

Weekly Market Focus

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HINDUJA BANK
SWITZERLAND

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ASSET CLASS REVIEW

Why is inflation not rising in Japan?

Economy: Japan

In Japan GDP growth has been above the potential growth, which is estimated at around 0.8%, for several quarters. This is, however, mainly due to an adjustment of the inventory effect. The contribution to growth from net exports and lively investment activity should result in economic growth that is above potential in the next quarters.

Real exports have been in an uptrend for around one year and rose by roughly 8% in May, year on year. However, momentum slowed in the last two months compared with the first quarter, reflecting the slight decline in global growth momentum. Analysts predict a continued solid if slightly weaker export growth rate. In May the trade balance was in surplus for 19 consecutive months. After the Fukushima catastrophe in March 2011, the trade balance had been in deficit for almost five years as Japan had to increase massively its oil and gas imports once all its nuclear power plants were shut down.

In spite of this development and the tight labour market, inflation (April: 0.4%) is not heading toward the central bank's 2% target.

The lack of inflationary pressure is due not least to the almost complete absence of wage growth, even though unemployment dropped to 2.8% in April, the lowest level since 1994. An important explanation for this is the segmentation of the Japanese labour market. The proportion of irregular (e.g. part-time or temporary) workers has soared from 20% in 1990 to almost 40% of total employees today.

These workers have enjoyed above-average wage growth, but their salaries are still around 40% lower than those of regular employees. This fact pushes total wage growth downwards.

The wages of regular workers are barely rising either. However, they enjoy greater job security, and their wage growth depends less on cyclical economic fluctuations but rather on the long-term outlook. Furthermore, the long-term potential growth is low not least due to the demographic trend. Since this situation will change only slowly, achieving the inflation target is hardly realistic in the foreseeable future.

Thus, it makes sense that the central bank left its expansive monetary policy unchanged at its last meeting in June.

A solution would require both labour market reforms and structural reforms to increase the potential growth.

FOREX

This week, the ECB again struggled to temper market expectations which has led to an appreciation in Euro assets. Sources cited concerns for the recent strengthening in the Euro and rates markets. Concern within the GC grows regarding the imminent end of the ultra-expansionary monetary policy. This noise from the ECB chimes with the exit the US suffered from its ending of QE, or better remembered as the Taper Tantrum. You may remember the Fed struggled to control market expectations, as the market was too quick in pricing in a steep yield curve resulting in a too strong USD.

USD

Across the pond, several FOMC members have expressed caution with how inflation is developing. The FOMC minutes on Wednesday will provide some more colour on current Fed thinking, however the FOMC are unlikely to lead to a 'volte face' on monetary policy. The minutes will likely underscore the point that balance sheet reduction is not seen as a substitute for higher rates. This is constructive for the USD. Also, Yellen recently expressed her ease with the development of the economy and inflation expectations. Yellen was quoted as saying, "We continue to expect that the ongoing strength of the economy will warrant gradual increases in the federal funds rate to sustain a healthy labour market and stabilize inflation around our 2 percent longer-run objective." Later in the week sees the release of ADP and NFP employment data. Considering the US economy is close to maximum capacity labour market, only a weak number here will force a significant move for USD assets. Note, that markets have discounted a 48% chance of one more 25 bps hike for 2017.

For EURUSD, the cross lost upside momentum having tested multi-month resistance lines at 1.1445/67. The common currency is now expected to retrace lower towards the key pivot area of 1.1290/1.1300. At this level we will be content to re-assume bullish strategies risking a close through the Apr/Jul trend line. The correction from 1.1445 came at the end of the month but it was mainly a stronger USD that turned price action. The USD has been supported by a strong Manufacturing PMI rekindling rate hike expectations. **Current factors, both technical and fundamental indicate a higher Euro for now.**

EUR

A roller coaster week for Euro saw the cross trade just shy of key resistance at 1.1467, 1.1445 marking the high. ECB's Mario Draghi provided fuel to the bulls saying that lower inflation in the Eurozone is transient. This comment was later cited as being taken out of context by ECB Sources. The correction from 1.1391 to 1.1291 lasted minutes. The market currently is content to ignore central bank warnings that core inflation in the Eurozone is unlikely to rise above 1% on a sustainable basis over the coming months despite the spike in June. It knows, and rightly so, that the ECB will step up its rhetoric into year end with regards to tapering QE. Rates markets too in the Eurozone have returned from lofty levels. The yield on the 10 year Bund again failed to significantly test the 0.50% RV resistance for the 3rd time this year. EONIA markets were less optimistic, the 12x24 only touching a high of -0.175 bps.

GBP

Sterling has strengthened considerably towards the end of June. Hawkish comments and a weaker USD pushed cable up to the year to date high at 1.3030. Rates markets too were quick to price in interest rate hikes for Q1'18. Prices have stabilised in the last two sessions and I now see GBPUSD retracing back to 1.2820/30. Data this week saw a disappointing print for PMI Services, and some dovish comments from BoE member Vlieghe, 'Interest rate rise now would be a mistake'. The MPC is more split over interest rates than at any time since 2011, with the committee dividing 5-3 in favour of keeping rates on hold at its June meeting. Not forgetting member Andy Haldane who revealed he too is ready to vote for a rate hike in the second half of the year. This indicates a potential 5-4 split for an interest rate hike at the next MPC meeting. This will underpin Sterling moving forward, the market now in a 'buy on dips mentality'. These factors together have taken the shine off the move and markets should now reflect on USD risk. There is little key data to support the bullish cause so expect an unwinding of risk towards the aforementioned 1.2830 support area.

We remain bullish for GBP and look to buy on dips to 1.2820/30.

AUD

The RBA left its key rate unchanged on Tuesday at 1.50%. The AUD however softened on disappointment that the central bank did not signal a tightening of policy in the foreseeable future, alike other key central banks that have recently changed their communication.

The RBA highlighted that an appreciating AUD could hamper the economic adjustment (to lower commodity prices), meaning a stronger AUD remains a problem for the central bank.

AUDUSD has stalled just shy of 0.7724, marking the 4th time prices have retraced from the May 2016 resistance line. This rejection of the highs and subsequent reversal indicates prices have seen a decline to the trend channel just above 0.7600. We will chase weakness through 0.7590 for a short term target just below the 200 mda at 0.7530 to 0.7490/0.7500.

In the scenario of corrective bounces, wait for probes to 0.7635/45 before shorting.

SEK

The Riksbank followed the current trend amongst key central banks signalling an end of expansionary monetary policy. The Swedish economy has been noting decent growth with an uptick in the inflation trend towards the 2% target. The bank announced Tuesday it was holding its benchmark repo rate unchanged at minus 0.50 percent, while eliminating the chances of a near-term cut. The rate path now envisages rates remaining at their current level until mid-2018, rather than suggesting the potential for further cuts through the end of the year.

Gold

Precious metals markets have come under pressure this week in the wake of renewed hawkish central bank rhetoric. Gold fell by 1.7% on a closing price basis, at one point testing support at 1,218, marking the biggest percentage daily loss since November. Prices glided through strong trend line support and 200 mda at 1234/35 before triggering stop losses and initiating speculative selling. Rising stock markets, higher bond yields and the firmer US dollar clearly prompted the move.

Where to from here?

Gold has found an interim base just above 1218 however we clearly are now in a strong decline. Further tests through here will see prices accelerate to 1195 and 1180 below. Over the short term prices have extended quickly so corrections back to the trend line and 200 mda resistance cannot be ruled out. At the time of writing prices are inside Tuesday's trading range so assuming new risk for gold is not compelling.

We prefer to wait for a correction higher to the latter noted points, 1233/35 before looking to sell.

VIEWS FROM THE TRADING FLOOR

Equity

S&P was down 0.4% on the last week, with no real change in volatility, VIX finishing the week at 11.22. On the upside we found footwear sector up 10% while Banks and trucking were up 6%. On the down side leading the decline we had home entertainment, Gold, and semiconductors all down 6%. In the US the focus this week will be on the labour market report released on Friday. After the disappointing employment growth in April (+138k) the economists clearly expects a rebound with a consensus at +177k for June. The unemployment rate is likely to have kept its 16-year low of 4.3% reached in May. It remains particularly interesting to take a look at wage development, which had recently disappointed. Due to a favourable calendar effect, there are signs of a clear wage plus of 0.3% mom up to 0.4% mom for June. The year-on-year rate should have climbed to 2.7%.

S&P 500: The first support area 2400-2387, mentioned last week can be considered as reached but we will probably see a second test of this zone. 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 has broken its 3525 support and fallen up to its 3435 support. We are now in a technical rebound that could bounce back up to 3525. The new trading range is now 3525-3435. A close below 3435 will open the way to a test of the strong 3400 a close below this level will immediately lead to 3325. A break above 3525 will fuel a rise to 3600.

EQUITY

Developed countries

Total return - 1 Week

SMI	↓	-1.2%
Euro Stoxx 50	↓	-1.5%
DAX	↓	-1.7%
FTSE 100	↓	-1.0%
S&P 500	↑	0.4%
Dow Jones	↑	0.8%
Nikkei 225	↓	-0.2%

Developing countries

Russia/Micex	↑	1.4%
India/Nifty 50	↑	1.5%
China (HK)	↓	-0.4%

↑ - Upward move ↓ - Downward move

FIXED INCOME

Developed countries

	2-year Yield	10-year Yield
USA	1.4%	2.3%
UK	0.3%	1.2%
Germany	-0.6%	0.5%
France	-0.4%	0.8%
Italy	-0.2%	2.1%
Spain	-0.3%	1.5%
Switzerland	-0.8%	0.0%

Developing countries

	2-year Yield	10-year Yield
Russia	2.3%	4.3%

COMMODITIES

Total return - 1 Week

Crude Oil	↓	-0.8%
Gold	↓	-4.3%

CALENDARS

Economic Events

Date of release	Domicile	Event	Period	Actual	Estimated
06 July 2017	US	Initial Jobless Claims	01 July 2017	243k	244k
07 July 2017	FR	Industrial Production MoM	May	0.60%	-0.50%
07 July 2017	BZ	IBGE Inflation IPCA MoM	Jun	-0.18%	0.31%
07 July 2017	US	Change in Nonfarm Payrolls	Jun	177k	138k
10 July 2017	JN	BoP Current Account Balance	May	--	¥1951.9b
12 July 2017	CA	Bank of Canada Rate Decision	12 July 2017	0.75%	0.50%

Company Earnings

Date of release	Domicile	Company Name	Period	Estimate EPS
11 July 2017	US	PepsiCo Inc	Q2 17	1.40

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