Weekly Market Focus

HINDUJA BANK SWITZERLAND

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ASSET CLASS REVIEW

EM Currencies

Increases in the prices of industrial commodities have helped to drive a rebound in some emerging market (EM) currencies since early September. But that rebound is already showing signs of faltering. We suspect that it will unwind, as commodity prices fall back and other factors weigh again too.

• Despite a bit of a wobble lately, EM currencies have gained around 1% on average against the dollar since 5th September (according to the Fed's OITP dollar index). But they are still far short of their level before they started falling back in mid-April.

• Their slide earlier in the year was caused primarily by concerns about a couple of factors, namely rising interest rate expectations in the US and slower growth in China's economy, with the latter partly connected to US protectionism. While rate expectations in the US have climbed further since 5th September, investors' worries about China generally seem to have eased slightly – the Shanghai Composite has jumped by 4%.

• The 10% rise in the price of (Brent) crude oil over the same period, to its highest level since 2014, has helped too in many cases. (The prices of most industrial metals have also picked up, albeit by less.) While the increase may also partly be down to relief about China's economy, we think that it is primarily due to worries about the supply of oil.

• The influence of commodity prices is reflected in the particularly strong performance of currencies which have historically had the closest relationship with the price of oil. The issuers of these currencies are major exporters of oil or other industrial commodities.

• One can doubt that rising commodity prices will continue to bolster these currencies, though. Indeed, EM commodity currencies should generally weaken this year and next, and fare no better than their peers. The main reason is that the price of oil could fall back, as investors' worst fears about oil supply prove to be unfounded. Analysts are a little less pessimistic about the prices of other industrial commodities, but mostly expect them to decline too.

• What's more, even if analysts are wrong about the outlook for commodity prices, there are other reasons to think that EM currencies will depreciate again. Their sharp falls across the board from mid-April to early September came despite a 7% increase in the price of oil. Even in the cases of the currencies that track the price of oil most closely, the impact of that increase was ultimately outweighed by concerns about Fed tightening and US protectionism (plus US sanctions in the case of the Russian ruble).

• Although there has been a little respite in the past few weeks, these concerns are likely to intensify again. There is a probability that the Fed will raise rates a bit more quickly than investors are anticipating in the next few quarters, and that China's economy will lose more momentum. Although one can suspect the Fed to stop hiking in mid-2019, if the US economy would start slowing. This would probably decrease demand for risky assets, and EM currencies typically fall in such circumstances.

Source: Capital Economics

FOREX

EUR

Even if it is not a drama yet, the events in Rome nonetheless cast a shadow on the development of the euro. It became quite clear on Friday that the market had become more skeptical as regards the Italian fiscal policy when EUR-CHF eased by one cent. Some Italian bank shares were on the stock market with a "limit down", which caused considerable uncertainty and thus a flight into the franc. The entire proposal with all key data has to be presented to the EU Commission by 15th October. That means the EU has not yet replied to Italy's budget plans. Even if the EU does not reject it, it can nonetheless turn into a stumbling block for the euro. The Vice President of the Commission Vladis Dombrovskis already sounded skeptical about the plans and President Jean-Claude Juncker even fears that it could send the country and the euro zone into similar market turbulence as that created by the Greek crisis 9 years ago. The reaction of the rating agencies could turn out to further stoke the fire if it was negative, which is likely. Even if the subject seems to remain on the back burner for the FX market at present, market participants should keep a close eye on it. It can cook up more rapidly than we think. We don't like to say so but Italy's fiscal policy, should it remain as expansionary as it is clearly planned, might be seen by the market to be unacceptable medium term. In that case, it would turn out to put lasting and considerable pressure on the euro.

GBP

After Brexit minister Dominic Raab had pointed out that the UK's willingness to compromise was "not without limits" and that a customs border between Northern Ireland and Great Britain was not acceptable, unconfirmed reports that Prime Minister Theresa May was going to make concessions to the EU supported Sterling yesterday. She was prepared to accept certain controls in the Irish Sea - i.e. between Great Britain and Northern Ireland - if in return both stayed in the customs union. In the past she had vehemently rejected a customs border in the Irish Sea, no doubt also with a view to the Northern Irish DUP, whose support May depends on in parliament since she has lost her majority there. The DUP however is worried about Great Britain and Northern Ireland drifting apart more than about anything else. The EU on the other hand has always insisted that only Northern Ireland could remain in the customs union. Sterling reacted cautiously optimistic to these reports. Over the course of the month, May will announce her plan in detail. We will have to see how the EU will react, as well as her own party. At least May has signaled further willingness to negotiate and compromise. That alone gives the impression that a transition agreement might be reached before the end of March which could provide certainty to companies and prevent major disruption for the economy. That in itself merits a small breather for Sterling, albeit a short one.

AUD

The economic backdrop in Australia is supportive again. The hard times following the collapse of the commodity prices are definitely over. GDP is growing above trend, exports are high, business sentiment is good and consumer spending positive. Moreover, the unemployment rate is falling further and is likely to lead to rising wages medium term. For the foreseeable future - i.e. in 2019 and 2020 - inflation will remain in the area of 2 ¼% and thus closer to the lower end of the 2-3% target range. In its financial stability report in August the Reserve Bank of Australia (RBA) pointed out that in view of the progress made with unemployment and inflation higher interest rates would become necessary at some stage. The RBA is nonetheless keeping everything on hold. Its conclusion in the August report was that all the expected positive developments will only be gradual. As a result the RBA is in no hurry to change interest rates. Its motto seems to be "take your time". In particular as slowing growth in China and its trade conflict with the US constitute a risk factor for the Australian economy that is virtually incalculable. We only expect the first RBA rate step in the spring, at the earliest. That means the AUD is not going to get much support on that front, it remains driven by the trade conflict, risk aversion and the development of the US dollar as a result of future Fed monetary policy.

KRW

Given South Korea's export-oriented economy, its economy and export performance are often viewed as a bellwether of the global economic situation. The latest export numbers for September posted a sharper than expected drop of -8.2% yoy from near 9% in August. Given the ongoing US-China trade tensions and IMF chief Christine Lagarde signaling a less optimistic outlook, one may believe this is the start of much weaker Korean exports. However, there are probably few reasons to panic as the latest data print was distorted by the higher base last year and fewer working days in September this year. We should see Korean exports rebound back to positive territory in coming months. Imports were also lower in September which lifted the current account surplus. In fact, the current account surplus is expected to remain in healthy territory this year at around 4.4% of GDP and should provide a key support for KRW. KRW is down 4% vs USD year-to-date. For USD-KRW, it has been rather stable over the past three months, within the 3% range of 1105-1140. It is back to the lower end of this range holding around the 1110 level. Going forward, the Chinese yuan (CNY) remains the key factor dictating the near term direction on top of the USD and the Fed.

INR

The FX market re-opens today with sentiment likely to remain cautious given the recent spike in oil prices and lingering nervousness in the domestic funding market. This followed the default of a shadow lender, but contagion risks have been contained after the government announced a swift bailout package. The collapse has however sparked concerns over the wider shadow banking sector and the recent emergence and reliance on the short-term debt market. Given the baggage of legacy loans for the banks, the shadow banking sector has grown in the past year in terms of providing new credit. The pace of growth along with a heavy reliance on short-term funding for long term infrastructure projects remain the key risks which will keep the market nervous. The focus shifts to RBI's decision this Friday. We look for another 25bp hike to 6.75%, which is consistent with the market pricing in 50bp hike over the next three months. The final RBI meeting this year is on 5 December. If the fallout is contained, we could see another hike in December too. Given the lingering risks and firm oil price, the bias remains to the upside for USD-INR near term.

VIEWS FROM THE TRADING FLOOR

Equity

S&P was up 0.3% last week, with a decrease in volatility from 12.42 to 12.05. The significant rise was for independent power producer up 5%. On the downside, we find Casino &gaming, home furniture and divers suppliers all three up slightly more than 5%.

As expected, the Federal Reserve raised the funds rate 25 basis points on Wednesday and largely reiterated their stance that U.S. economic growth and labor market conditions remain strong, while inflation remains in-check. The probability of a December rate hike is 74.6%. Until we have a better sense of what impact the tariffs will have on corporate in a couple of weeks at the beginning of the earning season, there is no trigger in sight for a significant correction on the US markets.

S&P 500: The index continues its uptrend and remains on track to reach its 2950 target. 2900 and 2870 are the first two supports. A break of this last level will lead to the 2800 support before 2770 (the bottom of the uptrend initiated in February 2016).

Eurostoxx 50: The index has reached 3450, our minimum target and has corrected a bit since. The rise could see an extension toward 3470 if new catalysts come into play. 3340 and 3260 are the first really significant supports.

EQUITY

Developed countries

		Total return - 1 Week
SMI	⬆	1.1%
Euro Stoxx 50	⬇	-0.7%
DAX	⬇	-0.8%
FTSE 100	⬆	0.0%
S&P 500	⬆	0.6%
Dow Jones	⬆	1.5%
Nikkei 225	⬆	0.3%

Developing countries

Russia/Micex	⬆	3.0%
India/Nifty 50	⬇	-1.9%
China (HK)	⬇	-1.5%

⬆ - Upward move ⬇ - Downward move

FIXED INCOME

Developed countries

	2-year Yield	10-year Yield
USA	2.8%	3.1%
UK	0.8%	1.5%
Germany	-0.5%	0.5%
France	-0.4%	0.8%
Italy	1.2%	3.3%
Spain	-0.2%	1.5%
Switzerland	-0.7%	0.0%

Developing countries

	2-year Yield	10-year Yield
Russia	3.7%	4.9%

COMMODITIES

		Total return - 1 Week
Crude Oil	⬆	8.0%
Gold	⬆	0.1%

CALENDARS

Economic Events

Date of release	Domicile	Event	Period	Actual	Estimated
03 Octt 2018	US	ISM Non Manufacturing Idx	September	58.5	58.0
04 Oct 2018	US	Factory Orders	August	-0.8%	2.1%
05 Oct2018	France	Trade Balance	August	-3490	-4848
03 Oct 2018	Germany	Services PMI	September	55.9	56.5

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