WEEKLY MARKET OUTLOOK

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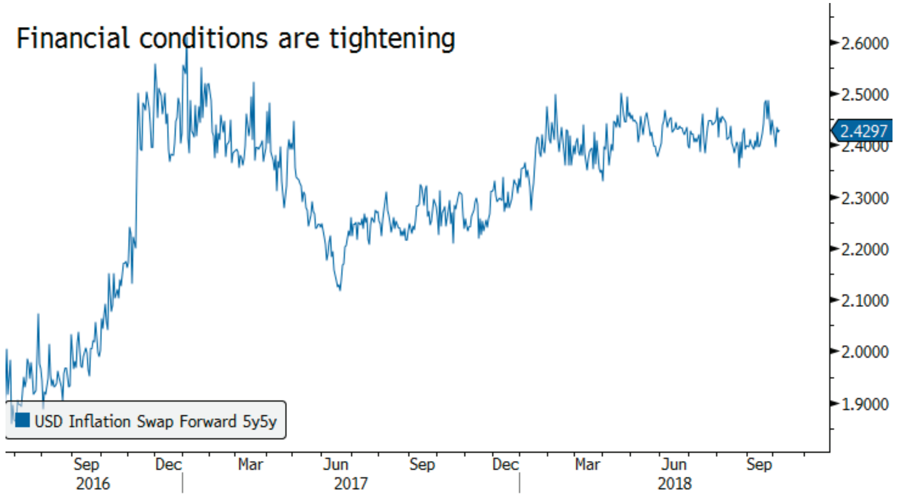
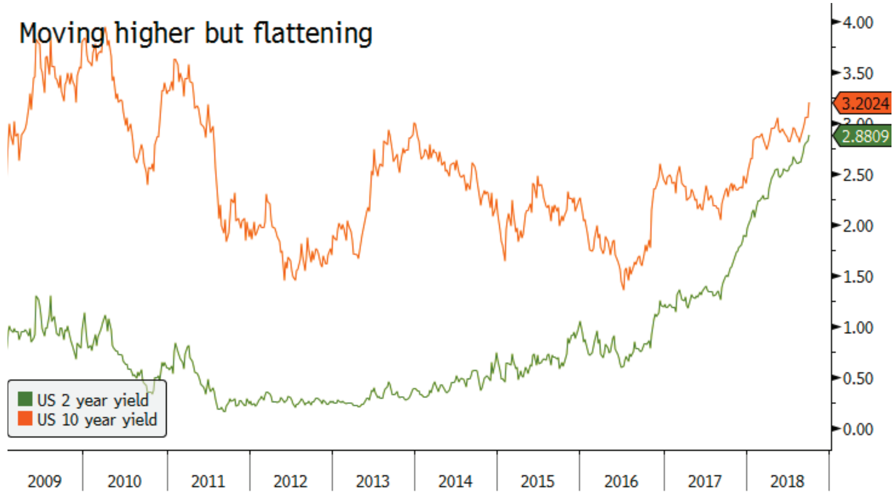
WEEKLY MARKET OUTLOOK - An Overview

FX Market

US Rates Move Higher

While some are claiming to fully understand why US yield were blowout yesterday, we are still scratching our head. 10-year treasuries surged to 3.225%, adding 0.12% overnight. USD bulls charged, bidding up the greenback versus developed and developing currencies alike. Worries of a slowdown trade tensions were nowhere to be found. Markets now expect a steeper rate curve in 2019 with additional rate hikes. Federal Reserve Chairman Jerome Powell boosted the sell-off, saying he is "very happy" with the "remarkably positive" economy, adding that the expansion might "continue for quite some time". Analyst are attributing the move to strong US data, hawkish Powell comments, technical factors or even possible demand for return premia. Yes, significant corporate issuance, higher dollar funding basis and even mortgage convexity hedging issues could all have provide reasons to push up the curve. All factors have a bit of truth, so your guess is as good as ours. However, given the expected heavy US issuances between sovereign and corporate we suspect that markets are getting crowded and solid US data just provided a push. Importantly for midterm, rates markets are driving real yields higher, indicating tighter financial and indirect monetary policy tightening. Interestingly the neutral rate (r*) jumped out of its range as the markets are pricing in an increase (US 5y5y real yields). The Fed has soften their own language around estimates of neutral rate, which has given the market room to re-forecast key levels. It's important to realized that the rise in rates is not just a US phenomenon. European yields have general kept pace limited spread widening. The correlation between US yield and USD and equities will eventually to turn negative. Right now higher yield represent firmer expectations for US growth. However, higher interest rate (US 10-year yields around 3.50%) also pressure financial conditions, which should weigh on stock valuations. Historically, equities do not raise in harmonization with rates. We hate getting caught watching the short-term but perhaps this is why we are seeing S&P 500 falling.....





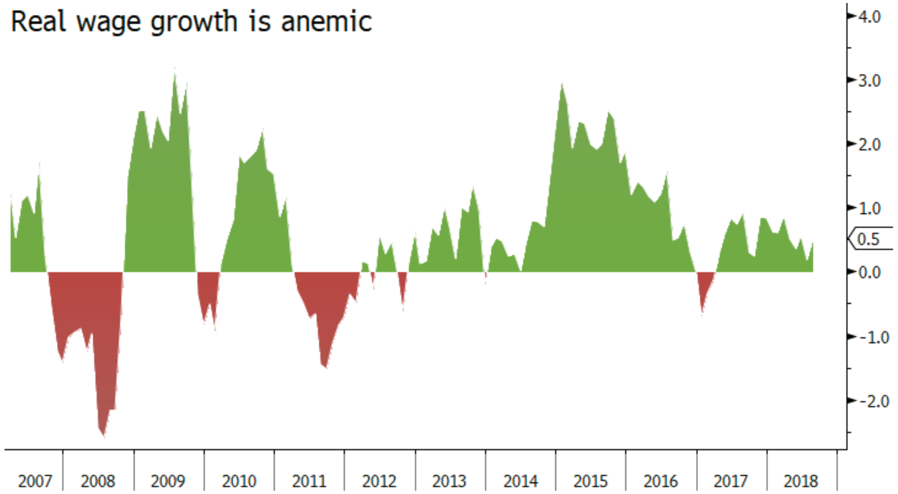
Economics

US Inflation Puzzle Persists

Over the past few months, the US job report has taken the back seat as investors' attention was inevitably drawn towards the trade conflict between the US and its main trading partners, mainly China. It has been months now that all indicators have been on green in the job market. The unemployment rate has reached 3.7% in September, the lowest level since 1969. On the inflationary side, even if developments have been more sluggish than expected, inflation has been moving in the right direction with the core PCE getting closer to the 2%y/y threshold – PCE core hit 2%y/y last August. This goldilocks scenario allowed the Federal Reserve to hike interest rates eight times over the last three years. According to the latest projections from the FOMC, this cycle would most likely stop in 2020. By then the Fed funds rate would have reached around 3.4%.

The market has now accepted the fact that the Fed funds rate will stay above the 3% mark in the longer-run - the level that is seen as neutral by the Fed. So what will drive exchange rates in the coming months/years? The US dollar has had a nice ride since the beginning of the year but has been unable to extend gains lately despite widening interest rate differential against most of its peers. One can argue that the Fed balance sheet unwinding will become the main driver for the buck but we believe it would mostly affect EM currencies, as DM countries are also (slowly) moving towards tighter monetary policy conditions. In fact, we believe that developments in the job market and in inflation will remain key drivers. Indeed, the tighter job market has failed to push real wage higher so far, which could act as a drag on inflation in the longer-term. Therefore, the Fed will remain sensitive to inflation developments.

In September, wage growth eased to 2.8%y/y, down from 2.9% in the previous month, which roughly matches the 2.7%y/y rise in headline inflation over the same period. Real wages are still stagnating and we don't see any reasons for this fact to change.



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