

Weekly Market Focus

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HINDUJA BANK
SWITZERLAND

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ASSET CLASS REVIEW

Could falling oil prices weigh on the economy? Headlines have focused on the news that oil has entered a “bear market”, having fallen by almost 20% over the past month. But at around USD 43.-, the price of a barrel of WTI crude is not far below the USD 45 – USD 55 range it has been trading over the past year.

Oil

Analysts still expect stronger demand to push oil prices higher over the coming years. However, with sentiment so negative, it is clearly possible that oil prices could fall further in the short term.

Even if prices fall from here, there are good reasons to expect the impact on the real economy to be fairly limited. First, in contrast to previous oil price slumps, financial conditions are loosening. Corporate bond yields for the energy sector have edged up in recent weeks, but overall corporate borrowing costs have remained on a downward trend. Meanwhile, equity prices have reached fresh records, and the dollar has been weakening. The sharp appreciation of the dollar during past oil price declines held back the export-focused manufacturing sector, which had a larger bearing on GDP growth than the mining sector.

Financial conditions have remained loose presumably because the latest falls in the oil price largely reflect higher supply, including from US shale. Weaker demand from China has played some role, but overall global demand prospects are stronger than they have been over the past few years, and we have not seen a repeat of the widespread fears over the global economy that drove the oil price down below \$30pb in early 2016.

Moreover, the oil sector is a much smaller part of the economy than it was in the past. Even after the 460% annualised rebound in the first quarter, mining investment was still only \$72bn, or 2.5% of total private investment, half its 2014 peak. The drop in the oil price means that mining investment will probably fall over the rest of the year. Taking into account the usual lags, the US rig count is likely to peak soon. If oil prices remain where they are, one can estimate that mining investment could fall by \$20bn over the second half of the year. That would be enough to knock 0.15%-pts or so from growth in the second half of the year. But it would only partly reverse the surge seen in the first quarter, and would be different from the situation in 2015 and 2016, when falling mining investment reduced GDP growth by around 0.25%-pts.

Lower oil prices would eventually provide some offsetting boost to consumption by lifting real disposable incomes. Admittedly, any boost will be small and probably take a while to feed through. As a guide, the fall in oil prices in 2014-15 saved consumers more than \$100bn on their gasoline bills. But households raised their savings by a similar amount over the course of 2015.

The most notable impact of falling oil prices will instead be on inflation. The bulk of the decline in headline CPI inflation already seen this year, from 2.7% in February to 1.9% in May, was due to lower energy inflation. At current oil prices, energy inflation will drop back even further.

That said, in weighing up whether to continue its gradual tightening cycle, the Fed will put much more weight on core inflation, which will be little affected. As long as officials remain convinced that the recent drop in core inflation is largely due to a one-off factor, then they will look through a weak patch in headline inflation. We suspect that by this time next year, core inflation could be running close to 2.5%. Against that backdrop, we expect the Fed to press ahead with hiking rates once a quarter over the rest of this year and next.

In conclusion, the US looks much less vulnerable to lower oil prices than it was a few years ago. Provided lower commodity prices don't trigger a sharp tightening in financial conditions, the economy is likely to remain on track.

FOREX

The USD started the week lacklustre as concerns for inflation rise and long term yields struggled to move higher from interim support. The market discounts one more interest rate rise by the FOMC this year however doubts for continuing increases through 2018 have become more vocal. Recent rhetoric by some FOMC members has been mixed. Chicago Fed Charles Evans, Philly Fed Patrick Harker as well as Fed's Robert Kaplan have all spoken in favour of a rate pause. The recently weaker development of inflation rates has clearly caused some uncertainty amongst FOMC members. This confirms market expectations of pushing back the next 25 bps hike back to December from September, the latter now only attaching a 20% probability.

USD

Chairperson Yellen however spoke on Tuesday evening and reaffirmed her confidence that the US economy can withstand higher interest rates. These concerns for inflation risks dollar exchange rates. Should the remaining FOMC members start sounding notably more hawkish or the US data generally surprise on the upside the market would quickly review the current pricing. On the other hand if the FOMC continue its rate hike cycle in September, the market may judge this as a strong signal that the Fed will maintain its current interest rate hiking cycle. This would demonstrate that the Fed is not deterred by weaker data and that it still believes firmly in its rate outlook. That would be a significantly positive signal for USD. The correlation is still strong for interest rate differentials and FX performance. US 2/10 spread and EURUSD 2 yr interest rate spread reflect this. This week has seen a strong auction for 2 yr Treasury notes. The bid-to-cover ratio was the strongest since November 2015. This interest to buy has been attributed to the flat 2/10 yield curve and a decline in confidence that the Fed can carry on raising interest rates as implied by the dot plot. Further along the curve long term yields, notably in the 10yr space, have again found support just above 2.13% providing a boost to USDJPY.

EUR

The EUR has found support this week against the USD on the latter's weakness and also from comments from the ECB. On Tuesday Mr. Draghi's introductory speech at the ECB Forum on Central Banking said 'temporary effects are weighing on inflationary pressures'. These comments prompted fresh euro demand pushing the common currency higher through 1.1200 towards the 1.1296 resistance. EUR rates markets too are on the move. The yield on the 2 yr Shatz has bounced 20 bps in the past 2 weeks to -0.58bps, levels not seen since last Oct. Probabilities of a 25bps hike by June 2018 have risen back to 50%. We have been bullish Euro for some time recommending buying on dips. At the time of writing EURUSD again tests 1.1296 resistance. Chasing a clean break through this pivot offers good risk reward respecting 1.1260 as a stop. Of particular note is EURJPY. The cross has broken through major support this week at 125.82. Having advanced through the double top at 125.78 we have now clearly broken higher into a new range. We see continued extension of the move towards the 128.80/129.40, a Fibonacci cluster resistance over the medium term. Buy dips in EURJPY 125.30/125.10 risking a 124.40 close.

JPY

We see being short JPY as the 'position to have' over the medium term. As central banks become more hawkish and keen to move away from normalisation, the JPY will weaken against its peers. Geopolitical risks have abated too, hence safe haven trades being unwound. USDJPY continues to be driven by long term US rates. There is little noise from the BOJ hence the one way direction in correlation with 10 year yields. Technically the latest move higher is consistent with momentum support. The 55 week ma has proved to be a good indicator of key pivots for USDJPY. The market has recently tested and bounced from this moving average. This cross should move higher. Having eroded trend line resistance higher price are now in store for JPY crosses. Last week we noted to buy USDJPY just above 111.00. Now having broken through 'ichi-moku' resistance lines upside targets rest at 112.70/112.90. Strong support now is found at the conversion of the 55mda and 200 mda at 111.10/15.

CAD

We mentioned last week that the CAD was being pushed and pulled by two forces, domestic growth and commodity prices. We still support the view that growth will support the Canadian dollar when measured against its reliance on oil. To date the 'Loonie' has been resilient on weaker crude prices even though the market is still concerned by the relationship with oil and growth. USDCAD has been attracted by the 1.3200 support zone following hawkish comments from the BoC and tests to 1.33 have been transitory. Normalisation of rates is not far with the IR curve discounting a 80% chance of a hike by year end. Headwinds for the CAD come from the protectionist approach on the part of the US administration, namely NAFTA. The US administration announced this week duties on timber imports from Canada. We remain bullish for the CAD.

Last week we highlighted CADNOK as a favourable way to assume CAD risk. We stand by this trade as long as prices stay above 6.31, looking for an eventual upside target of 6.5100+

USDCAD looks vulnerable while prices remain below the 200 mda at 1.3340 with the next downside target at 1.2970. Prices are now below the May2016 trend line and momentum favours a lower cross for now. Another cross we feel will outperform in the coming weeks is CADJPY. Having broken the bear trend from Dec 2015 prices now have extended through and bounced off the 83.65 pivot. Prices had been ranging since mid April and this break upwards is significant. We see the cross extending the move higher to the 76 % Fibonacci at 86.75, approx 2.5% higher from current levels, 84.60.

Look to buy this cross on any dip to 84.30/84.50 risking 83.70 close, for a 86.75 target.

VIEWS FROM THE TRADING FLOOR

Equity

S&P was down 0.7% on the last week, with no real change in volatility, VIX moving from 11.06 from 10.86. On the upside the only significant rise was for department stores, the sector being up 5%. On the down side home furniture's retailers was down 10% while food distributors were down 8.5%.

In the US the focus this week will be on the personal consumer spending figures in May released on Friday. The consensus expects an increase of 0.2% mom. According to Raiffeisen, as there should be a minimal decline of the private consumption deflator compared to the previous month, personal consumer spending is expected to have increased by between 0.2% and 0.3% mom in real terms. This, in turn, suggests an annualized increase of private consumption of roughly 3% qoq in the second quarter. Furthermore, Raiffeisen projects a decline of the PCE price index in year-over-year terms from 1.7% to 1.5% (in line with the market consensus). This is further grist to the mills of all those who hold the opinion that the Fed will abstain from a further increase of the key rate due to low inflation.

S&P 500: The index has started a correction and its first support will be 2400-2387. If this first support is broken on a close basis then there 2350 will be tested and probably 2325 will be tested too. On the upside 2453 is the first target a break above this level will lead directly to the first target area 2484-2500.

Eurostoxx 50: The index is testing the lower part of its 3525 and 3600 trading range. A close below this level will open the way toward 3455 before 3435 and maybe 3400. The first main resistance is still 3600.

EQUITY

Developed countries

Total return - 1 Week

SMI	↓	-0.4%
Euro Stoxx 50	↓	-0.2%
DAX	↓	-0.1%
FTSE 100	↑	1.8%
S&P 500	↑	0.1%
Dow Jones	↑	0.3%
Nikkei 225	↓	-0.4%

Developing countries

Russia/Micex	↓	-1.5%
India/Nifty 50	↑	1.3%
China (HK)	↑	1.4%

↑ - Upward move ↓ - Downward move

FIXED INCOME

Developed countries

	2-year Yield	10-year Yield
USA	1.3%	2.3%
UK	0.1%	1.1%
Germany	-0.7%	0.4%
France	-0.4%	0.8%
Italy	-0.3%	2.2%
Spain	-0.3%	1.6%
Switzerland	-0.9%	-0.1%

Developing countries

	2-year Yield	10-year Yield
Russia	2.0%	4.0%

COMMODITIES

Total return - 1 Week

Crude Oil	↓	-7.2%
Gold	↓	-3.0%

CALENDARS

Economic Events

Date of release	Domicile	Event	Period	Actual	Estimated
29 June 2017	US	GDP Annualized QoQ	1Q T	1.20%	1.20%
29 June 2017	US	Initial Jobless Claims	24 June 2017	240k	241k
30 June 2017	JN	Industrial Production MoM	May P	-3.00%	4.00%
30 June 2017	UK	GDP QoQ	1Q F	0.20%	0.20%
03 July 2017	US	ISM Manufacturing	Jun	55.00	54.90

Company Earnings

Date of release	Domicile	Company Name	Period	Estimate EPS
29 June 2017	US	Walgreens Boots Alliance	Q3 17	1.30
29 June 2017	US	NIKE Inc	Q4 17	0.50

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