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FOREX WEEKLY REPORT

7 - 13 April 2014

FOREX WEEKLY REPORT - An overview

Economics

Will the ECB eventually stop talking about it and do it?

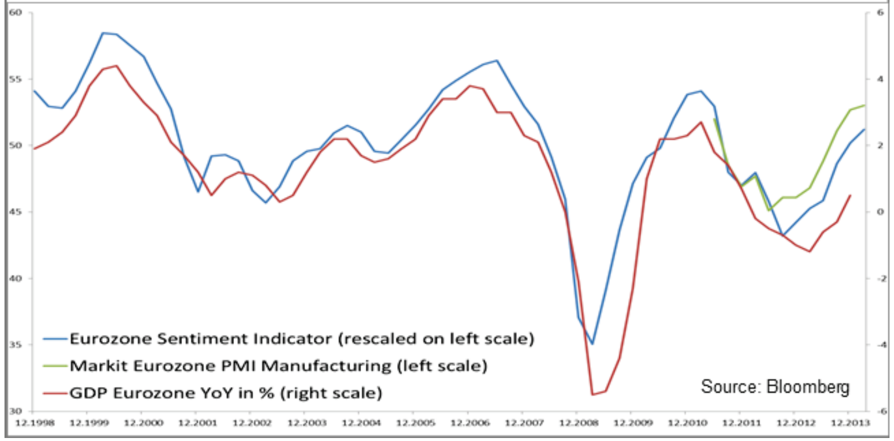
The ECB remains on the sidelines

Despite a new cycle low in European inflation at 0.5%, the ECB has abstained from any easing measures. This decision confirms a certain tolerance to low inflation from the ECB while focusing on the improving growth outlook. Furthermore, it has to be noted that the new low has more to do with the timing of Easter (usually inducing a rise in travel and hotel prices) than a worsening of the inflation outlook. As a result, the next month is expected to be supported by this transitory positive effect. Meanwhile, recent PMI indicators and sentiment indicators continue to suggest a persistent gradual recovery.

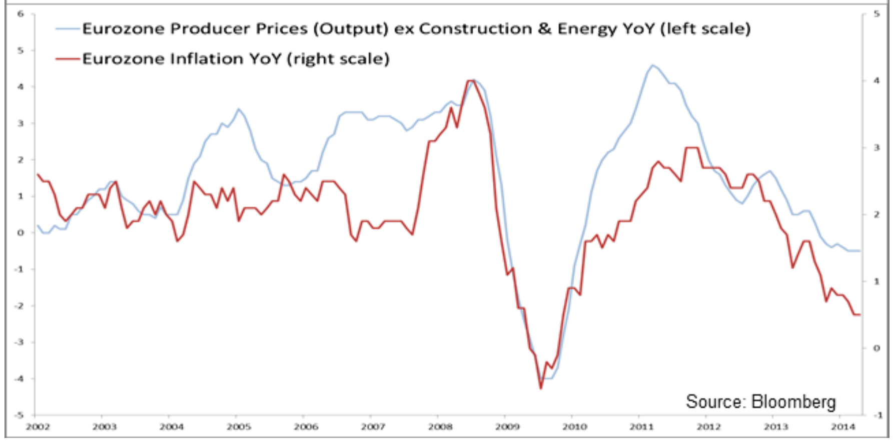
Can the ECB rely only on words?

The caveat to this recovery is that it will likely be a slow process. The recent unemployment data in the Euro-zone confirms that the current recovery has hardly led to any significant improvements in this area. As a result, persistent high unemployment in many European countries will continue to act as headwinds in wage growth and, consequently, on inflation, favouring an extended period of low inflation. In that respect, Mr Draghi explicitly added that the Governing Council unanimously recognised that such "too prolonged period of low inflation" would be a trigger for action. Therefore, even though the ECB keeps on showing reluctance for any concrete form of easing, we continue to believe that the persistent low inflation will eventually force the ECB to actively ease. The shape of the unconventional stimulus should depend on the inflation outlook. Should it be very dire, a large-scale QE could be launched. Otherwise, the ECB is likely to focus on measures to boost banks' lending to the real economy (SME in particular).

Growth outlook unlikely to prompt action from the ECB



But inflation outlook should force the ECB to action



Economics

More normal monetary policies are slowly approaching

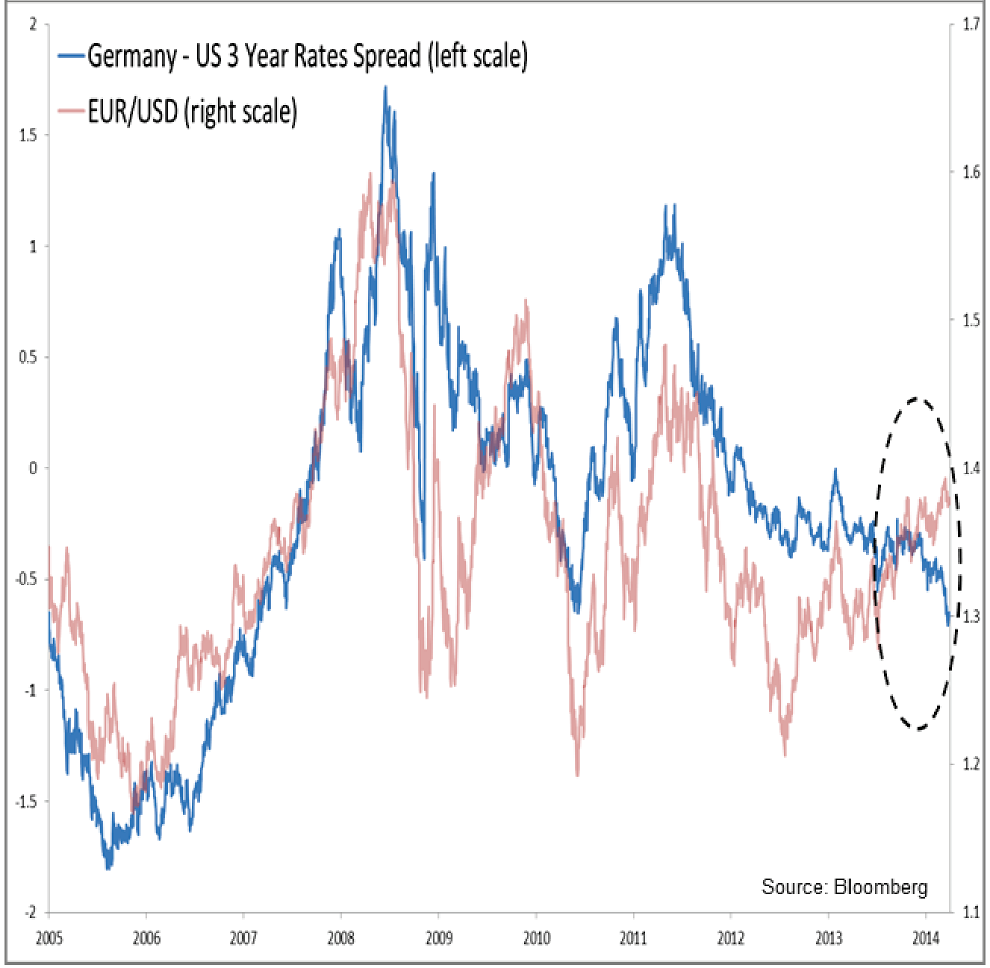
"Classic" FX drivers are expected to make a come back

One of the key relationship in FX markets is the one linking a FX cross with its respective rates differentials. In the last few years, the massive easing monetary policies set by many central banks have had a major effect on FX crosses. However, with the Fed on its way to end its asset purchases programme in 2014 and with the Reserve Bank of New-Zealand starting to raise rates, signs of a move towards more normal monetary policies are increasing. As a result, "classic" drivers of rates differential, like growth differentials, are likely to come back to the forefronts. Indeed, as the economic recovery is gaining traction, central banks in many developed countries are starting to work on the timing of a gradual shift toward more normal monetary policies.

Robust US growth favors a stronger USD

Looking at the four major currencies, the Euro and the Japanese yen are likely to be dragged by their rate outlooks. Indeed, both central banks are nowhere near raising rates as they are fighting a low inflation environment. On the other hand, the US and the UK are quite comparable in their growth outlook, suggesting a rather neutral stance on GBP/USD. However, the more balanced nature of the US recovery compared to the UK is likely to favour more upward pressure on US rates than on British rates. Overall, with extraordinary monetary policies slowly coming to an end, we see the US as the fittest economy to stomach a gradual rise in interest rates. As a result, we continue to see compelling reasons to support a higher US dollar in the longer term.

Rates and FX divergence is likely to matter in coming months



Source: Bloomberg

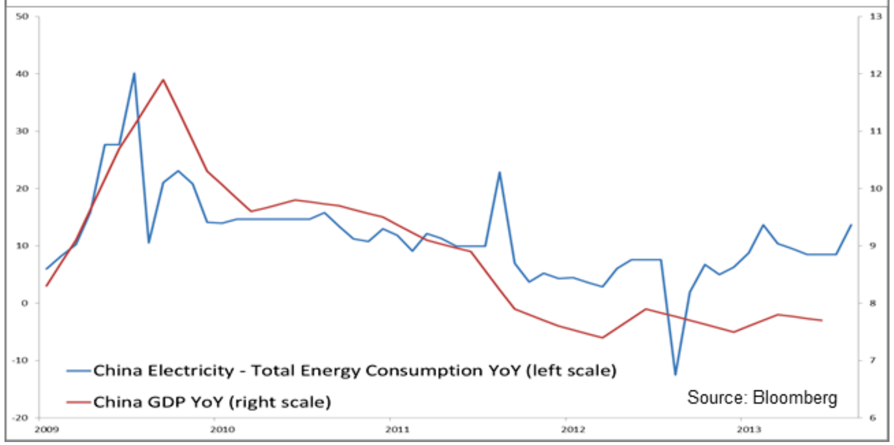
FX Markets

China policy will stabilize growth

In the first part of 2014, commodity indices have performed fairly well considering the significant drop in industrial metals. In particular, with concern over Chinese growth reemerging, China's sensitive commodities, particularly copper, came under heavy selling pressure, while the widening of the CNY trading band intensified the sell-off. Yet sharp rallies in the price of gold, silver, energies and food have held up the rest of the commodities complex. There are clearly reasons to believe that there are further upsides in commodities as capital rotates from government bonds and stock investments. This week, the Chinese government unveiled a combination of spending moves aimed at stimulating their faltering economy. This spending will focus on upgrading low income housing, tax relief for small business and infrastructure, aimed directly at increasing GDP. Despite the dire economic predictions with policy more growth supportive, we anticipate China to accelerate after a weak Q1. So far the spending level is nowhere close to late 2008's stimulus package that allowed China to rebound from the global economic downturn. However, there is a fresh emphasis on the immediacy of the short-term and keeping growth around that 7.5% target, rather than just blind support for economic reforms plans. We suspect that should growth continues to decelerate China will enact other stimulus including attempts to attract foreign investments, fast tracking infrastructure projects, keeping policy loose despite financial risks. As China stabilizes, commodities prices should continue to benefit. In addition, globally monetary policy remains extremely loose and further policy action in Japan and Europe (or at least strong forward guidance) are anticipated, allowing growth to improve. In the US, the economy looks to have survived the recovery disrupting winter and should rally in the coming quarters. The speculation of a tighter Fed policy has not sent investors from overvalued stocks and bonds, both sensitive to Fed adjustment. Interestingly, despite the rising yields we are not seeing a strong demand of USD which is generally negative for commodities prices. We suspect we should still see a sustained rally in commodities, led by the much maligned industrial metals.

Copper has come under heavy selling pressure

Electricity consumption is supportive for GDP



Economy / FX Markets

AUD/USD heading towards 0.9600

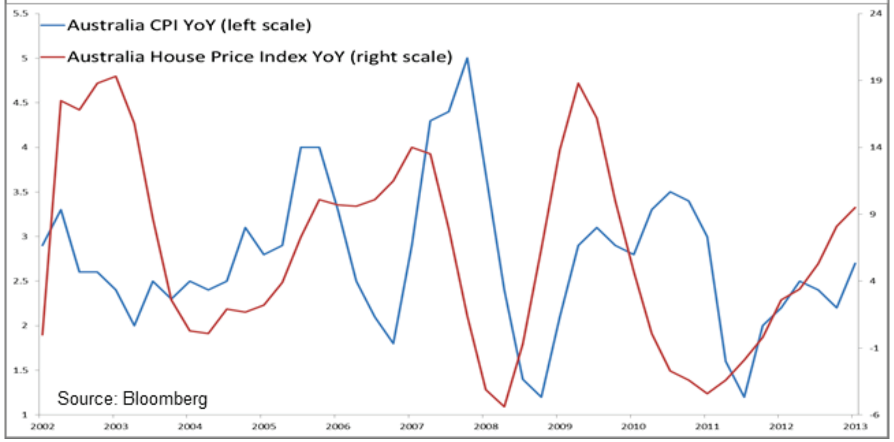
Further rates cuts unlikely in Australia

After bottoming in late January 2014, the much smeared AUD has slowly recovered. After peaking in 2013, mining investments have slowly unwound, China growth stalled and commodity prices remain under pressure, dragging growth down. Yet with the RBA cash rate at a record low 2.50%, there are signals that economic activity is increasing, as well as diversifying away from the resource development sector. In addition, inflation has risen quickly as the economy recovers and the weaker AUD are reflected in prices. While growth remains fragile, the RBA is unlikely to act with lower rates, as housing is in the middle of a boom and consumers are heavily indebted. Instead, the RBA might choose some lending controls and/or verbally manage the AUD from becoming too expensive (further fueling inflation).

Further upside seen in AUD/USD

On the 1st April, the RBA reiterated (only with minor changes) its 'neutral' bias and opinion that "the most prudent course is likely to be a period of stability in interest rates". Consequently, with China stabilizing, Australia can further rely on exports to their largest trading partner. From a global perspective, with the USD not significantly gaining, as was highly anticipated, and from the prospects of Fed tightening, we suspect that the AUD/USD can climb to 0.9600 before the RBA gets uncomfortable. Currently we continue to anticipate that the RBA will stand on the sidelines in 2014, before initializing to normalization rates in early 2015. However, should the upward trajectory of recent data continue, the RBA will be forced to act sooner than expected.

The housing boom supports a higher inflation



AUD/USD has validated a 3 month base formation

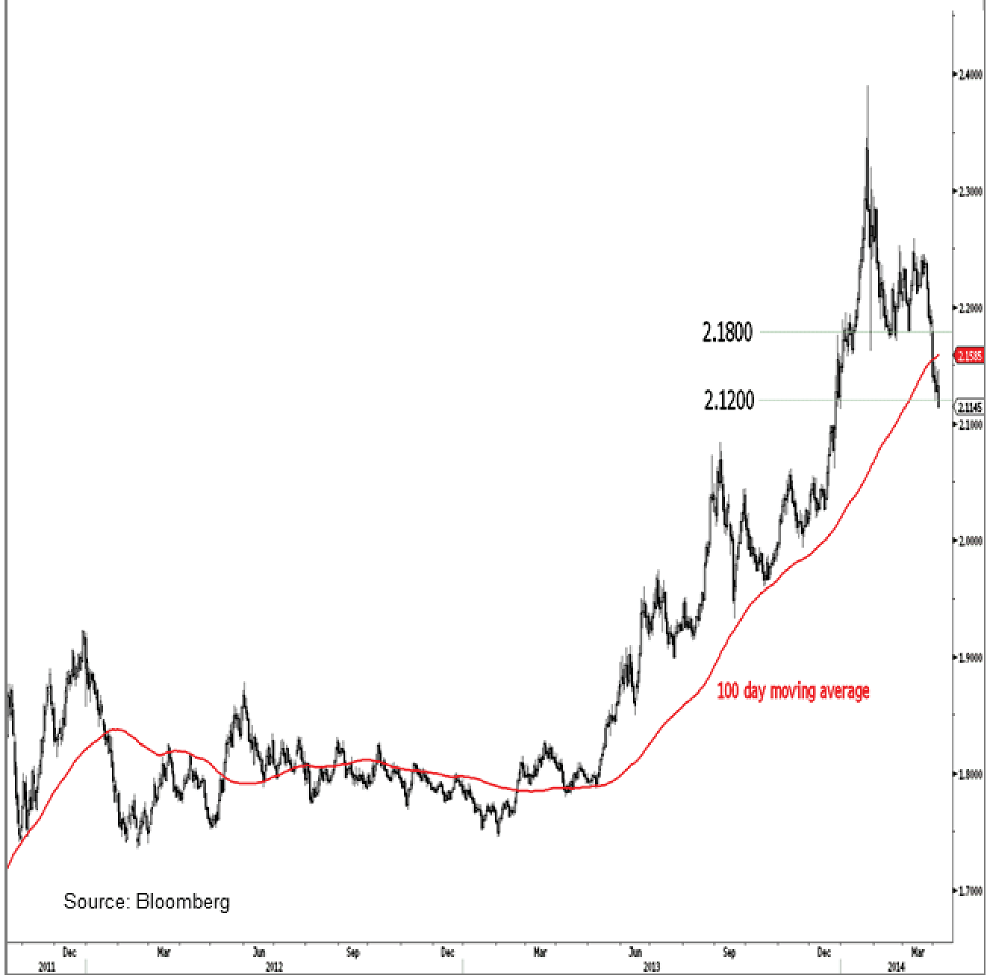
FX Markets

Erdogan urges for lower rates despite quickening inflation

Turkish consumer prices accelerated from 0.43% to1.13% month-on-month in March, from 7.89% to 8.39% year-on year. The CPI core hiked from 8.43% to 9.32%, the highest since April 2007. Pre-election uncertainties and the rising political / social unrest lifted the inflationary pressures in March, especially given the downside TRY volatility. Now that the municipal elections are over, the jittering in TRY should ease at least in the short run. Post-election TRY rally sent lira to end-2013 highs versus USD this week. Although markets gave limited reaction to CPI hike, the PM Erdogan's demand for lower interest rates pulled USD/TRY up to 2.1463 on April 4th.

In the coming days, the post-election rally in USD/TRY should slow down to rectify this week's overbought conditions in TRY versus EUR & USD. Regarding the USD/TRY chart, the psychological support should hold still at 2.1000 versus USD. More importantly, if Turkey Central Bank's goal is to fight the current account deficit, a lira approaching 2.1000s will fade expectations on hawkish policy action from the CBT, pushing USD/TRY back above 100-dma levels (currently at 2.1588). Regarding the price dynamics, if TRY strength is preserved in 2.1200/2.18000 band, the improved investor confidence and fading energy prices should help cool down the upside pressures on unprocessed food prices due to risk of drought in coming months. Decent option barriers pre- 2.2000 should keep the upside limited in April. In addition, if the Fed expectations remain balanced, we believe that CBT will keep its liquidity tightening / lira supportive tools (i.e. interest payment to TRY RR holdings) on the shelf. PM Erdogan can take a breather and smile.

TRY rallies to 3-month highs post-election



FX Markets

Kiwi eases from 32-month high

NZD/USD hit 32-month high of 0.8702 on April 1st yet failed to extend gains given the soft Global Dairy Trade milk auction result. In fact, we see accelerating decline in spot and forward dairy prices since mid-February and April 1st auction recorded the biggest fall since mid-2010. This is clearly not supportive of New Zealand's leading export market, yet the impact on NZD's bullish momentum is expected to remain limited given the RBNZ lean towards further rate hike at future policy meetings. And the rate action is, in our view, a more sustainable reason to long NZD.

March 25th CFTC data witnessed significant incline in NZD speculative longs, reaching the highest levels since May 2013. Although the high volumes of speculative longs increase the magnitude of potential sell-offs, the broader ascending trend suggests stronger NZD (in line with supportive RBNZ policy). In the short-run, the sharp reversal in trend momentum suggests deeper downside correction in NZD/USD. The first line of support should come into play at 0.8544 (Oct 2013), then 0.8502 (Mar 20th low & optionality). In mid-run, we keep our bullish view in NZD and shift our target to 0.8745 (Fibonacci 123.6% on Aug-Oct 2013 rally).

AUD/NZD tests the broad bearish channel top & 100-dma (1.0815) on the upside. While the short-term dynamics suggest the extension of gains, we keep our bearish view in AUD/NZD and see decent resistance pre-1.1000 (psychological level).

FX Markets

Swiss franc long positions are getting very elevated

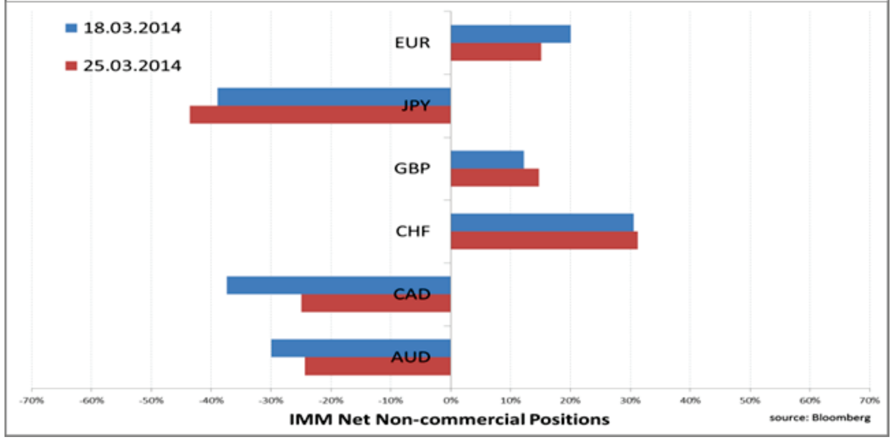
The International Monetary Market (IMM) non-commercial positioning is used to visualise the flow of funds from one currency to another. It is usually viewed as a contrarian indicator when it reaches an extreme in positioning.

The IMM data covers investors' positions for the week ending 25 March 2014.

No major changes occurred compared to last week. Among European currencies, the Euro saw some reductions in its long position. Meanwhile, long positions in the British pound have slightly increased (+14.71%) and are approaching levels associated with the January 2013 peak (+20.79%). The Swiss franc saw also a slight increase in long positions and is getting near extreme long positioning. As a result, we see significant hurdles stemming from this high long positions for any sustainable appreciation in CHF.

Commodity currencies have been bought, reducing their net short positions. Even though the previous extreme short positions could lead to further strength in these currencies, we remain sceptical of a major trend reversal, especially in the Canadian dollar.

Reduction in commodity currencies short exposure



Long CHFposition is getting near extreme levels