

WEEKLY MARKET OUTLOOK

15 - 21 May 2017

WEEKLY MARKET OUTLOOK - An Overview

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Economics

Don't Be Scared & Stay Long EM Risk

Much has been made of the historically low volatility seen across asset classes. Yet with key risk events over and lack of compelling drivers, low volatility environment is likely to remain. Of course there can always be a rogue iceberg that could derail the positive sentiment, but guessing on swan-like-trigger is unproductive. Investors should remain caution but hiding is not an investment strategy. Fears that refocusing on policy "normalizations" would damage risk appetite have not materialized as meaningfully shift is still months away. Still globally loose monetary policy environment has allowed markets to shrug off risk events such as Brexit, rising protectionism, geopolitical uncertainty etc. In addition, US President Trump destabilizing behavior has faded as an issue with most recent actions (firing of Comey) had a limited lasting market impact. And we don't expect that Fed's shallow rate path to spark significantly higher rates or rotation out of risky assets. The Fed's 14-June rate decision expected 25bp hike is already priced in. While EM economic growth data has further improved (as protectionist policy worries have declined) and subdued inflation indicate that more than a few EM Central Banks will cut rates this year. We see upside for EM growth outlook above 4.5%, so a bit of support from commodity prices will give EM another strong bound.

Judging by what only we can see there will be continued flow in EM carry trades as their risk metrics improve. Idiosyncratic risk such as North Korea, Mexico elections and China tightening is unlikely to snowball into a EM sell-off despite the large size of the current trade. Interestingly, the soft commodity prices have suspended investment into EM for some investors causing EM currencies to lag. We suspect there is still time to reload on high beta EM that also carry significant high carry such as TRY, RUB, IDR, MXN and BRL..

These currencies are most likely to benefit from the current low volatility environment. We especially like the EM Asia currencies as regional growth, despite credit tightening in China continue to improve. While news that US and China have agreed to a trade deal, while small in trading volume, suggest that a trade war or punitive currency policy is unlikely.

Vol remains low despite uptick



Crude Oil

Do Not Get Carried Away By Oil's Dead Cat Bounce

After falling as much as 20% in the second half of April, crude oil is making a comeback as the West Texas Intermediate bounced back at around \$48 a barrel, up roughly 3% over the week. After the decision of OPEC and its allies to cut supply back in November last year, investors entered into a wait-and-see mode and took their time to assess the effectiveness of the OPEC decision. The market's enthusiasm was only short-lived but the WTI stabilised at between \$48 and \$55, during the first quarter, at least.

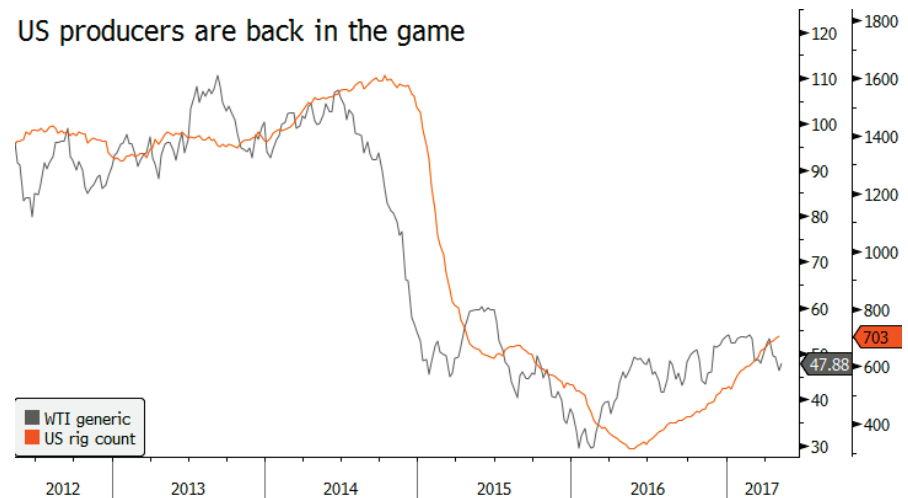
It is quite clear that OPEC is always a trifle late. A few years ago the Cartel, realising that the US shale industry could jeopardise its dominant position in the oil business, tried to nip them in the bud by flooding the market with cheap oil. This move stopped any new investments in upstream exploration and killed the momentum of the US shale industry. However, the move came quite late as North America's frackers were already too efficient and were able to lower their break-even price well below \$50 a barrel.

The problem now, is that OPEC countries are struggling with cheap oil prices, even though their breakeven prices are much lower (around \$20 a barrel for Saudi Arabia, for example), as they need a higher price to balance their state budgets. To lift prices, OPEC trimmed production last year and members are currently discussing to extend the cut. Unfortunately for OPEC and its allies, the US shale industry, which does not participate to the effort, is the primary beneficiary of those production cuts. Indeed, the higher the price, the higher the number of profitable US wells.

The number of US oil and gas rigs have been increasing steadily since May 2016 to reach 703 last week. In average, US drillers added 10 new rigs per week over the last 6 months.

Against a backdrop of supply glut and subdued demand, we believe that the recovery in oil prices is quite limited, especially given the current set-up. The Cartel will have to cut production more aggressively and for longer if it wants to lift prices substantially. Only in the latter case, may we see WTI above \$55 a barrel, but again, the primary beneficiary will be the US shale industry. We do not rule out a recovery in crude oil prices in the short-term. However, we do not believe that a TWI above \$55-60 is sustainable without significant improvement of the fundamentals.

US producers are back in the game



Economics**UK In Focus, BoE Keeps Its Rates Unchanged**

The Bank of England has decided to keep its interest rate unchanged at 0.25% against the backdrop of political uncertainties. Indeed, the 8th of June New General Election will take place, after Theresa May asked the Queen Elizabeth to dissolve the parliament. UK Prime Minister is attempting to gain a stronger majority before negotiations on the article 50 with the EU.

This is why the British central bank favoured the wait-and-see mode last Thursday. Political uncertainties regarding the 2-year negotiation period prevail. Anyway, the BoE has gained some time since last year as the UK economy had clearly benefited from pound devaluation after the Brexit vote. The inflation is now standing at 2.3% y/y. Yet the growth seems still a bit slow (0.3% for Q1 GDP). The unemployment rate keeps declining and is now standing at a 12-year low.

However, the UK is also facing some difficulties. The UK GDP missed forecasts and we may not see growth above the GDP forecasts within the next few years. Retail sales are falling at the fastest rate in seven years, yet, the UK economy is not collapsing as some had promised amid the Brexit campaigning. The UK is doing better than many western countries, which are still struggling with high unemployment rates, low growth and low inflation.

At this point, we do not believe that the BoE will provide any more hints regarding a possible tightening within the next few months. Inflation is getting stronger and this may be one opportunity to kill debt for the BoE. We recall that the debt-to-GDP ratio is 90% but however likely a rate hike of 25 basis point is, this would not make a significant impact on inflation and growth. Another point of concern now for the BoE is the level of real wages which are falling.

There is also one important thing to be said, the UK trade deficit is still very large despite the weaker pound. The trend is clearly negative and amounts for £3.6 billion. We believe that the overseas demand is falling for UK goods certainly on fears that the trade relations with the UK are unclear at the moment.

The future of trade relations are questioned a lot and this drives UK exports lower. The question is now to know whether there will be trade tariffs on importing product from the UK that would hit European business. This is the one reason why UK is facing a growing trade deficit. Replacement opportunities are now being searched for by foreign businesses. We know that long-term relations are always favoured but why would you import from the UK now if there is a threat that trade agreements in the future will ruin the profitability of your business by increasing costs.

Article 50 negotiations will obviously be key. Any positive development will provide a good traction for the UK economy and we must not forget that the UK has a certain number of bilateral agreements that existed before joining the EU. The uncertainties regarding the negotiations are sending the GBP lower. We believe the Sterling is largely undervalued and will strengthen when negotiations will unravel.

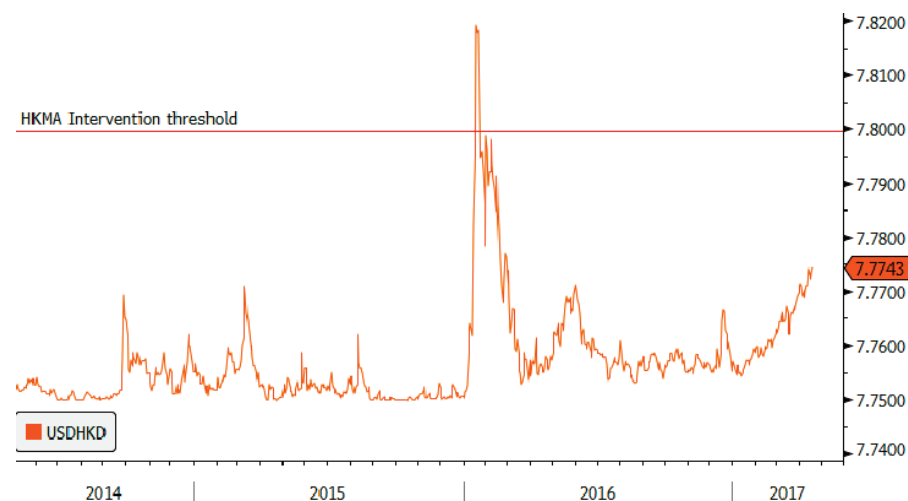
The election of Emmanuel Macron in France does not change much in our view even though he can be qualified as a hard Brexiter and he believes the UK has more to lose than the EU, which has the upper hand on the coming negotiations. He also said that the UK is now becoming a "US vassal state". Macron mentioned several times that he wants to make the UK exit harder as he does not want to provide the signal that it is easy to leave the EU.

FX Market

USDHKD Heads for Intervention Threshold

The long USD short HKD trade continues uninterrupted, clearly having no fears of preemptive official intervention at this point. USDHKD increased to 7.7891 in Asian trading well below the Hong Kong Monetary Authority's 7.85 upper band (7.75 to 7.85 convertibility range). HKMA has expressed commitment to the USD-linked exchange rate (expected to intervene at 7.8), yet the rapid HKD depreciations spawn questions about the sustainability of the peg. The widening US-HK interest rate differential makes borrowing cheap in HK and buying in US a tempting candidate for carry traders. Yet, Hong Kong's annual GDP growth is likely to have accelerated as 1Q GDP came in at 4.3% (above 3.7% exp). The read indicates that household spending and service exports remains solid. April PMI indicates that growth momentum will on a solid pace. From a fundamental standpoint Hong Kong is strong.

Concerns over Hong Kong's attempt to slow house price appreciations on tighter lending practices and increase in purchase tax has pushed Hibor (1-month Hibor 0.38 from 0.75 in Jan) below the US equivalent while high levels of interbank liquidity lower demand for HKD. In addition, China is also in the process of tightening financial conditions and expectations of gradual Fed interest rate increases and reduction in balance sheet are all generating excessive outflows. However, the hazard of waiting is that speculative short selling of HKD could complicate the HKMA objective and even threaten the stability of the banking system. Waiting could force the HKMA to intervene but possibly raise interest rates. Given the high level of leverage in Hong Kong households, a sharp increase in interest rates would pressure debt-holders and possibly constrict consumption (pressuring growth), a dangerous spiral. Currently given the manageable fundamental backdrop and the HKMA's massive \$3.5 trillion reserves, we see no threat to the USD peg. Should we see USDHKD at 7.8 that would be a tempting short.



Themes Trading

Gold & Metal Miners

The sudden collapse in commodity prices in 2014 sent mining stocks into free fall. In the long term, however, precious metals – and gold in particular – are the perennial go-to sources of protection against inflation and economic downturns, something investors should be looking out for. The gold market is dynamic, and there are compelling reasons why gold producers could rally. Consumer demand remains solid, with around 2,500 tons of gold mined worldwide every year. Over the long haul, gold as a commodity has appreciated by more than 287% over the past 15 years; by comparison, the S&P 500 has gained less than 44% over the same period. In a period of central bank policy shifts, it is reasonable to envisage a rebound in metal prices – something mining stocks will benefit from. Gold miners are a good way to tap into the benefits of precious metals without paying storage costs.

Given the sharp debasement of precious metal over the last few weeks, a reversal is more than likely. Take advantage of the move.

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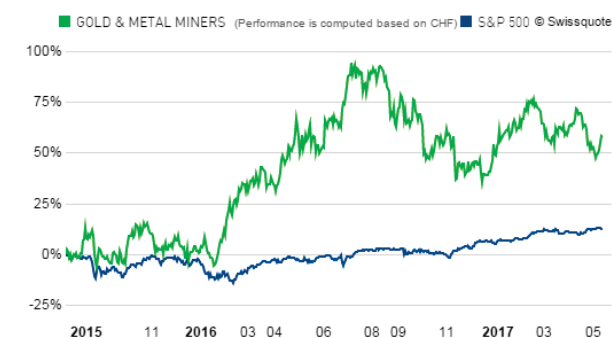
Gold & Metal Miners

Industry • Science • Technology

LONG TERM HIGH RISK

▼ -5.20% 1-month return

Since inception	▲ 57.88%
1-month return	-5.20%
Return day	2.21%
Est. dividend yield	0.00%
Inception date	20/07/15
See portfolio details	
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