FOREX WEEKLY REPORT

14 - 20 July 2014

DISCLAIMER & DISCLOSURES

FOREX WEEKLY REPORT - An overview

Economics

Is current US monetary policy "too easy"?

Wu & Xia's shadow rate suggest little Fed flexibility

A recent study by Wu & Xia gains traction in discussions on Fed and its extra-lose zero-rate policy augmented by unprecedented unconventional measures. The study is the extension of Fisher-Black (1995), which first suggested that zero percent is not the lower limit for nominal interest rates. Beyond the observed Fed Fund rate, the markets should evaluate the "shadow FF rate", which can be explained as the difference between the nominal rate and the value of a call option on cash with zero percent return. Xia and Wu estimate the shadow rate at -3.0% in 2014.

St Louis Fed President Bullard had asked "Is current US monetary policy "too easy"?" on November 2012 in Washington University. At that time already, the answer was yes. Today, it seems to be a deeper yes. Almost after two years, the Fed policy remains too expansive still and part of Fed members think this way; indeed the Fed dots settled a steeper policy path in June 17-18th meeting. However the FOMC minutes showed that the participants are not fully convinced on US recovery strength to start talking about a proper tightening yet. Minutes showed that US policy makers agreed to end the asset purchases program by October, yet also to keep the favorable financial conditions to sustain recovery. Some policy makers were concerned about the low inflation in Euro-zone and Japan that may damage the US inflation outlook. Fed participants continue anticipating the US PCE inflation below 2.0% over years ahead. Many of them sounded in favor of keeping the wide spread (20-30 bp) between interest rates on excess reserves (IOER) and reverse repo rate (RRP). Indeed, as long as there is enough liquidity in the markets, the IOER will be an efficient ceiling to short-term rates, while the RRP stands for lower band. Now, as banks has access to both tools while other financial institutions only use RRP, a higher IOER will continue pushing the liquidity towards banks, in hope to see this liquidity transmitted to real economy.

This said, the critical question is still not answered: when will the Fed start normalizing?

Markets will keep seeking the answer in the US economic data. After the recent meaningful improvement in US unemployment rate (6.1% in June) and the successive good NFP readings, economists revised their expectations in favor of sooner start of Fed normalization (the most aggressive players are already betting for the first Fed hike in Q1). Nonetheless, despite supportive labor data, the Fed should make sure that the economic recovery is well anchored. Some officials are well aware of the restricted flexibility the Fed has in dealing with new potential financial shocks. With the nominal rate at the zero lower bound and the CPI inflation already above 2.0%, we would not bet too much on a hawkish surprise from Yellen-the-dove nor her policy-mates.

Economics

Turkey Central Bank is expected to cut rates on July 17th

Is the macro-environment appropriate for further rate cut?

Turkish industrial production unexpectedly contracted by 1.0% m/m in May, pulling the yearly production pace down to 3.3%. Post production data, the average repo rate hit 8.01% in Istanbul for the first time since January 28th (the day before CBT emergency rate hike amid lira hit 2.39 vs USD), signaling that the markets can bear up to 75 basis points cut. USD/TRY retreated to 2.1150 on July 9th.

The rationale behind the "stronger" TRY story is crowded. Some think that the slowdown in industrial production should weather the domestic demand, thus the inflation dynamics over the next months. Lower inflation should pave the way for lower rates to revive the weak industrial activity and to boost growth. Higher growth perspective should, at its turn, attract international capital flows and thus, is TRY-positive. The current account data reinforced this reasoning as short and long-term foreign financing remained well sustained in May. Moreover, the steep improvement in the current account deficit signals that Turkey is now facing a period of economic activity slowdown, mostly due to lack of investment and even disinvestment.

We continue believing that the real reason behind the TRY strength is as simple as the international carry flows still favoring the high yielding EM – thus TRY and TRY holdings. Among the most popular carry currencies, Turkish lira pays the highest nominal interest behind Brazil. The official repurchase rate of the CBT is 8.75%, however the yearly inflation is at 9.16% leading to negative real rates unlike Brazil's 11.0% Selic rate and 6.52% y/y inflation. In this respect, the Central Bank of Turkey predicted the beginning of inflation cool down from June which would justify the latest 75 bp cut. However, the CPI y/y retreated slightly to 9.16%, instead of 8.80% anticipated by economists (& still lower than Swissquote's official forecast 9.50%). What a disappointment for cheap-money-based-growth hunters!

Moreover, the ongoing tensions in Iraq and the consequent higher and steeper energy curve are no good news for Turkish growth perspective, nor for its inflation levels. Finally, the political uncertainties before Turkish presidential elections (due in August) rise the negative volatility risk in TRY, therefore reaching a disinflationary frame in months ahead becomes more challenging. The above-stated factors strongly require a hawkish stand from the Central Bank of Turkey in July 17th meeting.

The decision on July 17th

The Central Bank of Turkey will meet on July 17th and is expected to proceed with further policy easing. Given the heavy pressures from the ruling AKP government, we expect an additional 50 basis point cut on weekly repo rate, the overnight corridor should be kept steady at 8.00-12.00% especially on the upper end. These "moderate" rate cuts carry important mid/long term stability risk. The failure to reverse down the inflation dynamics will result in need for longer period of higher rates to temper both lira weakness and the overheating inflation in the foreseeable future. The Central Bank of Turkey should think twice before proceeding with further "moderate" rate cuts. Growth is a mid-long term goal; the fragile capital flow dynamics cannot build a healthy base to take advantage of carry friendly environment.

Economics

Portugal situation: certainly not a game changer

No surprise: the peripheral risks are nothing new

The recent rush into Euro-zone's peripheral stocks and bonds went well beyond the rational. The significant narrowing in yield spreads between core and periphery bonds was alarming, yet the additional ECB stimulus successfully distorted the risk sentiment in EZ bond markets. Over the past months, the 10-year yield spreads between Spanish /Portugal vs. Germany fell to their lowest levels in more than four years, the 10-year Italy-Germany spread hit three year lows. The risk premiums were and are still mispriced; besides the ECB stimulus we see no meaningful reason to favor peripheral debt over the core. The yield spreads are not proportionate to relative sovereign risks, any negative news thus generates panic across the entire Euro-zone due to fragility of the financial situation. Unfortunately for Portugal, the Espirito Santo Bank has been the first to come under the spotlight, yet the majority of peripheral countries face similar concerns vis-à-vis their banks.

Today, investors' cheap-liquidity appetite curb as these insolvency risks materialize. This is bad news for victims of their appetite, yet good news for rationality. Interestingly, the Fed minutes released on Wednesday highlighted US policy makers' concerns about the inconsistent risk appetite and they were right. However we do not think that this situation is ready to change yet.

Who said the risk is unbearable?

There are two possible scenarios ahead of us: 1. The Portugal situation will either gain traction to increase the contagion risk across the periphery or, 2. this whole story will end up in a non-event and the core-periphery spreads will continue underpinning liquidity in the EZ. We overweight the second scenario and believe that the Portugal situation will perhaps have limited overall impact on markets. After all, it is all about the perception of risk. The financial setting is too profitable for investors to suddenly turn their back to this cheap liquidity/ easy money framework.

Moreover, the easy money is not only good for investors. The narrowing spreads in the Euro-area has also been encouraging in the sense that the peripheral countries could also benefit from cheap financing to fuel their economic recovery. This is the only way to reduce fragmentation in the heart of the EZ and the ECB has no choice but to make this happen. If the Portugal situation becomes contagious, the ECB will be brought to reconsider a broad based asset purchases program to ease the tensions. Who cares about risk?

FX Markets

Rates cut in Norway remains a remote possibility

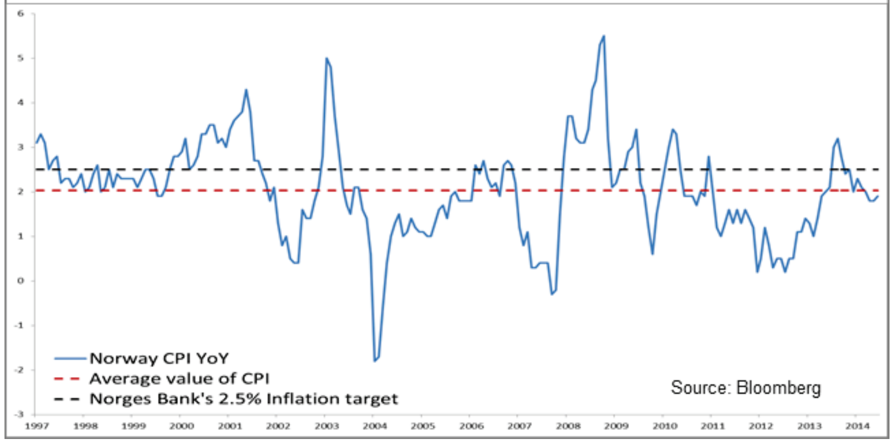
A rate cut remains unlikely in Norway

In June, the Norges Bank, the central bank of Norway, joined the club of central banks who manage interest rates expectations through communication. By anticipating no rate hike until the end of 2015, while leaving the door open for a rate cut should oil investment drop more than expected, the Norges Bank has also weakened the attractiveness of the Norwegian Krone. For the time being, the lower growth outlook from the Norges Bank anticipates oil investments to fall around 10% next year. On the other hand, Norway is one of the few countries which has a stable inflation near 2% (Norges bank's target is 2.5%). As a result, we suspect that a significantly weaker growth outlook would be needed to push the Norges Bank to cut rates. However, such worsening outlook remains unlikely. Indeed, several large projects scheduled to start near the end of 2015 should alleviate some of the downside risks on the growth outlook caused by oil investments. Furthermore, the housing market should remain resilient as households' ability to pay their mortgage debt is not at risk, as a drop in income (current wage growth is around 3.5%) and a sharp rise in interest rates are not expected in the next few years. Overall, as a rate cut remains unlikely, odds to see a sharp NOK depreciation are low.

Major resistances in USD/NOK and EUR/NOK intact

Looking at USD/NOK, the resistance area between 6.2720 (08/07/2013 high) and 6.3143 (04/02/2014 high) have thus far capped the upside. However, the succession of higher lows suggests an ascending triangle, which favours a bullish bias. In EUR/NOK, it is the December 2013 top, which has capped the upside. This resistance is strengthened by the 3 July massive shooting star (one-day bearish candlestick pattern). As a result, we suspect a limited upside potential. On the other hand, a decline toward its recent low at 8.0778 (10/06/2014 low) represents a probable downside risk. Given our rather resilient Norwegian economic outlook, we would favour a short position in EUR/NOK.

CPI in Norway remains stable close to its 2.5% target



EUR/NOK has successfully tested the strong resistance at 8.5459

Precious Metals

Avoid rushing into gold

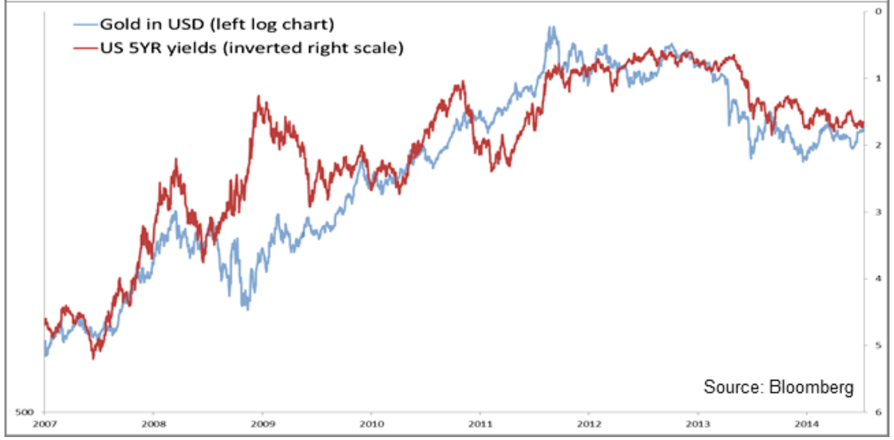
Subdued rise in gold despite a positive environment

The recent economic environment has been supportive for gold. Most of the major central banks (except the Bank of England) continue to remain very dovish, putting a lid on interest rates. Furthermore, geopolitical tensions have increased (notably due to the Ukraine and Iraqi crisis), favouring safe haven investments. Finally, physical demand has remained strong, while expectations of further Indian relaxations in gold import rules have increased among investors. However, despite all these supporting factors, gold appreciation has remained rather subdued.

US monetary normalisation represents a major threat for gold

Another reason for the muted strength in gold comes from the lack of participation by investors, who are uninterested by the low volatility and the lack of trend. Looking forward, the end of the Fed tapering process in October should trigger a steepening in US short-term rates as the first rate hike draws nearer. Meanwhile, the further expected improvements in US labour market and the upside risks in inflation suggest that the start of the tightening cycle is indeed coming in the US. This major negative factor for gold is expected to drive significant investors' outflows. Meanwhile, the aforementioned other supportive factors are unlikely to improve much. Furthermore, market positioning calls also for caution. Indeed, IMM data show a sharp increase in net long gold positioning in 2014, which stands now at 36.34% (standardised by the open interest), compared to an all-time highs at 50.90% in September 2009. Theses elevated levels represent significant obstacles for a further rise in gold. Moreover, even if there have already been outflows of roughly 35% in total ETF gold holdings since the 2009 peak, there is still a significant scope for long unwinding should gold move lower than its 2013 low. Overall, we would avoid a long exposure in gold, as our long-term 1181 (2013 low) downside risk could well be conservative. Among precious metals, palladium continues to offer much more upside potential.

The eventual rise in yields is bad news for gold



Sizeable long positions remain in gold ETF

CH-1196 Gland
forex.analysis@swissquote.ch
Switzerland
www.swissquote.com/fx

FX Markets

Short JPY positioning is being reduced

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 7 July 2014.

No major change has occurred in FX positioning, except a significant reduction in short JPY positions and net CAD positions moving into long territory. The reduction in short JPY positions reflects the increasing likelihood that the Bank of Japan will not ease in 2014. The net long CAD positioning, a first since February 2013, has notably been helped by the stronger inflation outlook, which may force the Bank of Canada into a more hawkish stance.

The Australian dollar has experienced a modest increase in its long positioning. The elevated net long AUD positions, coupled with an increasingly vocal Reserve Bank of Australia, are expected to act as significant headwinds for a further appreciation of the Aussie. The long positioning in British pound could also act as a short-term barrier as it leaves the currency vulnerable to less positive UK economic data.