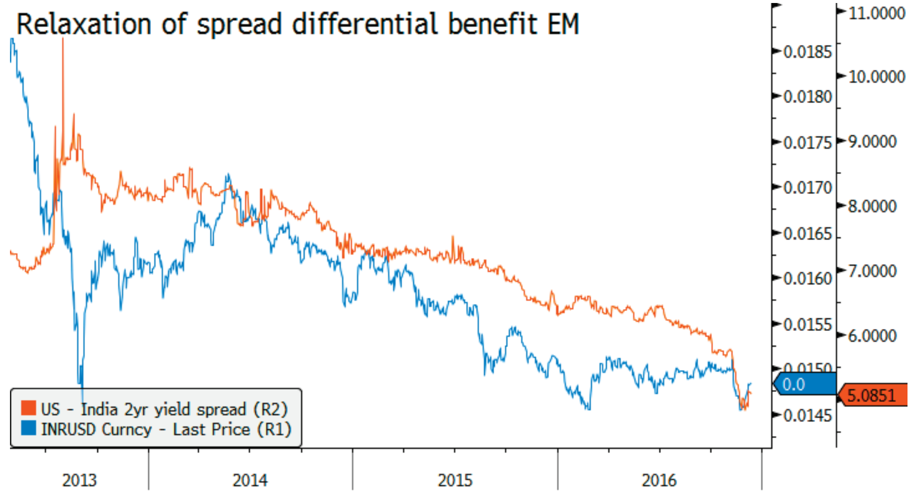
Exaggerated Hype Of Trump Rally In FX

For a majority of investors, the key theme of 2017 is the Trump presidency. Most expect that Trump's election will a global game changer and that his radical policy will have profound effect on asset prices specifically FX markets. However, we are contrarian with limited expectations for what can actually be achieved. This view is supported by Trump's first press conference in 8 months, which provided zero clarity on solid initiatives and quickly disintegrated into a circus.

Prior to the public spectacle, the dominant narrative was that Trump's pro-growth platform would be USD positive. Stronger trade protectionism and tax reform will be the driver of steady USD appreciation. However, other than headline-worthy tweets, there was no evidence that Trump's bold platforms have any chance of being executed. Even with an impressive cabinet, this lack of political experience will very quickly become apparent. In our view, the Trump rally is a classic case of "buy the rumour, sell the fact."

Interestingly, while the headlines continued to hype the strong USD story, DXY peaked on Jan 3rd and has deprecated since. Within the G10, only the GBP and NZD have been weaker against the USD over the last month. USD short-end yields started to adjust lower in December (falling to 1.164% from 1.30%) giving EM currencies, with the extreme exception of MXN, TRY, INR and CLP opportunity to appreciate. Spiraling towards Jan 20th, we anticipate the Trump reflation story to deflate further (we still suspect that US growth is indeed robust, but without the Trump miracle). The unwinding of USD front loading witnessed through October and November will give yield seeking investors further time to venture into high yielding, low volatility and weak correlation to US political uncertainty. We are bullish RUB, ZAR, and INR and if you are less concerned about carry, then PLN and HUF look interesting.





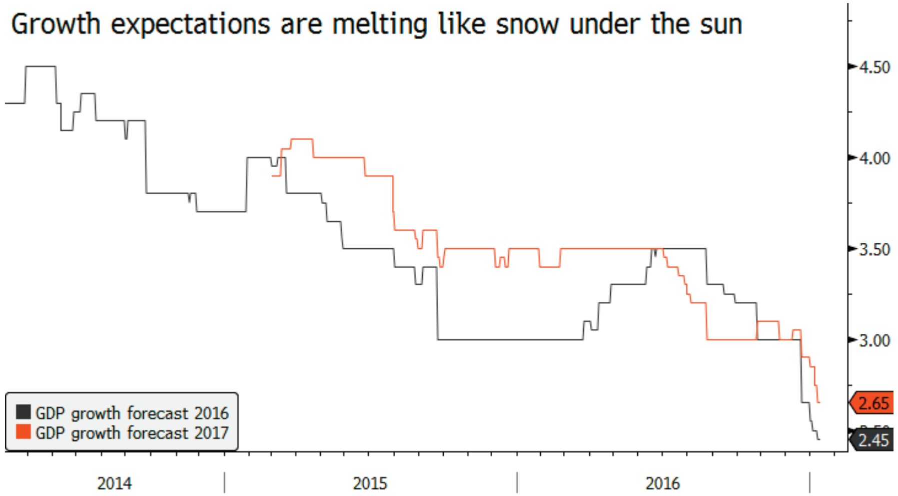
Economics

Rough Day Ahead For The Turkish Lira

The Turkish lira suffer one of its worst weekly sell-off as it fell as much as 7.5% against the US dollar before quickly reversing - only partially - the losses and cutting the damage to roughly -4% ahead of the week-end break. USD/TRY sky rocketed to 3.9415 and printed a new all-time high on Wednesday before stabilising in a very volatile range at between 3.75 and 3.83.

Overall, the lira has had a tough start into the new year, sliding almost 7% against the greenback since January 1st, making it the worst performer in the FX market, well ahead of the Mexican Pesos that fell 5.5% over the same period. The quick lira depreciation, coupled with rising inflationary pressures (+8.53%y/y last December versus 7% in November) has substantially increased the pressure on the central bank, which is now almost obliged to increase interest rates to try to curb inflation and limit the damage to its credibility. Indeed, the acceleration of the lira's depreciation since the beginning of the year is mostly due to the CBT's silence toward mounting inflationary pressure. The market is now wondering whether the CBT is still independent or under the government's thumb as Recep Tayyip Erdogan made clear he is expecting more rate cuts. This may be just the beginning should the central bank back off from its initial mandate, which is to control price pressure, and not to be the government's puppet.

Against this backdrop of political interferences, the central bank found another way to relieve the pressure on the TRY. On Thursday, the central bank did not provide any funding through its 1-week repurchase auction to local lenders, forcing them to borrow at a much higher rate through the late liquidity. This backdoor may be a good short-solution. Nevertheless the CBT will have at some point to lift rate if it wants avoid long-term damage to its credibility.



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China's Foreign Exchange Reserves Continues To Decline

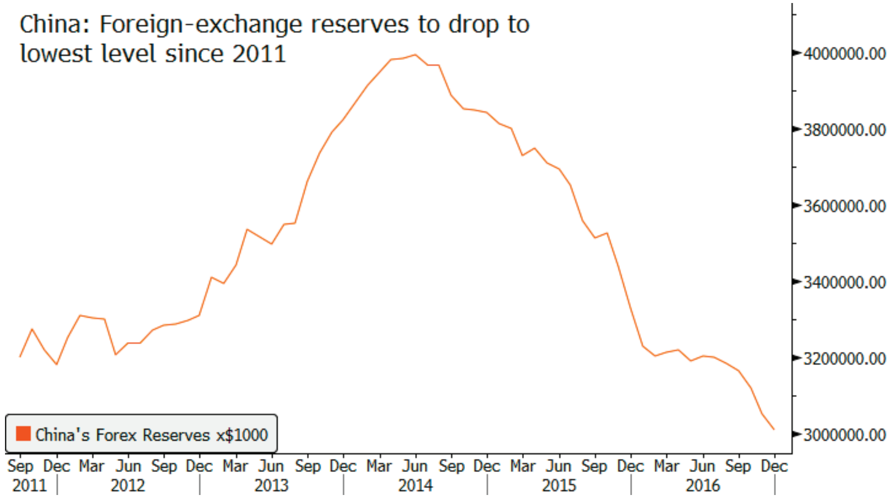
Last weekend, China disclosed its foreign reserves as of December showing a sharp $41 billion decline to $3010 billion from $3051 billion. China has stated that this decrease is a side effect of their efforts to stabilise the renminbi and to save the currency from further decline.

In our view, this seems rather contradictory. We consider that China is trying to devalue its currency to favour its exports. We also firmly believe that Mainland China wishes to get rid of the dollar as Chinese policymakers are likely concerned about the inflationary risks attached to it due to the Fed's ultra-loose monetary policies over the last decade.

China is then consistently dumping its U.S. Treasuries and this move is done to support the yuan. We consider this as a move of mistrust regarding the American currency. In addition, China is attempting to increase its Gold reserves. It does not make sense anyway that China is trying to prevent the collapse of its currency. China is rather trying to improve the credibility of its currency by owning more gold.

The decline of China's FX reserves also means that the commercial surplus (export minus imports) is declining, which will have an impact on growth. Moreover, China's shift towards a more domestic-driven economy may also justify the strong decline.

Finally, China is investing heavily in Europe and Africa where lands, forests, industries are being bought as an alternative to hoarding the dollar. As a result, we do not see any reason why USDCNY would not head towards 7 in the medium-term.



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