
Weekly Market Summary

27th of Nov 2015

Markets Seem to Have Made Up Their Mind.... Decision Makers Not Yet!! Fadi Nasser (SVP – Head of Treasury Sales)

Markets have been confined to narrow ranges over the past few days, though it appears that they have made up their mind ahead of the grand finale for the year! Below is a summary of market positioning going into possibly the most important two weeks of 2015, and what potential implications a surprise move - here or there – would have on market volatility / liquidity heading into year-end (whilst also setting the tone for the early part of 2016):

- **European Central Bank (ECB) Meeting, Thursday December 3rd / Euro Bearish:** The Euro is set for its longest stretch of weekly declines versus the Japanese yen since the common currency creation in 1999 - and has been steadily losing ground against the US greenback and sterling pound – as anticipation builds that the ECB will surprise many investors with the size of its stimulus at next week's monetary policy meeting (a la big surprise on January 22nd 2015, when "Super" Mario Draghi fired a bazooka by unveiling bigger-than-expected quantitative easing measures, including monthly asset purchases of €60 billion extending well into the second half of 2016!). *"If there is anyone who has the market's firm belief that they can over-deliver, it is always going to be Mario Draghi,"* Chris Weston, chief market strategist at IG limited in Melbourne, said of the ECB president. *"The reason we have not started seeing traders looking to fade the euro with any great conviction is because there is a genuine belief that he always guide the market to an extent and later come out and do more."* ECB policy makers will meet in Frankfurt on December 3rd and economists' consensus is currently for a minimum 15 bps cut to the deposit rate (last at -0.20%), along with an expansion of the quantitative easing program (with regards to size, composition and duration). As weird as it sounds, an ECB rate cut seems very likely simply because the market is expecting it! After all, recent better-than-expected European data and the expected US Fed rate hike have reduced the need for the ECB to cut, not to mention several problems related to more negative rates. However with Mario Draghi keen not to disappoint the market - and having done nothing to counter rate cut speculation in past days, but on the contrary announcing last Monday that the ECB will do what is necessary to reach its inflation goal rapidly - a sizable reduction in the deposit rate seems the most likely outcome now. €QE (Quantitative Easing) expectations are of course more difficult to read, with the latest Reuters median forecast going for an extension of the monthly ECB purchases by €15billion to €75billion.

Risk to the Consensus: While Draghi and Executive Board member Peter Praet, the institution's chief economist, have indicated more easing is in the cards, some governors have expressed unease. Estonia's Ardo Hansson, Slovenia's Bostjan Jazbec and Germany's Jens Weidmann have signaled since the last meeting that they see no need to ease policy further just now. *"I see no reason to talk down the economic outlook and paint a gloomy picture,"* Weidmann said in a speech at the same event as Draghi.

“Crucially, the decline in oil prices is more of an economic stimulus for the euro area than a harbinger of deflation.” **A less dovish ECB outcome at next Thursday’s monetary policy meeting would surely result in a quick jump in European government bond yields and lead to immediate Euro strengthening.**

- ***Fed Chair Yellen Speech to the Economic Club of Washington, December 2nd / Federal Open Market Committee (FOMC) Meeting, December 16th***: US Federal Reserve Chairwoman Janet Yellen will be addressing markets next Wednesday and is widely expected to strike a balance between cementing market expectations for a December lift-off, while at the same time not sounding too aggressive in order to avoid fueling a further rally in the US dollar or raising added concerns for Emerging market assets. Markets are currently assigning a 75% probability (roughly 17 bps) for a 25 bps Fed rate hike at the December 16th Fed meeting, though expectations remain for mild increases in short term rates afterwards (market pricing for the forward path of the Federal funds rate currently assumes a benign 50 bps jump in rates throughout 2016 and an additional 45 bps in 2017, well shy of the 200 bps yearly moves engineered by the Fed during previous tightening cycles). A number of FOMC participants have stated in past weeks that short-run rates would rise “only gradually” and remain below levels that had been considered normal during previous expansions. *“My best answer – with respect to a gradual pace of policy tightening – is that it does not occur at every meeting. Beyond that, it is difficult to predict what that would look like exactly”*, according to Atlanta Fed President Dennis Lockhart –a voting member on the FOMC this year.

Risk to the Consensus: We assign a very low probability (15% at best) for a weak November payroll next Friday (December 4th) that would - along with increased geopolitical tensions and renewed Chinese equity weakness – lead the Fed to remain on hold at its upcoming meeting. After all, jobs increased in October by the most in 10 months while the unemployment rate fell to a 7-year low, indicating a robust employment outlook that should not be profoundly impacted by a potential weaker-than-consensus release next Friday. **What really worries us is how one minute traders panic about the possibility of the Fed embarking on a rate hike cycle for the first time in a decade, and afterwards experience utmost serenity as a level of calm settles on expectations that it will be “one and done”.** A measure of implied volatility for US Treasuries (MOVE index, last at 70) has fallen this week to its lowest level for 2015!! **Not to be alarmist, but the transition to a rising rate environment is likely to be rockier than fixed-income markets are suggesting, especially if one assumes (pick me!) that the Fed has no clear vision for an exit strategy, or at least that it will find it more difficult to raise market rates in a world flooded with multiple trillions of new cash!**

- ***Organization of Petroleum Exporting Countries (OPEC) Meeting, Friday December 4th / Oil Outlook:*** Oil prices have shed some of the gains made earlier in the week. This morning saw Brent and WTI trading at \$45 and \$42 per barrel respectively. Geopolitical concerns have abated somewhat, as Russia’s President Putin assured French President Hollande yesterday that moderate rebels would be spared and that air strikes on IS would be intensified and better coordinated. This makes an international alliance to counter IS more probable, something that had become questionable following Tuesday’s shooting down of a Russian military aircraft by Turkey. As such, oil market participants’ focus/attention has shifted back to the oil oversupply/glut, which is likely to remain in place well into 2016 and result in a further increase in stock levels. US Inventories climbed on Wednesday for the ninth straight week and are now only slightly below the record level reached last spring (roughly 100 million barrels above the five-year seasonal average!).

And whilst members of OPEC prepare to meet in Vienna on December 4th, oil buyers and the market in general continue assuming that oil prices will remain depressed for long, especially that Iran will officially announce plans to boost production by 500,000 barrels a day, further lifting the 12-member group's output which has exceeded its output target of 30 million barrels a day for the past 17 months (boosted by increases from its biggest members, Saudi Arabia & Iraq)! Oil prices may drop to as low as the mid-\$20s a barrel unless OPEC takes action to stabilize the market, Venezuelan Oil Minister Eulogio Del Pino said on November 22nd. The Latin American nation and Algeria are among OPEC states most affected by crude's slump and have long urged fellow members to curb output. Saudi Arabia, the world's largest crude exporter, led the group to switch its strategy in November 2014 to focus on pressuring competitors (slowly working with the latest weekly number of rigs targeting oil in the US falling by nine to 555, the lowest level since June 2010 and close to half the number of active rigs operating just last December). *"It is obvious that everyone will continue with their output because they have to sustain their economies,"* said H. Kumar, managing director of India's Mangalore Refinery & Petrochemicals Ltd. *"If they reduce, their revenues will come down to that extent. So, this era of everyone sustaining output will continue and this is good for refiners".*

Risk to the Consensus: Although oil can clearly stay around current depressed levels or even move lower, many market professionals see a sharp spike in crude oil as more likely than a continued decline. They reason that the drop in crude comes from heavy supply and somewhat weak demand, and both dynamics are unlikely to get even more bearish from here (in other words, the market is currently priced for perfection: Oversupply that will remain in place or increase due to lack of trust amongst OPEC & non-OPEC members, weak demand for the foreseeable future given the weak growth prospects for the Chinese and European economies, little impact from current heightened geopolitical tension in the Middle East) . A jump in crude prices could easily be spurred by a worsening geopolitical situation, a weaker US dollar, an improving global economy or simply an agreement between OPEC & non-OPEC members to back Venezuela's former oil minister Rafael Ramirez proposal to resurrect OPEC's old price band mechanism and attempt to set a \$70 floor for the battered oil market. Even if the idea fails to advance, it could still represent the first meaningful step in months to move away from OPEC's laissez faire approach to collapsing oil prices, towards finding common ground that could help stabilize the oil market!

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