WEEKLY MARKET OUTLOOK

10 - 16 September 2018

Swissquote Bank SA | Ch. de la Crétaux 33, CP 319 | CH-1196 Gland | Switzerland
Tel +41 22 999 94 11 | Fax +41 22 999 94 12 | forex.analysis@swissquote.ch | www.swissquote.com/fx

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WEEKLY MARKET OUTLOOK - An Overview

Economics

Market Underpricing "Hard" Brexit

Its time to place your bets on the outcome of Brexit. From our view markets are playing it overly safe. Investors are pricing in an 80% probability to see a Brexit deal, with a 60% chance of a market neutral “soft” Brexit. This will make my next few words seem exaggerated and farfetched. Gone are our expectations of a “soft” Brexit. We don’t expect a realistic deal to be reach in time to meet the October deadline. Potently a headlines grabbing deal is put forward to lessen the impact of missed date, but that will likely fall apart under scrutiny. Agreed on 21-month "transition" period to smooth the way for post-Brexit relations will not provide comfort when Oct deadline is missed.

Even a loose form of a custom union for good and services will be hard to reach. And even harder to pass. News of German government abandoning key demands (accepting fewer details) and British willing to postpone key decisions until after Brexit day, has failed to ease the path to an EU / UK deal. Since a day earlier EU official described May’s Brexit plan as Dead. Heighten politicking will drive GBP significantly lower and volatility higher as normalization of elevated political volatility premium fails to occur.

While the three key “divorce” issues has, in theory been settled, the devil lies in the “details”. Judging from the hostility off the coast of France neither side is ready to give-up the “details”.

Key Dates

18th October 2018: EU summit. Submitted outline of future relationship to permit time for UK parliament and EU members to ratify deal by Brexit day.

13th December 2018: EU summit. Back-stop for Oct no agreement.

29th March 2019: “Deal” or “No Deal”, Brexit is expect to occur 23:00 UK time.

The uncertainty surrounding the Brexit process is increasing, driving volatility in the GBP. GBP/USD has marginally rallied and is consolidating at the 50 DMA at 1.3010. We suspect this is more a function of closing profitable short then shifting positive expectations around Brexit outlook. Thursday is BoE MPC Bank Rate decision should be a non event and stick with existing outlook.

Economics

Italy Promises To Respect EU Budget Rules (Trustworthy ?)

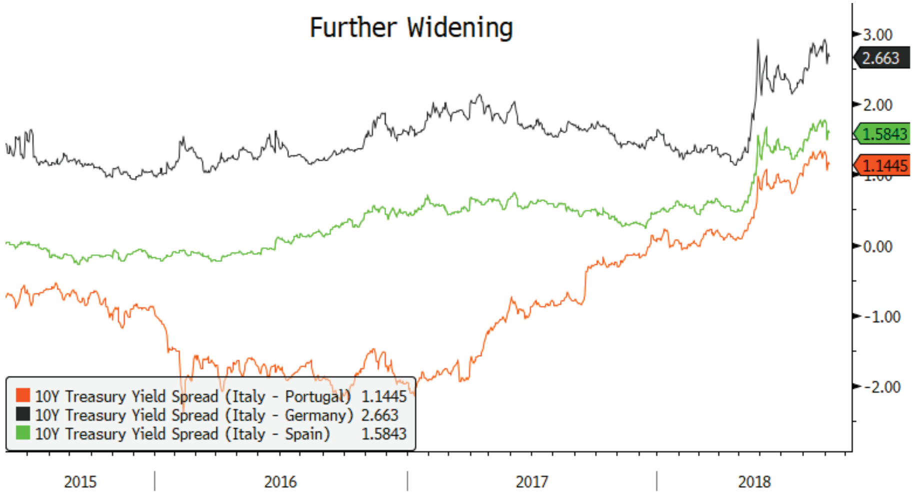
Italian economy is shaky, and the situation is probably not going to improve, even after June 2018 election period. Budget talks including Prime Minister Giuseppe Conte, Finance Minister Giovanni Tria, Deputy PMs Matteo Salvini and Luigi Di Maio started this week and Rome is due to provide its new public budget and economic growth expectations for 2019 by 27. September 2018, a draft that will be directly sent to EU Brussels-based commission in 15. October 2018 and that will most certainly generate considerable press commentary and attract investor attention.

Indeed, when looking at Italian treasuries (BTP), it appears that investors are starting to get nervous and rating agencies are making this known. Fitch, usually known for being the softest among the three agencies, recently published a negative outlook for the Italian economy after applying a downgrade of BBB to Italy's sovereign debt last April 2017 amid mounting political risks. The credit agency also confirmed that five Italian banks could have their credit ratings cut by year-end due to further vulnerability if the Italian coalition would move forward with its fiscal stimulus plan.

Based on prior estimates from outgoing Italian government, budget deficit target was given at -0.80% of GDP, a measure that is certainly expected to rise as the new government is now in place. The measure could even reach -1.50% of GDP, as Salvini's and Di Maio's requests to respectively implement a 15% flat tax rate and increase welfare payments for poorer social classes will necessarily widen budget deficit. The move would necessarily worsen the situation, keeping in mind that Italy remains the second largest debt-bearing state after Greece with a colossal debt estimated at 133% of GDP (€ 2.3 trillion) or 24% of the total 19 EU monetary union states.

Therefore, the outlook of a strong euro by year-end is hard to imagine but rather the opposite. Although fiscal stimulus plans could be set aside on Italian side, rumors are mentioning that the country would be asking for further support from the ECB, specifically if the country does not reach its deficit target set, pushing further pressure on the EU. Additionally, the perspective of Spring 2019 EU Parliament elections could be worrisome, as growing support for populist parties emerge across the Union.

Accordingly, EUR/USD is expected to decline further, as the single currency perspective could be skewed to the downside, despite current temporary optimistic tone related to the Brexit process. The pair is heading along 1.1550.



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