WEEKLY REPORT

28 July - 3 August 2014

WEEKLY REPORT - An overview

Economics

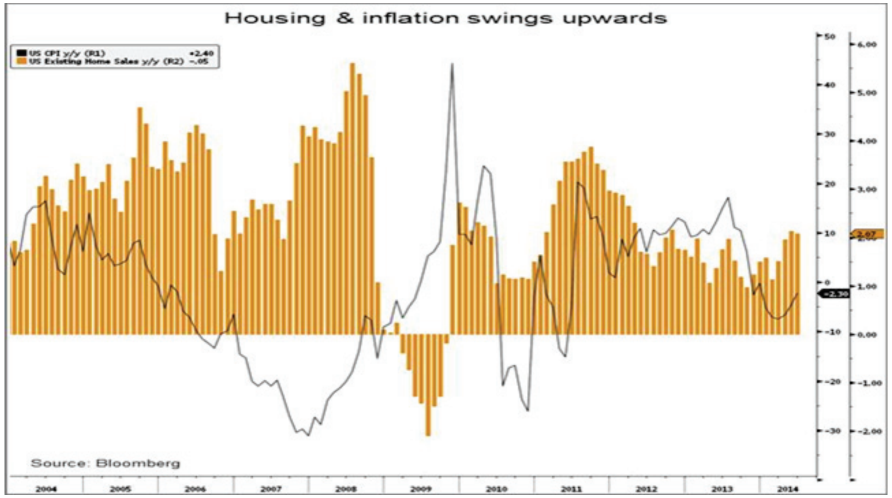
Inflation should be Yellen's concern

Data will slowly grind higher

Federal Reserve Chairman Janet Yellen remains cool on the idea that inflation in the US is beginning to accelerate. In her semi-annual testimony to the US congress she danced around the subject of inflation, instead sustaining a dovish tone. This makes sense since as long as Yellen rejects the building pressures, and exists only in a US with inflation below the 2% threshold, she can keep policy ultra-accommodating. Yet, the spillover effect of the unhurriedly improving US economy is clearly driving prices higher. The critical concept to understand with the current US recovery is that it will be slow and choppy. Data will not go in one direction but every downside economic surprise does not equal a growth reversal. June core inflation retracted slightly which has allowed the Fed's dovish members to take the high ground. However, inflations three-month pace has will remain an issue as structural drivers remain in place. Headline CPI y/y was steady at 2.1% for a second month, while core CPI y/y fell marginally to 1.9% from 2.0% in May. The underlying trend might be a tad softer then we had anticipated but is still will become increasingly difficult for the Fed to verbally discount.

Housing improving but slowly

As would be expected with an extended period of low interest rates, the housing market continues to recover. While New home sales fell -8.1% and May's read was revised lower to 8.3%, yet existing home sales climbed 2.6% in June to 5.04m, following a 5.4% rise to 4.89m in May. This is the fastest pace of sales since fall 2013 and strengthens our belief that housing market is recuperating after jump in mortgage rates last year and the harsh winter weather slowed activity this year. Housing prices, despite a minor correct, are still strong. FHFA US House Prices y/y rose 5.5% after peaking at 8.4% mid 2013. We suspect that rising prices and the threat of impending higher borrowing rates will only fuel home purchases. While the strong labor markets will also embolden buyers. The net results should be a steadily higher inflation. So while Yellen dances and the market fixates on the effect of individual data surprise, the broader picture continued a build of a sustain period above 2.0%. That will force the fed to react sooner than later and keep USD supported. Although, we don't expected much meaningful change at this weeks FOMC.



FX Markets

Is there any opportunity in NZD slide?

RBNZ suspends rate hikes

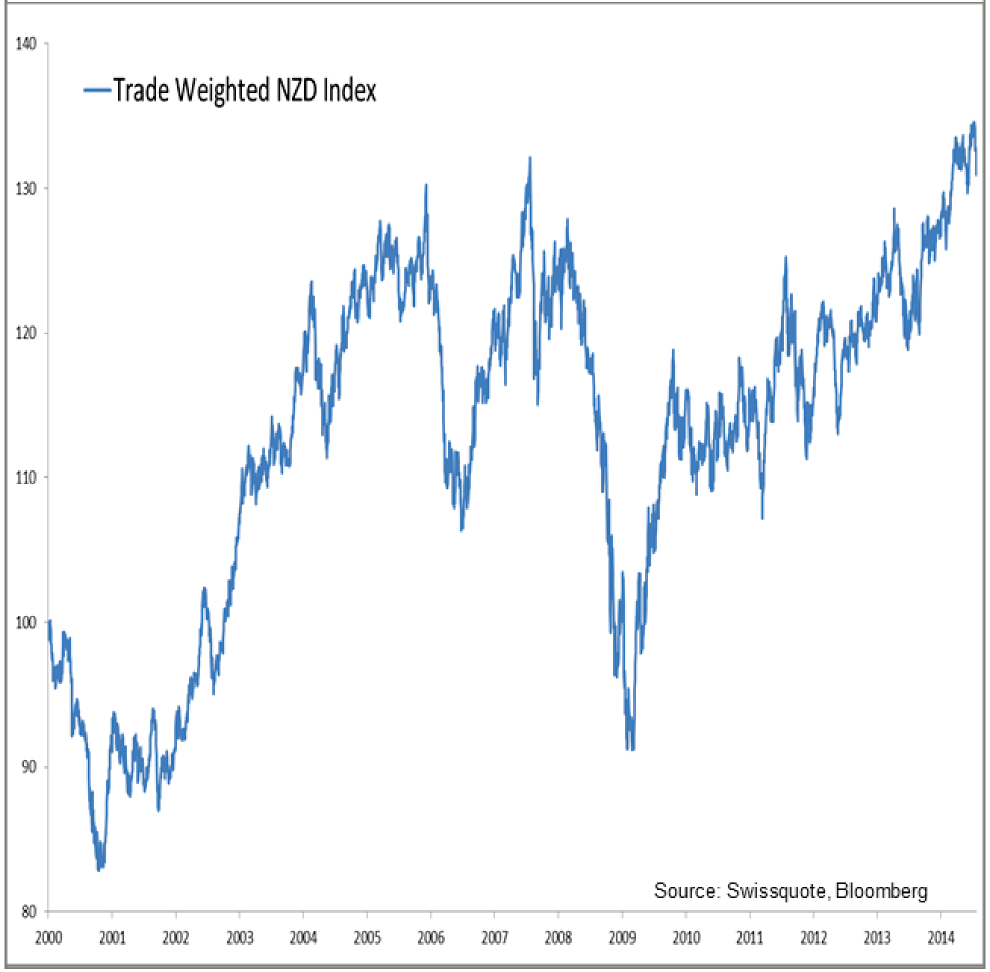
The RBNZ increased its OCR by an additional 25 basis points at July 24th meeting, with significantly less hawkish accompanying statement. The RBNZ Governor Wheeler said that the bank will suspend the rate hikes given the "unjustified and unsustainable" level of kiwi and the moderate inflation. "With the exchange rate yet to adjust to weakening commodity prices, […] there is room for significant fall" said Wheeler. A "period of assessment" is needed according to Wheeler before adjusting the interest rates back to "more neutral" levels. On trade weighted basis, the Kiwi is still at highest levels since 2008; this is more than 40% appreciation since 2009 down spike.

Data-wise, the second quarter inflation accelerated at the pace of 1.6% on yearly basis, significantly lower than 1.8% expected (vs. 1.5% last). In addition, the slowdown in house prices, the significant decline in dairy price and volumes as well as the latest deterioration in consumer and business confidence give room to Wheeler to keep the rates steady for several months ahead. We believe the status quo will remain to steady borrowing costs at least until general elections scheduled on September 20th.

Dip-buying opportunities

Kiwi took a dive after Wheeler's decision to take a breather after fourth consecutive month of rate increases. NZD/USD sold off below year-to-date uptrend floor, the bearish momentum reinforced as 50 and 100 dma (0.8652/0.8627 respectively) were pulled out. Despite the short-run negative bias, the oversold conditions should generate dip-buying opportunities in NZD-complex as the Kiwi is still a good carry currency. Profitable interest rate spreads should attract dip-buyers once the momentum stabilizes, especially against USD, JPY and EUR.

Trend remains positive in the trade weighted NZD



FX Markets | A technical take on EUR/USD

The technical deterioration in EUR/USD continues

The recent new lows in EUR/USD confirm the weakness in place since Mr Draghi hinted in May at a rate cut. Indeed, these new lows occur after a rebound in the second half of June, which stopped near the 38.2% retracement of the decline from 1.3993 (08/05/2014 high) to 1.3503 (05/06/2014 low). As a result, a succession of lower highs and lower lows is now in place in EUR/USD. Our current downside risk is at 1.3379, implied by the March-May double-top formation. Furthermore, this target coincides with the 50% retracement of the rise that started at 1.2755 (09/07/2013 low) and is above the key support at 1.3296 (07/11/2014 low).

USD/CHF needs to confirm the new lows in EUR/USD

The weakness in EUR/USD is mostly due to the depreciation of the single currency. Indeed, other crosses like USD/JPY or GBP/USD have a different price behaviour. On the other hand, the Swiss franc, with its close relationship with Euro, is roughly the mirror image of EUR/USD. However, USD/CHF has thus far failed to confirm the new lows in EUR/USD by breaking above the resistance around 0.9037 (05/06/2014 high, see also the declining channel that started on May 2013). An USD/CHF confirmation would increase the odds to see a steeper decline in EUR/USD in the next weeks. Indeed, the impulsive shape of the Euro weakness, coupled with the mild countertrend move in the second half of June, increases the odds to see a second leg lower of the same amplitude than the one that started on 8 June (at 1.3993). The downside risk, in that case, is given by 1.3210, which is close to the 38.2% retracement of the whole two year rise in EUR/USD. Given the impulsive nature of this potential decline, prices should not been able to break the resistance at 1.3549 (21/07/2014 high).

Recent new lows confirm an underlying downtrend in EUR/USD

FX Markets

Australian inflation rules out a rate cut

Australia inflation at the top of the RBA's target range

Australian inflation in 2Q2014 surprised to the upside. Even if the 0.5% QoQ rise in headline inflation confirms a series of declining readings since September 2013, it still pushes the YoY comparison to 3.0%. Therefore inflation is now at the top of the RBA's 2-3% medium-term target range. It has to be said that the Reserve Bank of Australia (RBA) looks at several inflation measures like the trimmed mean (2.9% YoY), the weighted median (2.7% YoY) and the ex-volatile items CPI (2.8% YoY). However, they also average at the high end of the RBA's range. Furthermore, demand among inflation components is surprisingly broad based given a fiscal budget consolidation and a year-to-date appreciation in the Aussie.

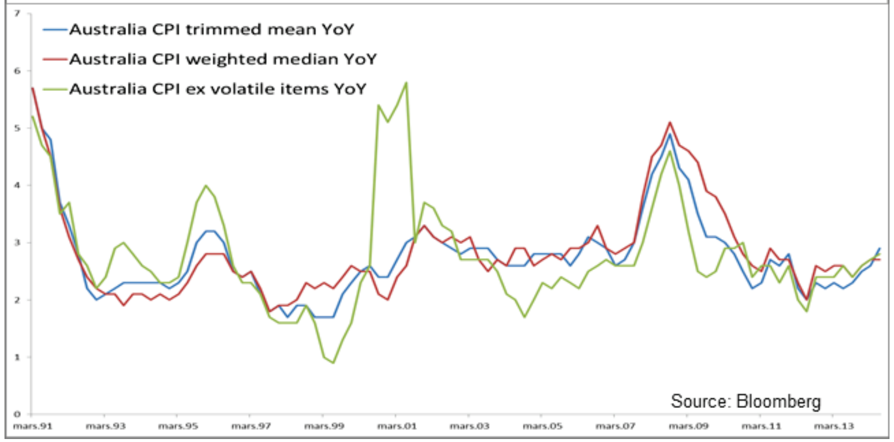
Lowering the AUD will be tougher for the RBA

Inflation measures leave almost no room for any rate cut, reducing the RBA's ability to "talk down" the Australian dollar. With a rate cut mostly out of the picture, the market will likely focus on the timing of a rate hike, which should support the Aussie. Meanwhile, the RBA is likely to favour low rates for the longest period of time possible to support the rebalancing of the economy away from the mining sector. In that respect, a change in wordings from the "period of stability in rates" guidance during the next monetary meetings will be crucial in order to have a better understanding about the timing of the future rate hike.

A short AUD position is now less attractive on a risk/reward basis

Even if the already stretched net long AUD positioning strengthens the resistance at 0.9505 (01/07/2014 high), the succession of higher lows since 2014 suggests a persistent buying interest. As a result, a further rise in AUD/USD seems less unlikely than a month before. On the other hand, the longer term downside potential is reduced given that the RBA has now less leeway for its dovish stance.

Inflation measures are creeping higher



The slope of the 200 day MA suggests a more balanced evolution

FX Markets | Commodity currencies continue to be favoured

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 15 July 2014.

There have been very few changes in FX positions for the week ending on 15 July. Euro net short positions have remained unchanged, while CHF net short positions have slightly decreased. Nevertheless, as it can be seen by the chart on the bottom right, positions in the single currency and the Swiss franc continue to move in sync since 2008.

British pound net long positions have been slightly reduced for the second week in a row.

Commodity currencies (AUD and CAD) continue to see further increase in their net long positions, reflecting a persistent interest for carry. AUD net long positions are elevated and are approaching levels linked to the April 2013 high in AUD/USD. As a result, despite the recent appreciation in Aussie, we continue to see positioning as a significant obstacle for a sustainable rise in AUD/USD.