Weekly Market Focus

HINDUJA BANK SWITZERLAND

10 January 2018

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ASSET CLASS REVIEW

The US tax reform will take effect at the beginning of 2018. The positive impact on the gross domestic product is estimated at one percentage point over ten years. Corporate earnings should benefit much more strongly. In the euro-zone, the economic indicators mostly sprang positive surprises. However, inflation is far from the European Central Bank's (ECB) target. Therefore, the economy shows no sign of overheating.

Economy

The leading indicators signal a solid real economic climate for 2018. Nevertheless, many financial market investors are becoming more and more skeptical, and the theory of financial instability is coming to investors' attention. This theory, developed by Hyman P. Minsky, an economist who was somewhat unappreciated in his time, says, "Stability leads to instability, and the more stable the relationships appear, the greater the destabilization when there is a crisis." According to Minsky, a financial market crisis is triggered by endogenous factors as defined in Schumpeter's theory of creative destruction, according to which a good starting point encourages investors to take excessive risks, which they finance with credit. At some point they fail to service the debt, and the speculative bubble bursts. Endogenous factors as the cause of financial crises are certainly intuitive. For every investment, the following are true: a) without risk there is no return, b) return and risk are inversely proportional to one another and c) the search for risk premiums leads to rising asset prices and falling risk premiums.

Thus, it is no surprise that Minsky's theory has once again come to investors' attention after a stock market boom that has lasted nine years. The asset price inflation, high valuations and negligible volatility. Will investors' complacency cause the apparent stability on the financial markets to revert to an unstable condition in the near future? The arguments above certainly led to a reduction in the risk premiums. Although we, too, are concerned about the heightened valuations, we do not consider this to be a threatening development.

One should not see a decoupling of the financial markets from the real economy, nor does the ratio between debt and capital costs – thanks to the expansive monetary policy – point to an imminent credit crunch. Against this backdrop, we consider the risk that the financial market forces are facing an immediate transition into an unstable phase with a sustained stock market slump to be small. The monetary policy tailwinds will ease off in 2018 but at a pace that the financial markets can easily handle. The globally synchronous growth remains above potential, and inflation is manageable. We continue to be constructive for risk assets in 2018. The potential for less stable or more volatile markets and hence falling risk premiums is possible as capital costs are gradually rising, and growth momentum will be heading towards its cyclical peak as of the second half of 2018.

While the Fed should raise interest rates three times in 2018 and is aiming to gradually reduce the balance sheet, the European Central Bank (ECB) is for now working on the ultra-stimulus measures such as reducing bond purchases. The Bank of Japan is even staying on the expansion track. The Chinese central bank has been pursuing a tighter monetary policy with extreme caution. There are still big differences in global monetary policies, but for all central banks the pressure to remain on an expansive course has eased considerably thanks to the positive economic outlook for 2018. How rapidly central banks normalize their monetary policies depends on the inflation trend. There is not yet any reason to hurry, and inflation is found where it is needed – and conversely. However, inflation is known to lag and is difficult to time.

FOREX

The USD is broadly reversing, the DXY finding decent support off its September lows since late last week. Commodity currencies are losing their allure judging by clear technical reversal patterns after a decent mid Dec rally. The market will be sensitive to Fed rhetoric and upcoming US macro figures for impact on the policy outlook. The March FOMC meeting currently discounts a 78% chance of a further 25 bps hike. Weakness has been on EUR crosses too. EURUSD's failure to trade through the 1.2090 resistance line has resulted in a 1.30%. EURJPY too has pulled back towards key support are at 1.3260. Long end US yields break higher through 2.50%. USDJPY continues to underperform as speculation grows for a change in BoJ monetary policy.

CHF

The SNB is expected to announce a record CHF54bn profit in 2017. Earnings at the central bank led by Thomas Jordan got a boost from holdings of foreign currency, which contributed 49 billion francs. The overall result dwarfs even the SNB's 2014 earnings of 38 billion francs. The valuation gain on gold holdings amounted to 3 billion francs, the SNB said in an initial estimate on Tuesday. The strong result is a consequence of the franc's 8.4% loss against the euro last year, the biggest annual decline since the common currency was created two decades ago. That boosted the value of the SNB's foreign exchange reserves, which it built up as it intervened to weaken the franc. Reserves totalled more than 700 billion francs at the end of November. The final result is due to be published on March 5. EURCHF again failed to sustain its gains above 1.1779, the December 17 high last week. Swiss inflation data for December remains static at 0.8% YoY. The SNB are unlikely to act on monetary policy ahead of the ECB, therefore the franc is likely to appreciate significantly which would put notable pressure on the Swiss inflation rate. For now it is the EUR side of the price that drives the EURCHF exchange rate barring any rise in geopolitical risk**.**

EUR

Recent inflation data from the Eurozone showed a 0.9% YoY rise in the core inflation measure, a disappointingly weak number that contributed to EUR appreciation pressure to evaporate. The ECB will be unwilling to act on monetary policy while the core rate of inflation remains stagnant. EURUSD enjoyed a late 2017 upswing in the wake of some hawkish comments by certain ECB members who pointed towards a "concrete end of the asset purchases". The market therefore has been disappointed due to higher inflation expectations. Perhaps the market got ahead of itself considering that only in October the majority on the ECB council had agreed to an extension of the asset purchases with an open end and sounded dovish at the same time. Thursday sees the minutes of the meeting on 14th December, which should divulge further information about the ECB thought. Despite the weak December core inflation, we see EUR as a buy on dips strategy over the medium term. Indeed it will be sometime until the ECB hikes interest rates, regardless of positive sentiment indicators and strong growth. Looking forward through 2018, we are constantly reminded that the Eurozone recovery is continuing at a steady pace, with a focus on when the ECB will signal the end of the APP. The current program set to end in September. Fair value levels based on the various PPP measures as well as FX swaps markets are seen to be closer to 1.2500, which is where the conservative targets for this year look to be.

Technically EURUSD failed at the 1.2092 now marking a potential double top formation. Prices have now eroded the 1.1960/55 support areas suggesting further weakness is in store for the common currency. Intraday rallies are expected to top at 1.1980 as downside momentum drives EURUSD back towards 1.1880/60 support which marks the 2017 trend line support. The overall bid does remain bullish but we see the current correction as a healthy pullback. As noted we continue to see higher prices for EURUSD during 2018 and wait for prices to bottom out out 1.1840/1.1810, the 55 mda before buying. Failure to sustain prices at this level could see a further clearout towards 1.1680 but we attach a low probability to this scenario. Objectives to the upside await at 1.2090 and through there 1.2220, marking the 50% Fibonacci off the 2014/2015 bear move**.**

GBP

Sterling pessimism is waning following the EU's December decision to commence the second phase of Brexit negotiations. Barring any setbacks, this is likely to remain the case. FX Options markets too reflect this tone as noted by three-month volatility levels. Weekly readers of this note will know our consistent buy on dips strategy since during 2017. This mood continues as we start 2018. The next deadline for Brexit negotiations that is currently under discussion is in October when it is hoped that the EUR and UK will have come to an agreement regarding trade. Little progress is expected over the near term for now, therefore market focus should turn towards domestic economic themes, BoE monetary policy and external factors such as the USD. There is little in the form of economic releases this week, only Industrial Production data on Wednesday. Next week brings CPI data for Dec 2017. Trading should remain light. Technically Cable is still pushing towards a retest of the 1.3600 handle, a breach of this level was short lived over the year end turn. Sterling optimism aside we do not envisage a sustained break through 1.3600 over the near term. Weekly indicators do indeed remain bullish, however the dailies suggest exhaustion judging by momentum indicators turning lower. Looking to the topside, through 1.3600 tough resistance awaits at 1.3850.

We prefer to wait for a pullback towards the 555 mda and the 2017 bullish trendline around 1.3300/1.3320 before assuming upside risk. A break lower through here would see a change in sentiment and a potential pullback towards 1.3030/50**.**

USD

The FOMC seem quite optimistic with regards to monetary policy for 2018. Recent comments indicate the following, Mrs Mester favours approx. four rate hikes in 2018, Mr Williams rather sees three, in a dovish speech this week Mr Bostic looks favours a “slow removal” of monetary policy stimulus, we can assume two. The FOMC members may not be singing from the same hymn sheet which may result in some volatility for the USD. Fed speakers this week see speeches from Williams, Bostic, Rosengren, Kashkari, Evans, Bullard and Dudley. This week market attention will be on the US inflation numbers on Friday. Judging by recent ISM manufacturing prices paid index expectations are for sustained levels above 2.00%. Energy may weigh on the headline CPI data due to gasoline prices slipping 3% in December. Remember Average hourly earnings were a touch higher last week so this coupled with a supportive inflation number may underpin the USD over the near term.

JPY

USDJPY and JGB Futures are falling following the BOJ’s tapering of its purchasing of longer-dated bonds resulting in Yen strength. PM Abe called on the governor of the BOJ Kuroda to continue to work towards a sustainable ‘reflationing’ of the Japanese economy. Kuroda’s term in office ends this April. Speculation about a change in leadership within the BoJ may be contributing to the uncertainty to BoJ Monetary Policy which in turn has been driving long-end JPY yields higher. A change in MP would no doubt make it much more difficult to sustainably anchor the rate of inflation at the target of 2%, so the market’s speculation of changes in MP may be premature. Technically USDJPY is breaking down having failed to trade higher through the 50% Fibonacci retracement and sloping triple top at 113.40/60. This area also marks the strong resistance trend line of the 2015/2017 down move. USDJPY now having sustained a break through the 112.00 support currently tests the 200 mda at 111.70/75. We see interim support here and would even attempt tentative longs, remembering recent performance of 10 year US yields while respecting tight stops through 111.45. Failure here sees stronger support at 110.84, the Nov 2017 low and 50% Fibo of the 2017 upswing. To the topside initial targets wait at 113.60/75, which guards further upside potential towards 114.70/75.

CAD

Canada saw a strong labour market report on Friday seeing 78k jobs been added in December and the UR lowering to 5.7%. USDCAD traded lower as a result but prior to the data already looked overstretched. Price action had seen 10 consecutive lower days and the cross was unable to sustain prices through the 61.8% Fibonacci level at 1.2389. USDCAD has retraced somewhat thus far this week but still within Friday’s range. The CAD nonetheless remains bid as rate hike expectations have jumped up notably, now 87% for the January 17th BoC monetary policy meeting. However there is a fly in the ointment. Despite the unemployment rate reaching its lowest level seen since the 1970s at 5.7%, some of this optimism is likely to have benefitted from the Christmas business, something that is likely to be corrected in January and affected further by the blizzard on the East coast in January. Moreover the fall in the unemployment rate is not leading to higher wages and thus price pressure in Canada either. The Bank of Canada has in recent rhetoric indicated that the recent rise in inflation was due to temporary special factors, mainly energy prices. It is likely that the BoC will further hike its key rate this year and may adjust some of its projections in the new monetary policy report in January, however it is possible that the bank may look through December’s labour market report and will want to wait for the future development of inflation. Risk reward errs on being long USDCAD into the meeting considering the percentage discount of a potential future rate hike. The 11 % strengthening off the CAD coupled with inflation likely to remain below 2% may hold the BoC’s hand steady.

Technically USDCAD has been adhering to the rules. Following the double top formation Nov/Dec the market corrected lower by 2%, stalling around the objective line at 1.24001.2390. Prices have bottomed out since then as fast cash positions reduce short risk into the BoC. The recent uptick from 1.2356 has broken the year end bear move, but whether this is a sustained move higher or merely a consolidation move is yet to be determined. We favour being long at 1.2430/25 with stops at 1.2390. Upside targets are 1.2610/15, the Nov 2017 low and 1.2730/35 the 55 mda. Risk to this is the BoC hikes rates by 25 bps with a hawkish communique.

VIEWS FROM THE TRADING FLOOR

Equity

S&P was up 2% on the last week, with a very little increase of the volatility moving from 9.77 to 10.08. On the upside, we find auto parts & equipment up 7.5% and oil & gas equipment and life science tools up 6%.

The stock markets began 2018 by an impressive rally, with US main indices advancing from a record high to the next one in each of the trading sessions. This week's rally followed an impressive 2017 campaign for Wall Street, during which the S&P 500 surged nearly 20%, and defused the belief that the new lower tax rates, which took effect on Monday, would invite some profit taking at the start of the new year. The minutes from the December FOMC meeting were released last Wednesday, showing that most FOMC members backed a continued path of gradual rate hikes. Some members even saw the possibility for more aggressive tightening due to the new tax code, which Fed officials expect will boost consumer and capital spending. The current probability for a rate increase announced at the March FOMC is around 68%.

S&P 500: The index has not corrected as expected in our last comment and it has reach its 2750 target. This strong bull trend will remain in place as long as 2600 remains a support. In the short-term we expect a correction toward 2700 and a possible extension to 2673. Any break of this level will probably lead to a test of the 2600 support.

Eurostoxx 50: After a break of the lower side of its trading range at the end of last year the index as very quickly recovered and is at the moment testing the upper side of its 3525 and 3615 trading range. A break above 3615 will lead to 3666 and possibly 3700.

EQUITY

Developed countries

		Total return - 1 Week
SMI	⬆	1.0%
Euro Stoxx 50	⬆	3.2%
DAX	⬆	2.9%
FTSE 100	⬆	1.0%
S&P 500	⬆	1.5%
Dow Jones	⬆	1.9%
Nikkei 225	⬆	4.4%

Developing countries

Russia/Micex	⬆	5.3%
India/Nifty 50	⬆	1.7%
China (HK)	⬆	1.7%

⬆ - Upward move ⬇ - Downward move

FIXED INCOME

Developed countries

	2-year Yield	10-year Yield
USA	2.0%	2.5%
UK	0.5%	1.3%
Germany	-0.6%	0.5%
France	-0.5%	0.8%
Italy	-0.3%	2.0%
Spain	-0.4%	1.5%
Switzerland	-0.9%	-0.1%

Developing countries

	2-year Yield	10-year Yield
Russia	2.4%	3.9%

COMMODITIES

		Total return - 1 Week
Crude Oil	⬆	10.6%
Gold	⬆	5.6%

CALENDARS

Economic Events

Date of release	Domicile	Event	Period	Actual	Estimated
10 January 2018	US	Import Price Index MoM	December	0.7%	0.4%
10 January 2018	US	Export Price Index MoM	December	0.5%	0.3%
10 January 2018	US	Wholesale Trade Sales MoM	November	0.7%	0.6%
10 January 2018	Germany	GDP YoY	2017	0.6%	1.1%

Contacts

Geneva – Headquarters

Hinduja Bank (Switzerland) Ltd

Place de la Fusterie 3bis
1204 Geneva, Switzerland
Tel. +41 58 906 08 08
Fax +41 58 906 08 00

Branches

Zurich
Florastrasse 7
8008 Zurich, Switzerland
Tel. +41 58 906 05 05
Fax +41 58 906 05 06

Lugano
Viale Serafino Balestra 5
6900 Lugano, Switzerland
Tel. +41 91 910 43 43
Fax +41 91 923 55 73

Representative Office

London
Room no: 117,
First Floor, Regus,
100 Pall Mall,
London SW1Y5NQ
Tel. +44 20 7321 5642

Subsidiaries

Switzerland
Rowena AG
Grenzstrasse 24
9430 St Margrethen, Switzerland
Tel. +41 71 747 49 59
Fax +41 71 747 49 51

Dubai
Hinduja Bank (Middle East) Ltd
Dubai International Financial Centre
Building GV 10, 2nd Floor, Office 205
Dubai, UAE 506783
Tel. +97 14 436 65 88

Mauritius
HBS Trust Services (Mauritius) Ltd
Hinduja India Mauritius Holdings Ltd
3rd Floor, 3B Citius Building,
31 Cybercity, Ebene, Mauritius
Tel. +230 465 54 79
Fax +230 465 64 19

USA
Hinduja Capital Advisors Inc
520 Madison Ave., 34th Floor
New York, 10022, USA
Tel. +1 212 355 07 55
Fax +1 212 752 73 12

UK
Amas Investment & Project Services Ltd
Room no: 117,
First Floor, Regus,
100 Pall Mall,
London SW1Y5NQ
Tel. +44 20 7839 4661
Fax +44 20 7839 5992

India
Paterson Securities Pvt Ltd
Bhavani Mansion 3, 4th Lane
Nungambakkam High Road
Chennai - 34
India

Cayman Island
Hinduja Bank & Trust (Cayman) Ltd
c/o P.O. Box 2407GT
Grand Cayman
Cayman Islands

Publisher

Hinduja Bank (Switzerland) Ltd

Place de la Fusterie 3 bis

1204 Geneva, Switzerland

Tel. +41 22 906 08 08

Fax +41 22 906 08 00

www.hindujabank.com

info@hindujabank.com

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