

WEEKLY MARKET OUTLOOK

23 - 29 January 2017

WEEKLY MARKET OUTLOOK - An Overview

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Economics

UK Still On Course For A Hard Brexit

Earlier last week, financial markets became fearful ahead of Theresa May's speech. The pound kicked off the Monday market session down two figures over growing uncertainties about the PM's strategy and was trading against the greenback below \$1.20 for the first time in 32 years. The pair has since significantly bounced back above this level. Besides, the market continues to wait for the doomsday effects of Brexit to kick in, a concern we do not share. The UK's most recent data supports our contrarian position. Long GBPUSD looks increasingly like the trade of the year.

In the background, the Supreme Court are expected to give before the end of January their final decision on the role of parliament concerning the triggering of Article 50. We believe that the chances of parliament blocking Brexit presents an underestimated risk.

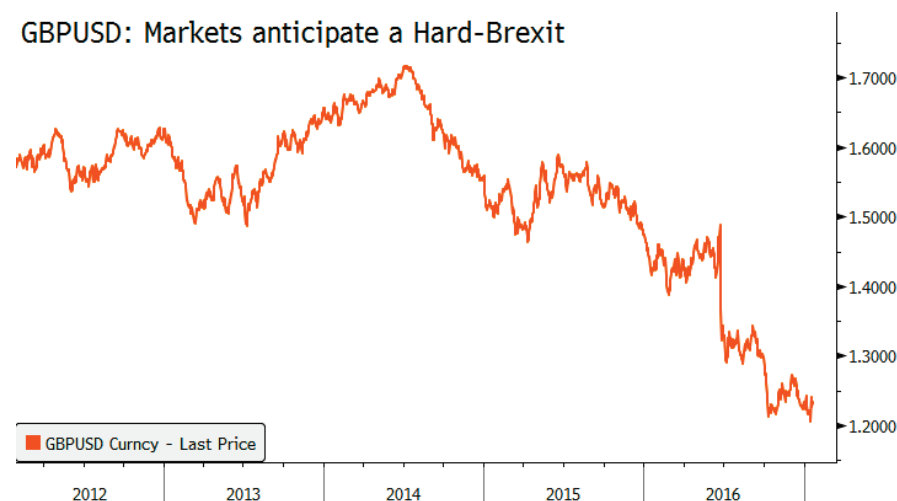
Contrary to the rumours propagated the weekend before the press conference, Theresa May said that the relationship with the EU really does matter for Britain and that a hard Brexit is not a path to follow. The UK PM also reiterated the fact that the UK does not want a partial membership of the EU, which was inevitable in order to respect the Brexit referendum results.

In our view, the negotiations between the UK and the EU have already started way before the triggering of the Article 50. It is likely that the rumours of exiting the single union without conditions were there to add pressures on EU officials. According to us, the European Union does not definitely have the upper hand. Indeed, the relations between the US and the UK are good which could push the US to negotiate better bilateral agreement with the UK. On top of that, the very open relations between US and Russia are finally isolating a bit more Europe and are also providing the UK with an edge on its exit from Europe.

This is why Theresa May claims that "no deal for Britain would be better than a bad deal".

Amid the press conference, European stocks were then edging higher and banking stocks were also performing after May's declarations relieved fears of an exodus of UK-based banks. Single market access is key and abandoning would spell the end for such institutions to provide services across the EU. As a result there was some relief in the market last week. Nonetheless, uncertainties remain. HSBC, Goldman Sachs amongst others, declared that they are ready to move part of their UK workforce in Europe. This is definitely a way to add some more pressures on UK.

GBPUSD: Markets anticipate a Hard-Brexit



Economics**Trump's Inauguration: What's Next?**

It has been a busy week on in US with a lot of action on the political with Donald Trump's inauguration as 45th president of the United States, while on the monetary policy side Janet Yellen addressed two speeches, which highlighted the fact that the result of the US elections has significantly obfuscated the US economic outlook, making it difficult for the Fed to give clear forward guidance. Writing this text just a few hours before inauguration, we do not expect the President-elect to provide any clarity on his policies, especially those concerning his fiscal stimulus and tax cut plans, which are the most anticipated. It will take more than a few days to assess the effect of a Trump presidency on the US and global economy. The market will therefore quickly shift focus on the US data and the Fed's tightening path.

On the monetary policy side, Yellen's last two speeches were rather confusing. Indeed last Wednesday, Fed Chair Yellen dropped a few hawkish comments as she stated that waiting too long before continuing to rise rates against the backdrop of accelerating inflation could risk a "nasty surprise". During her second speech on Thursday, she appeared more dovish than expected and asserted that the Fed was not lagging behind in tightening its monetary policy, therefore implying that the Fed has not been slow-playing the market by only lifting rates twice in the last 13 months. While she emphasised that it would be risky to allow the economy to shoot up, it did not feel as though she was in a hurry to lift interest rates. Just like investors, the Fed is waiting on Trump to get further clarity about its presidency.

On the data side, it wasn't that good. December's retail sales, released on Friday, came in rather on the soft side in spite of an upward revision of November's figures. Advance retail sales printed at 0.6%*m/m* in the last month of the year, missing estimates of 0.7%, while November data was revised to 0.2% versus 0.1% first estimate. The strong figures came on the

back of a pickup in demand for automobiles and gas station sales (+2.4% and +2% respectively) as the core measure - the one excluding automobiles and service stations - disappointed substantially, printing flat versus an expected rise of 0.4% (previous reading was revised to 0.3% from 0.2%). All in all, the data showed that US consumers held back in December, failing to translate the strong Trump election rally into solid spending. The trend in core retail sales has been rather flat over the last two years with the 6-month moving average stuck below 0.5%, and sliding to 0.2% last month. Unless Trump delivers his stimulus package, we may have to deal with lacklustre consumption data over the next few months.

On the inflation side, the headline gauge rose 2.1%*y/y* in December versus 1.7% in the previous month, thanks to a sharp increase in crude oil and food prices (the WTI stabilised above the \$50 threshold). The core measure, which excludes the most volatile components such as energy and food, came in slightly higher at 2.2%*y/y* from 2.1% a month ago. Finally, industrial production soared to 0.8%*m/m* vs. 0.6% expected but November's reading was downwardly revised to -0.7% from -0.4% first estimate. To sum up, there was nothing to get carried away. In the short-term, the Trump story will remain the main driver with the significant downside risk in the Mexican pesos mostly. On a broad basis, the US dollar could also be at risk should market participants lose faith in Trump's ability to jump start the US economy. In this case, the JPY will be a good asset to hold.

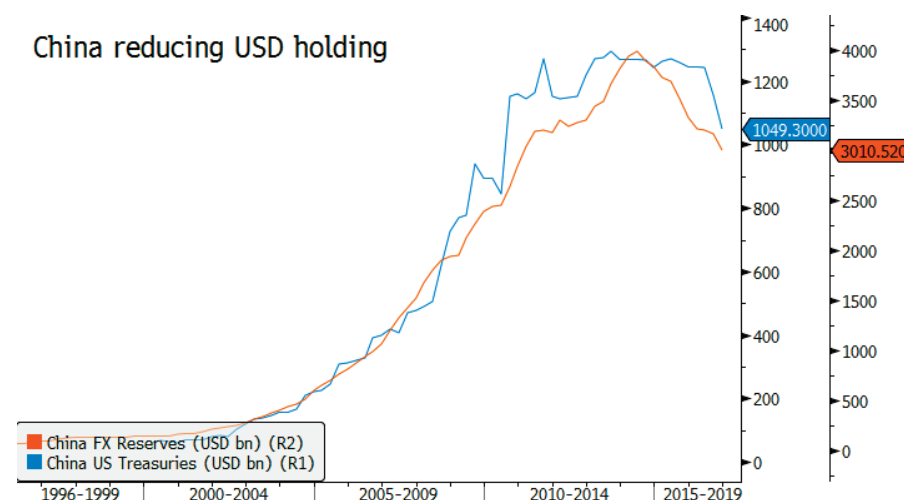
Economics

CNY Stable But Pressure Building

US rate market rallied sharply last week with many investors equating the unexpected move to Yellen's "warning" over the pace of interest rate hikes and/or expectations of Trump pro-growth agenda. Yet, a more sensible rationale is China's running behavior in capital markets. Chinese authorities continue to struggle to contain capital outflows. The most recent data indicates that China continues to struggle to keep the RMB from significantly depreciating. The latest US TIC data indicates that China has become a net seller of US treasuries. China US sovereign holding has dropped to its lowest level since 2010 with the liquidation of \$65bn worth of US paper. Correspondingly, capital outflows from China accelerated in December to \$95bn from \$80bn in November. This capital flight continues despite the government's increased efforts to control cross border flows (such as tightening funding conditions). The failure of recent government effort to slow outflow suggests further pressure on China FX reserves and likely depreciation in CNY.

Data release indicates that China's economy expanded 6.7% in 2016. The firmer growth data was ominously supported by the surge in the property market which is clearly in the bubble territory. The stabilization of the RMB has a higher cost in indirect funding tightening. Controlling outflows using fx reserves and increase swap rates will eventually makes monetary policy tighter and potentially pop China's real-estate growth engine. Meanwhile the rhetoric between China-Trump has heated up as China declared the gloves would "come off" and potential commerce secretary Wilbur Ross accused China being the "most protectionist country". These is a high probability that Trump will label China a currency manipulator and increase risk of being hit with protective tariffs. It unlikely that China wants to aggravate Trump into action by allowing steep RMB depreciation yet given the pressure against China at 3-5% fall in RMB should be expected.

China reducing USD holding



Politically motivated stability?



Economics

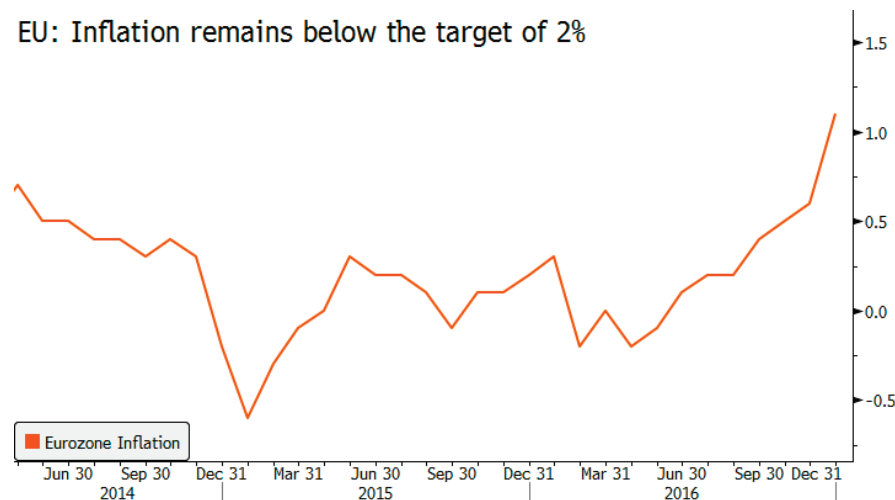
Mario Draghi Concerned By Inflation

Unsurprisingly, the European Central Bank announced last Thursday that it would hold its rates unchanged. At the following press conference, ECB President Mario Draghi announced that no major changes have happened since the last meeting in December. The status quo continues. He underlined the fact that inflation remains subdued and that the latest increase is mostly due to higher energy prices. Inflationary pressures should remain weak this year.

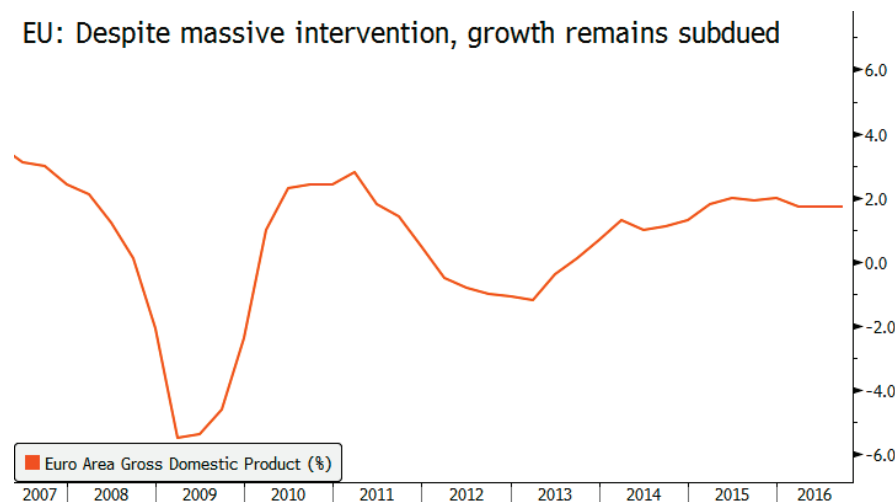
Current monetary policy remains clearly accommodative until December when the QE programme is set to end. As we know, the asset-purchase program amount will be lowered to €60 billion a month. In our view, the aim of this reduction is to address the possible scarcity of bonds in the medium/long run. We nevertheless believe that the ECB could eventually decide to re-increase the amount of asset purchases if needed.

What surprises us is that the ECB board believes that the current monetary policy course has been so far successful. It would appear that success for European policymakers is subdued growth and inflation as well as low interest rates, which underpin asset bubbles, despite the billions of euro being pumped into the economy. With uncertainty at an all-time high, Mario Draghi attempted to provide financial markets with a reassuring message, while keeping a dovish tone. The EURUSD barely reacted yesterday. Pressures will remain on the single currency for some time to come.

EU: Inflation remains below the target of 2%



EU: Despite massive intervention, growth remains subdued



FX Market

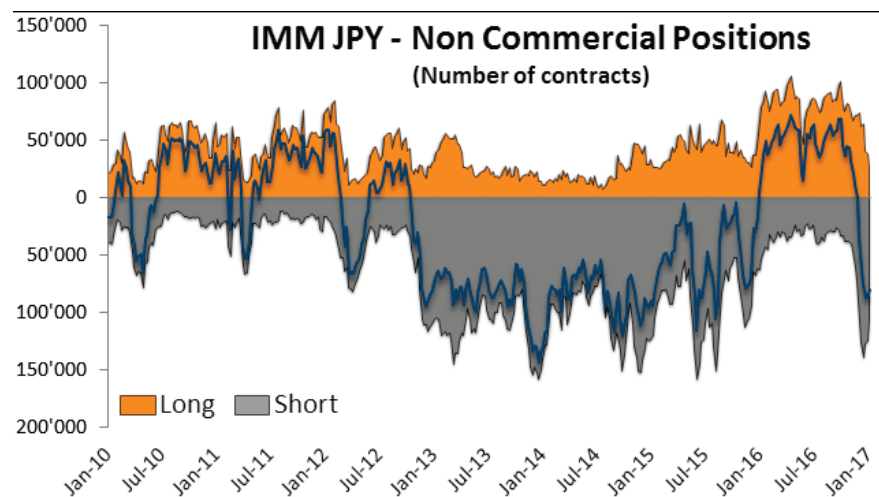
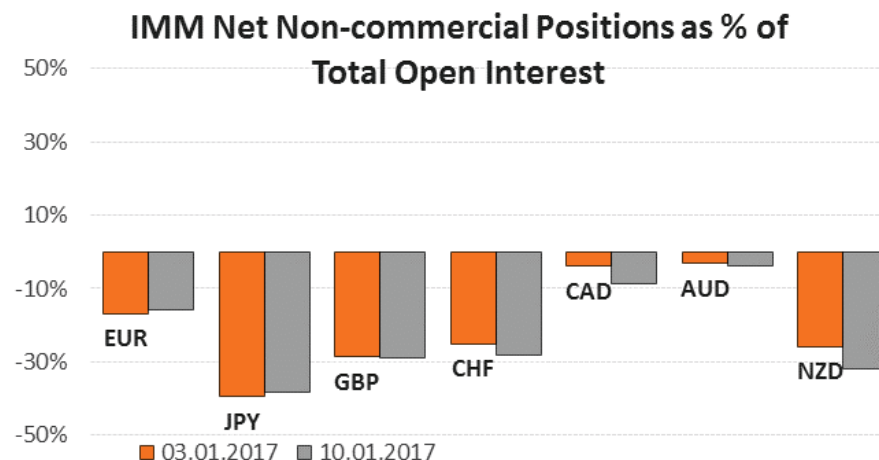
IMM Non-Commercial Positioning

The International Monetary Market (IMM) non-commercial positioning is used to visualise the flow of funds from one currency to another. It is usually viewed as a contrarian indicator when it reaches an extreme in positioning.

The IMM data covers investors' positions for the week ending January 10th 2016.

After reaching extreme levels, net short positions in JPY have stabilized recently. Net short positions eased to 38% of total open interest compared to more than 39% a week ago as the USD/JPY rally has been running out of steam. USD/JPY has been supported by the rising interest rate differential between the US and Japan as the BoJ is still committed to maintain JBG yields close to zero. However, the currency pair is highly vulnerable to any disappointment from the Trump government.

EUR short positions have also decreased slightly as Fed rate hike expectations fade somewhat. The market is now pricing in - through the Fed funds futures - only a 35% chance of a rate hike in March, while the likelihood of a December move stalls around 74%. However, unlike USD/JPY, the speculative positioning is not as pronounced, meaning that a sharp correction appears less likely.



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