

Weekly commentary

The Fragile One

September 26, 2016

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Key takeaways

- Last week was probably the most important week of the year in terms of macroeconomic news.
- After the Bank of Japan (BoJ) meeting, and the European Central Bank (ECB) meeting earlier this month, the question remains whether these two banks are inching towards a regime change.
- It is pretty clear that both the BoJ and the ECB have moved away from specifically targeting currency weakness and are open to allowing their currency to appreciate.
- The bottom line, at the beginning of the year, the Federal Reserve signaled four hikes by the end of 2016 and now the most they can do is one.

Full commentary

Last week was probably the most important week of the year in terms of macroeconomic news. The Bank of Japan (BoJ) was underwhelming in most respects, but creative in others. The BoJ kept the deposit rate unchanged at -0.1% and its annual Japan government bond (JGB) purchases at ¥80trn. Additionally, the BoJ scrapped the 7-12 year average maturity target for bond buying and replaced it with a yield target on 10-year JGBs around the current level of 0%.

After the BoJ meeting, and the European Central Bank (ECB) meeting earlier this month, the question remains whether these two banks are inching towards a regime change. This shift won't be a Federal Reserve (Fed) style tapering announcement, because the motivation would be operational and political constraints rather than attainment of macroeconomic goals. A series of minor pivots, over a succession of policy meetings through 2017, can focus minds on the endgame in overvalued bond markets. Thus leading to position adjustments (accounts remain long duration), higher yields, capital repatriation and currency strength.

It is pretty clear that both the BoJ and the ECB have moved away from specifically targeting currency weakness and are open to allowing their currency to appreciate. Devaluing the currency doesn't work when everyone is doing it, even the Swiss National Bank (SNB) was forced to accept a stronger Swiss Franc and abandon the floor of 1.2 against the Euro. This regime change may not be as clear in real time, compared to the Fed signals in 2013, but there seems to be enough circumstantial evidence that something is changing. We remain comfortable with forecasts for a higher yen and euro over the next year.

So if the ECB and the BoJ are not driving the Euro and the Yen lower, can we see a U.S. Dollar strength caused by the Fed? We believe this is very unlikely. The Fed delivered what some market participants are calling a "hawkish hold". The statement offered a mixture of tones: they are on hold "for the time being" and the risks are now seen as "roughly balanced." They "judged that the case for an immediate increase in the federal funds rate is stronger," yet "it would be sensible" to wait. There were three dissenters, but they were all regional presidents, not board members, which is a key point.

The bottom line, at the beginning of the year, the Fed signaled four hikes by the end of 2016 and now the most they can do is one. The case for monetary policy divergence is less transparent. A December hike remains likely, but it is far from certain. The upcoming U.S. elections can easily cause volatility to pick up, and if we get a softer employment report in October or November, we might get another "hawkish hold" in December.

The U.S. Dollar is likely to remain the most fragile currency in 2016 (see Exhibit 1), the only exception being the British Pound, which is weakening due to Brexit.



This week's market developments

Monday, September 19

Tuesday, September 20

- US Housing Starts decreased to 1,142,000 (s.a.a.r.) for August
- US Building Permits decreased to 1,139,000 (s.a.a.r.) for August

Wednesday, September 21

Thursday, September 22

- US Existing Home Sales decrease to 5,330,000 (s.a.a.r.) for August
- US Leading Index growth decreased to -0.2% m.o.m. for August

Friday, September 23

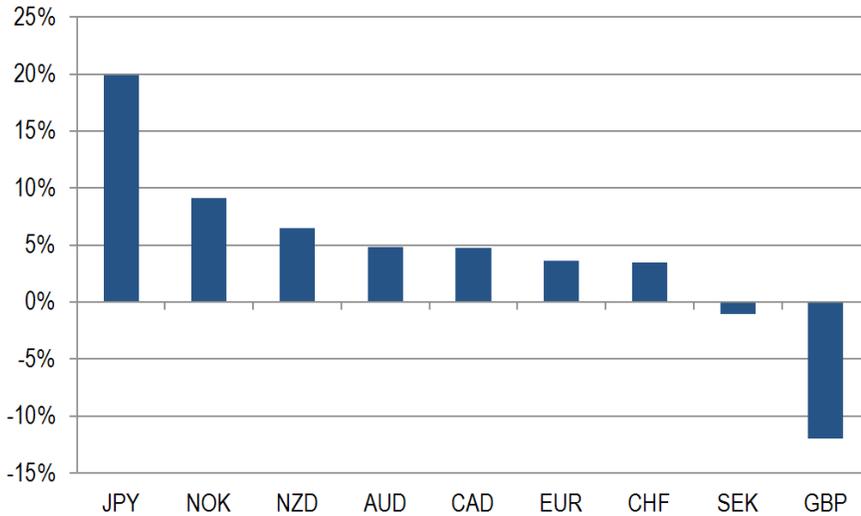
- Japan All Industry Activity Index growth decreased to 0.3% m.o.m. for July
- Eurozone Markit Manufacturing PMI Index (prelim estimate) increased to 52.6 for September
- Eurozone Markit Services PMI Index (prelim estimate) decreased to 52.1 for September
- US Markit Manufacturing PMI Index (prelim estimate) decreased to 51.4 for September

Source: Bloomberg, as of September 26, 2016



Chart of the week

Currency Performance vs. the US Dollar (12/31/15 - 9/26/16)



Source: Bloomberg, as of September 26, 2016



Next week's market developments

Monday, September 26

- US New Home Sales are expected to decrease to 600,000 (s.a.a.r.) for August

Tuesday, September 27

- US Markit Services PMI (prelim estimate) is expected to increase to 51.2 for September
- US Consumer Confidence Index is expected to decrease to 99.0 for September

Wednesday, September 28

- US Durable Goods Orders (prelim estimate) is expected to decrease to -1.5% m.o.m. (s.a.) for August

Thursday, September 29

- UK Mortgage Approvals are expected to decrease to 60,200 for August
- US Wholesale Inventories growth is expected to remain at 0.0% for August
- Japan Industrial Production growth is expected to increase to 0.5% m.o.m. (s.a.) for August

Friday, September 30

- Germany Retail Sales growth are expected to decrease to -0.2% m.o.m. for August
- Eurozone Unemployment Rate is expected to decrease to 10.0% for August
- US Personal Income growth is expected to decrease to 0.2% m.o.m. for August
- US Personal Spending growth is expected to decrease to 0.1% m.o.m. for August

Source: Bloomberg, as of September 26, 2016



Central Bank watch

	Last move	Date of move	Current policy rate	Implied 3m rate on December 2016 Interest Rates Futures Contract	Next meeting
Fed	+25 basis points	December 16, 2015	0.25 % - 0.50 %	0.47 %	November 2, 2016
ECB	-5 basis points	March 10, 2016	0.00 %	-0.21 %	October 20, 2016
BoJ	-20 basis points	February 16, 2016	-0.10 % - 0.00%	0.04 %	November 1, 2016
BoE	-25 basis points	August 4, 2016	0.25 %	0.30 %	November 3, 2016

Source: Bloomberg, as of September 26, 2016

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