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WEEKLY REPORT

30 June - 6 July 2014

DISCLAIMER & DISCLOSURES

WEEKLY REPORT - An overview

FX Markets

GBP has valid reasons to strengthen

The UK's semi-annual Financial Stability Report highlighted the risks behind UK's high level of mortgages and announced measures to temper the boom on the housing market. In his speech on 26 June, Carney insisted that "without policy action, the risk of excessive household indebtedness is material". The set of macro-prudential measures to cool down the housing market includes minimum down-payments and maximum debt limits for insured mortgages. In this respect BoE's FPC recommend to cap the proportion of mortgages at 4.5 times the income and no more than 15% of lenders' new home loans. The borrowers who have failed to repay their debts should be declined. Seemingly, these measures announced by Carney have been light enough to trigger a fresh wave of GBP demand. "If we were to put in place something that was restriction at three times, we would restrict more than half the mortgages that are currently being underwritten" said Carney in a television interview post-FPC. "That would not just slow the housing market, it would reverse the housing market, it would have implications for the recovery and it would do too much in our judgment" he said. On a side note, we highlight that, although the BoE doesn't see the housing debt as immediate risk to financial stability (perhaps not to create useless panic in the markets), Britons hold 1.28 trillion pound debt on their houses, which roughly equals 76% of the nation's GDP. You be the judge.

Have the lighter-than-expected restrictions been received as signal for earlier BoE rate hike? Perhaps. The MPC ambiguity and crowded communication from the BoE can only inject more volatility to financial markets as the expectations are not canalized towards a clear policy path. After almost one year of governorship, Pat McFadden, a member of Parliament's Treasury Committee compared Carney to an "unreliable boyfriend" (!)

The UK 1Q final GDP figures confirmed the previous estimate of 0.8% QoQ, the GDP YoY grew 3.0% (slightly below 3.1% est.). GBP/USD shortly spiked to 1.7016, rapidly recovered on narrower 1Q current account deficit (GBP -18.5bn vs. -22.4bn last quarter). The total business investments extended significantly for the 5th consecutive time (5.0% on quarter, 10.6% on year versus 2.7% and 8.7% expected), recording the longest expansion period over the past 16 years. This is good news for BoE hawks given that the major issues that the policymakers have been pointing out recently were slower exports and weak FDI. GBP/USD did not challenge fresh highs post-GDP but the breach of 1.7063 (June 19th high) is just a matter of time. On the EUR leg, despite post-FPC aggressive sell-off, EUR/GBP is still in the bullish recovery phase. Given the divergence in UK/EZ outlooks, we see limited upside with first offers eyed by 0.80456/0.80500 (21-dma / optionality).

FX Markets

Turkey cuts rate as Basci aims for flat yield curve

The Central Bank of Turkey cut the weekly repo rate (policy rate) by 75 basis points to 8.75% in June 24th meeting following persistent pressures from the government. The overnight corridor remained unchanged at 8.00-12.00% as well as the reserve option coefficients and required reserve ratios. In the policy statement, the CBT mentioned its goal to keep a flat yield curve until there is sizeable progress in the inflation outlook. The Turkey's headline inflation advanced to 9.66% in May with improvement foreseen from June. However, given the tensions in Iraq and higher oil prices, we do not rule out a surprise deterioration through the coming months. Turkey releases the June inflation numbers on July 3rd, the consensus is a deceleration of the headline CPI to 8.80% YoY, the core inflation is anticipated slightly faster at 9.90% (vs. 9.77% in May).

Fortunately, the unchanged overnight corridor, most precisely the higher band, is a good safety measure in case of emergency. Currently, the cheap liquidity conditions and the carry-driven EM appetite keep the lira well supported thus should curb the overheating prices to some extent. According to Basci, the depreciation in lira has stood for 3 ppts in inflation figures. Although the lira recovers (alongside with other high yielding currencies) the funding behind the TRY strength remains fragile and is contingent on Fed-related/carry-driven risk appetite. In case of reversal in international capital flows and the anticipated rush back into US dollars, the low Turkish rates will certainly discredit the lira. The asymmetric corridor should then provide the flexibility that CBT may need to control the lira volatility and sharp changes in the global trading environment.

Moving forward, we are ready for further cuts through the year-end, ceteris paribus. If the improvement in inflation dynamics materializes, the 10-year government yields should head further down. We do not expect to reach the pre-Gezi levels (6 – 7%) seen through May 2013, yet consider the extension of weakness towards 8.00-8.25% zone. If this is the case, the CBT should be tempted by additional 50-75 bp cut this year. We however see the o/n lower band intact.

The potential positive behind this whole Turkey story is the bullish boost in market sentiment. Should the country manage to take benefit of lower rates to reduce the current account deficit, we can talk about a new era for Turkey. For the moment, we keep our cautious stand vis-à-vis TRY and TRY holdings.

FX Markets

Choosing the right carry

Carry strategists favorite bet: BRL

The poor economic data out of the US increase popularity of carry trades, as the cheap liquidity conditions sustained by the Fed are expected to last longer. Among the EM currencies, the Brazilian real is certainly one of the favorite carry-long-legs, not only because the BCB prepares for Fed normalization by consequent policy rate hikes since last year, but also because of its commitment to sustain the real directly. Real trades at a month highs against the USD as the central bank pledged to support the currency at least until December 31st by offering 200 million US dollar worth swaps for every business day. Brazil's determination to fight its above-the-target inflation (6.37% YoY in May versus 4.5% YoY target +/- 2%) increase carry strategists' appetite in BRL and more importantly tempers the volatility risk should the international capital flows reverse. In fact, Brazil's Selic rate is at least twice more than its rate-setting Latin American peers. There is no secret for carry-lovers; BRL is the place to be.

TRY, RUB opportunities require solid nerves

The favorable carry environment benefit to lira and ruble as both currencies offer interesting returns due to higher rates implemented on several internal and/or external political and geopolitical issues. The carry spreads are thus motivating for long TRY and RUB positions (vs. USD, CHF, JPY and EUR), however the risk carried through these currency holdings are somewhat elevated due to ongoing uncertainties. At the end of the day, the carry spread is nothing but a small portion of the carry trade returns, the most important issue is to make sure that the long-leg exposure of the strategy doesn't wipe out gains through inevitable periods of carry unwinds.

The reason why we analyze TRY and RUB under the same title, is mostly due to the similar risk/rate history they have been recently subject to. Both countries' central banks proceeded with surprise and significant rate action in 2014 after their respective currencies depreciated to unsustainable levels due to numerous endo/exogenous factors. However today, the risk/reward picture diverges partially due to escalating tensions in Iraq.

In Turkey, the ruling government AKP is by hook or by crook persistent for lower interest rates (and the central bank is somehow obedient perhaps to avoid any political conflict with such governmental power). This is a risk for the Turkish rate spread as further rate cuts seem to be underway. Combined to the geopolitical turmoil in Iraq, the proximity and the high implication of Turkey across its eastern border and the threat on its oil imports, the lira risk adds to carry-spread risk. Hence, we conclude that the total TRY-carry-risk is getting relatively disproportionate compared to expected returns.

Obviously the situation is transposed for the energy-exporter Russia. Although the ruble is still subject to heavy geopolitical tensions in Ukraine and decent political pressure from the EU & US, the tensions in Iraq certainly appear at the right time for Russia. After record low levels recorded against USD and EUR on March (Crimea referendum), the ruble remains meaningfully below its past 5-year averages on both decks. Today, this depreciation gives advantage to long-RUB bets, first because technically the USD/RUB broad uptrend channel bottom (building since April 2011) stand at the distant 32.00 levels, thus giving the RUB sizeable room for further recovery (appreciation). Second, and most importantly, the Iraqi crisis is no more considered as a temporary, local conflict and thus should certainly weigh on global oil supply in the mid-run. The relatively cheap ruble and sustained demand for Russian oil is a safety bag for drastic ruble depreciation.

Stock Markets

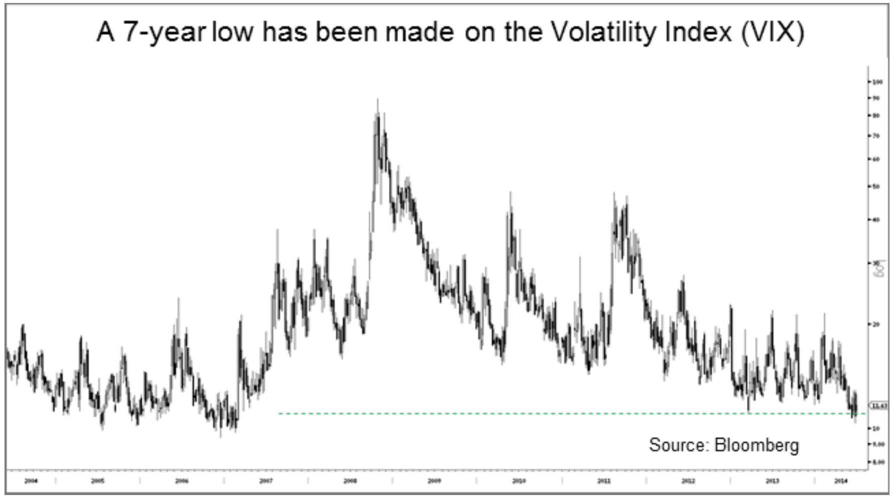
A technical take on the S&P 500

VIX moves to new lows despite Iraqi crisis

It would have been unsurpising to see weakness in the S&P 500, given the overextended nature of the rise and the rising uncertainties around the Iraqi crisis. However, for the time being, the US stock market seems completely unaffected by the potential downside risks linked to this event, as can be seen by the recent 7 year low in VIX. This "fear gauge" indicates that investors are not expecting a severe decline in the near future. It also suggests a certain type of complacency as investors less and less factor a risk of a significant correction. This development is even more impressive as the market is at all-time high levels and overbought on most technical metric.

Overbought but strong

However, overbought markets do not automatically mean that prices are heading for a severe decline. Looking at internal measure, like the Advance Decline Line, we note that it rises in sync with the market, indicating that the majority of stocks are confirming the market uptrend. This broad based rise is also highlighted by the recent new highs made by the S&P 400 Midcap index. As a result, the overbought levels in technical indicators should be seen as a confirmation of the market strength instead of a sign of vulnerability. Therefore, even if the US stock market is overbought and one-sided, we do not see the seeds for a severe market decline yet. We remain cautiously bullish on the S&P 500 with a target at 2000.



FX Markets

Persistent high prices in oil support a stronger CAD

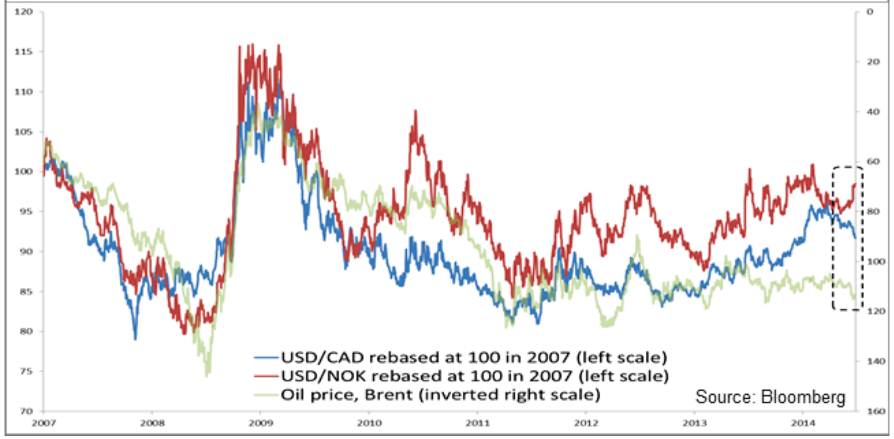
Canadian dollar boosted by the rise in oil

Among the major currencies, the Canadian dollar and the Norwegian Krone are the most sensitive to a rise in oil. However, since the Norges Bank has hinted at a rate cut, CAD is the favourite vehicle to benefit from a rise in oil. In that respect, the supply-side squeezed created by the tensions in Iraq should last as no sign of abatement is visible. Furthermore, demand for oil is unlikely to decline in Q3. As a result, the Canadian dollar could strengthen further on the back of elevated oil prices. But persistent high oil prices should also boost Canadian exports and the balance of payments. CPI inflation should also be lifted by rising oil prices, forcing the Bank of Canada to be more hawkish as policymakers revise the duration of the rise in oil into something less temporary. All these factors favour a stronger CAD. As a result, as upside risks in oil prices continue to dominate, USD/CAD is likely to face further downside pressures.

Where are the supports in USD/CAD?

Looking at USD/CAD, the break of the support at 1.0814 (08/05/2014 low) has ended a 5-week consolidation, confirming persistent selling pressures. A test of the key support implied by the long-term rising trendline (around 1.0630, see also the 38.2% retracement from the rise at 0.9633) is expected. Another key support can be found at 1.0559 (29/11/2014 low, see also the 38.2% retracement from the rise at 0.9407). Below these levels, the long-term positive rounding bottom would be invalidated, suggesting that the 20 March top at 1.1279 would likely mark the end of the CAD depreciation cycle started in 2011.

Positive correlation between NOK and Oil negated by Norges Bank



Can the nearby supports stop the decline in USD/CAD?

FX Markets

Long AUD positioning is getting elevated

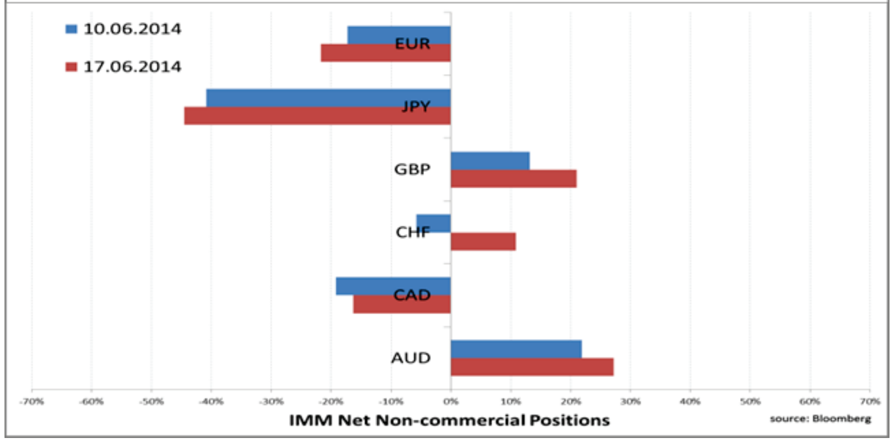
The International Monetary Market (IMM) non-commercial positioning is used to visualise the flow of funds from one currency to another. It is usually viewed as a contrarian indicator when it reaches an extreme in positioning.

The IMM data covers investors' positions for the week ending 17 June 2014.

The net short Euro positioning has further increased. The sharp decline since May is a significant obstacle for further short-term weakness in EUR/USD, and leaves EUR/USD increasingly sensitive to any positive EUR or negative USD news like the recent dovish speech by Fed Chair Yellen. The Swiss franc has been heavily bought, moving from a short to a long positioning. However, the decline in EUR/CHF, though persistent, remains slow in pace. As a result, the 1.20 threshold is far from being jeopardised. The British pound net long positions remains elevated. Given the major resistance at 1.7043 (05/08/2014 high) in GBP/USD and the recent less hawkish comments by Mr Carney, the cable seems vulnerable to a short-term correction.

In the commodity currencies block, a sharp 1-week decline in long NZD positions (from 51.16% to 13.11%) has occurred after the 12 June hike from the Reserve Bank of New Zealand. This massive profit taking has not been an obstacle for buyers of CAD and AUD. The Australian dollar is approaching elevated levels while prices are close to the strong resistance at 0.9461 (10/04/2014 high) in AUD/USD. On the other hand, the Canadian dollar remains significantly net short, which is worrying given the persistent downward pressures in USD/CAD.

EUR and CHF positions are diverging



Carney's hawkish speech has lifted long GBP positions