# NUS INVESTMENT SOCIETY

# GLOBAL MACRO AY2018/2019

# SEMESTER 1 RESEARCH REPORT

## GLOBAL MACRO RESEARCH TEAM – AY 2018/2019 SEMESTER 1

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**[All information accurate as of 21st December 2018]**

# JAPAN – OVERWEIGHT

The Japanese economy is the 3rd largest in the world by nominal gross domestic product (GDP) and 4th largest by purchasing power parity (PPP). As history has shown, Japan is also regarded as a safe haven in which investors will seek refuge, during a risk-off landscape.

Following the Japanese asset price bubble collapse in 1991, Japan faced a long period known as the 'Lost Score' which it suffered from deflation and stagnation for approximately the next 20 years. This laid the foundation for Prime Minister Shinzo Abe to take on a bold strategy to a problem-laden economy when he took over in December 2012, giving rise to the colloquial 'Abenomics'. Under 'Abenomics', Prime Minister Shinzo Abe believed that aggressive monetary easing and fiscal policies would be able to effectively to tackle deflation while undergoing structural reforms. These structural reforms included slashing business regulations, liberalizing the labor market and agricultural sector, cutting corporate taxes, and increasing workforce diversity – in aims to revive Japan's competitiveness.

However, while Japan has moved on from deflation, it now struggles with a new issue of a sky-high public debt at 253% of Japan's GDP as of December 2018.

Japan is primarily an export-driven economy. Japan's key exports come from the automobile industry (20.9%) and electronic goods (34.9%). The country is the world's 3rd largest producer of cars and the 2nd largest producer of ships. Japan is a country with very limited natural resources and thus is highly dependent on imports to meet its needs of raw materials and energy.

<u>Status Quo for the Time Being</u>

As shown on Figure 1 below, the Bank of Japan (BoJ) left shorter-term interest rates unchanged at -0.1% on 19th September 2018 and kept the target for the 10-year Japanese government bond yield at around zero. It is expected that the economy will continue to expand modestly despite intensifying trade tensions sparked by the US-China trade war.

In its current state, the Bank of Japan is adopting an accommodative monetary policy. Under the current stimulus program, the BoJ buys approximately 80 trillion yen of government bonds a year to maintain interest rates. By doing so, interest rates are kept low, with the goal being to drive businesses and households into riskier investments. This is expected to stimulate economic activity and raise prices, with a goal of reaching 2% inflation and self-sustaining economic growth. While progress has been made, the goal of reaching 2% inflation remains elusive with current inflation at 1%. As a result of the stimulus, the large public-debt to GDP ratio has raised concerns in recent times – leading to discussions and speculations as to whether the BoJ will seek to adjust its monetary policy in the near future in order to maintain a healthier level of public debt in the Japanese economy.

However, the BoJ appears to be in no rush to abandon its easing cycle as the Japanese economy struggles to achieve the 2% target for inflation. Hence, the central bank may continue to fine-tune its asset-purchase program in 2019 as a growing number of officials endorse dovish forward-guidance for monetary policy.

As such, we adopt a status quo stance towards developments in the field of interest rates in the time being. Nevertheless, we are keeping up with developments in the Japanese economy and will adjust our projections accordingly.


*Figure 1: Japan Interest Rates as per BoJ (Source: TradingEconomics.com)*

Labor Reform in Japan as new Growth Strategy

In October 2018, the Japanese government started the process of crafting a new economic growth strategy – one with a strong emphasis on labor reform. This labor reform is expected to lead to more companies continuing to employ workers past the age of 65. The new legislation mandates companies to keep willing workers on the payroll beyond age 65, increasing from age 60.

Japan's aging population has plagued the labor landscape of Japan, given the poor fertility rate of 1.44. Without an increase in working age, Japan's workforce is projected to shrink by 28% in the next 50 years. Despite work-style reforms and subsidies, Japan has still been unsuccessful in encouraging more childbirths. To mitigate the downside from an aging population, the increase in retirement age hopes to achieve higher levels of consumer spending in Japan through a greater spending power for the employed elderly. In turn, this might spur the private sector to hire more people with prior work experience and allow for an increase in real wages.

A shrinking workforce also means fewer workers paying into the national pension scheme. This is likely to hurt the government's budget as well. As such, it has also been proposed that the elderly start receiving pension payouts only past 70. While this may come across as a controversial move, Japan is a well-known hub for healthcare, and the government has put in plans to develop the healthcare sector to care for more diseases associated with an aging population as well.

On top of the increase in retirement age, Japan recently passed a new regulation with regards to its immigration laws to welcome more foreign labor. This was done with regards to the labor shortage problem through a revised visa system to allow lower-skilled workers into the country. This was largely due to the struggle to fill job vacancies in the elder care, agriculture and construction sectors. The government has also issued a forecast of 345,000 foreign workers entering the economy within the next 5 years. However, given Japan's ranking of 29 out of 63 countries with regards to its ability to attract talent and develop talent paired with the issue of widespread criticism of the revised immigration laws with its citizens, the success of the revision in immigration laws will be uncertain moving forward.

If successful, this revision in immigration law will aid Japan in boosting its weak domestic consumption. With domestic consumption being a lagging problem in boosting the economy of Japan, these labor reforms are projected to spur growth in domestic consumption which will become a driver for sustained growth.

Public Enemy #1 - USA

With the trade conflict between the United States and China being a key macroeconomic theme in 2018, the destruction it has brought about in trade agreements may be a silver lining for Japan. With the USA adopting an aggressive protectionist trade policy and primarily targeting China, this has led to a possible rekindling of China-Japan ties that had been strained since 2012's island conflict as leaders of China and Japan seek to defend free trade.

As of October 2018, China and Japan are working towards resetting their troubled bilateral relationships now that the USA has become their common threat on the trade front. Prime Minister Shinzo Abe had concluded a range of agreements on his first official visit since 2012 with Beijing. The agreements consisted of a 3-year, $30 billion credit swap agreement between the two country's central banks and co-operation on infrastructure projects overseas.

The currency swap deal underlines both China and Japan's willingness to forge a closer relationship to counter the climate of risk and uncertainty as the trade war with the USA rages on. Under the currency agreement, the People's Bank of China (PBoC) and the Bank of Japan will be able to exchange up to 3.4 trillion yen for 200 billion yuan and vice versa over the next three years – designed to help ensure financial stability and facilitate financial ties, according to a statement from China's central bank. However, it is important to note that the real value of the currency swap deal is actually limited financially but instead plays a key significance in the restoration of China-Japan ties.

On the other end of the increased collaboration, it is an alternative to Japanese participation in Beijing-led institutions such as the Asian Infrastructure Development Bank. This marks an effort to corral Chinese aid into international projects and is a way to avoid cut-throat competition between China and Japan for infrastructure deals in countries such as the development of smart cities in Thailand and Indonesia.

With Japan's export-driven economy being closely tied to China given that China accounts for 19% of Japan's exports, this sets a positive sentiment in the upcoming days as we await further developments in the Japan-China discussions.

Japan Bonds Back in Action

The long-term expectations of increasing Japan Government Bond (JGB) yields have recently been set in place. With the advancement of bond yields in Japan, JGBs are back on the radar of life insurers which are among the Japan nation's largest buyer of foreign debt. Given the prolonged landscape of low government bond yields in Japan, this has led to Japanese holdings of overseas bonds propelling to $2.4 trillion as we can see from Figure 2 below. With the JGB 30-year yields creeping close to 1%, it is seen as the level which will start tempting Japanese life insurers to shift some of their foreign debt back home. This is because there will not be much of a difference between 10-year European debt – after hedging – and Japanese bonds. This is projected to lead to an increased demand for JPY once again.

Additionally, the increasing yields in Japan will result in a steepening yield curve which will boost the relative allure of super-long dated JGBs as their carry and roll-down income will exceed that from overseas bonds after taking out currency hedging costs.

Recently, volatility has been seeping back into the Japanese bond markets, given that the central bank recently doubled the range for the benchmark Japan 10-year bonds, as part of their yield curve control policy.

Furthermore, given the global landscape that is currently being haunted by the US-China trade war, the consequences of Brexit, and the crash of emerging markets, the world is gradually starting to adopt a risk-off sentiment towards the markets. With a risk-off sentiment, Japan's status as a safe haven will likely start seeing an inflow of JPY as well, as Japanese investors are likely to retract their foreign investments in a riskier climate.

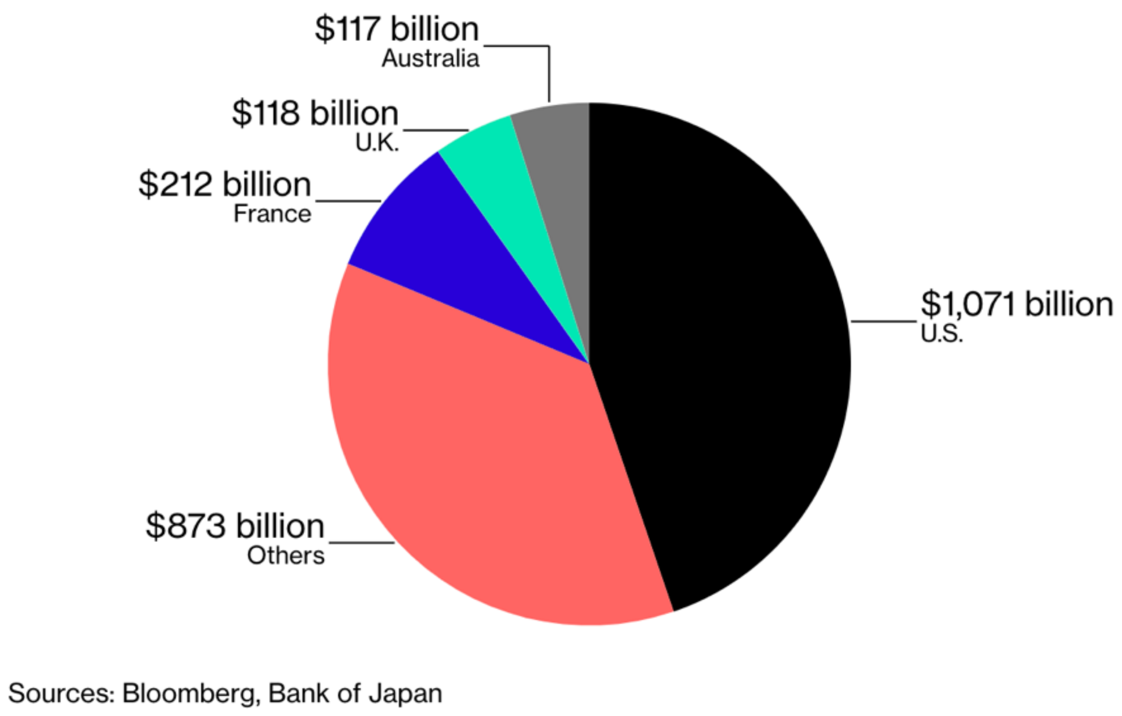


*Figure 2: Components of Japan's overseas bond holdings (Source: Bloomberg, BoJ)*

## FX TRADE IDEA: SHORT USDJPY


*Figure 3: USD/JPY daily chart (Source: Tradingview.com)*

On the trade front, markets were happy to hear that China will be buying US soybeans and that the world's 2nd largest economy is willing to change its controversial China 2025 program. However, the cheer did not last for too long as investors realized that Chinese home prices are struggling. This data points toward significant decelerations in industrial output, retail sales and a weaker demand for USD as well.

One of the most significant events recently was the all-important Fed decision. Generally, a rate hike has been fully priced in, but expectations about the guidance for 2019 remain wide open. The latest forecast on rates by the Fed showed three increases next year. Recent dovish comments and unimpressive economic data then caused some second thoughts about only one hike or even none at all. The latest substantial release raised the stakes once again: retail sales jumped in November.

The USD/JPY pair is more likely to move on headlines regarding a potential government shutdown. US President Donald Trump remains adamant about receiving funding for a wall on the US-Mexican border while Democrats and most Republicans are against it.

The pair also tends to move with stocks and bonds. At the moment, US bonds are slightly lower while S&P futures are marginally higher.

**Entry: 111.15**

**Take Profit: 110.00**

**Stop Loss: 113.00**

USDJPY was initially trading within a narrow range earlier this week when the pair was hovering slightly above the 50 (red line) and 200 (dark blue line) Simple Moving Averages.

Following a sell-off in the yen, we look towards the 200-day SMA for new support levels. If the pair were to fall below the 200-day SMA, it indicates a strong bearish signal. If the 200-day SMA fails as a level support, we will be looking at the August low of 109.77 as our next level of key support for greater confirmation of the potential bearish signal.

## CFD TRADE IDEA: LONG JP225 CFD


*Figure 4: JP225 CFD daily chart (Source: Tradingview.com)*

With domestic consumption and business sentiment picking up in the Japanese economy, we expect a recovery in the upcoming months. The seasonally adjusted diffusion index of business sentiment among people in positions sensitive to economic trends rose to 51.0 in November, up 1.5 points from the month prior, according to the Cabinet Office's Economy Watchers Survey. That represents the second straight month of gains and the first time the index has climbed above the boom-or-bust line of 50 since December 2017. Furthermore, household activities rebounded in November as shown by rising hotel and restaurant reservations. As such, we expect a recovery in the upcoming months following the massive sell-off.

**Entry level: 19750.00**

**Exit level: 21250.00**

**Stop loss: 19600.00**

While technical analysis is indicative of a strong bearish signal in the short-term given a strong a strong downtrend within a narrowing channel, the RSI is also indicative that the JP225 is oversold and may see a reversal in the upcoming months given the narrowing channel that signals a potential reversal as well.

Based on Fibonacci extensions and retracements, JP225 is approaching our first support level at **19705.3** (50% Fibonacci retracement) where a strong bounce might occur above this level pushing price up to our major resistance at **20915** (61.8% Fibonacci extension, 23.6% Fibonacci retracement). As such, JP225 may still see a strong bounce-off and recovery if it fails to break through major resistance of 20915 and support our bullish stand on a bullish JP225 in the medium-term.

# CHINA – UNDERWEIGHT

In China, strong GDP growth continues with a growth rate of 6.5% in Q3 2018. The country now accounts for one-third of global growth, with over 800 million people being lifted out of poverty. After years of high-speed expansion, China now is focusing more on high quality-growth by easing domestic credit conditions, fueling domestic consumption and fostering openness with the Belt and Road Initiative (BRI). The escalating trade war with the US and limited Chinese retaliation doubled, with policymaker's decision to ease credit growth contributing to a more than 8% depreciation in the CNH relative to the USD.

Prudent Monetary Policy by the People's Bank of China (PBOC)

Throughout 2018, the People's Bank of China continued to maintain a 'prudent and neutral' monetary policy stance by adopting multiple policy tools to keep liquidity ample and to promote a reasonable growth of money supply, credit and total social financing. The benchmark interest rate is currently at 4.35%. The PBOC has always adopted controlled interest rates, with the last cut of 25 basis points in October 2015. Despite the US Federal Reserve's decision to hike interest rates in September, the PBOC reacted with a muted response by keeping the interest rate for open market operations unchanged. The rate for 7-day reserve remains at 2.55% and 28-day reverse repurchase agreements at 2.85%.

This appears understandable as the debt repayment pressure for Chinese companies is mounting, coupled with domestic slowdown and potential fallout of the trade war. The PBOC promised not to devalue Yuan during the uncertain trade war and this promise would likely be delivered provided that the long-term economic performance of China is optimistic. However, earlier this year, China reshuffled its central bank monetary policy committee with Governor Yi Gang becoming the new panel chief. Although the appointment has not had any clear impact on China's monetary policy, closer observation for both Chinese political policy actions and Fed decisions would be necessary to draw a more concise conclusion on the future trend of the USD/CNH.


*Figure 5: China Interest Rate (Source: Tradingeconomics.com)*

## Strong Growth with More Uncertainties Shadowing Inflation

In 2018, economic growth in China continued, but at a slower pace. The real GDP rose by 6.8% in Q1, followed by a 6.7% increase in Q2 and 6.6% in Q3. Once relying heavily on fixed-asset investment and exports, the Chinese government now is focusing on the consumption and service sectors in order to transform the economy from the 'world factory' to the 'world marketplace'. In contrast, with the US Federal Reserve having raised rates on the back on strong economic performance, the PBoC adopted a more polarized approach by cutting the reserve requirement ratio to release more money in liquidity, thus stimulating economic growth. Despite trade frictions with the US in the first half of 2018, consumption showed much resilience and contributed to 78.5% of GDP growth. The government is also stressing on the development of innovation by encouraging old companies to innovate and helping the tech firms to go abroad. From September 2018 onwards, the Chinese government exercised tax reductions for tech firms to encourage more innovation and development, helping home-grown tech giants like Huawei to save about 3 billion US dollars.

Inflation in China experienced more pronounced ups and downs in 2018. China's consumer price inflation rose to a seven-month high of 2.5% year-on-year in September, up from 2.3% in the previous month. The price surge was identified to be driven largely by an increase in food prices due to bad weather condition and outbreak of swine flu earlier this year. Still, inflation remained below the Chinese government's target of around 3% for 2018 and the impact of the escalating trade war and the many rounds of tariffs is yet to reflect on consumer price index in China.

We expect looser monetary policies to spur growth in the near future. However, the downside would be a resulted depreciation of Yuan battling against other currencies.

## Escalating Trade War and Belt and Road Initiative

Amid the trade frictions with the US, China saw a current account deficit of USD 28.3 billion in the first half of 2018 for the first time in 20 years. With a narrowing trade surplus and a widening service trade deficit, the current account is expected to be more volatile in the future and provide less support to the Chinese Yuan. Currently, in terms of volume of trade, the US remains as China's top trading partner despite the many rounds of tariffs. On the US side, higher tariffs indicate a one-off increase in import prices for consumers. However, the Chinese government on the other side would probably face a more painful complication on its already shrinking exports sector, the unsettled financial market as well as both domestic and foreign investments. Although the Chinese government refused to depreciate the Chinese Yuan to counter the negative impact on the exchange rate against the USD, the future is still uncertain.

Meanwhile, the infrastructure projects promoted by the Belt and Road Initiative are falling short of Beijing's ideals. Debt sustainability, governance flaws and policy opacity are some of the main issues in countries like Malaysia, Pakistan, Cambodia and Sri Lanka. The bursting bubbles of trillion-dollar deals may start hurting the economic performance of China.

## FX TRADE IDEA: USDCNH (NEUTRAL)


*Figure 6: USD/CNH weekly chart (Source: Tradingview.com)*

USDCNH is currently in an upward trend as demarcated by the trend lines below. The trend is supported by a region of 6.79121 and is on the verge of breaking the previous high of 6.97177. Since the beginning of 2018, the pair has been gaining much upward momentum due to a persistently strong US dollar.

At the moment, a breakout from the existing resistance level of 6.97177 is highly possible and we can expect the bullish trend to continue. The question remains whether the pair will eventually break the critical level of 7.00000 in the coming months. As the Chinese government is always prudent and cautious about the exchange rate, we do not think a breakout is likely. Rather, we expect the pair to trade sideways for the near future and recommend that investors observe the pair closely before taking any action.

ETF TRADE IDEA: iShares China Large-Cap ETF

**Listed on**: Hong Kong Stock Exchange

**Ticker**: NYSEARCA: FXI

The iShares China Large-Cap ETF seeks to track the investment results of the FTSE China 50 Index composed of large-capitalization Chinese equities that trade on the Hong Kong Stock Exchange. FXI is among the largest and most popular China ETFs, with superb AUM and strong daily volume. The fund holds 50 of the largest H-shares, P-chips and Red Chips. The fund carries a heavy concentration in financials, with China's big, state-run banks making up a huge portion of the portfolio.


*Figure 7: FXI weekly chart (Source: Tradingview.com)*

**Entry level: 38.00**

**Exit level: 52.00**

**Stop loss: 34.00**

After hitting the low 50 twice and being met with the high volume selling, the FXI looks like heading down to the previous lows. We could be expecting either a spring back from the critical resistance level 33.99 or a continuation of bearish trend hitting the precious bottom of 29.14 level. As broader market sell-off is intensifying due to trade war uncertainties and concerns over slowing global economy hurting investors' sentiments, the latter scenario is more possible. Looking ahead, investors should keep clear from the pessimistic Chinese stock market and short FXI if possible.

# SOUTH KOREA – UNDERWEIGHT

Ranked 11th amongst the world's largest economic powers and 4th in Asia, South Korea's economy is renowned for its spectacular rise from one of the poorest countries in the world to a developed, high-income country in just one generation, commonly known as the "Miracle on the Han River". According to 2017 data from the World Bank, South Korea's economy was composed of 70.3% in the services sector, 24.8% in the industrial sector and 4.9% in the agricultural sector. Prominent industries include textile, steel, car manufacturing, shipbuilding and electronics with South Korea being the world's largest producer of semiconductors. Furthermore, South Korea has earned the reputation as a global information and communication technology (ICT) leader with the government and family-owned conglomerates constantly investing in R&D to modernize their entire economy.

<u>Bank of Korea Raises Interest Rate for First Time in a Year</u>

In a bid to curb snowballing household debts which stand at a record 1,514 trillion won ($1.78 trillion) as of late September 2018 and surging housing prices – especially in Seoul – South Korea raised its benchmark overnight inter-bank lending rate by a quarter point to 1.75% in November 2018.

The move was widely expected in light of increasing concern of capital flights from Seoul financial markets after a series of rate hikes in the US. Despite recent announcements by the US Federal Reserve of a possible slowdown in rate hikes, we believe that the possibility of future interest rate hikes by South Korea remains high as interest rate differentials between South Korea and the US remain prominent and we believe that the current hike will be insufficient in significantly reducing the ballooning household debts. However, with the global trade war sapping away demand for Korean – made cars and high-tech gadgets, this move by the Bank of Korea will further deter consumer spending and adversely affect South Korea's already sluggish economy.

<u>The Next Lost Decade?</u>

A high unemployment rate coupled with falling corporate investments have cast a dismal outlook for South Korea's economic growth in time to come. The number of the unemployed, soared 51,000 on-year to reach 1.11 million in the January-September period, marking the highest figure since 1999 when the country was still reeling from the aftermath of the 1997 Asian financial crisis.

Along with disappointing employment data, South Korea's Q3 corporate investments dropped 5.7% from a year before with an expected overall decline of 0.3% in 2018 as business confidence falters. This constitutes a fall in construction investment by 6.4% on-quarter, the lowest drop since the 6.5% decrease in Q2 of 1998, as well as a 4.7% slip of local companies' facility investment from the previous quarter.

As a result, South Korea's economy grew by only 0.6% in the 3rd quarter of 2018, slightly lower than the 0.7% gain in Q2 and 1.0% expansion in Q3. The Bank of Korea and market analysts have subsequently lowered their growth forecast for 2018 from 2.9% to 2.7%, signaling a less than positive vision of the South Korean economy.

Won (One) Korea?

In the first trip to Pyongyang in a decade by South Korean president Moon Jae-in for the September 2018 Inter-Korean summit, the two countries have made advancements on inter-Korean ties with plans to link up their railways, allow more reunions for families separated by war and co-operate on health care. Furthermore, the South's defense minister and head of the North Korean army also signed an agreement to reduce military tensions with a buffer zone to be established along the border to prevent accidental clashes. In the latest move by both countries, North and South Korea have each dismantled 10 of their guard posts along the heavily fortified Demilitarized Zone and it is the first time since the division of the Koreas that the soldiers from both countries crossed into each other's territory peacefully.

We believe that the South's dovish policy of engagement with the North hints at greater diplomacy and possibly better economic cooperation between the two Koreas in time to come. However, this is in contrast with the United States which has maintained its assertive stance on Pyongyang until it achieves "complete, verifiable, irreversible denuclearization". Recognizing the fact that South Korea is a close ally of the United States, the current situation points towards the South being more concerned about forging closer ties with the North than aggressively putting pressure on their denuclearization efforts.

Therefore, we believe that while it may still require some time for the end goal of denuclearization to be attained, recent advancements in relations between the two Koreas reveal that the dream of a one united Korea may not be that far-fetched after all.

## FX TRADE IDEA: LONG USDKRW


*Figure 8: USD/KRW daily chart (Source: Tradingview.com)*

With a declining Korean economy and the Fed hinting at slower rate hikes moving in 2019, we foresee the USD appreciating against the KRW owing to fundamental such as stronger economic growth in the US and interest rate differentials. Furthermore, we foresee that the effects of the trade war will be felt by the Korean economy much harder in the next few months, signaling a bigger economic slowdown for the world's 11th biggest economy.

**Entry: 1124.00**

**Exit: 1144.00**

**Stop-loss: 1120.00**

We can see that the 50SMA has remained above the 100SMA and 200SMA since June and July 2018 respectively, indicating an uptrend in the coming years. The channel between the light green lines also suggests an uptrend that is closing in, signaling a buy signal in the near future before the market can decide on the next direction. Hence, a buy trade can be entered at 1124.00, slightly above the closing level and a stop-loss of 1120.00 below the channel support can be utilized to prevent getting stopped out of the trade in the situation of a false breakthrough of the channel support. A safe take-profit level of 1144.00 below the channel resistance will be used.

Therefore, assuming the current circumstances, the USD is projected to appreciate against the KRW and this signifies a possible buy signal for the next couple of months.

<u>INDEX TRADE IDEA: LONG KOSPI 200 Futures Inverse Index</u>

**Listed on**: Korea Exchange

**Ticker:** KOSPI200IN

The KOSPI200IN is an index that trades inversely to the KOSPI 200 Index, a capitalization-weighted index of 200 Korean stocks which make up 93% of the total market value of the Korea Stock Exchange and is largely considered as a reliable benchmark for the South Korean economy. Top 9 stocks on the KOSPI 200 Index by market capitalization include Samsung Electronics, SK Hynix, Hyundai Motor, POSCO, Korea Electric Power, LG Chem, Naver, Shinhan Bank and Hyundai Mobis.


*Figure 9: KOSPI200 Futures daily chart (Source: Tradingview.com)*

Battered by the tightening of monetary policy, decreased global trade due to the US-China trade war and a general slowdown in economic growth, the outlook for South Korean companies is generally unfavorable. Furthermore, we will expect the true impact of the trade war to be felt in the coming months, signaling impending headwinds for early 2019 and a continuation of dismal earnings in South Korean companies. Therefore, we believe that the KOSPI200IN will likely stick to the uptrend due to a weak economic outlook.

**Entry: 885.00**

**Exit: 965.00**

**Stop-loss: 872.00**

A strong uptrend has been observed since June 2018 and the 50 SMA has remained well above the 100 SMA since July 2018 with the gap between them increasing in recent months. Furthermore, an uptrend channel can be seen between the light green lines drawn, foreshadowing a future increase in the index. With respect to the strong resistance level of 880.80, we would set the entry point at 885.00, slightly above the resistance level to ensure a true breakout unlike the one observed in October 2018. A stop-loss level of 872.00 will be used to prevent heavy losses should there be another false breakout. Exit level will be set at 965.00, slightly below the next resistance to safely reap profits.

In conclusion, 2018 has been a depressing year for South Korea with its economy suffering heavily from rising interest rates and the global trade war. Furthermore, complemented with domestic issues such as record unemployment figures and ballooning household debt, the near outlook for the South is bleak and it is highly likely that 2019 will be a very tough year for them as well.

## SINGAPORE – NEUTRAL

In 2017, Singapore was ranked as the world's 2nd most open economy and pro-business regime by the Heritage Foundation's *Index of Economic Freedom* and the World Bank's *Doing Business* report respectively. A tiny state with a surface area of around 700km$^2$ combined with a lack of natural resources, Singapore's economy is largely driven by exports which made up 173% of GDP in 2017. Situated on the southern part of the Strait of Malacca, the Port of Singapore serves as the world's busiest container transshipment hub due to its prime location along major trading routes, signaling its strong influence as a crucial harbor for global maritime trade.

According to 2017 numbers by the Department of Statistics Singapore, Singapore's economy was primarily composed of the service sector which accounts for close to 70% of GDP while about 25% was generated by goods-producing industries. In recent years, the Singapore Economic Development Board has been shifting its focus from technology-intensive initiatives towards innovation-intensive activities such as R&D in line with the government's goal to transform the nation into a global innovation hub.

### MAS Tightens Monetary Policy Twice in 2018 – What's Next?

Amidst a backdrop of strong economic growth in the first half of 2018, the Monetary Authority of Singapore (MAS) announced the first tightening of its exchange rate-based monetary policy in six years on 13th April 2018.

Subsequently, on 12th October 2018, the MAS mentioned in its bi-annual policy review that the slope of the Singapore dollar's nominal effective exchange rate (S$NEER) policy band will be slightly increased while the width and level of the policy band, its other two levers, will remain as per status quo.

This move came as Singapore's economy grew by 2.6% in Q3, slowing less than expected following strong average growth of 4.3% in the first half of the year, signaling confidence in the economy amidst growing concerns about a setback in global growth. Furthermore, the MAS added that rising global oil and food prices could potentially lead to greater imported inflation, justifying the tightening of monetary policy to keep inflation within the desired range of 1.5 to 2%.

Despite the Singapore dollar gaining less than 0.1% to 1.3758 against the US dollar following the announcement, the impact of the move turned out to be less significant than expected with the USD/SGD pair rebounding to the 1.3800 region within the next few days. We believe that this is due to prior expectations regarding the MAS move in tightening monetary policy to align with that of key central banks around the world, resulting in much of the effect already being priced into the market.

Moving forward, we postulate that the MAS will continue normalizing monetary policy in 2019 owing to expected hikes in interest rates by the US Federal Reserve and domestic demand-related price pressures from the improving labor market. However, this should be taken with caution with the heavy correction in global crude oil prices in the end of 2018 that could pose a downside risk to the core inflation forecast of 2% in early 2019. Nonetheless, we believe that much of the MAS's monetary policy decision will be tied to the Fed's stance on interest rates which remains hawkish despite recent skepticism about future hikes and hence continued tightening of Singapore's monetary policy at least into early 2019.

Negative Spillover from US-China Trade War

Singapore has remained relatively unaffected by the US-China trade conflict as of late, but it was announced by the MAS during its half-yearly macroeconomic review in October 2018 that the effects "are likely to impact the Singapore economy in the latter part of this year and beyond". Much of the negative spillover comes from Singapore's electronics segment being hit by US tariffs on China's electronics exports with electronics manufacturing falling by 5.5% in September 2018. Singapore's economy is poised to expand within the upper half of the 2.5 to 3.5% range in 2018 and moderate slightly in 2019 as compared to the 3.6% growth in 2017.

However, a recent survey by AmCham China and AmCham Shanghai cited that out of 430 American firms polled, approximately one-third have either moved or are considering moving their production out of China with South-east Asia polled to be the top destination for relocation. This could possibly bring about some positive spillovers to Singapore as a leading business hub, but it may take a few years before the effects can be seen.

Furthermore, signs of progress in US-China trade talks at the G20 summit also point to a possible betterment of protectionist sentiment around the world but we predict that it may still be some time before a true deal will be ratified. Current uncertainty surrounding the issue has reduced global consumer confidence, causing us to align with experts' forecast about the slowdown in economic growth as Singapore weather the headwinds in the coming months.

Singapore-Malaysia Maritime Dispute

On 25th Oct 2018, Kuala Lumpur unilaterally gazetted extended port limits for Johor Bahru in a document published by the Attorney-General Chambers, encroaching into Singapore's territorial waters. In response, the Maritime and Port Authority of Singapore issued a circular instructing shipmasters and owners of vessels to disregard Malaysia' gazette notification. Subsequently, Singapore lodged a "strong protest" with the Malaysian government in view of repeated intrusion into Singapore's territorial waters off Tuas by Malaysian vessels. However, this was refuted by Malaysian Prime Minister Mahathir Mohamad who remained adamant that Malaysia had not breached Singapore's border.

Tensions ensued between the two neighboring countries for over two months and eventually de-escalated in December 2018 with both sides claiming to be open to negotiations with each other. Since then, Singapore announced that it had filed a declaration under Article 298 of the 1982 United Nations Convention on the Law of the Sea (UNCLOS) to ensure that other states cannot "unilaterally commence third party arbitration or adjudication against Singapore in respect of maritime boundary disputes". The two countries are scheduled to meet in the second week of January 2019 to discuss the issue.

In view of the above situation, we expect the conflict to be resolved amicably as Singapore and Malaysia rely heavily on each other in various aspects of their economy. For example, Singapore's water supply depends a lot on imported water from Malaysia and on the other hand, a large proportion of Malaysians find work in Singapore to benefit from the SGD/MYR exchange rate which typically stands at about 3.00. Therefore, we believe that the maritime row between Singapore and Malaysia will be settled swiftly in due time and the risk of an escalation of tensions is highly unlikely.

## FX TRADE IDEA: LONG USDSGD

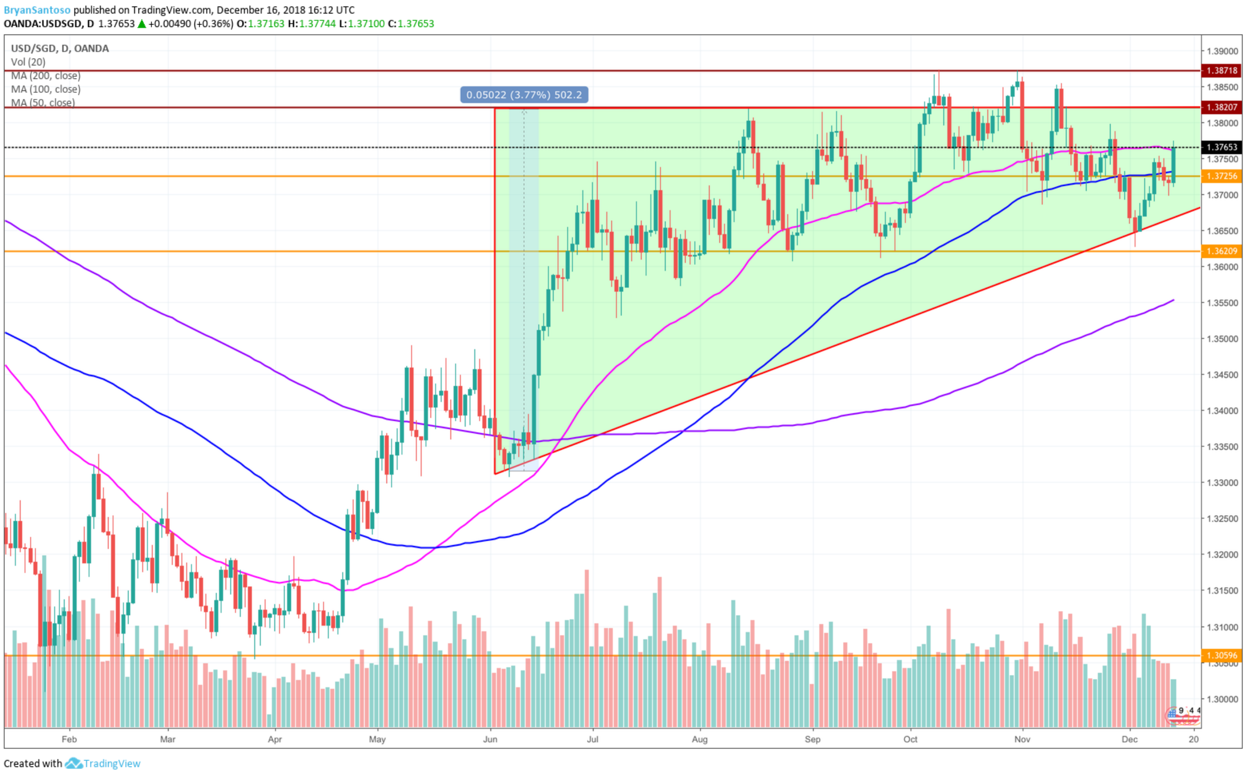


*Figure 10: USD/SGD daily chart (Source: Tradingview.com)*

While trade tensions between the United States and China could ease, economists see the Singapore economy slowing a notch further in 2019 to 2.6% from the 2.7% expansion predicted previously.

On the other hand, amidst the ongoing trade war, the US economy grew at a 3.5% pace in the 3rd quarter, faster than expected and consumer spending which accounts for two-thirds of US economic activity grew by 4% in the same quarter, the strongest since the 4th quarter of 2014. Under the backdrop of a possible trade deal between the US and China as well as the successful signing of the United States-Mexico-Canada Agreement (USMCA), we believe that US economic growth is buffered by various factors and not be hit by a slowdown as much as Singapore. Furthermore, despite a less hawkish tone from the Federal Open Market Committee in November 2018, it remained determined at continuing to increase interest rates in time to come at a slower rate, signaling a potential strengthening of the USD.

Therefore, assuming the current circumstances, the USD is projected to appreciate against the SGD and this signifies a possible buy signal for the next couple of months.

**Entry: 1.38718**

**Exit: 1.43000**

**Stop-loss: 1.38190**

We can observe an uptrend in the USD/SGD pair, as shown by the golden cross of the 50 SMA over 100 SMA in May 2018 and the 100 SMA over 200 SMA in July 2018. Since then, the 50 SMA has remained well above the 100 SMA, indicating a general upwards trend for the greenback. Furthermore, an ascending triangle (shaded in light green) can be seen, a possible signal that the uptrend should be sustained in the months to come.

Should there be a successful breakout above the triangle at the year-high of 1.38718, a continued uptrend to the level of 1.43229 (the difference between the highest and lowest point of the triangle added to the highest point of the triangle) is highly likely to occur. A safe take-profit level of 1.43000 is chosen. However, should it turn out to be a false breakout, a stop-loss of 1.38190, slightly below the strong resistance level of 1.38207 will prevent heavy losses from being incurred.

CFD TRADE IDEA: SHORT Singapore 30 CFD

**Ticker:** OANDA: SG30SGD

Singapore 30 is a contract for difference that follows the Straits Times Index (STI) movements very closely. Maintained & calculated by FTSE, the STI is the most globally-recognized benchmark index and market barometer for Singapore. Dating back to 1966, it tracks the performance of the top 30 largest and most liquid companies listed on the Singapore Exchange. Its largest constituents include DBS Group Holdings Ltd (D05.SI) at 15.6%, Oversea-Chinese Banking Corp (O39.SI) at 11.5% and United Overseas Bank Ltd (U11.SI) at 10.5%. As of 20 December 2018, STI's YTD performance has been dismal at -10.12% and has recently breached the 3,000 psychological support level that was last broken in November 2015.


*Figure 11: SG30SGD daily chart (Source: Tradingview.com)*

Amidst a forecasted slowdown in Singapore's economic growth, the outlook for Singapore companies, including the top 30 largest firms listed on the STI, will generally be unfavorable. Hence, we will expect the index to continue on a decline due to the impending headwinds in the coming months.

**Entry: 339.55**

**Exit: 324.00**

**Stop-loss: 344.00**

A strong downtrend has been observed since May 2018 as depicted from the red shaded area and the 50 SMA has remained below the 100 SMA since crossing it from above in late June 2018. As of late July 2018, the 100 SMA has also crossed the 200 SMA from above and remained well below it, indicating a strong downtrend in recent times. Hence, we believe that one should enter the trade as soon as possible to ride on the downtrend and exit slightly above this channel support level at 324.00 to reap profits. Stop-loss will be set between the entry level and the channel resistance level at approximately 344.00 in case the market acts against the trade.

In conclusion, we hold the view that Singapore's economic outlook for 2019 will weaken due to fundamental factors such as continuous tightening of monetary policy, negative spillover from the US-China trade war and also Singapore's worsening relations with close neighbor Malaysia. Furthermore, with the IMF's October 2018 announcement regarding a cut in global growth forecasts for 2018 and 2019 by 0.2% to 3.7%, Singapore's export-dependent market will definitely be negatively impacted, potentially pointing towards difficult times moving forward.

# HONG KONG – UNDERWEIGHT

Hong Kong is one of the world's leading international financial centers, with strategic advantages of low taxation, almost free port trade and firmly established presence in the international financial market. Its currency, the Hong Kong dollar, had been pegged to the US dollar at the rate of 7.8 since October 1983, backed by Hong Kong Monetary Authority's foreign currency reserves amounting to US$426.4 billion as of September 2018.

Hong Kong is the most service-oriented economy in the world, with over 90% of GDP being service oriented. It's four key industries are namely trade, financial services, tourism and professional services. It has the highest degree of economic freedom in the world and is highly dependent on international trade and finance.

Sandwiched! US-China Trade War Affects Hong Kong's Trade

With trade making up a large portion of Hong Kong's GDP, and it being a key re-export hub between China and US, the trade war might potentially threaten the strong economic figures released in the early half of the year. While the US and China have agreed on a temporary 90-day truce during the G20 Summit in 1st December 2018, current tariffs will still weigh down on trade. Close to half of Chinese goods shipped via Hong Kong to the US have been affected. Signs of its impact have already begun to show as quarterly GDP growth rate shrank for the first time in August by -0.2% below forecasts. Also, a number of small and medium enterprises in Hong Kong had been greatly affected by the trade war and tightening credit conditions. These factors may lead to a slowdown in Hong Kong's economic growth.

Running Out of Steam! Property Prices Fall for the First Time in 28 Months

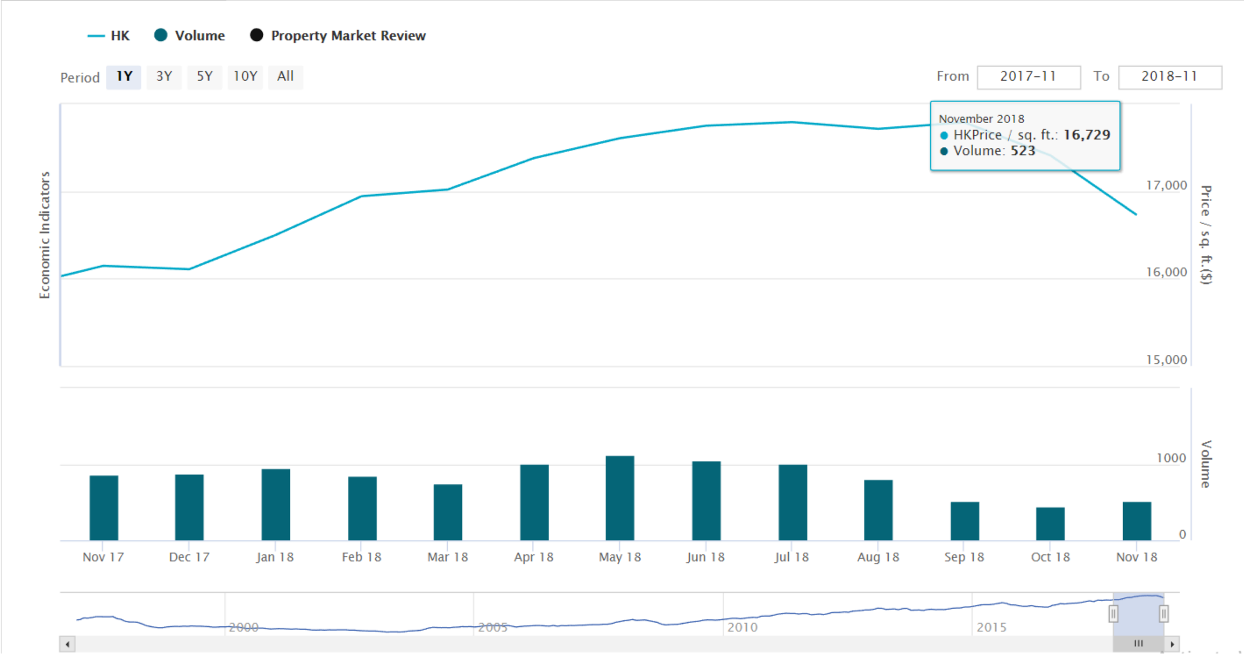


*Figure 12: Hong Kong property price chart (Source: Midland Realty)*

Monthly property prices fell for the first time in 28 months in September and continued to drop throughout October to December. This indicates a clear dampening of buyers' sentiment in an aged bull market. A gloomy outlook looms over the market as rates continue to rise in an effort to keep up with US normalization, the trade war between the US and China remains tense, and the bearish trend on the Hang Seng Index continues to accelerate since the start of the year. Cooling measures by the government over the recent years will begin to sink in, further exacerbating the fall in prices. With such a strong headwind not likely to end anytime soon, we expect prices to continue falling over the next 6-12 months.

Rising HIBOR Pressures Economy More


*Figure 13: Hong Kong 3-months HIBOR (Source: Tradingeconomics.com)*

The Hong Kong Interbank Rate (HIBOR) is the actual rate used by banks in Hong Kong for credit lending. The HKMA has been tightly following the US with regards to interest rate hikes, and thus the HIBOR rates have been rising in tandem. A higher HIBOR rate means tighter credit conditions for Hong Kong's economy and businesses, putting additional pressure onto businesses which are already facing challenges from the trade wars. This is also not a good sign for the already declining property market, which may put the economy at risk of turning sour.

FX TRADE IDEA: USD/HKD - Trading off Support & Resistance


*Figure 14: USDHKD daily chart (Source: Tradingview.com)*

With both HKD-positive (rising rates) and HKD-negative (trade wars and property market) in play, we view the HKD with a relatively neutral fundamental outlook, and thus decided to have a greater focus on technical analysis for our strategy.

Following a sharp downward spike back in 21st September where it briefly tested the 7.79 level before bouncing back up to 7.84, USD/HKD is now resuming a bearish channel.

The unique characteristic of USD/HKD is that the HKMA maintains a dollar peg of 7.75-7.85 HKD to 1 USD. As a result, we tend to see the USD/HKD being attracted to and bouncing off of key levels around 7.75, 7.80 and 7.85, providing an opportunity for traders to take advantage of this phenomenon.

Currently, as the price has rebounded upon testing the 7.80 level and broke out of a trend line upwards, short-term traders may look for buys on the lower timeframes, riding the momentum of the breakout towards the 7.85 level.

Longer-term traders can look to short the USD/HKD at 7.85000 and target 7.80000. As the 7.85 level is protected by the peg, we may seek to enter a tight stop loss just above the 7.85 level at 7.85200.

## INDEX TRADE IDEA: HSI Mean Reversion with Bearish Bias


*Figure 15: HSI daily chart (Source: Tradingview.com)*

Fundamentally, global business cycles seem to have peaked and are beginning to turn as we see numerous global equity indices breaking below the 200-day SMA. Though the trade agreement prospects between the US and China appear to be improving, the damage of the trade war has been done. As Hong Kong gets caught in between the US-China trade war, we expect that its trade will worsen in coming months. Furthermore, with the property market going into a bearish phase, it is expected to weight down on HSI in a negative reinforcement cycle.

The HSI peaked around 33500 back on 29th Jan 2018, retraced sharply, consolidated in a range, and then broke downwards past the 200-day EMA, confirming a strong bearish trend. Since then, it has continued to trade in a bearish channel. We seek to place a short trade at 26900 on the retest of channel high, with a stop loss at 28100 just above the previous swing high. There are 2 potential targets at a channel low of 23000 and a major support level at 21500, depending on the momentum of the downtrend. We stand to gain a potential reward-to-risk of around 3.2 to 4.5.

## Conclusion

Although the US-China trade war has come to a standstill, current tariffs will continue to dent Hong Kong's trade and GDP. Domestically, the continued fall in property prices is a looming threat to the economy. In addition, the rising HIBOR will lead to tighter credit conditions for businesses, slowing down the economy even further. With numerous downside drivers, we believe Hong Kong is potentially due for a recession and thus recommend that investors stay underweight on Hong Kong in their portfolios.

## MALAYSIA – UNDERWEIGHT

Malaysia's economy is the 3rd largest in Southeast Asia. Malaysia was initially an agriculture and commodity-based country but has progressed to one that now plays host to robust manufacturing and services sectors, that have propelled it to become a leading exporter of electrical appliances, electronic parts and components.

Malaysia's productivity growth over the past 25 years has been below those in several global and regional comparators. Over the medium to long-term, the need to accelerate productivity growth has become more pressing as traditional growth engines have slowed.

Malaysia is also one of the most open economies in the world, with a trade to GDP ratio averaging over 140% since 2010. Malaysia also enjoys a trade surplus with its key export destination being Singapore (13.6%), China (12.6%) and Japan (12.2%). Its key exports include electronic equipment and commodities (Petroleum, LNG, Palm Oil, Rubber).

Usurping of Trade Balance

Malaysia's trade surplus narrowed sharply to MYR 1.6 billion in August of 2018 from MYR 9.9 billion in the same month of the prior year and far below market estimates of a MYR 9 billion surplus. It is the smallest trade surplus since October 2014, as exports fell while imports surged. Exports decreased by 0.3% to MYR 81.8 billion, after a 9.4% rise in July and missing market consensus of a 5.7% growth. Imports went up 11.2% to MYR 80.2 billion. Considering the first eight months of 2018, the trade surplus increased to MYR 70.4 billion from MYR 63 billion in the same period of 2017. US and EU Sales shrank by 2%, the EU 8.9% respectively while China and Singapore increased by 4.5% and 2.2%.

Despite a global climate of uncertainty fueled by global tightening among central banks, an appreciating US dollar and the recovery of the energy cycle, Malaysia is still relatively stable in its trade balance given the strong correlation of the economy with energy and oil markets. However, in the next 6 months, the outlook for Malaysia trade surplus is likely to continue narrowing given moderating export growth and strong import growth.

Declining Growth Outlook

Multiple forecasts are predicting that Malaysia growth to ease in Dec 2018 to Feb 2019. The Malaysia leading index, FTSE Bursa Malaysia KLCI decreased by 0.9% in Aug 2018. These signals slowing growth given that the index movements suggest a slowing in the growth of the stocks in Malaysia. Furthermore, the coincident Index (CI), a measure of overall current economic performance, fell 0.3% in August 2018 with Capacity Utilization in the manufacturing sector falling 3% and being the main component that led to the decrease.

Also, adverse weather conditions and supply disruptions in the 2nd quarter of the year impacted the agriculture and mining sectors which make up a significant portion of its commodity exports. In 2019, growth is expected to slow further to 4.6% due to slower growth in global demand and continued fiscal consolidation both within Malaysia and on a global level.

Against a backdrop of rising global risks and fleeing of emerging markets, the impact of the trade war is still uncertain for Malaysia as it remains neutral towards USA and China and there is a possibility that exports could still pick up as the two giant economies redirect their investments from each other to elsewhere.

## FX TRADE IDEA: USD/MYR – Long-Term Hold, Short-Term Buy


*Figure 16: USD/MYR daily chart (Source: Tradingview.com)*

**Entry level: 38.00**

**Exit level: 52.00**

**Stop loss: 34.00**

The USDMYR has been in a major sideways market since late-2015, swinging between highs of around 4.467 to lows of 3.8676. Since 2018 April, USDMYR has been on a stable low volatility bull swing. Short-term traders may seek to take longs on lower time frames in order to capture some of the upside movement. However, longer-term traders may find it better to remain patient and look for a mean reversion trade when price approaches the highs or lows of the major range.

## INDEX TRADE IDEA: SHORT KLSE


*Figure 17: KLSE daily chart (Source: Tradingview.com)*

**Entry level: 38.00**

**Exit level: 52.00**

**Stop loss: 34.00**

The KLSE peaked around 1891 in April 2018, which was the historical peak back in July 2014, thus forming a multi-year double top bullish reversal pattern. Over the course of mid-2017 to late-2018, We see a major head and shoulders bullish reversal pattern which broke down sharply, further confirming the bearishness of the index. Look to trade the bearish channel formed since October 2018.

A short trade can be taken on a retest of the channel high and 20-SMA around 1685, with a target price of 1616 on a historical support and a stop loss of 1708 above the previous channel swing's high and 50-SMA. This provides a good reward-to-risk of 3.0 with a trade horizon of 3-6 months.

# AUSTRALIA – UNDERWEIGHT

Australia is a resource-rich country and the Australian Dollar (AUD) is highly driven by the economic developments and prices of commodities. Australia plays a significant role in the global market for commodities as its top exports are iron ore, coal, natural gas, beef and wheat. Since January 2018 the Australian dollar has been performing moderately and has been on a gradual decline against the USD. This has been largely attributed to the growing trade tensions between the US and China as the impacts on Australia's largest trading partner will prove to be a key weakness for the Australian Dollar if China goes south.

Australia's economy is largely driven by its strong services sector which contributes 70.3% to GDP and employs 70% of the workforce. In recent years, Australia has benefitted from improving terms of trade although this growth has slowed by 0.7% due to the fall in commodity prices. Australia's natural abundance of diverse natural resources is a major driver for foreign investments and economic growth as Australia has seen major improvements in its agriculture and mining industries. Another example of prominent services sectors contributing to the economy is education-related travel services which have accounted for $21.6bn in 2017 which marked a significant increase from $18.5bn in 2016.

In light of global trade tensions, the US has drastically changed the playing field in terms of international trade under the Trump Administration. President Trump has held firm on his belief that every trade agreement made by the US should be in favor of their economy. For most of the post-war period, Australia ran a trade deficit. However, in the last five years, Australia has been benefitting from a trade surplus. This can be attributed to the significant increase in trade with China which has been a key factor in the economy's high growth rates. Historically, Australia has been an open economy that is affected by cyclical changes in the global economy as trade plays a significant role as a driver for economic growth.

Possibility of Downward Revision of Interest Rates in Australia

On the last meeting held on the 4th of December, the Reserve Bank of Australia (RBA) decided to leave its cash rate unchanged at 1.5%. Governor Philip Lowe reflected positive sentiment on the current economic performance of Australia as he believes that unemployment rates have been low alongside a global economic expansion. The RBA has maintained its target interest rate at 1.5% since the 3rd of August in 2016 and has remained undeterred on its current strategy for monetary policy.

Despite rising trade tensions, members of the RBA have been comfortable with the current performance of the economy and have decided that maintaining the current cash-rate is the best approach to support economic growth in Australia while trying to achieve its targeted inflation rate. Since unemployment and inflation are in stable conditions, there is no strong case for any short-term changes in the cash rate. Although there have not been changes in the attitudes towards the interest rates, we believe there might be a possibility of the RBA leaning towards lower interest rates in 2019 if growth continues to slow as shown in the data published in the 3rd quarter of 2018.

## Australia Faces Weakest Economic Growth in 2 Years

Previous expectations of a strong economy in the second quarter for Australia turned slightly dull as the Australian Bureau of Statistics published figures for the 3rd quarter of 2018. The Australian economy grew by 0.3% in the 3rd quarter of 2018 which is a significant decrease in growth from 0.9% in the 2nd quarter which was shy of 0.6% from the market consensus. This is the slowest pace of expansion since the last contraction that was seen in the 3rd quarter of 2016.

On an annual basis, through 2018, the economy grew by 2.8% and remained below expectations of 3.3% growth which was the weakest pace of expansion since the 4th quarter of 2017.

Generally, there was a slowdown across most areas albeit positive growth rates. Consumer spending only grew by 0.3% (down from 0.9% in the previous period). Despite government spending increasing by 0.5% in the third quarter, this has been offset by a fall in state and local government spending which fell by 0.5% as well. On a brighter note, export of goods and services edged up by 0.1% while imports were down by 1.5%.

A major cause of the quarterly slowdown was due to a fall in construction output which contracted 2.2%. Notable decreases were seen in civil engineering and construction services (-4.5%). In addition, coal mining and iron ore mining also contracted by 6.1% and 0.3% respectively.

Despite the poor economic performance in the 3rd quarter, business conditions continue to remain strong alongside an increase in public sector investments. The consensus is for the Australian Economy to grow by approximately 3.5% over the 2018 and 2019 before slowing down in 2020 due to a pessimistic outlook regarding export growth in the future. Additionally, household consumption continues to be a prominent source of uncertainty as household incomes have remained low, debt has increased, and asset prices have declined.

## Inflationary Pressures Cooling Amidst Slowing Economy

The Governor and the Treasurer of the RBA have agreed that the appropriate target for monetary policy in Australia should be 2-3%. Moving forward, this should be sufficiently low enough to prevent any disruptions in future macroeconomic decisions and also private sector inflation expectations. Australia's 3rd quarter inflation numbers have eased to 1.9% year on year. Down from 2.1% in the 2nd quarter in 2018. This has been attributed to the slowdown in the cost of housing in Australia and also economic growth.

Export Dependence May Test Australian Economy

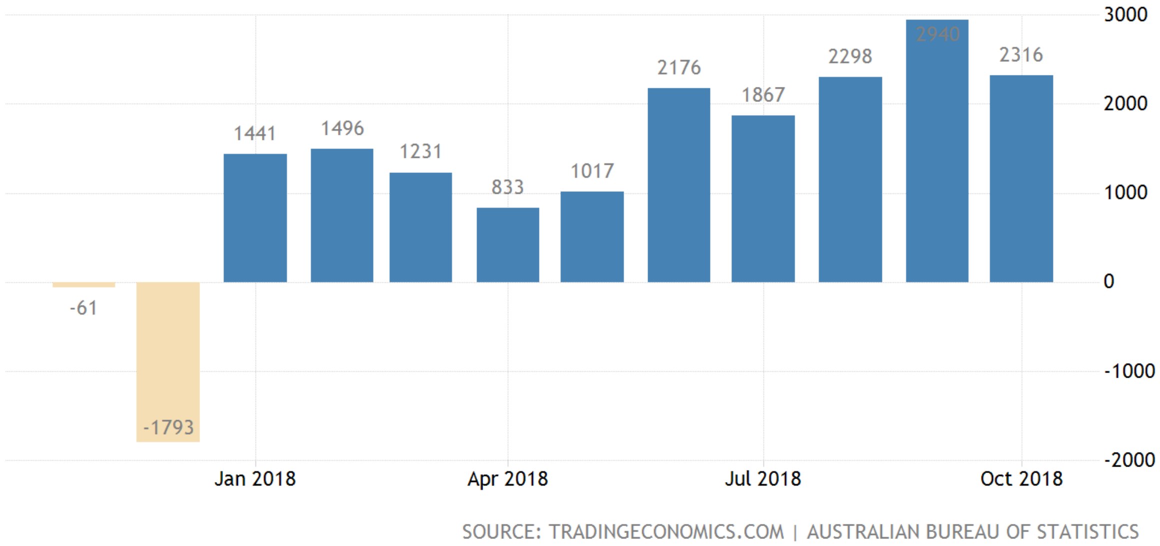


*Figure 18: Australia's Balance of Trade (Source: Tradingeconomics.com)*

Trade contributes close to 36% of GDP in Australia which explains Australia's dependence on international relations and the performance of the global economy and its major trading partners. Although Australia's trade surplus narrowed to AUD 2.32 Billion, trade has remained strong and has been fueling the Australian economy despite rising trade tensions.

Australia's total goods and services exports have reached a record $401 billion for the first time, bolstered by strong export growth to China. These record exports were fueled by increased resources exports including coal and iron ore.

More importantly, data reveals that Australian exports to China, their largest trading partner, grew by 11% from 2017 to 2018, exceeding the $100 billion mark for the first time to reach $105 billion. These record numbers can largely be attributed to the benefits provided by the China-Australia Free Trade Agreement. However, escalating trade tensions continue to test the stability of Australia's strong trade performance and ability to sustain its current economic performance in the next few months as China struggles to maintain its own economic growth when battling head to head with the US.

The massive trade deficit that occurred early in December 2017 has shown to have significant impacts on the Australian economy as GDP growth slowed to 0.5% before recovering to 1% at the start of 2018.

## FX TRADE IDEA: SHORT AUDUSD - SELL


*Figure 19: AUD/USD daily chart (Source: Tradingview.com)*

Over 2018, the Australian Dollar has been in a constant decline against the US Dollar which has gone from a rate of 0.81 to 0.72 in more recent months. The RBA does not seem to be concerned about the weakening of Australian Dollar against the US dollar. Although it has signaled intentions to intervene if it reaches 0.6, this is unlikely to be the case in the near future.

Due to poor recent economic performance and lower commodity prices, interest rates are more likely to be revised downwards in the following months since inflation remains controlled in light of a slowing Australian Economy. RBA's Deputy Governor Debelle has also signaled that a lowering of interest rates is not out of the picture and this could be the Australian dollar's main source of weakness.

Economic growth has remained strong in the US albeit dipping to 3.4% in the 3rd quarter of 2018. This has been supported with unemployment rates reducing to a 49 year low at 3.7% in September 2018. Given the current climate, the US Federal Reserve is likely to continue to take a hawkish stance in terms of monetary policy as suggested by Fed Chairman Jay Powell. In the 4th Federal Reserve meeting in 2018, the Fed raised the targeted Fed funds rate to 2.25 - 2.50%. Despite the recent decline in equity markets, the Federal Reserve is still strong on its position for increasing interest rates over 2019 and 2020 although at a slower pace as mentioned in the Financial Times due to “tepid inflation” falling short of its 2% target. Projections show possibilities of rate hikes extending into 2019 in order to keep inflation at a healthy rate. As RBA keeps its cash rate constant at 1.5%, the interest rate differential is likely to result in downward pressures on the AUD/USD.

In China, Australia’s largest trading partner, the economy grew by 6.5%, year-on-year, which was worse than a forecasted 6.6% growth rate and 6.7% in the 2nd quarter. This has sparked worries in Australia as China hits its lowest growth rate since 2009. A slowdown in economic growth can cause potential problems for Australia in addition to Australia’s weak domestic consumption being unable to sustain economic growth. The Australian Dollar moved from $0.71033 to a low $0.70981 upon release of the figures, down 0.01% for the session.

**Entry: 0.73503**

**Take Profit: 0.70514**

**Stop Loss: 0.7464**

The AUD/USD pair has still been trading around the 0.72. We recommend to short AUD/USD at an entry price of 0.73503 if prices recover to that level of resistance. Although prices have been on a rapid decline, we expect AUD/USD to recover to higher levels of resistance and trade sideways in the shorter period of 1-3 months.

Based on a 6 to 12 month horizon for this currency pair, we identified a key level of support at 0.70514 at which the Australian dollar has been bouncing off and yet to break through. Our key level of resistance is indicated at 0.74644 which we also identified as our stop loss. Following the performance of the AUD/USD pair throughout 2018, a price channel with a negative slope signals a bearish downtrend for the Australian dollar which has been consolidating recently.

We believe that given current global macroeconomic conditions, the Australian Dollar is likely to further depreciate against the USD to new record lows if the Aussie is able to break past the level of support.

## NEW ZEALAND – NEUTRAL

New Zealand is Australia's smaller, less populated neighbor. The economy is heavily dependent on trade and tourism and also has a sizeable manufacturing and service sectors. Moreover, the technology sector of New Zealand is on the rise. The main drivers of its economy are its exports, primarily dairy and other agricultural products which occupy 30% of its GDP. However, being heavily dependent on international trade has left the New Zealand Dollar susceptible to global macroeconomic events.

<u>Carry trade status?</u>

During the latest meeting of the Reserve Bank of New Zealand (RBNZ) on 8th November 2018, the central bank elected to maintain its interest rate at 1.75%. This is due to GDP slowing in the first half of 2018. Hence, interest rates have been kept low in an attempt to spur the economy forward. If the economic situation of New Zealand stagnates, a possible rate cut would be possible may be expected. However, this contradicts the current narrative being signaled by the RBNZ which is that current rates will not be adjusted until late 2019 at the earliest.

Hence, the next 6 to 12 months would be a good indicator of the direction the RBNZ would take next in terms of monetary policy. However, the new RBNZ governor, Adrian Orr, has been interpreted by many to be dovish in his stance on monetary policy, which could result in the depreciation of the New Zealand Dollar in the long run. The NZD/USD has already experienced a ten-month long path of depreciation which has only stopped since the 1st of November and has been on a relatively bullish-run up the time of this analysis. This could partially be attributed to the markets responding to the dovish outlook of the RBNZ.

However, the NZD's previous status as a relatively safe vehicle for the carry trade has not been held up lately as the US federal interest rates are exceeding it by 0.75%. Other determinants of suitable carry-trade currencies would be cross-rate volatility and strong fundamentals which weakens the NZD's position. Even though fundamentals have been relatively strong, recent price trends in the various NZD pairs have shown that volatility may be too high for the NZD to be suitable for a carry trade,

<u>Cash cow woes</u>

The dairy sector of New Zealand directly contributes $7.8 billion to its total GDP, which is about 3.5% of GDP. This is not counting the crucial role in supporting regional economic development, as well as a range of supplying industries, such as the agricultural chemicals and the fertilizer industry. The dairy industry employs over 40,000 workers. This rate of employment growth has been greater than its total employment rate. The dairy sector has been a key source of strength for New Zealand. However, there has been recent falls in milk prices, which have been exacerbated by increases in global supply and may adversely affect the lifeblood of New Zealand. On the 31st August 2018, Fonterra had cut the 2018/2019 milk price forecast to $6.75kg from a previous forecast of $7/kg. Even though dairy production had stalled momentarily in the 2nd quarter of 2018, according to the Rabobank Report, the global supply from the "Big 7" is expected to increase as poor weather conditions are alleviated. Moreover, there has been an increase in milk supply outside the traditional major producers. These new players include Belarus, Canada, Iran, and Turkey, which combined produces dairy twice of that of Australia. Over the next 6-12 months, there could be a further fall in dairy prices, which could have negative implications on the New Zealand Economy.

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The dairy sector has been a key source of strength for New Zealand. However, there have been recent falls in milk prices, which have been exacerbated by increases in global supply. On the 31st August 2018, Fonterra – a multinational dairy cooperative – had cut the 2018/2019 milk price forecast to $6.75kg from a previous forecast of $7/kg. Even though dairy production had stalled momentarily in the 2nd quarter of 2018, according to the Rabobank Report, the global supply is expected to increase as poor weather conditions are alleviated. Moreover, there has been an increase in milk supply outside the traditional major producers. These new players include Belarus, Canada, Iran, and Turkey, whose aggregate output is twice of that of Australia. Over the next 6 to 12 months, there could be a further fall in dairy prices, which could have negative implications on the New Zealand economy.

The figure below shows the Global Dairy Trade (GDT) Price Index between 2008 and 2018. There has been a steady decline of GDT prices between 17$^{th}$ April 2018 and 16$^{th}$ October 2018.

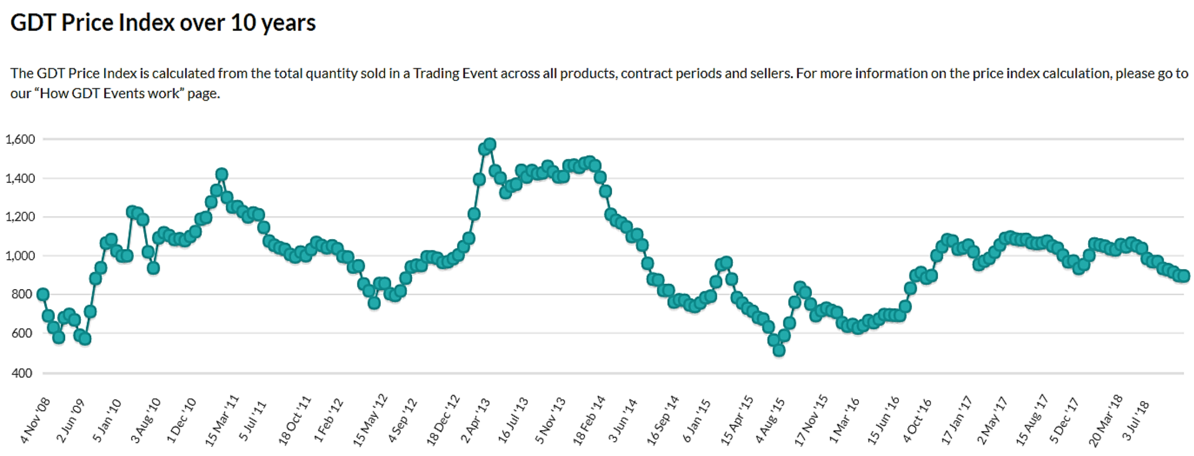


*Figure 20: GDT Price Index*

<u>"Mini Barometer" of the world</u>

Although Australia is often touted as the barometer of the world, New Zealand is also heavily involved in trade with numerous economies around the globe. Its major trading partners, China (22.7%) and the USA (10%) could spell trouble if the trade war threatens the future of the global economy. China recently experienced its slowest growth in the 3rd quarter of 2018, amid trade disputes with the USA. New Zealand's exports to China had tripled over the last decade, with milk powder being the largest export commodity and clothing being the top import commodity. Regardless of the direction trade war takes, the New Zealand economy is bound to suffer, with possible implications on the state of the NZD against major currency pairs. Current trade tensions have been slightly eased when both Washington and Beijing have agreed to a period of truce where no extra tariffs can be levied for 90 days starting from the 1st of December 2018. Regardless, the 1st quarter of 2019 is still a period of uncertainty, which would hurt New Zealand's economy unless both China and the US are willing to compromise heavily which in our analysis, appears to be an unlikely prospect.

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The graph below highlights how trade with China has been on the rise, at a significant rate, between 2007 and 2017.

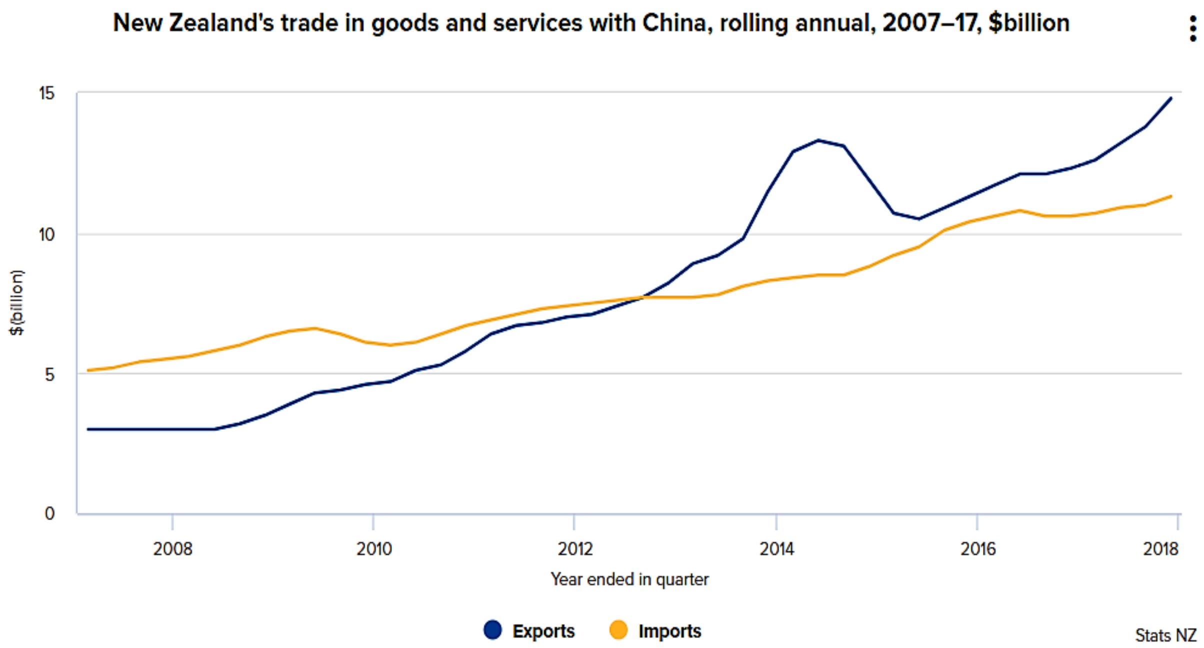


*Figure 21: New Zealand's Trade with China*

FX TRADE IDEA: SHORT NZD/USD - SELL


*Figure 22: NZD/USD daily chart (Source: Tradingview.com)*

The NZD has been on a downward path of depreciation for the past 6 months, from with the USD/NZD pair falling from 0.7395 to 0.6497 as of 25th October. However, since 1st November, the NZDUSD had broken out of the descending channel. Since then, the NZDUSD had been bullish until strong resistance was met at 0.698. Prices have since been bearish, with increasing weakness given by the unreconciled trade tensions between the US and China.

**Entry: 0.67084**

**Take Profit: 0.64301**

**Stop Loss:0.67943**

From a technical perspective, the RSI has broken a key support level at 40.0. Given these factors, we would recommend a short order at current price levels, with the stop loss being placed just above the support level at 0.67943. We also recommend taking profits at 0.64301, the lowest price reached in 2018.

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Given these factors, we would recommend selling the NZD against the greenback at current price levels, with the stop loss being placed just above the support level at 0.67943. We also recommend taking profits at 0.64301, the lowest price reached in 2018.

In the longer term, a dovish RBNZ would encourage the depreciation of the NZD, in order to prop up the economy via exports in lieu of unresolved trade tensions.

# GOLD – OVERWEIGHT

Gold is often touted as a safe haven asset where central banks, institutional and retail investors around the world heavily invest in gold as part of their reserves. Gold is also historically known to be negatively correlated to the US dollar. With ongoing trade tensions and increasing budget deficits in key global players, gold is likely to be an asset where investors may wish to retreat to.

Looming Global Debt Crisis Remains as a Key Source of Strength for Gold

The US government is under pressure to narrow their fiscal debt. In May 2018, the Treasury signaled intentions to borrow nearly $1 trillion US Dollars over the next three years. With a high debt to GDP ratio, which is expected to rise over the fiscal year, the US is at the risk of further interest rate hikes as investors concerns about the federal government's ability to pay grow in the market are growing.

Given the political climate of the US, the government is likely to choose to continue with expansionary policies rather than having more austerity. This will only further the problem of debt in the US. Historically, the US has always been driven by debt to finance public spending.

With the ongoing debt crisis, we believe that confidence in the market will deteriorate and investors are more likely to retreat to gold and hold significantly higher amounts of gold in their portfolios to neutralize the effects of a poor performing equity market. A key indicator of the strength of gold demand has been observed in the poor performance of equities in the last quarter of 2018. Amidst the sharp selloff in technology stocks, many would expect to see changes in yields for US government bonds. Surprisingly, yields on government treasuries did not show significant signs of fluctuation. This may be a cautionary sign that indicates the uncertainty that investors have in both the public and private sectors. Hence, we remain firm on our stance that gold may be a source of strength for institutional investors who are seeking refuge looking to diversify their portfolios.

Growing Central Bank Demand

A major source of demand for gold over the years has largely been from central banks. With growing debt burdens from emerging economies and the risk of government default, the general sentiment towards gold by central banks remain positive as most central banks regard it as a safe way to diversify their reserves.

According to Bloomberg, the Russian Central Bank is expected to add another 1% to its gold holdings. This comes amid a recent trend of Russia selling US treasuries and allocating more to gold. Emerging markets have also been increasing their gold holdings at a steady rate to diversify their reserves while hedging against inflation.

Central banks such as the Bank of England view gold as the ultimate asset to hold in times of emergency. It is widely regarded as a store of value and an asset that only depreciates because of market forces. Historically, gold has generally preserved its value against inflation and has always been an accepted medium of exchange between countries. According to the World Gold Council, central bank demand was up 42% y-o-y.

Poor Supply Outlook for Gold

On the supply side, it appears that supplies are struggling to expand. According to Kitco News, gold mining contracts require a price of $1500/oz since costs have been increasing at a compounded rate of 10% over the past 15 years. New mining supplies will also be dragged down in the next 30 years solely due to mining and discovery costs.

According to the Financial Times, global gold mine supply has already plateaued in 2017. The biggest gold producer in the world, China, had already seen a decline of 9% in terms of supply. China accounts for 15% of total global gold production and its future outlook for gold mining may significantly affect the supply of gold in the long run.

Due to the lack of profitability from the perspective of the producers, it is highly probable that the supply for gold will inevitably slowdown on top of the already scarce nature of the precious metal.

ETF TRADE IDEA: LONG SPDR GOLD TRUST - BUY

**Ticker: GLD**

**Listed on: NYSEARCA:GLD**

**YTD return: = - 6.56%**

The SPDR Gold trust ETF offers investors a relatively cost-efficient and safe way to enter the gold market. SPDR Gold shares were initially designed to track the price of a tenth of an ounce of gold. As of 23rd December 2018, the trust had 24,842,190 ounces of vaulted gold. SPDR Gold Shares is one of the top ten largest holders of gold in the world.

Australia is the second largest producer of gold in the world and produced 295.1 tons of gold in 2017. Other significant producers of gold include China, Russia, the US and Canada. In recent years, Australia has enjoyed an increase in the production of gold in 2017 by 3 tons. In addition, more mining companies have experienced growing margins in recent years. Mining consultancies such as Surbiton Associates have hinted at the possibility of a few upcoming mining projects. Hence, key developments in Australia will play a significant role in determining the price action of gold-backed securities.


*Figure 23: SPDR Gold Trust daily chart (Source: Tradingview.com)*

Global debt is projected to hit new record highs this year as stated by the international monetary fund. The global economy currently appears to be bearing fruit in terms of economic growth however the market has yet to understand that a lot of debt is fueling growth in the economy. In terms of International Financial Risk, China poses the greatest problems as it struggles to deleverage its economy as it faces its first current account deficit in 20 years as recorded in the 1$^{st}$ quarter of 2018.

On the other hand, the US is also running a budget deficit which it desperately seeks to curb by hiking interest rates. The recent sell-off in US technology equities showed signs of worry and uncertainty in market sentiment. Considering volatility in the market, retail investors may seek to retreat to safe havens which will mean that gold can be used as a significant strategic asset class to hedge against the risks in the economy.

**Entry: 118.72**

**Stop Loss: 113.24**

**Take Profit: 123.03**

We recommend going long on GLD at an entry price at the current price of 118.72 with a potential take profit at 123.03 judging from a 6-month time horizon. We have identified 114.81 as the initial level of support which price is likely to pull back to if any improvements have been made in the equity markets.

To allow for the price to range more freely without being stopped out too early due to our long-term view on GLD and potential developments in the global economy, we have positioned our stop loss at 113.24. We expect price levels to increase in the short to medium term since GLD appears to be at the level of resistance based on the past YTD figures. Hence, if price continues to trend upwards with a strong momentum, we can expect GLD to maintain a bullish rally towards 123.03.

# COPPER – OVERWEIGHT

Copper is used in a variety of applications, such as electronics, communications, equipment and infrastructure. As an important contributor to national economies of mature, developed and developing countries, copper is one of the crucial metals that is used for building and maintaining a country's infrastructure. Furthermore, it is one of the most recycled metals as recycled copper can retain its properties even after few rounds of recycling.

Many of the Latin American Countries such as Chile and Peru account up to 40% of the world copper mine production, while China, Japan and Chile account up to 50% of world copper smelter production.

## The Year So Far

2018 has been a turbulent year for copper. The market consolidated for the first half of the year after copper prices rally in December 2017 due to supply concerns. However, supply concerns eased in July 2018 and the US-China trade war further raises demand concerns driving the prices down from US$3.29 to US$2.66. Although supply concerns have eased, the growth of supply is expected to increase at a much slower rate; the demand for copper is expected to perform grow at 2.5% in 2019 due to increase in demand for copper for industrial purposes and clean energy.

## Growing Global Demand for Copper

China's consumption for copper is expected to increase by 4.7% in 2018 and a lower growth of 2.7% is expected in 2019. Similarly, usage of copper in the US is weaker in 2018 due to the reaction from the trade war at 2.8% and it is expected to grow at 2.2% in 2019.

On the other hand, EU and Japan remain positive with higher growth in 2018 compared to 2017 around 4%, but Japan's growth is expected to dampen to 0.8% in 2019. The outlook for the rest of the world is expected to grow by 1% in 2018 and 2.5% in 2019. As a result, global reported copper demand is expected to increase by 3.0% in 2018 and a softer growth of 2.5% in 2019.

## Slowdown in Copper Mining Threatens Supply Prospects

According to International Copper Study Group (ICSG), mine output is expected to decrease by 1% while refined copper production is expected to increase by 2.8% in 2019. After the supply declined by 1.5% due to supply disruptions in 2017, it is expected to recover and grow by 2% in 2018. Most of the growth is due to the recovery from the constrained output in Chile and Indonesia. In July 2018, a labor pact was proposed between the union representing workers in Chile's Escondida mine and BHP Billiton. This resulted in supply pressures easing.

Furthermore, the restart of temporarily closed capacity in Democratic Republic of Congo and Zambia has further ease supply constraints. On the other hand, growth is negatively affected by outputs in Canada, China, Peru and the US due to operational problems. Overall, mine production is expected to increase by 2% in 2018.

The growth of supply is due to the settlement of labor issue and the re-opening of facilities. Hence, it is generally expected that mine outputs should decrease by 1% in 2019.

Refined production

World refined production increased by 2.7% in 2018 (reduced from 4% as predicted in April) due to shutdowns and operational issues at smelters in Australia, India and Philippines, combined with lower than expected output in Canada, Chile and the US. These problems are offset by the strong increase in countries where plants were closed for maintenance in 2017. In 2019, world refined production is expected to increase by the similar amount at 2.8%.

Demand for refined copper in the EU-28 in 2018 is forecast to be 3.27 million tons, up 3.0% compared with 2017. A further increase of 0.3% is expected for 2019 when refined copper demand might be 3.28 million tons.

Furthermore, world refined production projections indicate that there will be supply deficits of 90,000 tons and 60,000 tons for 2018 and 2019 respectively.

China's influence on Copper Prices

The Chinese share of global demand for copper has increased significantly from 23% in 2005 to 46% in 2017 and Asia's consumption of copper averages about 68%. In 2017, President Xi outlined the 14$^{th}$ 5-year plan for the nation, which includes the Belt and Road Initiatives and building a cleaner China. These developments require large quantities of minerals and metals, including copper, as many of the clean energy products require more copper (e.g. Electrical Vehicles require 3 times more copper as compared to a petrol-powered vehicle) due to its chemical properties.

China is the largest consumer of copper because many of its industries are reliant on the prices of copper. The copper tariff that was imposed in June will hurt China infrastructure companies badly and the government's 14$^{th}$ 5-year plan for the country. Furthermore, China retaliated with similar copper tariffs on the US.

Trade tensions have been intensifying which negatively impacts demand for copper. Although the future of an extended trade war remains uncertain, the current 90-day truce has been a source of relief. China's demand for copper is expected to grow in the next year, albeit dampened. Hence, we expect the prices of copper to increase but not above 2018's high at $3.29.

<u>FUTURES TRADE IDEA: LONG Copper Futures (May 2019) - BUY</u>

**Ticker: HGK2019**

**Listed on: COMEX**


*Figure 24: HKG2019 Futures daily chart (Source: Tradingview.com)*

**Entry: 2.8980**

**Take Profit: 3.1200**

**Stop loss: 2.7870**

Currently, the daily chart shows a downward trend from the 200MA and the price has been ranging between the 2.8975 (resistance) and 2.62 (support) level.

In the short term should there be no drastic adjustment to the supply, we would expect the prices to range between the resistance and support level and consolidate in the next 1-2 months. Fundamentally, with the expected deficit of supply in copper to continue in 2019, we expect the price of copper to rise. Should the price break the 2.8975 resistance level, copper futures may potentially reach 3.0120.

We remain conservative in our views on copper in the shorter term. For a 6-month time horizon, we recommend going long on Copper futures and buy copper at an entry level of 2.8980. We believe that there would be a bullish uptrend towards our targeted take profit level of 3.1200 if resistance can be challenged and broken through. As seen by the RSI, a possible reversal may happen if the RSI trends below 30.

# IRON – UNDERWEIGHT

Iron is often touted as the most important of metals, given that 90% of all metals refined today are from Iron. Steel is used in civil engineering, manufacturing and many other industries. There are numerous variations of steel, such as corrosion resistant stainless steel and alloy steels. Iron itself is essential in the production of ammonia, as well as the conversion of syngas into liquid fuels. Hence, the prices of iron will fluctuate greatly depending on the state of the global economy.

China is the world's largest producer, consumer and importer of iron ore (44% of the world output), followed by Australia (15% of world output). Steel production is also led by China, as well as the EU. Due to steel's essential nature in global economic growth, it is a suitable proxy for the determination of the world's economic health. Since iron is used to produce steel, steel prices would be an appropriate measurement for the tracking of iron prices.

### Demand for Steel Forecasted to Grow

The World Steel association had forecasted growth in global demand of steel by 1.8% in 2018. Demand is projected to rise due to numerous developing economies experiencing stronger growth, which fuels public spending on infrastructure. Hence, the demand for steel in construction and developing economies has been strengthening. Current Belt and Road initiatives in China has been a key indicator of support for iron demand. Research conducted by Morgan Stanley also supports this prediction and they have estimated that 2018 has been one of the better performing years for steel.

Although the USA has shown a fall in imports of the metal in 2017 due to its aggressive tariffs in order to protect its steel industries and automobile industries, this may be offset by the other growing economies, such as South East Asia. One notable example would be India, where demand is being propped up with increased investments and infrastructural programs. Other developing economies, such as Indonesia and the Philippines, are expected to experience a growth in demand for steel. In addition, the recent trade war truce that was announced may be a source of strength for steel demand. We believe that trade tensions are likely to ease in 2019 since both the US and China have seen slowing economic growth.

### Growth in Steel Supply Might Experience Slowdown

Supply of steel has been increasing rapidly over the past few years, as of 2016, the world's steel capacity had doubled since 2000. While steel supply has been consistently growing, it appears to be doing so at a diminishing rate. China, which is responsible for half the world's steel supply, may see a fall in the metal's production, due to increasing government regulations and reforms. Both Morgan Stanley and S&P Global Ratings have similar views that supply may grow at a much slower rate.

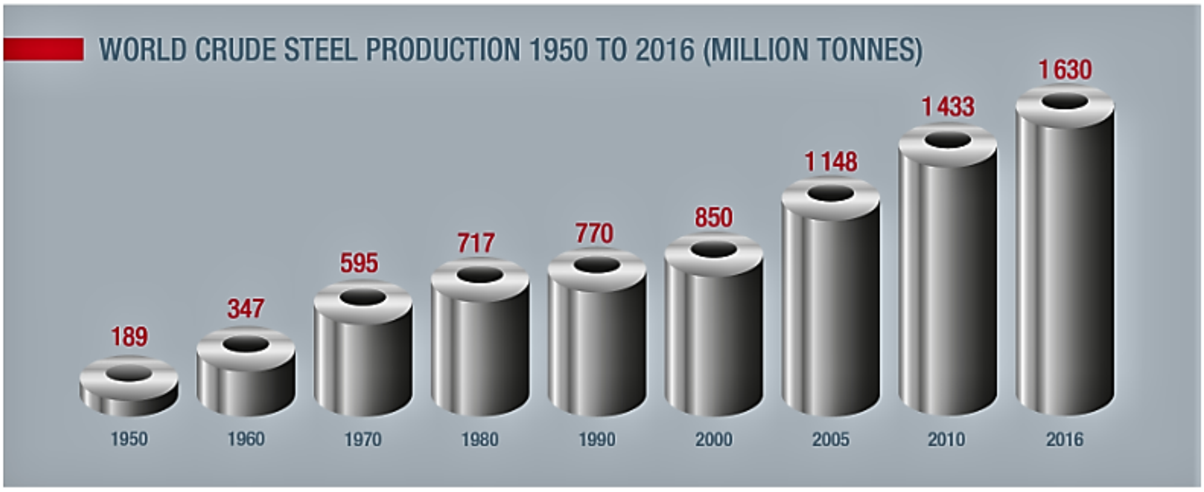



*Figure 25: Global Crude Steel Production*

<u>Effects of US Steel Tariffs Unlikely to Persevere</u>

The US's imposition of a blanket tariff on steel on numerous countries, including Canada and Mexico, would undoubtedly reduce imports of steel in the US. However, China's export would be unlikely affected due to punitive tariffs already imposed before the Trump administration. Rising steel costs in the US had led to many businesses reliant on the metal to be affected. Even companies who are reliant on US metal suppliers had seen the tariffs have inflationary effects. The steel tariffs were first imposed on the 23rd of March 2018 and have risen steadily over the past few months. In 2002, tariffs of up to 30% were imposed, but withdrawn after 21 months as the US consumers and businesses had lobbied against the negative effects of the tariffs that they had to bear.

The implication to this is that while steel prices are rising, it may be a temporary, short-term phenomenon. This is dependent on how further negotiations develop, and if President Trump is willing to continue his aggressive protectionist policies. As of today, there appears that reconciliation would not take effect until the 2nd quarter of 2019. As such, prices of steel can be expected to continue rising over the next few months.

FUTURES TRADE IDEA: LONG IRON ORE 62%, CFR CHINA (TSI) - BUY

**Ticker: TIO=F**

**Listed On: NYMEX**


*Figure 26: Iron Ore Futures daily chart (Source: Tradingview.com)*

Given the current construction plans in China and projections that steel demand will remain strong considering ongoing belt and road developments, it is estimated by BHP that BRI projects could increase steel demand. Hence, we remain firm on our belief that prices of iron will go up in the future. Combined with slowing supply due to government and environmental regulations, we believe that we have a good setup to go long on iron.

**Entry: 68.99**

**Take Profit: 73.61**

**Stop Loss: 65.18**

The chart above shows that the price of Iron Ore had been on a gradual increase since 2017, before peaking at 73.61 mid-2018. We believe that prices have been consolidating in the recent months of the second half of 2018 due to US-Sino trade negotiations and uncertainty in the markets. Nevertheless, prices broke both the trend line and the support at 65.18, before bouncing off the secondary support at 62.90 on the 23rd of November. Since then, prices have been on a bullish run and we believe that a bullish uptrend is likely to continue in the first half of 2019. Hence, we recommend setting the take profit at 73.61, the highest price the future has reached. We have identified our stop-loss below the level of support at 65.18 which would give us enough room for prices to pullback should trade tensions continue to persist.

## TURKEY – UNDERWEIGHT

Despite being shaken by chronic economic and financial crises, Turkey's real gross domestic product (GDP) has grown by more than 34% over the last five years and the nation has the world's 17th largest nominal GDP. Turkey's largely free-market economy is driven by the industrial and service sectors. Agricultural employment accounts for around 25.2% of the workforce, the highest across all the industries. Among the world's largest producers of agricultural goods, motor vehicles, chemical and manufactured goods, Turkey's economy depends heavily on domestic demand and capital inflows. However, the Turkish currency and debt crisis in 2018 deteriorated the economy, generated financial market volatility and threatened Turkey's economic outlook.

Rising interest rates to rescue tumbling Lira

Following a 40% plunge in the Turkish lira this year due to the economy's excessive current account deficit and with inflation hitting close to 25%, the Central Bank of Turkey raised its interest rate by 625 basis points to 24% on 13th September 2018. The recent hike pushed borrowing costs to the highest since 2004 in a means to stem inflation. With the inflation rate steadily increasing, the Central Bank's stance towards interest rates has been hawkish. Turkey's interest rates have risen from around 8% to 24% over the past 2 years and the significant hikes have been mostly in 2018 following the turbulence of the past ten months.

This move has proven to be effective. Following the announcement of the hike in interest rates, the Lira rallied 5% against the USD. The Lira touched as high as 6.0030 against the USD. Therefore, strong monetary tightening is the immediate solution to Turkey's high inflation problem due to rising borrowing costs from banks. Consumers would be less receptive to borrowing money hence less disposable income would be spent in the economy.

After the mammoth rate hike in September, the Central Bank left interest rates unchanged during the recent meeting on 25th October. Following a bigger than expected decline in inflation in November (22% compared to a peak of 25% in October), the recent monetary policy committee meeting on 13th December came to a decision to hold its benchmark interest rate at 24% for the 2nd time in a row.

Looking forward, we do not foresee a hike in interest rates for the rest of the year. The Lira has recouped some of its losses - roughly 35% - and has been on recovery following improved ties with the United States after the release of the Christian pastor, Andrew Brunson. In the short term, there should not be a possibility of an escalation in tensions between the U.S. and Turkey. Although President Erdogan has been raising the pressure to lower interest rates as his belief is that "interest rates are the mother and father of all evil", we believe that it would not make sense for interest rates to be lowered as that would result in the Lira depreciating and would detrimentally affect investor's concerns about financial stability. Therefore, we do not forecast a rise in interest rates over the next 4-6 months.


*Figure 27: Turkey's Interest Rates (Source: Tradingeconomics.com)*

<u>Ailing economy needs to pick up the pace</u>

One of the fastest growing economies in the world in 2017, Turkey reported 7.3% growth in its GDP in the first quarter of 2018. However, after the Turkish lira suffered a devaluation due to the country's foreign debt and a loss of investor confidence in its ability to service the debt, Turkish annual GDP growth rate fell to 5.2% for the second quarter of 2018. The fall in economic growth was also attributed to the U.S. announcing a new doubling of tariffs on Turkish steel and aluminium in August after talks with Turkey to secure the release of pastor Andrew Brunson made no progress. Andrew Brunson was later released in October 2018.

The effects of the relatively high inflation and low consumer demand fueled by the Lira crisis also reflected the slowing of economic growth as the economy grew by a meagre 1.6% in the 3 months to September. On a quarterly basis, GDP contracted 1.1%. Fixed investment fell 3.8% while imports slumped by 16.7% due to the weak lira. In addition, data from the Turkish Statistical Institute revealed the construction sector fell by 5.3% while household consumption fell to 1.1% compared to 6.4% from the second quarter. As a result, it appears that the government's target for economic growth for 3.2% will be missed.

We believe the economy has entered a technical recession and the economic growth would contract even further for the fourth quarter with the persistence of the slowdown in consumer confidence and investments.

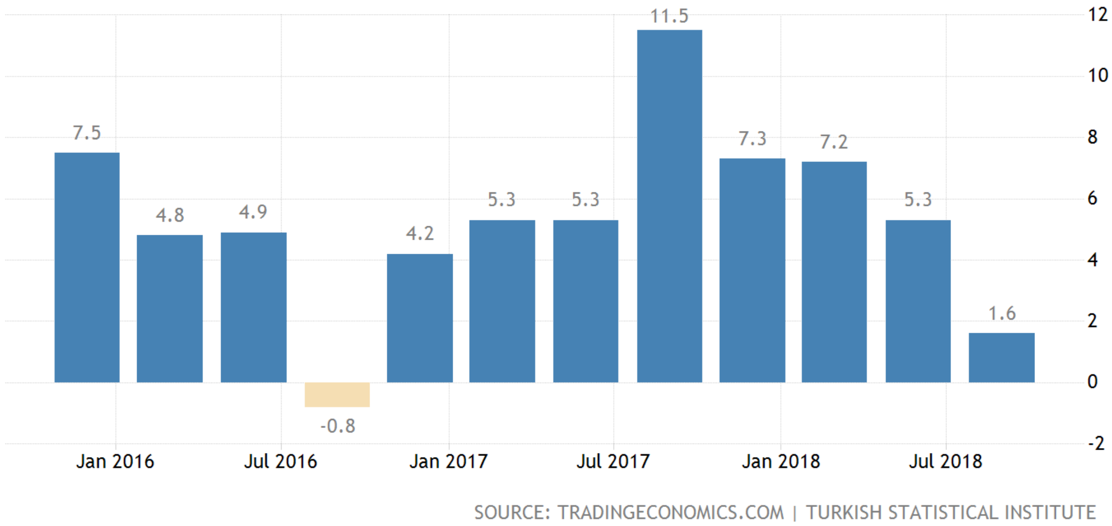



*Figure 28: Turkey's quarterly GDP growth (Source: Tradingeconomics.com)*

Turkey's inflation rate climbed to 24.52% year-on-year in September 2018. This was the highest inflationary level recorded since August 2003. The primary cause of the rise was the severely devalued Lira which led to a surge in net exports and demand-pull inflation. The main upward pressure that drove this trend up were prices of food, housing and utilities as well as furnishing.

Following the recovery in the Lira and with a cut in taxes on consumer products such as vehicles, furniture to encourage shops to offer at least 10% discounts, Turkey's consumer price inflation eased to 21.62% year-on-year in November 2018. Transportation prices slumped 6.46% while food and non-alcoholic beverage prices fell 0.74%.

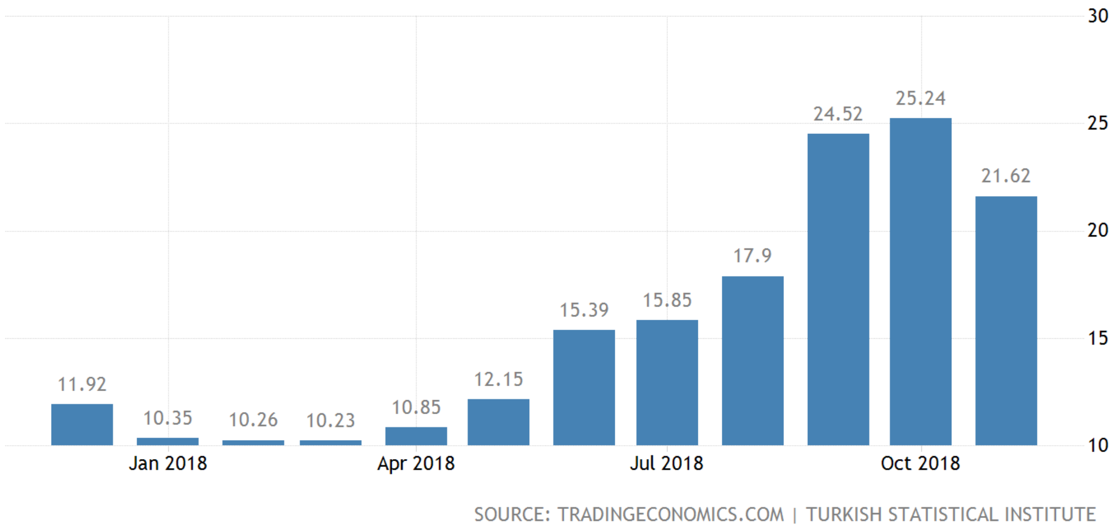



*Figure 29: Turkey's monthly inflation rates (Source: Tradingeconomics.com)*

In order to address the high inflation rate, Turkey's Finance Minister Berat Albayrak announced the medium-term economic program on 20th September 2018, promising cost-cutting measures of nearly $10 billion dollars and more efficient spending. Since public spending mainly fueled the 18% inflation rate in August, Turkey would be freezing government investment and infrastructure projects. The Finance Minister expects inflation to drop to 15.8% in 2019 before hitting 6% by 2021.

With a consensus between President Erdogan and the Central Bank of the Republic of Turkey on the severity of the current economic crisis, there is a greater potential for success for the medium-term economic program to lower inflation and balance economic growth.

We believe the current success in the "Full-scale Fight against Inflation" campaign which offers discounts in the retail sector and lowers interest rates for bank loans, would also help to continue to ease inflation.

<u>Current account switches to a surplus!</u>

Apart from the Customs Union with the European Union, Turkey is part of regional free trade agreements (FTAs) with the European Free Trade Area and the Economic Cooperation Organization. China, Russia and Germany are Turkey's major trading partners. The country's major exports and imports are both machinery and transport equipment as well as manufactured goods.

The expansion in economic growth in the 1st quarter of 2018 was attributed to a surge in government spending fueled by foreign-currency debt denominated in U.S. dollars. This borrowing resulted in Turkey running deficits in both fiscal and current accounts. According to the International Monetary Fund, Turkey's foreign currency debt corresponded to 51.8% of its GDP at the end of June.

However, the current account balance, the fundamental external vulnerability behind the Lira crisis, drastically switched to a USD 2.592 billion surplus in August 2018, reducing the 12-month rolling deficits to USD 51 billion. Turkey's first current account surplus since September 2015 has been surprising considering high inflationary levels. Turkey's previous current account deficits have been worrying for investors as it makes the country heavily reliant on foreign inflows. With a surplus, Turkey's government would be able to pay investors with the country's finances rather than borrowing. We believe that countries prefer to hold their current account surplus to manipulate their exchange rate if needed so it would not be sustainable to use all their surplus to repay debt.

For the 3rd straight month in a row, the current account posted a surplus of USD 2.77 billion for October 2018. The goods account recorded a USD 0.80 billion surplus in October in contrast to a USD 5.64 billion deficit last year. Imports fell 22.6% following a weak lira and slowing economy while exports surged 10.8%. This is a sign that further indicates that the economy is entering a recession.

With weakening domestic demand due to poor consumer confidence, we do not see Turkey posting a current account deficit over the next few months.

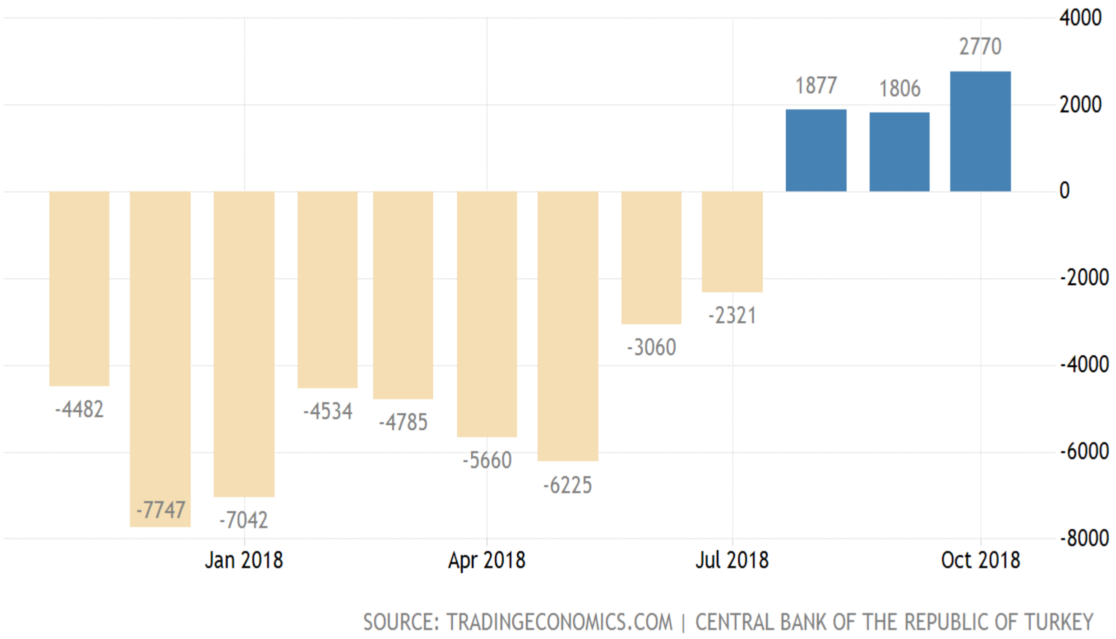



*Figure 30: Turkey's monthly current account balance (Source: Tradingeconomics.com)*

## FX TRADE IDEA: LONG USD/TRY


*Figure 31: USD/TRY daily chart (Source: Tradingview.com)*

The Lira has been strengthening the past 2 months following the interest rate hike to 24% in September 2018 and the release of U.S. pastor Andrew Brunson. However, this is expected to be short-lived as the economic situation in Turkey is more unstable than it appears. According to the Institute for International Finance, economic growth is forecasted to slow down for the rest of the year and lurch to a 1% contraction in 2019. With President Erdogan pushing for lower interest rates to boost investments, the Central Bank will struggle to respond to the continued rise in inflation.

**Entry: 5.35**

**Take Profit: 6.30**

**Stop Loss: 5.00**

Based on the technical indicators, the price of the USD/TRY is expected to rise. The Relative Strength Index (RSI) reading of 45 is interpreted as an undervalued condition that signals a change in the current downward trend. The 100-day Moving Average is above the 200-day Moving Average and the two indicators are diverging, indicating a strong momentum.

The current price at **5.35** is above its support level which is an ideal entry price and a stop loss should be placed at **5.00**, just below its support level. A take profit at **6.30**, below the peak of the 50-day Simple Moving Average should be taken, amounting to a risk to reward ratio of 2.71.

ETF TRADE IDEA: SHORT iShares MSCI Turkey ETF

iShares MSCI Turkey ETF is an exchange-traded fund listed on the NASDAQ. The ETF seeks investment results that correspond to the performance of the MSCI Turkey Investable Market Index. Financials at 26.05%, Industrials at 22.73% and Consumer Staples at 15.76% make up for the 3 largest industries. The top 3 constituents are BIM BIRLESIK MAGAZALAR A 9.24%, TURKIYE GARANTI BANKASI A 8.85% and TURKIYE PETROL RAFINERILERI A 7.56%. As of 30th November 2018, its Year to Date (YTD) return is -38.03%, 1-month SEC yield at 3.87% and 1-year trailing yield at 3.96%. The ETF trades at an average price/earnings ratio of 7.56 as of 13th December 2018, compared with nearly 12 for global emerging markets, indicating that investors are anticipating lower growth in Turkey.


*Figure 32: iShares MSCI Turkey ETF daily chart (Source: Tradingview.com)*

One of this year's worst-performing single-country emerging markets exchange-traded funds, the iShares MSCI Turkey ETF has been trending steadily downwards throughout the year due to increasing interest rates in the U.S. and the weakening of the Lira.

Although the ETF has enjoyed an impressive fourth quarter gain of 21.53% capped by a fading greenback strength and the U.S. economy experiencing some signs of peaking growth, we believe the gains are short-lived. For an outlook of 6-12 months, with weak economic growth, incredibly high inflation and weak domestic demand, we believe it is more practical to short the ETF. In addition, the Federal Reserve has raised interest rates by a quarter point for a 4th time in December and intends to raise rates several more times in 2019. Therefore, investors would prefer to park their funds in the U.S. compared to riskier emerging market assets.

**Entry: 24.5**

**Take Profit: 22.0**

**Stop Loss: 25.5**

Our fundamental analysis can be substantiated with the death cross in May 2018, when the 50-day Simple Moving Average crossed below the 200-day Simple Moving Average. This indicated a bearish signal and the ETF has been mainly on the downside. An RSI reading of 49 also provides a signal of selling territory.

The trade idea, as a result, would be to short the iShares MSCI Turkey ETF. The entry would be at **24.5**. The stop loss will be at **25.5**, slightly below the highest level (26.65) that the ETF was priced at since August 2018. The take profit would be at **22.0**, leading to a risk-reward ratio of 2.5.

With the economy's weak fundamentals, we believe the success of the medium-term economic program would be key in achieving sustainable economic growth in Turkey.

# SOUTH AFRICA – UNDERWEIGHT

The 2nd largest economy in Africa, South Africa is one of only four countries in the region with an upper-middle-income economy according to the World Bank. The nation has shifted from a primary and secondary sector to an economy mainly driven by the tertiary sector. South Africa's economy has a comparative advantage in the production of agriculture, mining and manufactured goods and is well diversified with such key sectors, with mining being the main driving force of the economy.

However, persistent problems such as crime, corruption and political instability have negatively impacted the economy of South Africa. In addition, the country has been facing major headwinds due to high levels of unemployment, increasing debt and high inflation, leading to economic performance remaining subdued.

Benchmark repo rate raised amidst recession

Interest rates had been cut from 6.8% to 6.5% at the start of 2018 to boost investor confidence. However, on 23rd November 2018, the South African Reserve Bank (SARB) surprisingly decided to increase the interest rate by 25 basis points to 6.75%. This hike has put a financial strain on cash-strapped consumers, who would struggle to repay bond and vehicle agreements and will inevitably lead to a slower economic growth, one of the chief concerns of the economy.

This interest rate hike came despite the SARB lowering its headline consumer price inflation forecast for 2018 and for 2019 from 4.8% to 4.7% and from 5.7% to 5.5%, and its GDP growth forecast for 2018 from 0.7% to 0.6%.

The South African rand has devalued after the economy fell into recession on top of an emerging market sell-off. Since July 2018, the rand has depreciated by 7.3% against the U.S. dollar. However, the rand has recently strengthened against the U.S. dollar by around 4%.

We believe that the motivation behind the SARB's rate hike is to sustain the rand and ensure that it continues to appreciate against the U.S. dollar. According to a Reuters poll, the SARB will not raise interest rates again until May 2019.


*Figure 33: South Africa's monthly interest rate (Source: Tradingeconomics.com)*

<u>Strongest growth rate, Accelerated Inflation Levels</u>

Following two back to back quarters of economic contraction, the South African economy entered a technical recession. Quarter-on-quarter GDP contracted by 2.6% in the first quarter and 0.7% in the 2nd quarter of 2018 respectively. The downward contributions were from the agriculture, transport and trade sectors. Ratings company Moody's Investors Service more than halved its growth forecast following news of the recession.

The technical recession came to an end on 11th December 2018 when it was announced that the economy expanded 2.2% in the 3rd quarter, following a downwardly revised 0.4% contraction in the previous period and beating market expectations of a 1.6% expansion. This was the strongest growth rate since the last quarter of 2017. Growth was mainly driven by a 4.5% rise in the secondary sector due to manufacturing as well as the tertiary sector, which grew by 2.6% due to boosts in the trade, transport and finance industries. However, analysts believe that overall GDP growth for 2018 is expected to remain weak following the recession and the contractions in economic growth in the previous quarters. The South African Reserve Bank has projected a 0.6% real economic growth for 2018.

To improve economic growth, President Ramaphosa announced a multi-billion-dollar stimulus program to provide funds for job creation, infrastructure development and structural reforms such as lowering barriers to entry and enabling growth in labor-intensive sectors such agriculture. We believe that a combination of the stimulus program and expansionary monetary policy would be effective in ensuring the growth forecast for 2019 remains unchanged at 1.9%. In addition, the recent sharp fall in oil prices and increased agricultural production should help to improve domestic real GDP growth in 2019.

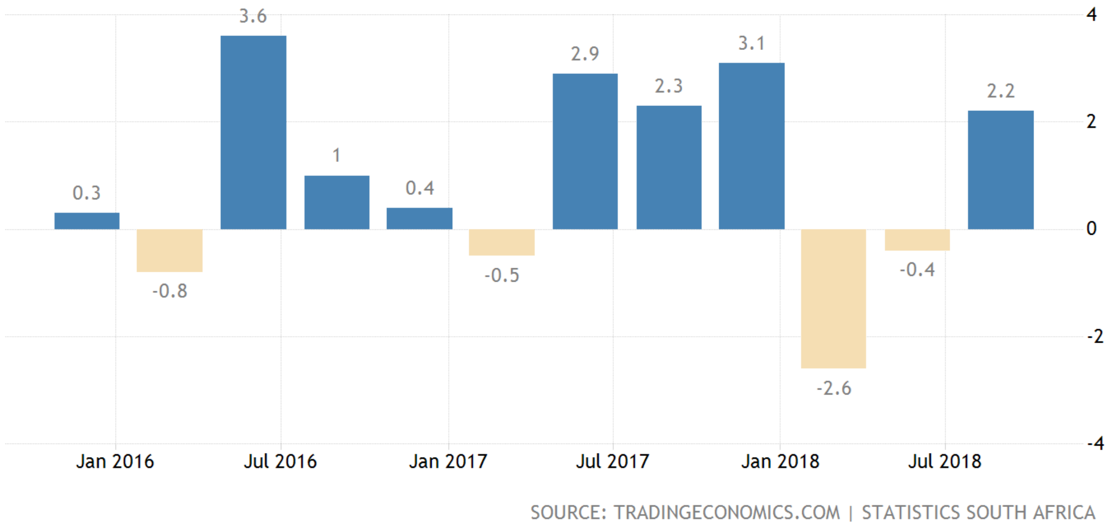



*Figure 34: South Africa's monthly GDP growth rate (Source: Tradingeconomics.com)*

Consumer price inflation accelerated to 5.2% in November 2018, up from 5.1% in October. According to data from Statistics South Africa, inflation is at its highest level since May 2017. Transport had the biggest price growth of 10.7% due to higher fuel costs, which rose by 19% over the past 12 months, followed by health that registered 5.1%.

This unexpected rise in inflation eases criticism on the decision made by the SARB to increase interest rates when forecasts were lowered prior to the monetary policy committee meeting. With headline inflation moving further away from the mid-point of its target range, we believe the rise in interest rates would be essential to lower inflation for the next few months. However, this might come at a cost with a weakening in economic growth.

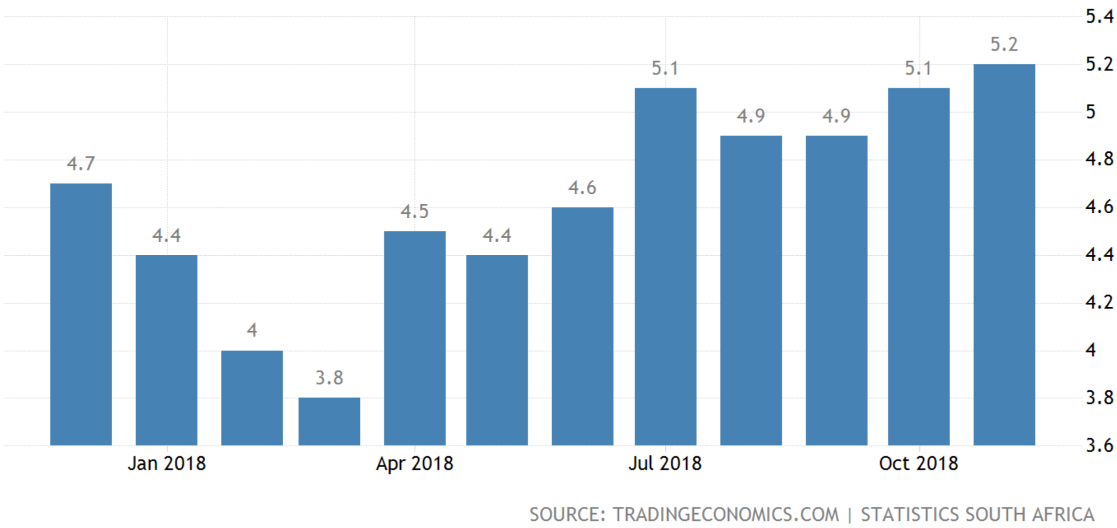



*Figure 35: South Africa's monthly inflation rates (Source: Tradingeconomics.com)*

Worsening balance of trade

The current account deficit in South Africa widened to ZAR 177 billion in the third quarter compared to the previous period, which recorded a deficit of ZAR 167 billion. The goods and services surplus narrowed sharply to ZAR 3 billion from ZAR 33 billion as imports increased faster than exports in both volume and price. This was driven by higher purchases of vehicles and transport equipment as well as machinery and electronics. The trade deficit widened to ZAR 5.55 billion in October 2018 compared to expectations of a ZAR 2.25 billion shortfall, making it the largest trade gap since January 2018. In addition, the current account deficit widened to 3.5% of GDP in the 3rd quarter, leading to the weakening of the rand by more than 2% on 13th December 2018. This is indeed worrying as the government's goal is to keep the deficit ratio to GDP ratio at 3%.

South Africa's main international trading partners include Germany, China, U.S. and the United Kingdom, exporting diamonds, metals and minerals while importing machinery and transportation equipment which made up for more than one-third of the value of South Africa's imports. The nation has FTAs with the European Union and the European Free Trade Association.

The South African Treasury forecasts the budget deficit to rise to 4% of its GDP for 2018 and for the deficit to increase to 4.2% for the next two years. Although 90% of government debt is domestic currency denominated, the ballooning debt is worrying, with the government's gross loan debt at an estimated 55.8% this year and is reported to increase to 59.6% by 2023/2024. We believe that the government should be targeting foreign investment to prevent further borrowing of funds, especially for the latest stimulus plan.

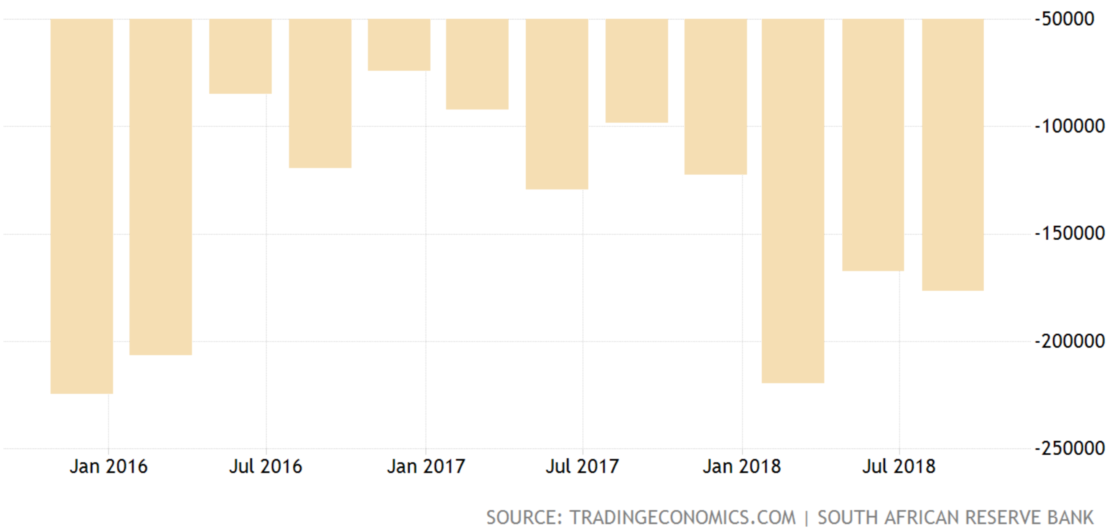



*Figure 36: South Africa's current account balance (Source: Tradingeconomics.com)*

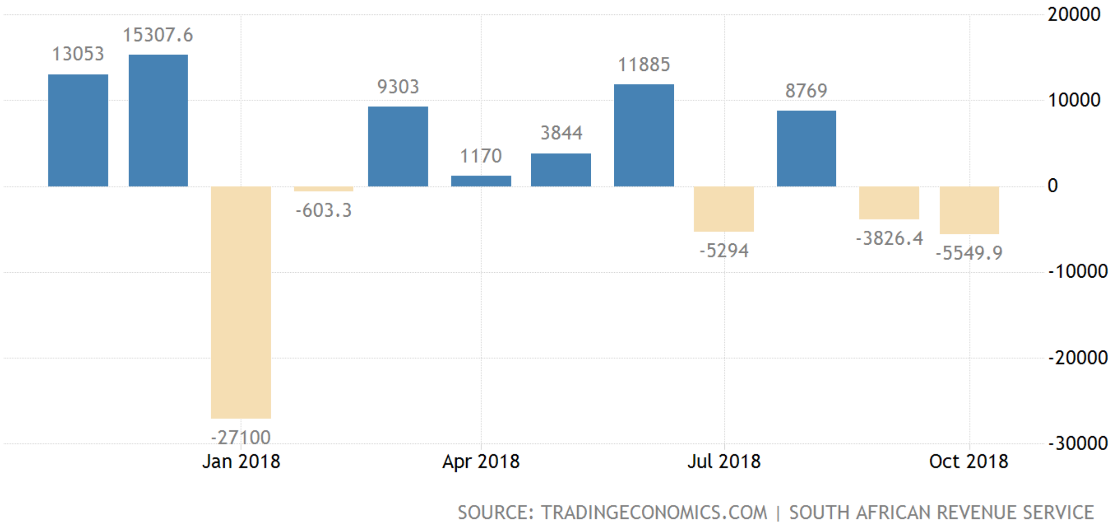



*Figure 37: South Africa's trade balance (Source: Tradingeconomics.com)*

## <u>FX TRADE IDEA: LONG USD/ZAR</u>


*Figure 38: USD/ZAR daily chart (Source: Tradingview.com)*

The announcement of the 2018 mid-term budget signaled worse than expected economic performance for South Africa. With a growing budget deficit, high debt burden, tax revenue revising downwards and a lower forecasted economic growth, investors piled out of the Rand. In the coming months, Moody is expected to downgrade its investment grade rating on South Africa which would weaken the rand.

While the nation has raised USD 55 billion from investors to pull itself out of recession and a recovery plan has been created to focus on job creation and infrastructure development, external vulnerabilities such as a stronger U.S. dollar and global geopolitical worries continue to deteriorate investor confidence in the rand.

**Entry: 14.1**

**Take Profit: 15.2**

**Stop Loss: 13.7**

Based on the chart of the USD/ZAR, the currency has been on the uptrend this year. A golden cross pattern is visible as the 50-day simple moving average broke above the 200-day simple moving average, indicating a bullish breakout pattern. Seeing as the Relative Strength Index (RSI) being above 50 is considered an uptrend, the current RSI level of 63 shows that the rand is expected to further weaken.

Hence, a long position of the USD/ZAR should be taken with an entry point at **14.1** and a stop loss placed at **13.7**, a number that the currency has not deviated below since August 2018. A take profit signal should be made at **15.2,** slightly below the resistance level. This will result in a risk to reward ratio of 2.75.

We believe that the current challenges experienced by the economy primarily structural in nature and cannot be solved by monetary policy alone. The introduction of the stimulus program is key to ensuring sustainable economic growth when used hand in hand with monetary policy.

# INDONESIA – NEUTRAL

Ranked 16th globally in terms of nominal GDP and 7th in terms of GDP (Purchasing Power Parity), Indonesia is the newest member of the trillion-dollar club, having joined the prestigious club a year ago. The major industries are agriculture, livestock, forestry and fishery. Collectively – according to 2013 data – these industries contributed 15% to the GDP and provided jobs to more than 49 million people, or about 41% of Indonesia's labor force.

Indonesia is also considered as a good investment destination, thanks to its "Investment Grade" credit rating. In 2017, S&P increased Indonesia's credit from BB+ to BBB-. Investment is the second largest component of Indonesia's GDP.

Indonesia's biggest trading partner is Japan, followed by China and the United States. Its major exports are briquettes, crude palm oil and petroleum gases. Indonesia is also the top producer of palm oil in the world, supplying 50% of global palm oil consumption. It currently has 23,166 square miles of palm oil plantation and counting.

<u>Interest Rate Hike to Help Limping Rupiah</u>


*Figure 39: Indonesia's monthly interest rate (Source: Tradingeconomics.com)*

Bank Indonesia (BI) has decided to maintain the interest rate level at 6% during its last meeting on 20th December 2018. Cumulatively, the interest rate has increased by 175 basis points in 2018. The move was mainly influenced by external factors. The United States has been increasing its interest rate this year. Moreover, the ongoing trade war between the United States and China has created uncertainty worldwide. This situation has made the US dollar much more attractive – relative to the Indonesian Rupiah – for investors are looking to minimize their risk. Like many other emerging markets worldwide, Indonesia also suffered from a massive outflow of funds. Thus, increasing the interest rate will help Indonesian rupiah remain attractive and consequently will dampen the depreciation.

Generally, the move taken by Bank Indonesia has proven to be effective. At about 7% since the beginning of 2018, Indonesian rupiah's depreciation against the US dollar is still much lower than other emerging market currencies. For instance, against the US dollar during the same period, Turkish Lira depreciated about 39%, Argentine Peso about 100%, while Russian Ruble and Brazilian Real depreciated about 15% and 17% respectively.

Looking forward, the US Federal Reserve is expected to only increase its benchmark interest rate twice next year, and thus we can expect a less aggressive interest rate hike from Indonesia too.

Sustainable Growth for Indonesia

The Indonesian economy is set to grow by around 5.1% this year, which is desirable during this period of economic uncertainty but slightly lower than the initial forecast of 5.2%. Splitting the GDP into its major components, the main reason why the economic growth cannot meet the initial forecast is that investment level is expected to grow by only 6.76%, lower than the initial forecast of 6.9%. Investment is the second biggest component of Indonesian GDP.

As mentioned previously, Bank Indonesia increased the interest rate significantly this year. Consequently, the cost of borrowing is likely to increase, and investors are less willing to undertake risky investments. Additionally, the Indonesian rupiah had a bearish trend for a large part of this year and thus investors postponed their investment plans since they expected their investment value to increase in the future due to the depreciation. Hence, investors would wait until the Indonesian rupiah stabilizes.

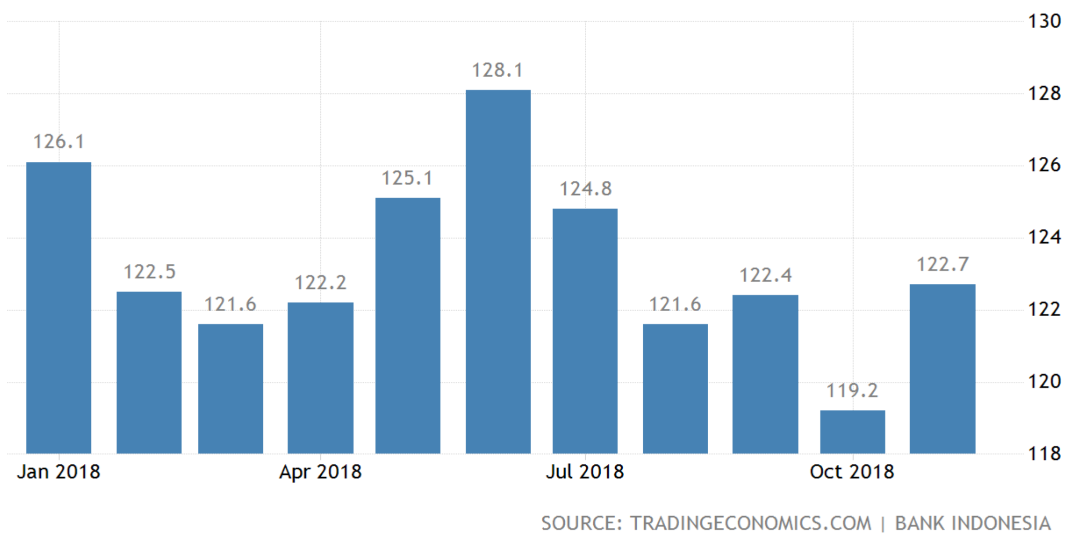



*Figure 40: Indonesia consumer confidence index (Source: Tradingeconomics.com)*

Moving on to other GDP components, domestic consumption, which accounts for more than half of Indonesian GDP, is set to grow by 5.06% this year. This is well within the expectations of 5.02% to 5.07%. Growth is expected to be driven by the high consumer confidence index, which stayed above 120 throughout 2018 except for October. Government expenditure, on the other hand, is expected to grow by 4.17%, which is also within expectation of 4.02% to 4.17%. The government remains committed to improving infrastructure as it spends approximately US$27 billion this year.

Some GDP-related highlights of the year include the Asian Games, which was held from 18th August to 2nd September 2018. During the 3 years of preparation and the actual event, it was reported that Indonesia enjoyed direct economic benefit of US$2.67 billion. US$1.9 billion came from infrastructure spending, US$513 million came from operational spending and the remaining US$250 million came from tourist spending during the actual event. The event itself was reported to have boosted the economy by 0.05%.

Lastly, during the recent annual International Monetary Fund meeting in Bali, it was reported that Indonesia successfully secured US$13.5 billion worth of investment.

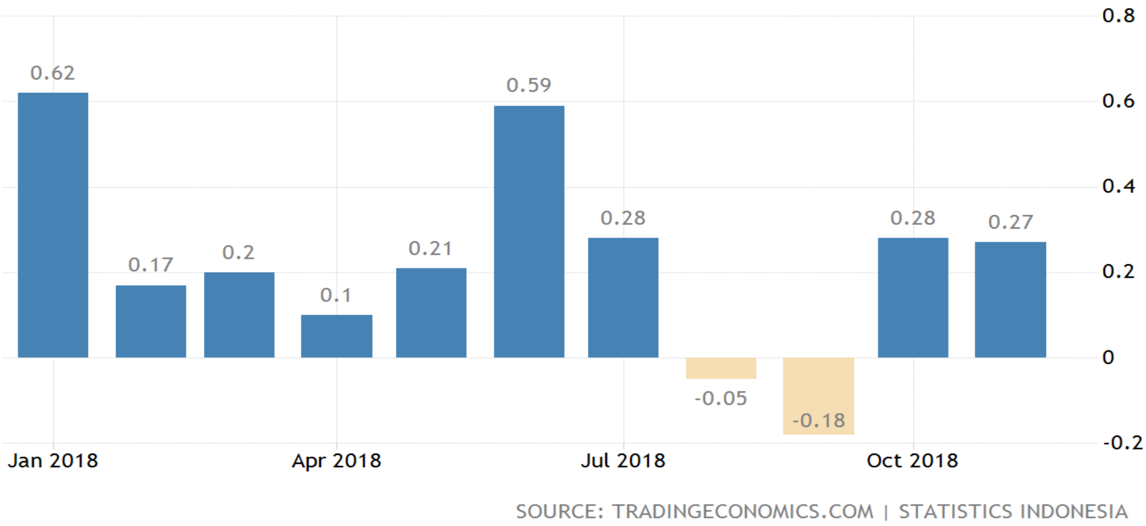



*Figure 41: Indonesia's monthly inflation rate (Source: Tradingeconomics.com)*

The 5.14% of economic growth that Indonesia is set to enjoy this year is accompanied by a desirable inflation rate. Cumulatively since the beginning of the year, Indonesia's inflation rate is currently at 2.49% and it is expected that it will end the year with an inflation rate of 3.2%. After a relatively high monthly inflation rate on June and July due to the Hari Raya spending splurge, Indonesia registered deflation on August and September followed by moderate inflations on October and November.

Bullish Oil Hurts Trade Balance

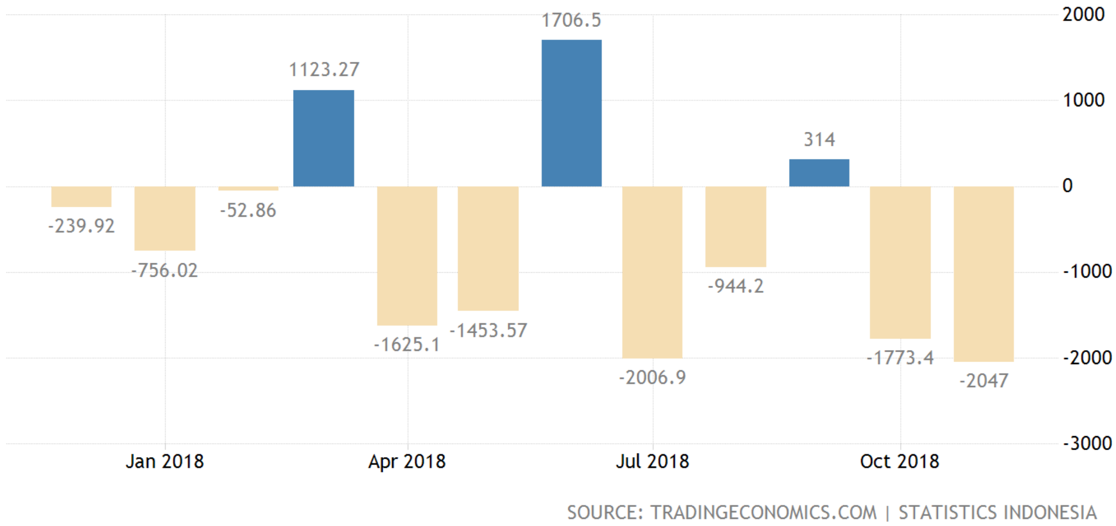



*Figure 42: Indonesia's monthly trade balance (Source: Tradingeconomics.com)*

Indonesia registered a trade deficit of US$2.047 billion in November 2018, the biggest monthly deficit since 2013. The import value was US$16.88 billion, a 4.47% fall from October 2018 thanks to falling oil prices. However, exports fell by 6.69% to US$14.83 billion. Cumulatively, the overall trade deficit stands at US$7.52 billion.

There are a few key reasons for this deficit. Firstly, the value of oil imports keeps increasing. Although Indonesia is an oil producing country, daily production capacity is only at 500,000 barrels per day, while daily consumption is at 1.3 to 1.4 million barrels. As such, Indonesia needs to import oil to make up for the shortfall. Given that oil had been on a bullish trend for a large part of this year – excluding the last few months - the value of imports increased.

Secondly, Indonesia does not have any products that can boost exports. In the past, Indonesia relied on plywood and textile products to boost its exports but that is no longer the case as demand for these products has fallen.

Lastly, it was reported that the government initially wanted to postpone several major infrastructure projects to reduce imports of raw materials. However, this was not possible since most of the construction was already ongoing and thus postponing them would result in more expenses due to bank interest. Imports of raw materials thus continued, contributing to the trade deficit.

All Eyes on April 2019 General Election

There will be an election happening in April 2019 in which the current president Mr. Joko Widodo is highly expected to win. Recently, he just completed his 4th year in charge and his performance was satisfying.

President Widodo's Administration oversaw the construction of significant infrastructure projects, including 11 airports, 48 dams, 12,783 km of roads, 369 km of railways, 905 km of highways and 162,000Ha of irrigation systems. Unlike the previous presidents, Mr. Widodo's administration did not focus solely on developing the key island of Java. Previously untouched regions such as the Island of Papua was given a great deal of attention too and this helped Indonesia to achieve better wealth distribution.

Helping President Widodo's cause is the underwhelming opposition he faces. Opposition candidate Prabowo Subianto has minimum past achievements and is struggling to promote himself with concrete plans. Furthermore, his team is facing allegations of campaigning inappropriately by spreading negative rumors on social media to bring down the current government's reputation.

FX TRADE IDEA: SHORT USD/IDR


*Figure 43: USD/IDR daily chart (Source: Tradingview.com)*

USD/IDR recently ended its 10-month bullish rally as it broke out from the support line. Starting with the fundamentals, from the US dollar side, the recent G20 meeting has given a new hope for the ongoing trade war between China and the US. During the meeting, President Trump and President Xi have agreed to stop implementing new tariffs for 90 days. If an agreement could be reached within this 90-day period, it would put an end to the massive fund outflow from emerging markets caused by uncertainty from the trade war.

From the perspective of the Rupiah, we believe that Bank Indonesia still has room to increase interest rates, in anticipation of further interest rate hikes from the Fed next year. Thus, any effect from US interest rate hike can be minimized, giving more room for rupiah to appreciate.

**Entry: 14220**

**Take Profit: 13280**

**Stop Loss: 14650**

From the technical perspective, investors could wait until the price touches the nearest support at **14220** and prepare for a breakout. Coupled with a death cross between the 20-day Simple Moving Average and the 200-day Simple Moving Average, a bearish trend can then be confirmed, and investors can take short positions on the USD/IDR.

A suitable long-term profit taking level would be at **13280**, which was the starting point of the previous bullish trend. Lastly, a stop loss should be done if there is a trend reversal, which is marked when the price breaks out from the resistance line at about **14650**.

ETF TRADE IDEA: LONG Premier ETF

**Ticker: R/LQ45X:IJ**

**Listed on: Indonesia Stock Exchange**

**YTD return: -8.93%**

The Reksa Dana Premier ETF LQ-45 is an open-ended exchange traded fund registered in Indonesia. Its goal is to produce results closely related to the LQ45 index - an index consisting of Indonesia's 45 most liquid stocks. It manages approximately US$81 million worth of assets and the fund invests at least 80% of it on the LQ45 stocks and at most 20% on money-market instruments.


*Figure 44: R-LQ45X daily chart (Source: Investing.com)*

**Entry: 1030**

**Take Profit: 1125**

**Stop Loss: 1000**

A falling wedge chart pattern can be seen from the above figure as the price broke out from converging trend lines. A bullish trend is further confirmed with a golden cross between 20-day SMA and 200-day SMA. Stochastics also indicate the security is entering the overbought area, as shown by recent candles that are pushing higher. Investors can choose to enter at the **current price** with profit taking level at **1125**. If the price goes below **1000**, investors should exit.

# PHILIPPINES – OVERWEIGHT

With more than US$313 billion of GDP in 2017, the Philippines is the 34th largest economy in the world by nominal GDP. Its economy has been fairly resilient in facing recent external shocks thanks to its lower dependence on exports, strong domestic consumption and massive remittances from over 10 million Filipinos working at all over the world. The Philippines is the world's second largest coconut producer after Indonesia with annual production of almost 20 million tons and is the world's largest pineapple producer.

Under the leadership of President Duterte, the Philippines enjoys high annual economic growth driven by high government expenditure to boost infrastructure. However, this high economic growth is rather unsustainable as it comes with high inflation rate. Additionally, the Philippines is still struggling to improve its wealth distribution. A worrying 33% of the population is currently living below the poverty line. In some regions, this figure can go as high as 75%. While the entire economy grew by 6.7% in 2017, certain regions only grew by about 1% to 2%, further highlighting the disparity in economic performance and metrics across the country.

<u>Rising Interest Rate to Rescue Peso and Inflation</u>


*Figure 45: Philippines monthly interest rate (Source: Tradingeconomics.com)*

The current interest rate is at 4.75%, the highest level since 2009. Bangko Sentral Ng Pilipinas (BSP) decided to pause the interest rate hike during the latest meeting on 13th December 2018 after inflationary pressures were somewhat relieved in November. Cumulatively, the interest rate has been increased by 175 basis points in 2018, after staying at 3% for a long period of time. This hawkish stance has been taken largely to dampen the depreciation of the peso, and curb inflation. The hike was widely expected and was deemed necessary after higher wages and transportation costs were implemented recently. Just like other emerging markets' currencies, the Philippine peso has depreciated significantly against the US dollar, reaching its lowest point since 2006 due to rising United States interest rate and global uncertainty caused by the ongoing trade war. President Duterte's famous "build build build" program has also resulted in massive import bills because of imports of raw materials. Moving forward, it is highly likely that the BSP will increase the interest rate in each of the 1st three quarters next year to pull down the inflation rate to a more moderate level.

Rapid Economic Growth for The Philippines

The Philippines is set to enjoy economic growth of 6.7% this year – one of the highest among ASEAN countries. Consumption remains as the biggest component of the nominal GDP. However, its contribution towards the GDP growth is minimal since it is reported to only grow by 5.9% this year.

President Duterte's "build build build" policy has resulted in a huge growth in government expenditure. Government spending is about US$102 billion in 2018, a 13.6% increase compared to last year, as the country continues to boost infrastructure to improve wealth distribution. Lastly, net export growth slowed down to 9.8% from 19.5% last year.

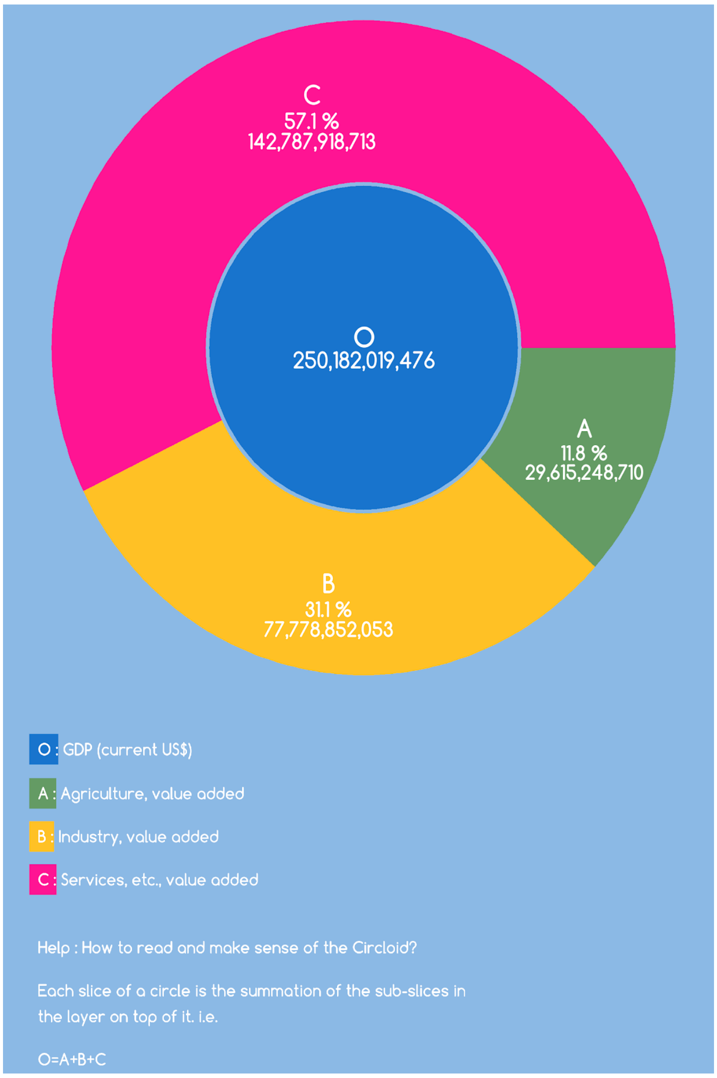



*Figure 46: Philippines GDP composition breakdown*

It is worth noting that when we split the economy by sector, the Philippines has gradually shifted from an agrarian to an industrial and service-oriented economy. The agricultural sector once contributed about 25% towards the GDP, but that number has fallen to just 11.8% last year. Still, this sector employs 30% of the Filipino's workforce.

The main reasons for the decline in the agricultural sector are poor infrastructure and low investment. Currently, the services and industrial sectors dominate the economy, thanks to industrialization. Last year, the industrial sector grew by 7.2%, the highest among all major economic sectors, and contributed 31.1% to the GDP. Services, on the other hand, contributed a staggering 57.1% to the GDP.

Meteoric Rise of Inflation Rate

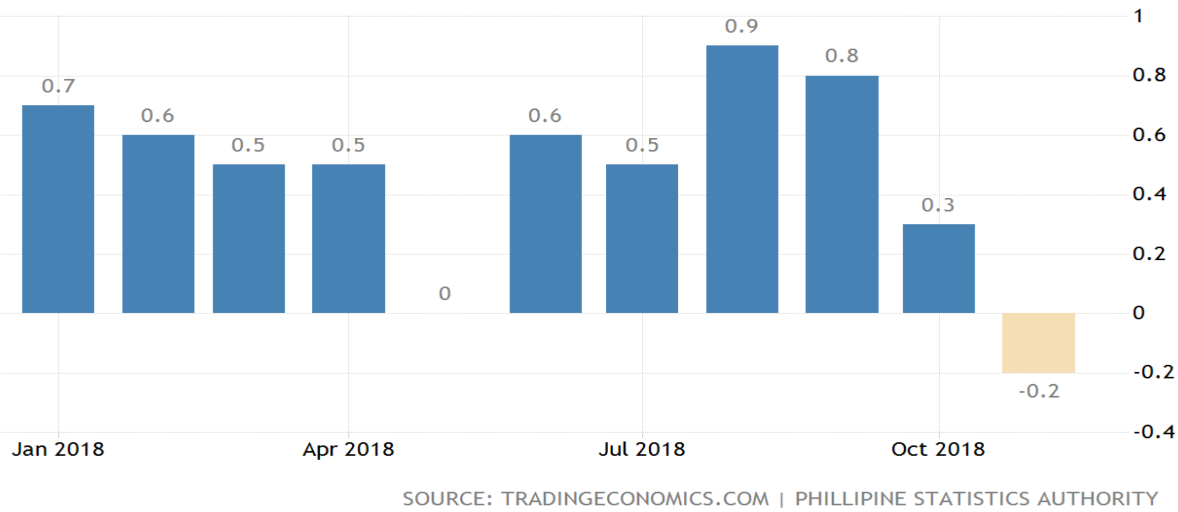



*Figure 47: Philippines monthly inflation rate (Source: Tradingeconomics.com)*

Despite the strong economic growth, we believe that the Philippines' economy is overheating. Inflation rate stands at a worrying 5.2% as of November 2018. This figure is way above the government's annual inflation rate target of below 4%. The Philippines' inflation rate is also the highest among ASEAN countries. The main reason for this is the rise in oil prices over the first half of 2018. As a non-oil producing country, the Philippines has to import oil from other countries. Hence, rising oil prices will directly affect the inflation rate.

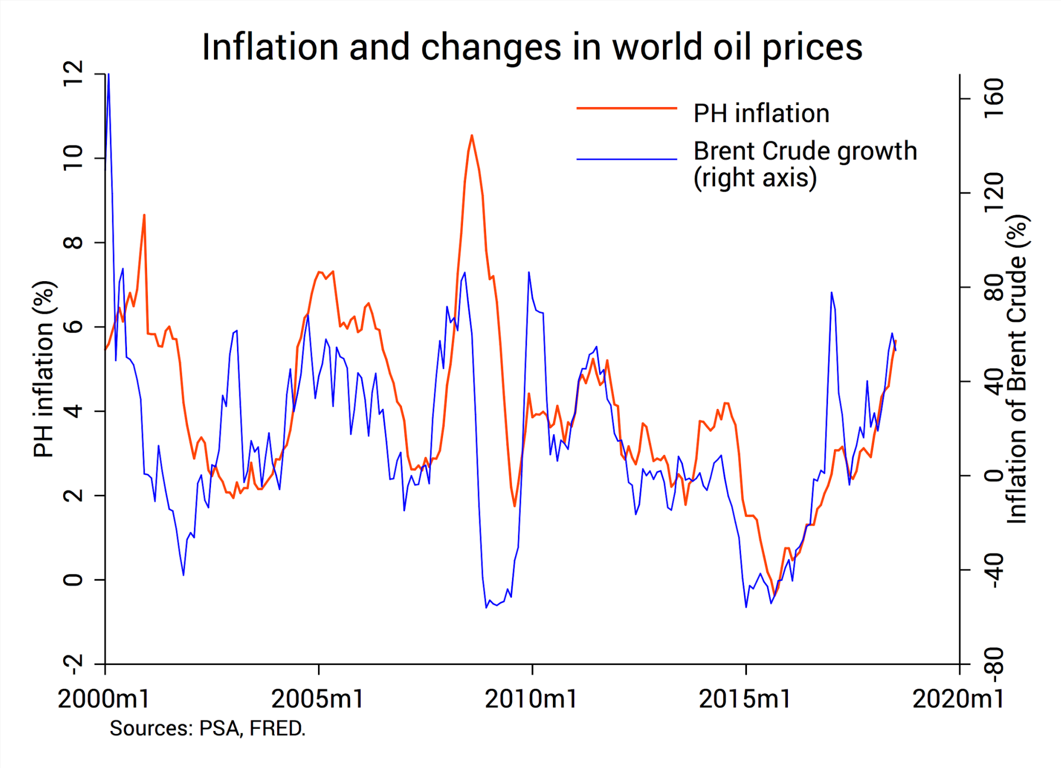



*Figure 48: Philippines inflation rate vs. Oil price*

President Duterte's 'build-build-build' infrastructure program also plays a major role in the high inflation rate. With massive infrastructure construction, the Philippines imported tons of raw materials, which results in a weakening peso and consequently imported inflation. The high level of imports also resulted in a current account deficit for the first time since 2009.

The recent fall in oil prices, however, gave the Philippines a moment to breathe as it enjoyed a month-on-month deflation on November. Next year, BSP is expected to continue its hawkish stance and the inflation rate is targeted to be around 4%.

Trade Balance Perpetually on the Negative Zone

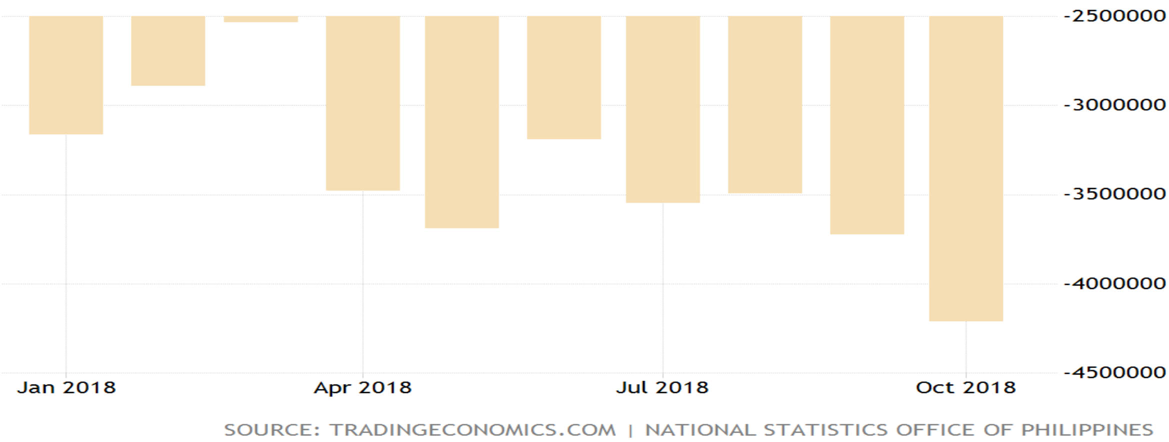



*Figure 49: Philippines monthly trade balance (Source: Tradingeconomics.com)*

The Philippines incurred a trade deficit of US$33.92 billion during the first ten months of 2018. It has constantly registered a monthly trade deficit this year. In October 2018, the Philippines registered its largest monthly trade deficit ever recorded of US$4.2 billion as imports rose much more than exports. In October, the Philippines made US$10.32 billion worth of imports – a 21.4% year-on-year growth. Its massive ongoing infrastructure projects were one of the major contributing factors to the trade deficit as the Philippines imported tons of raw materials. Furthermore, oil makes up about 10% of imports, thus the rising oil price also contributed significantly to the trade deficit.

## FX TRADE IDEA: LONG USD/PHP


*Figure 50: USD/PHP daily chart (Source: Tradingview.com)*

If we look at the daily chart, it seems as if USD/PHP has ended its 7-month bullish rally as there was a breakout from the support line on early November followed by a death cross between 20-day SMA and 200-day SMA.


*Figure 51: USD/PHP weekly chart (Source: Tradingview.com)*

However, looking at the weekly chart, the USD/PHP is still having a major bullish run since September 2016. Starting with the fundamentals, The Fed still has room to increase interest rates given that at the current rate the United States is still getting desirable economic growth and inflation. The Fed is widely expected to increase interest rates two times. This will put more pressure on the Philippines peso as the US dollar will be more attractive.

On the other hand, “build build build” policy is not showing any sign of slowing down, with Filipino government planning to spend over US$70 billion next year on infrastructure and human capital development. The massive infrastructure constructions come at the expense of trade balance and consequently currency since the Philippines needs to import large quantities of raw materials. The situation will put more pressure on the peso and thus over the next 6 to 12 months, the peso is expected to continue its bearish trend against the US Dollar.

**Entry: current price**

**Take Profit: 54.4**

**Stop Loss: 52.0**

Referring to the weekly chart shown above, the current price level can be a good entry point given that it just rebounded from the support line. A golden cross can be recently seen on the stochastic indicator as well. It is also leaving the oversold area. Investors can trade this currency pair by following the trend line. Nearest target would be **54.4**. Stop loss should be done if the price falls below **52**.

However, it is worth noting that the outcome of the ongoing discussion between President Trump and President Xi Jinping would have a large effect on this currency pair. Should they manage to reach an agreement to end the trade war, a trend reversal could happen as one of the main reasons why the US dollar appreciated so much this year is the uncertainty caused by the US-China trade war.

# RUSSIA – NEUTRAL

Russia, despite being the largest country in the world, is still regarded as a developing country with its economy still largely being dependent on the export of natural resources. It is the largest exporter of natural gas and second-largest exporter of petroleum, only behind Saudi Arabia. After the fall of the Soviet Union in the 2000s, Russia has slowly transitioned to a market economy, though the Kremlin currently still frequently encroaches on private business activities and there are large state-owned enterprises heavily involved in the banking, oil and gas and utility sector.

The largest sector contributions to GDP are services at 62.3%, industrials at 32.4% and agriculture at 4.7%. Unsurprisingly, the fuel and energy complex in the Russian economy, comprising mining, production, processing and consumption is arguably of core importance to the country.

Russia's three largest trading partners are China, The Netherlands and Germany. The top 15 importers of Russian goods make up 67.3% of Russia's total exports.

Russia's Hawkish Hiking


*Figure 52: Russia's monthly interest rates (Source: Tradingeconomics.com)*

14th December saw the Bank of Russia (BOR) hiking interest rates by 25 basis points. This came as a surprise to the markets, which had forecasted that the BOR would hold rates unchanged. The BOR's decision was based heavily on food prices and the arrival of inflation pressures from the VAT increase happening in January 2019.

26th October saw the BOR keeping interest rates unchanged at 7.50%, matching analyst estimates. However, the BOR reiterated its stance that "pro-inflationary risks remain elevated, especially over a short-term horizon", indicating its willingness to act should inflation pressures emerge. This comes after September's surprise decision to raise the key rate for the first time in 4 years by 25 bps to 7.50%.


*Figure 53: Russia's inflation expectations vs. Ruble spot rate (Source: Bloomberg)*

With yet another surprise by the BOR to hike rates, we see that inflation pressures still remain elevated from the VAT increase. Hike expectations also remain centered on the threat of new US sanctions, accompanying Ruble weakness. It is in our view that the BOR is preemptive in hiking as seen from December's and September's decision which explains our hawkish view.

Muted Growth but Inflation Pressures Creeping Up

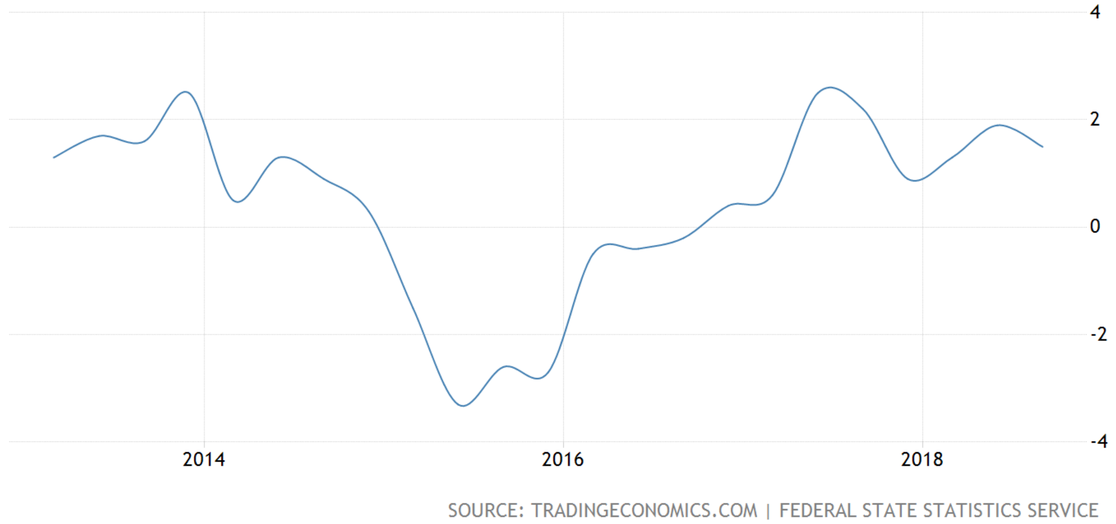



*Figure 54: Russia's annual GDP growth rate (Source: Tradingeconomics.com)*

Russia's GDP growth stood at 1.5% YoY in Q3 of 2018, higher than estimates of 1.3%. Within the service sector, the biggest gains were in the financial & insurance activities at 9.7% vs 8.6% in Q2 and administrative & support service activities at 3.1% vs 1.8%. The biggest declines were seen in public administration & defense, compulsory social security at 0.3% vs 2.8% in Q2 and accommodation & food service activities at 5.6% vs 6.9%. Major industrial activity sectors were mining & quarrying coming in at 5% vs 2.6% in Q2 and water supply, water disposal, organization of waste collection & disposal, pollution control activities rebounding to 1.8% vs -2.2%.

Meanwhile, GDP growth stood at 1.9% YoY in Q2 of 2018, higher than estimates of 1.8% on the back of a 1.3% gain in Q1. A large part of this growth was due to the 2018 FIFA World Cup that took place in Russia in June and July, driving increases in the hotel, transport and restaurant sectors.

Q3 GDP growth was largely in line with our forecasted slowing from Q2 figures due to the World Cup being a one-time event causing consumer demand to be temporarily inflated. Though oil prices have taken a beating in the past 2 months, we take the view that this is a temporary dislocation of prices. Moving forward, prices should still resume their upward trajectory, which coupled with Russian oil output flexibility, should help to boost exports. This stance is supported by Russia's crude production jumping to a new post-Soviet record of 11.2m barrels per day in September, covering for oil production shortfalls resulting from Iran sanctions and Venezuela troubles. This should help keep GDP growth around 1.5% for the remaining of 2018 and into 2019.


*Figure 55: Russia's monthly inflation rates (Source: Tradingeconomics.com)*

Russia's annual inflation rose further to 3.8% in November, the highest since July 2017 largely due to rising food costs of 3.5% vs 2.7% in October and non-food products of 4.2% vs 4.1% with service inflation slowing to 3.8% vs 4%.

Annual inflation is returning to the targeted 4% level faster than expected by the Russia central bank. The depreciating Ruble is seen to further contribute to inflation pressures, with the Russian VAT increase from 18% to 20% from January 2019 also adding to the pressures. Moving forward, we see inflation moving to the upside, in line with BOR's forecasts of annual inflation to be 5-5.5% in 2019.

Current and Trade Surpluses with Sanction Risks

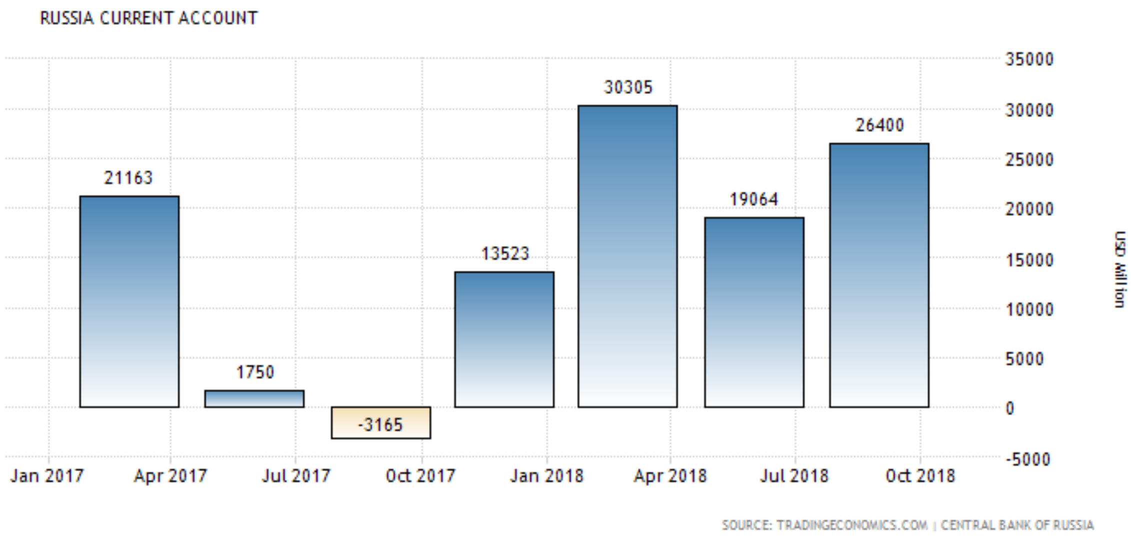



*Figure 56: Russia's monthly current account balance (Source: Tradingeconomics.com)*

The current account in Q3 amounted to a USD 26.4 billion surplus vs a 3.2 billion deficit YoY. Goods surplus stood at 46.7 billion from previous years' 20.7 billion, service surplus dropping to 8.6 billion from 9.9 billion, investment income deficit declined to 9 billion from 10.9 billion, and secondary income gap was down to 2.4 billion compared to 2.7 billion.

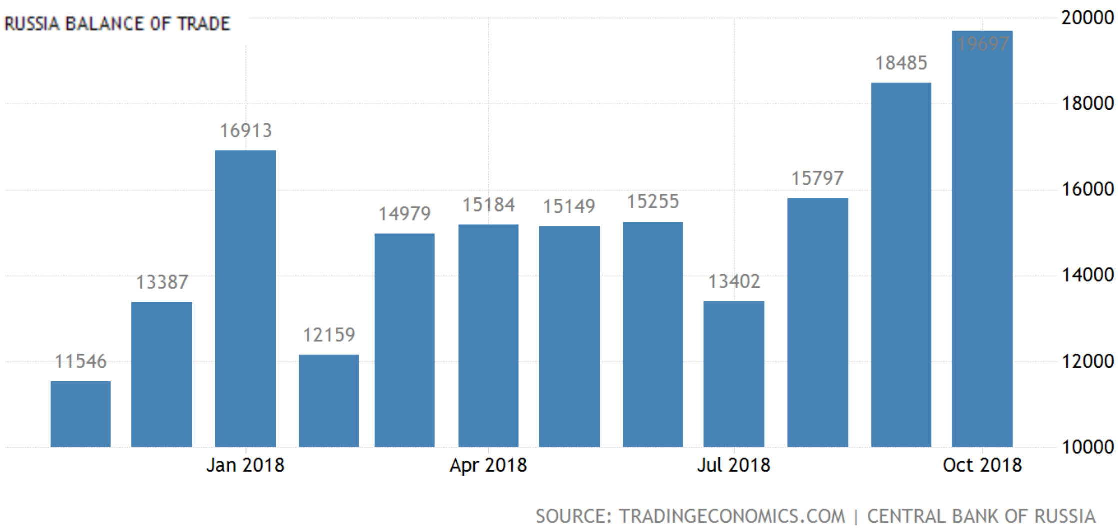



*Figure 57: Russia's monthly trade balance (Source: Tradingeconomics.com)*

October's trade surplus widened to USD 19.70 billion vs 10.1 billion in the previous year, beating analysts' expectations of a 17.90 billion surplus. Exports climbed to 35.9 billion, a 33.7% increase YoY while imports crept up to 21.62 billion, a 0.5% YoY increase.

Rising oil revenues from higher prices and output are likely to have boosted exports, which account for over 70% of Russia's exports. However, given the recent market decline in oil prices, the projected short-term figures should come out worse though in the long run we still expect oil prices and trade numbers to at least par these declines.

However, there are also sanction risks that Russia continues to face. The EU extended the sanctions from the lack of progress over the Ukraine peace accord for another six months in December.

The US is also threatening Russian exports, with The Trump Administration again warning on the 26th October 2018 of further sanctions remaining a possibility over Russia's interference in the US elections and the annexation of Crimea. Sanctions over the ability of Russian banks to conduct dollar transactions are also being discussed. It was our view that these sanctions threats were being used as an election tool to boost electoral support in the short term for the midterm elections and thus sanction fears are overblown in the long term. Indeed, sanctions talk from the US have been muted since the passing of the midterm elections.

However, tensions between Ukraine and Russia have recently elevated due to the Russian-Ukraine military clash that on 25th November. Russia captured three of Ukraine's naval vessels and 23 crew members that were sailing off the coast of Crimea which was annexed by Russia back in 2014. Till date, Russia has not released neither the naval vessels nor the crew, with Russian president Vladimir Putin saying during the G20 summit in early December that it is still "too early" to return them. This has increased the possibility of the US further pressuring Russia on sanctions.

FX TRADE IDEA: LONG USD/RUB


*Figure 58: USD/RUB daily chart (Source: Tradingview.com)*

The Ruble remains extremely sensitive to the possibility of future sanctions imposed by the US, as seen by sanction fears in April and August significantly boosting the USD/RUB pair. The Ruble fell by more than 16.7% based on the combination of these two threats alone, showing its importance in determining the outcome of the currency. Should the threat of new sanctions be placed on the table, especially after the recent Russian Ukraine incident, market participants will still feel jittery in the short term and overreact, even with our view that hard-hitting US sanctions are unlikely to play out in the long run. We see this as a potential for further spikes in the USD/RUB pair.

**Entry: 68.124**

**Take Profit: 70.589**

**Stop Loss: 65.394**

Increasing divergence between the 50 and 200 SMA with the golden cross established since May also signals a continued bullish run. MACD also indicates that the pair is bullish with a golden cross. We propose to trade the channel with an entry at **68.124** with take profit when it hits the next support of the upward channel. Stop loss would be at **65.394,** the previous support level established after the leg up from April to August.

It is in our view that Russia story is still developing, with a neutral low growth story on the backdrop of yet again heightened sanction risks from its continued provocations in Ukraine. Whether or not the economic picture improves largely depends on that and inflation pressures from both food and energy prices.

# INDIA – UNDERWEIGHT

India clinched its position as the fastest-growing major economy in the world in FY2018, overtaking China's number one spot. As a primarily domestic-driven economy, it has been well sheltered from the trade tensions in the past months.

The largest sector contributions to GDP are Services at 53.66%, Industry at 29.02% and Agriculture at 17.32%. The service sector continues to grow at a strong pace with an annual CAGR above 9% since 2001, contributing to an increasing share of GDP while agriculture is seeing a decrease. The IT industry is the fastest-growing part of the economy and is the largest private-sector employer in India.

The three largest trading partners of India are China, the United States and the United Arab Emirates, with the fifteen largest trading partners of India representing 59.37% of total trade.

## Further Interest Rate Hikes to Come

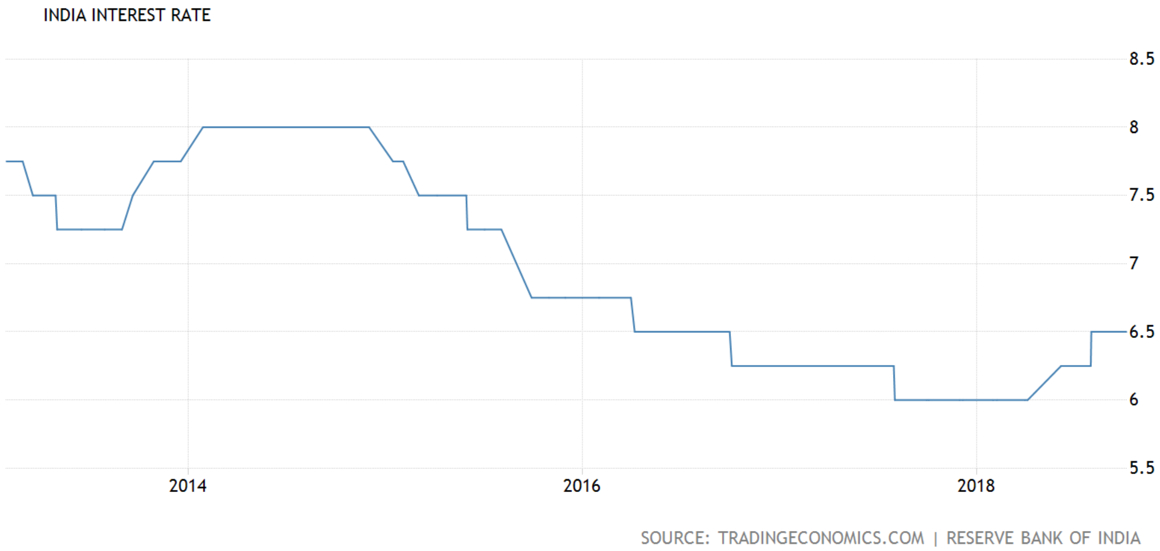



*Figure 59: India's annual interest rate (Source: Tradingeconomics.com)*

Keeping in line with expectations, the Reserve Bank of India (RBI) kept interest rates steady at 6.5% in the 5th December meeting, helped by weakness in energy prices globally and a fall in food prices.

This comes after the RBI had surprised markets in October by choosing not to raise the policy repo rate, with consensus estimates expecting a 25 bps hike. This left the key rate at 6.5%, despite a falling rupee and inflation pressures from rising oil prices. The first interest rate hike in 4 years occurred in June, bringing rates from 6% to 6.25% and the second hike in August by another 25 bps to 6.5%.

The policy reasoning moving forward is likely to be square on inflation risks and not on currency management as the decision to hold rates steady did not help to stem the depreciation of the rupee, which is one of the worst-performing emerging market currencies, losing over 12.6% year-to-date.

On the backdrop of a further weakening currency and rising oil prices resulting in increased inflation risks, we see the RBI taking precautionary measures by hiking rates to prevent inflation from getting out range rather than reacting afterwards. The change in stance from neutral to calibrated tightening suggests future hikes to come, albeit at a delayed pace.

However, there are certain risks to RBI's current stance given Governor Urjit Patel's sudden resignation on 11th December 2018 over differences between the central bank and the Indian government. Shaktikanta Das was appointed as the new Governor and is viewed to be less hawkish as compared to former governor Urjit Patel. In all, we maintain the position that the RBI will still have an overall hawkish stance, though it may be slightly more muted.

Neutral Growth and Inflation on the Horizon

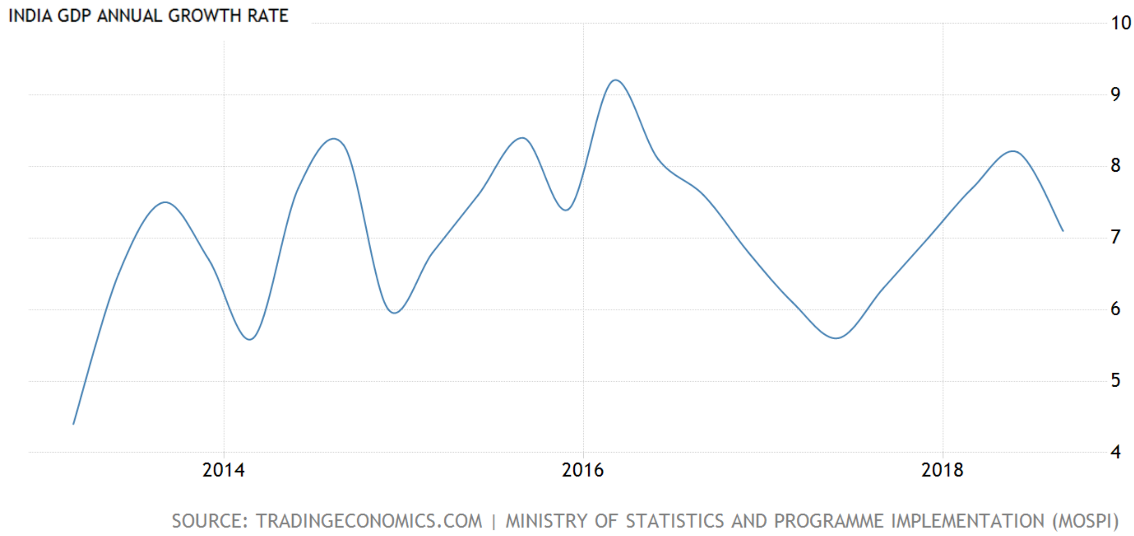



*Figure 60: India's annual GDP growth rate (Source: Tradingeconomics.com)*

The 3rd quarter of 2018 saw India's GDP growing 7.1% YoY, slowing from the previous quarter's 8.2% growth and below market expectations of 7.4%.

The economy seems to have recovered from the demonetization efforts of Nov 2016 which resulted in both demand and supply shocks and the implementation of the GST system in July 2017. However, it was threatened by a decrease in consumer spending likely amid high oil prices and a falling rupee. Household spending only grew at 7% vs 8.6% in Q2. Though exports came in strong at 13.4% vs 12.7%, imports grew faster at 25.6% vs 12.5% in Q2.

It is in our view that the main growth driver of private domestic consumption may be threatened in the coming months due to the loss of purchasing power stemming from the currency depreciation. Furthermore, a rise in oil prices in the middle to long term may impact consumptions figures going forward which we see as a potential risk that may induce downward pressure on growth and cause India to miss estimates.

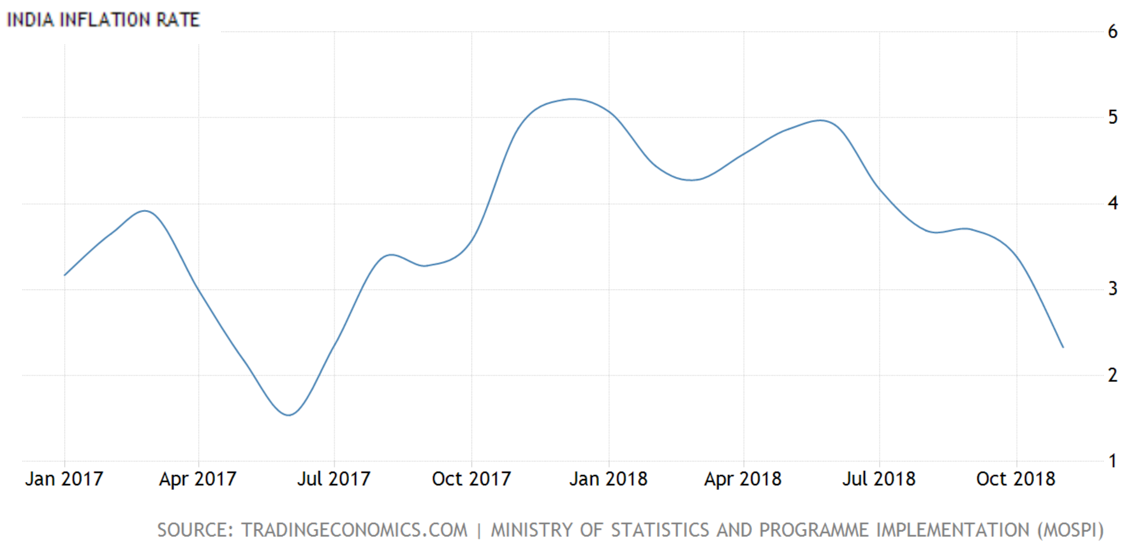



*Figure 61: India's monthly inflation rate (Source: Tradingeconomics.com)*

Annual consumer inflation fell to 2.33% in November, below expectations of a 2.8% increase, bringing it to the lowest levels since June 2017. This was helped by a continued absence in the seasonal uptick in fruit and vegetable prices and the rapid fall in oil prices. The RBI again revised estimates downwards to 2.7%-3.2% till March 2019.

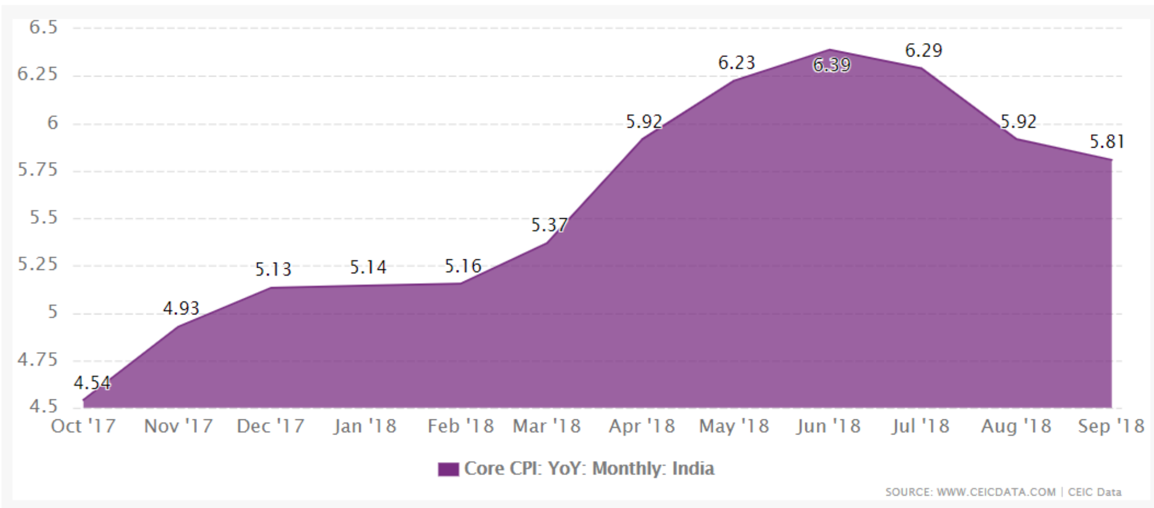



*Figure 62: India Monthly Core CPI YoY Growth*

Core CPI has moderated to a 6-month low at 5.81% year-on-year. However, core inflation remains elevated, contributed by higher services transport costs. With volatile energy and food prices excluded, core inflation tends to reflect long term trends in price levels and is a key concern, making future hikes to step core inflation a highly probable scenario.

Moving forward, with a depreciating rupee and possible upward oil price pressures, we do not feel that this decrease in CPI will be sustained moving forward, with the effect of low food prices likely to persist only in the near term and the other inflation pressures taking over in the medium term. This is in line with the RBI's warning of inflation risks being on the upside. However, with our view that domestic consumption gains will be capped, inflation will likely be muted and remain flat or back the downtrend from June's peak.

Defiant Deficits to Persist

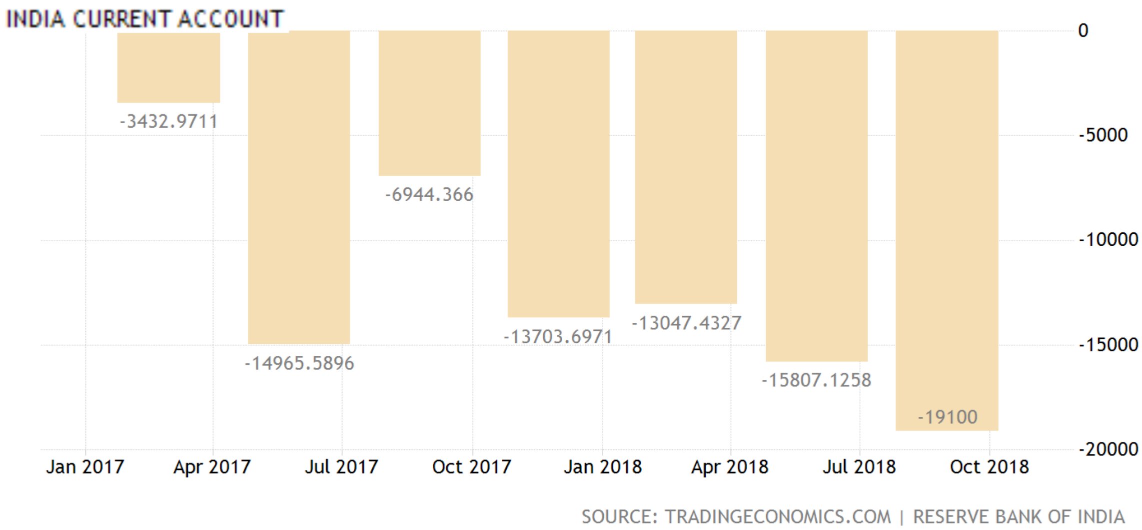



*Figure 62: India's monthly current account balance (Source: Tradingeconomics.com)*

The current account continued its streak of deficits, which further increased by USD 19.1 billion in 3Q 2018 from 6.9 billion last year, now being 2.9% of GDP vs 1.1% previously. The goods deficit was up to 50.0 billion from 32.5 billion, service surplus went up to 20.2 billion from 18.4 billion, secondary income surplus went up to 19.4 billion from 15.7 billion and primary income gap increased to 8.7 billion from 8.6 billion.

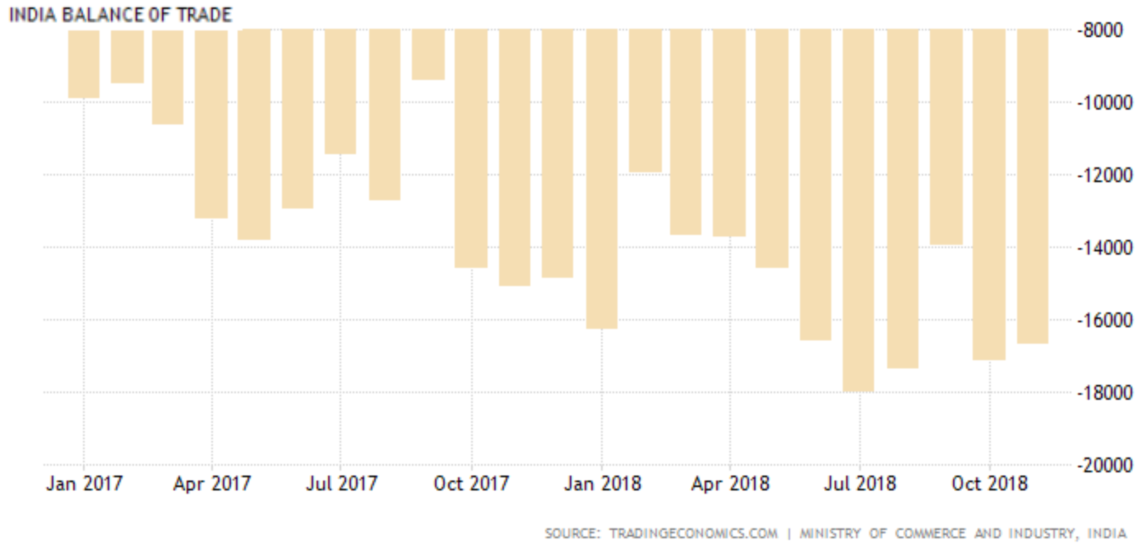



*Figure 63: India's monthly trade balance (Source: Tradingeconomics.com)*

India's trade deficit also further increased to USD 16.67 billion in November compared to 15.1 billion the previous year. Exports came in at 26.5 billion, a 0.8% increase YoY. Sales growth occurred primarily in petroleum products at 42.7%, electronic goods at 37.1% and chemicals at 12.3%. Imports were up by 4.3% to 43.17 billion, driven by purchases of petroleum and crude at 41.3%, coal, coke and briquettes at 12.5% and chemicals at 10.8%.

The weaker rupee was responsible for some of the increase in import figures. However, the weaker rupee did not help boost exports by as large an amount, and research by DBS has shown that India's exports are more correlated to global import demand rather than its currency strength. With the US being the largest export market for India at 17% and on the back of the continued trade rhetoric of the US, we see future global imports dampened and expansion limited. Coupled with the continued rupee depreciation and higher oil prices driving imports up, we foresee future deficits to worsen.

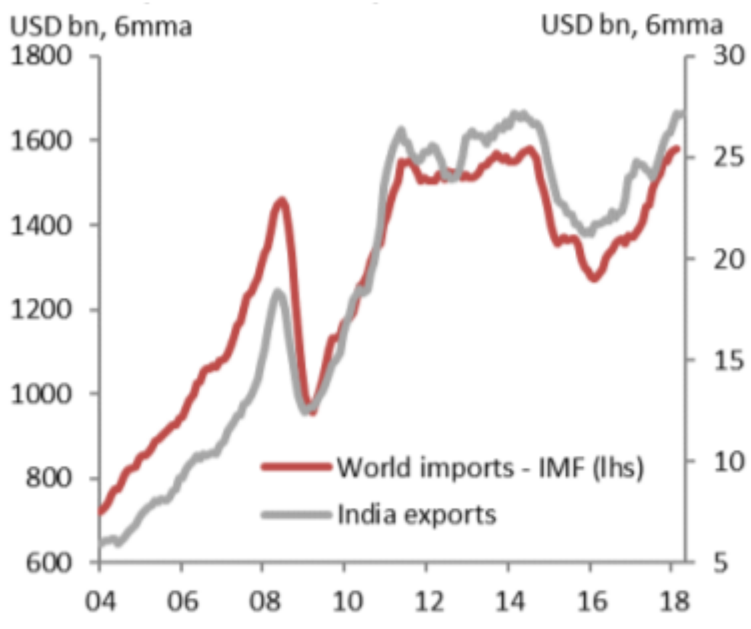



*Figure 64: Global imports vs. India export figures*

<u>General Elections Not as Secure as Before</u>

India's general elections are due to be held sometime around May 2019. The ruling Bhartiya Janata Party (BJP) led by Prime Minister Narendra Modi is still forecasted to remain as the winners with the National Democratic Alliance (NDA). However, their clear majority over the United Progressive Alliance (UPA) based on the latest ABP News poll in October 2018. However, that majority has now been questioned with the BJP trailing in two states and facing a close call in the third, out of the five Indian state elections. We see that it is unlikely for the BJP and Modi to lose their majority in the upcoming elections unless the still partially fractured opposition can fully unite and prove to be an extremely powerful contender. However, the opposition may be able to claw some spots from the incumbents and somewhat dilute their power in the government.

## FX TRADE IDEA: LONG USD/INR


*Figure 65: USD/INR daily chart (Source: Tradingview.com)*

The US Fed is on track to continue raising rates, enhanced by continued strong growth with 3Q numbers reported at 3.5% in late October which increases the likelihood of current projections of a December hike and 2 more in 2019, a bullish sign for the dollar. With a current emphasis of the RBI not focusing on currency support but on inflation, we see room for further rupee depreciation. There is a moderation on global imports with higher oil prices leading to continued deficits and muted inflation pressures forecasted. Alongside continued foreign capital outflows as investors rotate back into the US from emerging markets, we take the stance that the rupee will continue its downward decline and thus are bullish on the USD/INR pair.

**Entry: 74.463**

**Take Profit: 80.500**

**Stop Loss: Dynamic**

Increasing divergence between the 50 and 200 SMA with the golden cross established since May signals a continued bullish run. Entry would be when price breaches October all-time highs at **74.463** with long run take profit around **80.500**, taken using the distance between the June - August resistance level and the entry price. Stop loss would be a dynamic one, when a death cross of the 50 and 200 SMA is established.

ETF TRADE IDEA: SHORT iShares MSCI India ETF

**Ticker: INDA**

**Listed on: NYSE:ARCA**

**YTD Returns: -9.62%**

The iShares MSCI India ETF tracks the MSCI India Index comprising large and mid-cap segments of the Indian market. Financials at 22.52%, Information Technology at 17.35% and Energy at 13.81% make up for the 3 largest industries. The top 3 constituents are RELIANCE INDUSTRIES LTD at 10.10%, HOUSING DEVELOPMENT FINANCE CORPOR at 9.41% and INFOSYS LTD at 7.61%. As of 14 Dec 2018, it's YTD return is -10.44% 1-year return at -7.74% and 3-year compounded annual return at 7.97%.


*Figure 66: iShares MSCI India ETF daily chart (Source: Tradingview.com)*

With our muted view on India's growth outlook due to domestic consumption pressure arising from the rupee continuing its downtrend, coupled with worsening deficits from rising oil prices, we foresee further fund outflows out of India's equity markets. Thus, we are bearish on the Indian equities and propose bucking the trend to short INDA.

**Entry: current price**

**Take Profit: 26.08**

**Stop Loss: Dynamic**

A death cross was established on 24th October with the 50 SMA falling below the 200 SMA and with a strong negative MACD value showing strong downside momentum is in line with our short idea.

Entry to short would be at the current price of **32.57** with long run take profit around **26.08**, a key support line in 2H 2016. Stop loss would be a dynamic one, if the 50 SMA crosses the 200 SMA to form a golden cross, signaling a bullish reversal.

India being one of the country's most reliant on oil imports, remains heavily sensitive to the developments in oil prices. With our continued bullish stance on oil prices, we still see rising inflation and interest rates as a strong possibility, dampening GDP growth.

## BRAZIL – OVERWEIGHT

Brazil is the 8th largest economy in the world and the largest in Latin America. Brazil is also one of the most populous countries in the world with 210 million inhabitants. Until 2010, Brazil had been one of the world's fastest growing economies, with an average annual GDP growth rate of over 5%. Brazil's exports are driven by its agriculture and mining sectors with soybean and iron ores making up 10% and 7% of Brazil total exports.

However, in recent years, Brazil's economic growth has decelerated and even entered a recession in 2014. Although Brazil has since exited the recession, it is still facing many issues. Lula da Silva, its fifth president, was once one of the most popular and successful politicians in the history of Brazil was arrested in April this year on the charges of money laundering and passive corruption. The diesel crisis also happened this year in May, as truckers protested the increase in oil prices, leading to nationwide paralysis of transportation routes.

<u>President Bolsonaro - Moving Brazil forward or more of the same?</u>

With the market having largely priced in the effects of a Bolsonaro victory, our attention has turned to the effectiveness of a Bolsonaro administration in the first year. Brazil's fiscal deficit has been spiraling downwards for the past few years mainly due to unsustainable social welfare schemes such as the pension scheme. Fiscal and budget reforms need to be carried out immediately in order to curb the government spending and narrow the fiscal deficit that Brazil is running.

While President Bolsonaro has promised ambitious pension reforms, it is still unclear if he will honor them and if he has the political acumen to execute this reform. President Bolsonaro has been known to be a political extremist and has weak congressional support. Any constitutional reforms such as removing the pension scheme will require a majority in the House and Senate to pass the bills.

President Bolsonaro also comes from a military background and enjoys strong support from military establishments. The armed forces are one of the biggest beneficiaries of the pension scheme and it is unclear if the President will risk provoking his strongest supporters even after he is elected in.

Brazil's general government debt is expected to hit 77.5% of GDP in 2018 and will continue to rise beyond 2018. Fitch credit rating agency has also given Brazil a BB rating stating that the country still experiences "weak growth prospects and a challenging political environment".

Given that the market has painted such a positive outlook for Brazil, there is plenty of room for disappointment as President Bolsonaro will likely face challenges in implementing reforms. A continuation of the old path will then lead to debts widening and a BRL selloff.

Interest Rate stagnant amidst political upheavals


*Figure 67: Brazil's monthly interest rate (Source: Tradingeconomics.com)*

Brazil's Central Bank has recently elected to hold the interest rate at an all-time low of 6.5% for the sixth straight meeting. In addition, it also hinted that it is likely to hold off raising the interest rate for longer than expected. The Central Bank cited a slower than expected economic growth rate and repressed inflation expectations as reasons for the holdoff. With the latest statement in December, only 4 out of 33 economists polled by Nasdaq indicated that they expect the interest rate to rise in 2019, doubling down on the dovish outlook. The Central Bank would likely keep a close eye on the economic policies of President Bolsonaro before making any interest rate movements.

Sluggish inflation rate, sluggish economy

The inflation rate has subsided significantly since the truckers' strike in May. Inflation for the month of November experienced a larger-than-expected drop as consumer prices tracked by the benchmark IPCA index dropped to 4.05% in November, as compared to 4.56% in October. The lower than expected inflation rate further supports the view that interest rates will likely stay put for the near future. IMF also recently revised Brazil's projected GDP growth in 2018 to 1.4%, 0.4% lower than the initial 1.8% prediction. This is likely due to the spillover effect of the US-China trade war as the US and China are the top 2 exporters and importers of Brazil. Although Brazil's 3Q GDP grew by 0.8%, this is largely in line with expectations and cannot mask the fragile state of the economy.

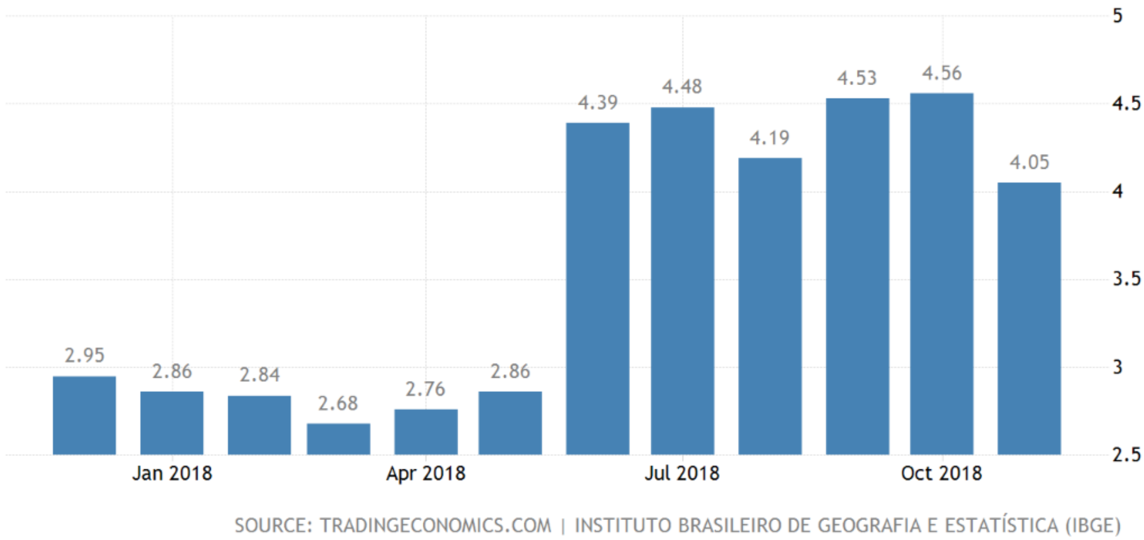



*Figure 68: Brazil's monthly inflation rate (Source: Tradingeconomics.com)*

<u>FX TRADE IDEA: LONG USD/BRL</u>


*Figure 69: USD/BRL daily chart (Source: Tradingview.com)*

With the interest rate held at 6.5%, the interest rate differential between Brazil and the US continues to narrow as the Federal Reserve is set to hike interest two more times in 2019. Investors will likely shift their money out of Brazil and into the US causing the Brazilian real to depreciate against the dollar. Investors coming in with positive sentiments about Brazil's reforms might be in for a huge disappointment as President Bolsonaro will likely struggle to execute the much-needed pension reforms due to his lack of political acumen, weak congressional support and the risk of offending his friends in the military.

**Entry: 3.9330**

**Take Profit: 4.20**

**Stop Loss: 3.8121**

A look at the RSI shows that there is no divergence between the moving average and RSI. We suggest to long the USD/BRL right above the line of significant resistance of **3.9330** with a take profit level at just below the previous key resistance level of **4.20** and a stop loss at price level of **3.8121** to ensure a risk to reward ratio of above 2.

ETF TRADE IDEA: LONG iShares MSCI Brazil Capped ETF

**Ticker: EWZ**

**Listed on: NYSE ARCA**

**YTD Returns: -0.01%**

iShares MSCI Brazil Capped ETF is the largest pure-play Brazilian ETF and tracks the MSCI Brazil 25/50 Index. EWZ invests primarily in Brazilian large- and mid-capitalization sized firms. As of 21st December 2018, the fund has a 3-month return of 22.65%


*Figure 70: iShares MSCI Brazil Capped ETF daily chart (Source: Tradingview.com)*

EWZ sold off sharply and fell 33% in the first half of 2018 – between late January and early June, largely due to the nationwide truckers' protest. The fund's price started to recover throughout July, before testing the June swing low in early September. From the chart we can see that the ETF has formed a double bottom pattern and just formed a golden cross after a period of consolidation, potentially signaling a bullish run. Fundamental analysis also signals that the business climate in Brazil will take a positive turn as President Bolsonaro will likely be a market-friendly president with free-market oriented policies.

**Entry: 37.77**

**Take Profit: 43.57**

**Stop Loss: 34.89**

We suggest an entry at **37.77**, slightly above the key neckline and setting a take profit level at **43.57**, an equidistant from the neckline to the double bottom. We also suggest putting a stop loss at **34.89** to ensure a risk to reward ratio of at least 2.

In general, Brazil Central Bank's future interest rate decision and the majority of the FX reactions are dependent on the type of economic policies that President Bolsonaro will announce in January after taking office and the effectiveness of his implementation.

# USA – OVERWEIGHT

The United States of America (USA) is the world's foremost economic power, with an unmatched global reach in terms of its economy and capital markets. America accounts for 25% of the entire world's total GDP, with domestic consumption fueling around 70% of total GDP. Capital markets in the US also have a dominating global presence due to their massive size and liquidity. According to Bloomberg estimates, the US's equity market accounts for 43% of the world's $78 trillion market capitalization despite only housing 17% of global equities. A similar narrative is also observed in the fixed income space, where the $41 trillion US dollar bond market accounts for almost 40% of the global bond market.

As an economic powerhouse that is deeply integrated within the global financial system, developments in the US economy and financial markets are closely monitored by both investors and policy-makers due to the potential effects it can create on investment decisions and economic policies worldwide.

<u>Hawkish Federal Reserve looks to tighten monetary policy via gradual rate hikes</u>

The Federal Reserve (Fed) is the central bank of the United States (US). It is an independent and autonomous organization that decides on the country's current monetary policy. The Fed operates with a dual mandate of achieving full employment and stable prices. Decisions regarding monetary policies are made by the Federal Open Market Committee (FOMC), which is currently chaired by Jerome Powell.

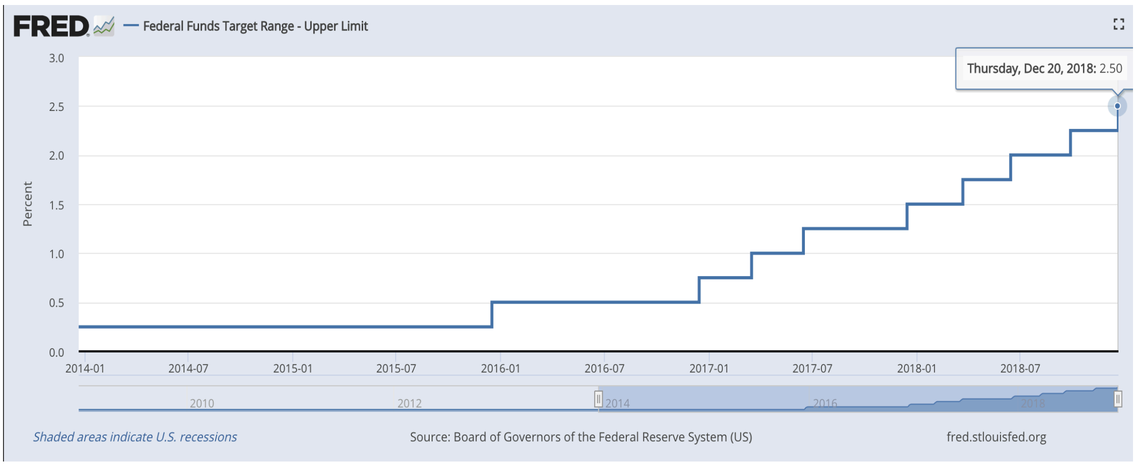



*Figure 71: US Federal funds monthly target range (Source: FRED)*

Over the past 3 years, the Fed has adopted a hawkish view on interest rates due to inflationary concerns over an economy that is nearing full capacity. From Figure 71, we can observe that the Fed has raised interest rates 9 times since monetary tightening started in late 2015. While interest rates are still accommodative, they will be progressively normalized to the neutral rate (the rate that that is neither accommodative nor restrictive) through the unwinding of quantitative easing (QE) policies and the shrinking of Fed balance sheets.

In recent times, President Trump has openly criticized the Fed for “aggressively hiking rates” and labelled them as “loco”. He believes that the Fed is making a huge mistake due to his view that higher rates would slow down the economy by dampening his administration’s tax cuts and fiscal stimulus policies.

However, public pressure on the Fed to pause rate hikes will likely fail since the Fed would not want to be viewed as yielding to political pressure. True enough, the widely anticipated rate hike proceeded as usual on 19th December 2018, when the Fed raised the target range up by 25 basis points to 2.25-2.50%. Chairman Jerome Powell strongly asserted central bank independence during the press conference and stated that “nothing will deter them from doing what they think is right for the economy”.

As the US stock market continues to slump into correction territory, a growing number of economists and investment professionals are beginning to agree with President Trump’s rhetoric. Strategist Michael Arone, chief investment strategist for the US SPDR exchange-traded-fund of State Street Global Advisors contends that the Fed does not know what the “neutral” federal funds rate are, which means that they may not know when or where to stop raising rates. Investors would therefore re-price financial assets to reflect the possibility of a monetary policy mishap. This view is also supported by Minneapolis Fed President Neel Kashkari, who argues that the Fed should consider pausing rate hikes as the central bank’s 2% inflation goal is “symmetric”, meaning that after years of undershooting that mark it should permit a mild overshoot. Putting the brakes on rate hikes would allow the Fed to test how far unemployment would fall before inflationary concerns of a tight labor market would justify further rate hikes.

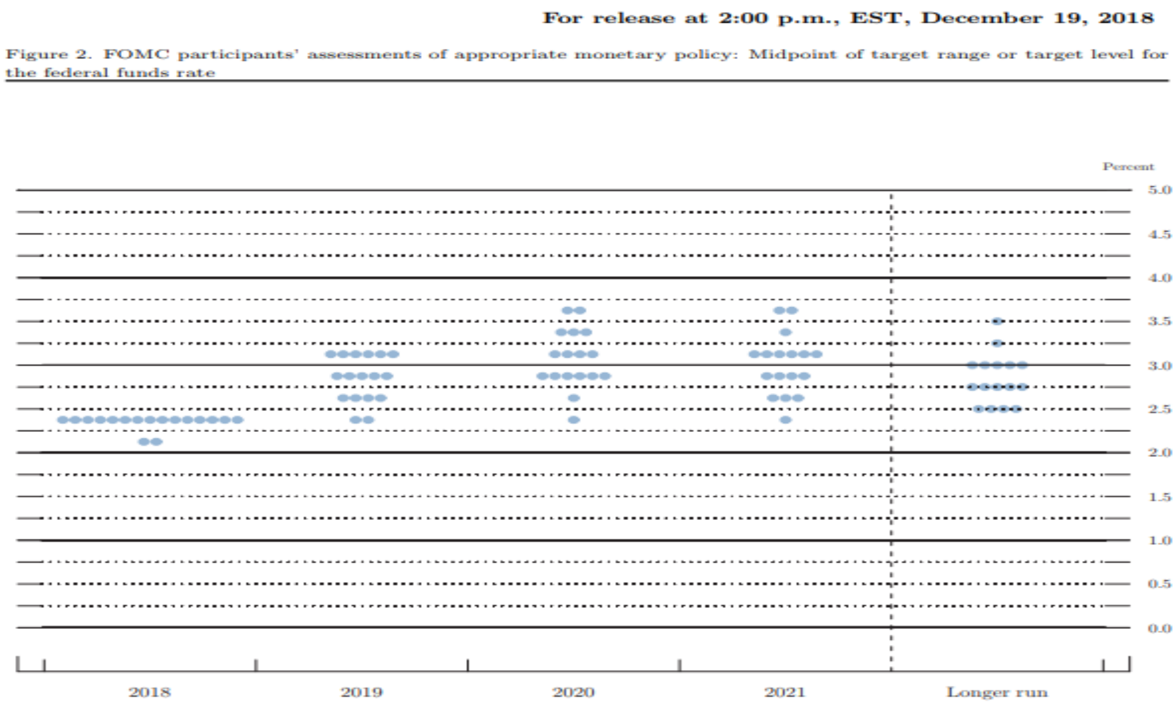



*Figure 72: US dot plot projections (Source: Bloomberg)*

The Fed funds rate is projected to rise to a median of 2.875% in 2019 and 3.125% by 2020. This is a downward revision from 3 rate hikes in 2019 to 2 rate hikes, along with 1 more rate hike expected in 2020. This is congruent with Fed Chair Powell's recent adjustment in monetary stance, as he pivoted from his remarks that the economy was "a long way from neutral rates" in September 2018 to "just below the neutral rate" in November 2018.

Despite the general hawkish stance of the Fed, they have noted that the implementation of future rate hikes may be contingent on US macroeconomic data and outlook. If macro shocks such as having a full-blown trade war start to weigh on the economy and produce softer numbers, we can postulate that the Fed would keep rates level or even lower, as evidenced from Jerome Powell's current change in stance.

However, it is important to note that in this climate of uncertainty in the equities space, the Fed would not make decisions just to calm the markets. In contrast to Alan Greenspan who has been known to appease markets in the past by lowering interest rates during market crashes, Jerome Powell has a different ideology that would make any replication of the "Greenspan put" unlikely. Powell believes that the past two recessions have been caused by financial market excesses like asset price inflation rather than a Fed-led monetary tightening. As such, the recent downturn in financial markets would unlikely trigger an overturn of monetary direction at least for the short term.

Slowdown in economic growth expected despite strong economic fundamentals

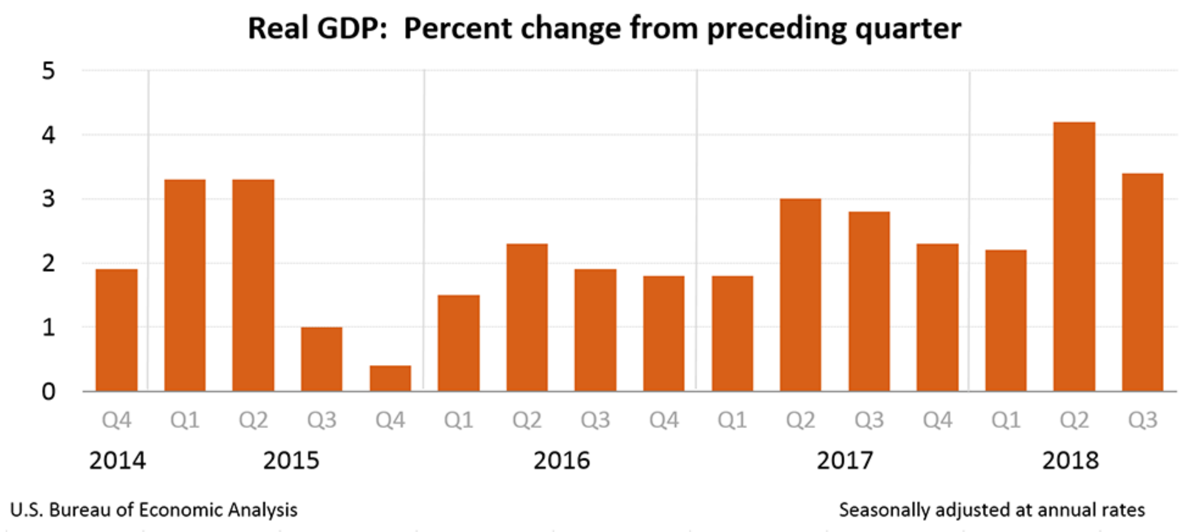



*Figure 73: US real GDP quarterly change (Source: Bureau of Economic Analysis)*

The US economy has been on a long-run expansion ever since the 2008 financial crisis. Under the Trump administration, GDP growth has been fueled by a low interest rate environment, fiscal stimulus & tax cuts as well as a strong labor market. As of Q3 2018, GDP growth stands at 3.4% However, economic growth will likely fall below 3% target in 2019 as factors like gradual rate hikes, tapering of expansionary fiscal stimulus & tax cuts and tariffs from the US-China trade war continue to weigh on growth.

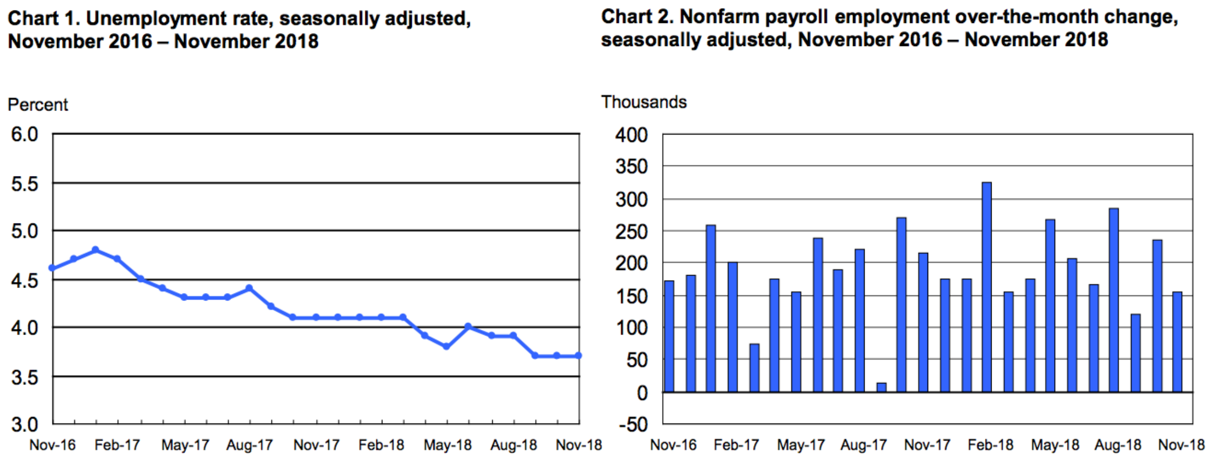



*Figure 74: US monthly unemployment rates and non-farm payrolls (Source: Bureau of Labor Statistics)*

Currently, the unemployment rate remains low at 3.7%, the lowest level since December 1969 and is expected to reach full employment of 3.5% by 2020. Job growth fell short of expectations in December 2018 as non-farm payrolls increased by 155,000 only, below estimates of 200,000. Over the past 12 months, 211,000 jobs were added on average due to strong job creation in sectors like healthcare, construction and hospitality despite widespread sentiment that the economy is near full employment.

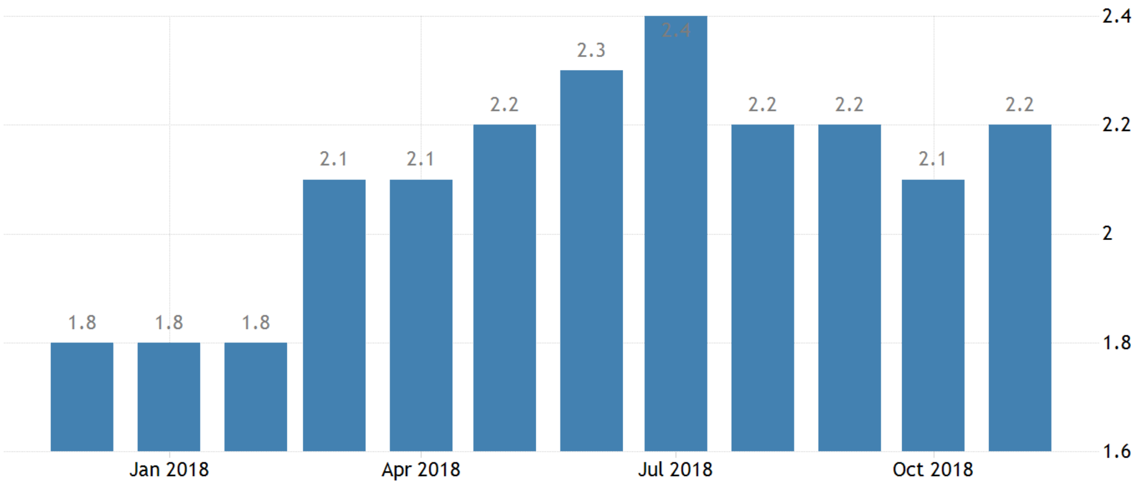



*Figure 75: US monthly CPI (Source: Bureau of Labor Statistics)*

As the labor market continues to tighten, a rise in wages would subsequently increase inflation expectations and push the Fed to further rate hikes in an attempt to prevent the economy from overheating and inflation in the 2% range.

<u>"America First!" as President Trump wages trade wars around the globe</u>

Under the Trump administration, a series of tariffs have been imposed or planned on multiple countries such as China, Canada, Mexico, EU and even allies like Japan and South Korea. These tariffs were part of Trump's economic agenda to reduce trade deficits and negotiate for better terms of contract for the US. The legal basis for Trump's trade policy is based on Section 232 of the Trade Expansion Act signed in 1962 which under certain circumstances such as concerns over national security allows the president to impose tariffs based on the recommendation from the U.S Secretary of Commerce. However, it is important to note that Section 232 was never invoked since the World Trade Organization (WTO) was established in 1995.

As of September 2018, the US has imposed tariffs of 10% on $200 billion of Chinese goods and this is set to hit 25% by January 2019. China has retaliated and imposed tariffs on $60 billion worth of US goods. Tensions are already running high, with the US planning to impose an additional 10% tariff on the remaining $267 billion worth of Chinese imports if no trade agreements can be reached. Both Washington and Beijing have been stuck in a political standoff as both seek to defend their sovereignty on the international stage. This gridlock is further exacerbated by recent political developments, such as allegations that China has been planting spy chips in US computer motherboards, a near collision between the US Navy destroyer and a Chinese warship and Mike Pence's speech in October 2018 that slammed China for interfering with US domestic politics in the Midterm elections.

Under the Trump administration, trade deals with other countries have also been revamped. Following the scraping of the Trans Pacific Partnership (TPP) and President Trump's threats to impose tariffs on various nations, the US and South Korea have renegotiated the United States - Korea (KORUS) Free Trade Agreement on September 2018. This has granted greater protection to American manufacturers, such as an increase in the number of car exports (50,000 from 25,000) that comply with American safety standards. Also, America's current 25% tariff on Korea's imported light trucks which is due to go by 2021 will now remain until 2041. The US and Japan have also recently reached an agreement on their bilateral trade agreement. This comes after the President threatened to impose 25% duty on Japanese auto imports.

Looking towards North America, the Trump Administration has also dismantled the North American Free Trade Agreement (NAFTA) and replaced it with the United State-Mexico-Canada Agreement (USMCA). The new agreement opens up the Canadian dairy market to US imports and increased the percentage of automobile parts from 62.5% to 75% that must be made within the Americas region in order for it to be exempted from tariffs. While the rationale has been to keep and bring back automobile sector jobs to the US, economists like Dr. Robert Lawrence of Harvard University have argued that automakers can simply outsource their manufacturing to lower cost countries if it cheaper than paying the 25% tariff under new regulations.

Trade relations with the EU have improved since President Trump met with Jean-Claude Juncker, President of the European Commission to agree on a deal that put on hold the risk of an immediate trade war from breaking out with the EU. President Trump has agreed to refrain from imposing car tariffs on European automakers while the EU will start talks on cutting trade barriers such as making commitments to import more soybeans from the US.

To date, the effects of tariffs are already beginning to show signs of undercutting US's economy. Based on model estimates by the Tax Foundation, if all the tariffs (imposed and planned) were implemented, US would suffer from a fall in long run GDP of 0.38% ($94.4 billion) and correspondingly lead to wiping out of 290,000 jobs and depression of wages by 0.28%. Trump's trade war is also starting to affect corporate profits. Many of the industries such as automotive, industrials and electronics have also mentioned in their Q3 2018 earnings call that tariffs have been increasing costs, dampening demand and disrupted their supply chain. While companies are still willing to absorb the cost of this temporary trade war, a prolonged US-China trade war will mean that costs would ultimately be passed on the consumers and this leads to both inflation and spillover to slower growth.

Many economists have criticized Trump's trade policy due to the flaw in economic logic that the Trump administration is attempting to justify their decisions on. Harvard economist and former chairman of former President Obama's National Economic Council Lawrence Summers found that the tariffs imposed worsen deficits by making American companies that export steel and aluminium overseas less competitive and by inviting foreign retaliatory tariffs against other exports. The idea that economic outlook could be improved by reducing US's trade deficit, as argued by the Trump administration is an absurd one since the US ran a trade deficit in goods and a surplus in services with most of its trading partners. This trend has been consistent with the structure of the US's private sector that is more anchored towards service output as a share of GDP and therefore shed light on how trade deficits do not serve as an effective yardstick of US economic performance. The trade war is clearly political in nature as it is common for President Trump to engage in such rhetoric in his attempt to pursue increasingly protectionist goals.

Moving forward, it would be mutually beneficial for both the US and China to seek a peaceful resolution to the trade disputes. As of December 2018, President Trump has agreed to a 90-day day trade tariff truce with China after the G20 summit in Bueno Aires in Argentina, where talks of further tariff increases are put on halt until further negotiations can be reached. For a start, China has agreed to purchase American soybeans and reduce tariffs on US automobiles from 40% to 15%. It is important to note that this is effectively a reversion to the previous status quo and does not represent any real progress yet. With controversy such as the arrest of Huawei's CFO Meng Wanzhou complicating the trade talks, global markets continue to hinge on the fragile US-China tension. For real progress to occur, both countries have to address fundamental issues that had underpinned the trade tensions, such as access to the Chinese market for American exporters and protection of intellectual property rights. Failure to reach a peaceful resolution may drag lead to a contagion effect on global economies due to the fact that the US & China alone accounts for 40% of the world's GDP.

Rising US Debt Concerns as US loosens fiscal policy

In December 2017, the Republican party's tax cut was passed in Congress with a 51-48 vote in the Senate. Under the tax reform bill, corporate tax rates were reduced from 35% to a 21% flat rate while personal income tax was reduced across all income brackets. This creates over $1 trillion in tax savings for corporations over the next decade (set to expire in 2025) and $0.46 trillion for working Americans.

Adding to concerns about federal debt, a massive spending bill was also signed in March 2018 to boost government expenditure on military spending while social spending on areas like healthcare, education, arts & culture and environmental regulation were reduced. Republicans believe that the tax cuts and fiscal stimulus would help to boost spending, while economists argue that this will only be a short-term boost.

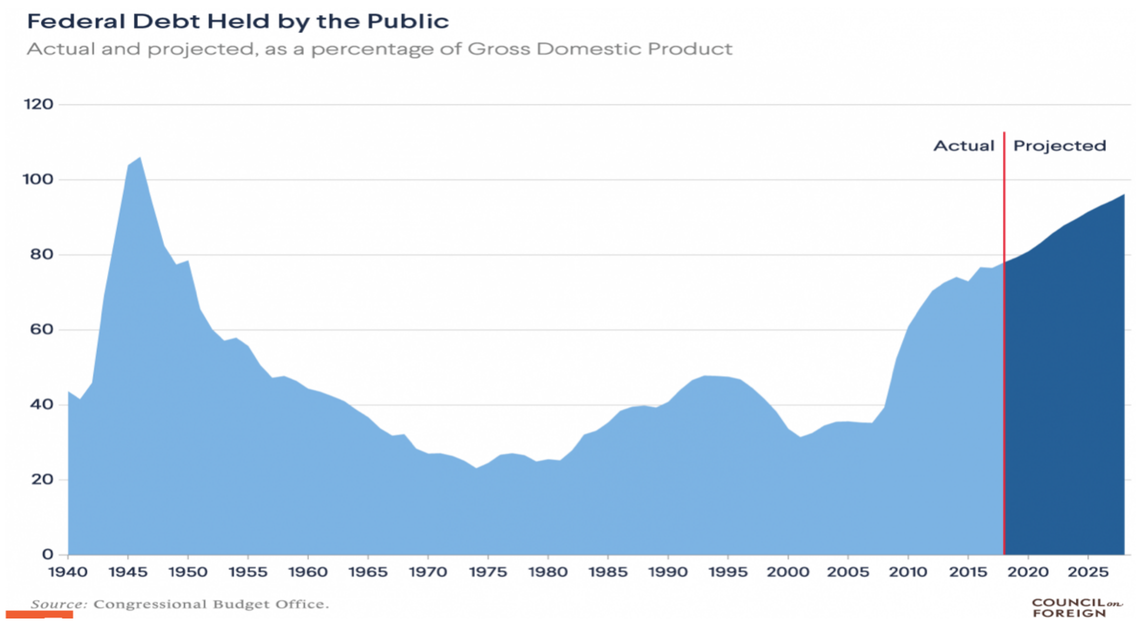



*Figure 76: US monthly federal debt as a % of GDP (Source: Congressional Budget Office)*

With budget deficits expected to hit $1 trillion by 2020 (4.6% of GDP), US debt is at an all-time high as it skyrockets from $585 billion (3.2% of GDP) in 2016. The Debt-to-GDP ratio is projected to rise from the current levels of 78% today to 96% by 2028. This is bad for the US economy since empirical studies by Harvard professors Kenneth Rogoff have suggested that the average GDP growth rate drops by 4% when Debt-to-GDP ratio approaches 90%. In a rising interest rate environment, interest expense on US debt is set to increase by $2.9 trillion and become an increasing burden on the annual budget over the years as well. This effectively put the US on a dangerous fiscal cliff that may trigger a financial crisis in the future if fiscal discipline is not practiced.

This current fiscal situation has both short-term and long-term risks. In the short term, the increased borrowing by the Fed to finance debt reduces the availability of funds for private investments and dampen an economy that is already projected to experience slower growths (crowding-out effect). Also, discretionary spending is squeezed with lesser funds to spend on social programs and defence. Over the long term, a highly leveraged economy would inevitably lead to a reversal in tax cuts and a sharp decrease in purchasing power of households and businesses, driving down consumption and putting further strain on economic expansion. Creditors would also demand higher interest rates to price in higher default risks, further dampening growth. Moreover, in the event of a recession, it will be tough to use fiscal policy for stimulus. Monetary policy would also be increasingly limited as interest rates need to be kept high to attract investors to buy US Debt. This may lead the Federal Reserve to monetize the US debt and lead to inflation, which would hamper growth and ultimately lead to a recession.

Washington comes to a gridlock after US Midterm Elections

As of 8th November 2018, the Midterm elections concluded with a Democratic takeover of the House of Representatives while the Republicans took further control of the Senate, resulting in a split Congress. While the election outcome was not a surprise, stock markets still reacted positively to it at the end of closing bell as the Dow Jones Industrial Average gained 545.29 points, or 2.1%, to 26,180.3, while the S&P 500 increased 58.44 points, or 2.1%, to 2813.89 and the Nasdaq Composite added 194.79 points, or 2.6%, to 7570.75. A divided Congress is a positive outcome for investors as the market is able to expect more certainty in policy outcome due to the Washington gridlock.

<u>New themes to consider that have arisen out of the new political paradigm in Washington.</u>

### What can the Democrats do now?

The Democrats are now in a position where they have procedural powers to launch an investigation into the Trump administration. While Nancy Pelosi, the current leader of the Democrats has said that she would not be interested in moving to impeach Trump, the majority of the Democrats have expressed their resolution to use their new subpoena power to dig into the alleged Russian interference in the 2016 Presidential elections and to look into his tax returns. If incriminating evidence were to emerge from those investigations, House Democrats will be pressured by voters to take actions. However, it should be noted that "impeachment" is not identical to "removal from office" since actually convicting and removing Trump would be the Senate's job and that it would take a two-thirds majority, 67 senators to make that happen. In an era where most decisions made are partisan, that likelihood is extremely slim given the Republican-controlled Senate.

### How will the dynamics of Congress change?

Secondly, we will be able to expect more political gridlock when it comes to passing legislation since a Democratic House majority means that Republicans can no longer pass a single bill unless Democrats agree to let them. As such, certain Republican agenda such as tax cut 2.0 initiatives to make personal income tax cuts permanent, repealing the Affordable Care Act (Obamacare) and deregulating industries like automobiles are effectively dead in the water.

Nevertheless, we might see some form of bipartisan compromises that are made in order for each party to pursue their own agendas. For instance, with the Democrats regaining control of the House, a push to raise the corporate tax rate from 21% to 25% might be in the works in exchange for their support of the Republican's planned infrastructure spending bills.

### What will remain the same?

Despite the balance of power now in Congress, foreign policy decisions such as the application of sanctions on Iran and the US-China trade war will still be dependent on President Trump as he is entitled to significant executive powers. Regardless of bipartisan support, the Trump administration is expected to continue the trade dispute with China and employ the use of sanctions as their primary foreign policy tool in navigating its conflict with other countries.

It is also expected that President Trump will continue to openly criticize the Fed so that he can use them as a possible scapegoat if the US economy starts to show signs of cracking.

## What the Midterm Elections mean for Financial Markets?

### Impact on Bonds

With the Democratic house expected to block attempts by the Republicans to advance further tax cuts and install roadblocks to future budget spending, we can reasonably expect that it will produce a combined effect of undercutting prospects for further budget deficits. This is a bullish signal for bonds since it eases upward pressure on rising yields which were driven recently by fears of higher inflation expectations and a rising budget deficit.

### Impact on Equities

Equity markets have traditionally been bullish after Midterm elections. On a historical basis, the S&P 500 has risen on average 3.1% from election day to year end. Similarly, one year after the midterms, stocks have risen 20 out of 21 times with an average gain of 15.2%.

### S&P 500 Sector Analysis Post Midterm Elections

### 1. Technology Sector

Technology companies have emerged as a common point of scrutiny in a rare bipartisan support that favours a tighter regulation on online privacy rules. It is expected that increased regulation will be enacted due to controversial events like the Cambridge Analytical data breach and the alleged Russian interference that has taken place via the use of social media platforms like Facebook and Snapchat. A fair amount of Congress hearings would lead the headline risk of huge companies like Facebook, Amazon, Apple, Netflix, Google (FAANG) to examine several anti-trust issues that is on the horizon.


*Figure 77: US equities technology sector vs. S&P 500*

As seen above, a sell-off in technology has been experienced since its high in June 2018 and resulted in its outperformance over the benchmark index shrinking to 13.65% as of October 2018. While it is unlikely that legislation will immediately affect the bottom line of these companies heading into the future, the headline risk associated with this industry should be a cautionary tale for investors looking to buy the dip in the recent market drawdown.

### 2. Healthcare Sector

With the democratic takeover of the House, it is expected that no further changes would be made to the Affordable Care Act (ACA). Healthcare stocks have been historically positively correlated to the prospects of a split Congress. While it is predicted that the Democrats will go after Pharmaceutical companies via drug pricing hearings, gridlocks are expected due to the Republican Senate backing less regulation on drug prescription price. The uncertainty that is removed from a government mandated price change will be a bullish signal especially for companies like Johnson & Johnson & Biogen Inc who have depended on price hikes to increase revenue for the past 3 years.


*Figure 78: US equities biotech and pharma vs. S&P 500*

Based on Bloomberg estimates, Biotechnology and Pharmaceutical stocks are currently trading at a discount relative to the broader market index and this could represent a buying opportunity for investors since no legislative changes are expected until after the 2020 Presidential elections at least. Nevertheless, investors should price in the downside risk that President Trump has been relatively sympathetic with regards to legislation that will reduce the cost of prescription drugs for Americans since it was part of his campaign agenda.

### 3. Financials Sector

A Democratic House may exert pressure on bank stocks due to the likelihood of regulatory scrutiny on big banks. Congress might return attention to Wells Fargo's misdeeds, investigate Deutsche Bank's ties to President Trump and also attempt to break up big banks in attempts to reduce overall systemic risk. A Democratic House majority might create "headline risks" for large financial institutions like JP Morgan, Goldman Sachs, Morgan Stanley and US Bancorp due to hearings but any House passed legislation would likely die in a Republican Senate.

The SPDR S&P Bank ETF KBE is down more than 24.84% year-to-date despite a rising interest rate environment. Higher net interest margins from rate hikes proved to be insufficient in boosting bank stocks due to a multitude of reason. Bank stocks have been falling alongside the broader S&P 500 index due to protectionism holding down long term expectations of growth. The uncertain investment environment due to the US-China trade war is dampening investor outlook and appetite for investment. Banks are also getting hit by a flattening yield curve that reduces their ability to make money from the tightening credit spread.

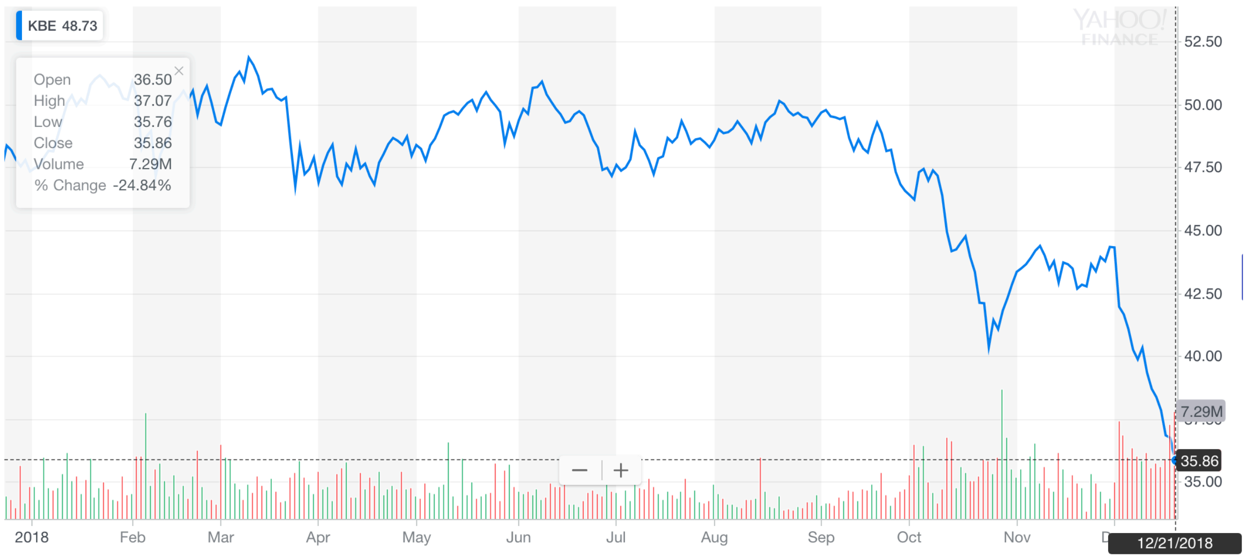



*Figure 79: SPDR S&P Bank ETF KBE daily chart (Source: Yahoo Finance)*

### 4. Energy Sector

In the energy industry, investors have to keep tabs at the state levels, especially companies who are in the oil exploration, production, refining and drilling business. For instance, a Colorado proposition 112, a bill that would keep wells 2,500 feet from any "structure intended for human occupancy could be important for the overall industry, since it might gain traction and grow beyond that state. A Democratic House will likely try to tighten environmental regulations by the Trump administration. Although those bills are unlikely to get through a Republican Senate given that 90% of energy policy is administered from the executive branch, a focus on environmental regulation will create headwinds for these energy companies since they will be considering the 2020 Presidential election where legislative changes could hurt them in the long run and therefore make risk adjusted decisions today.

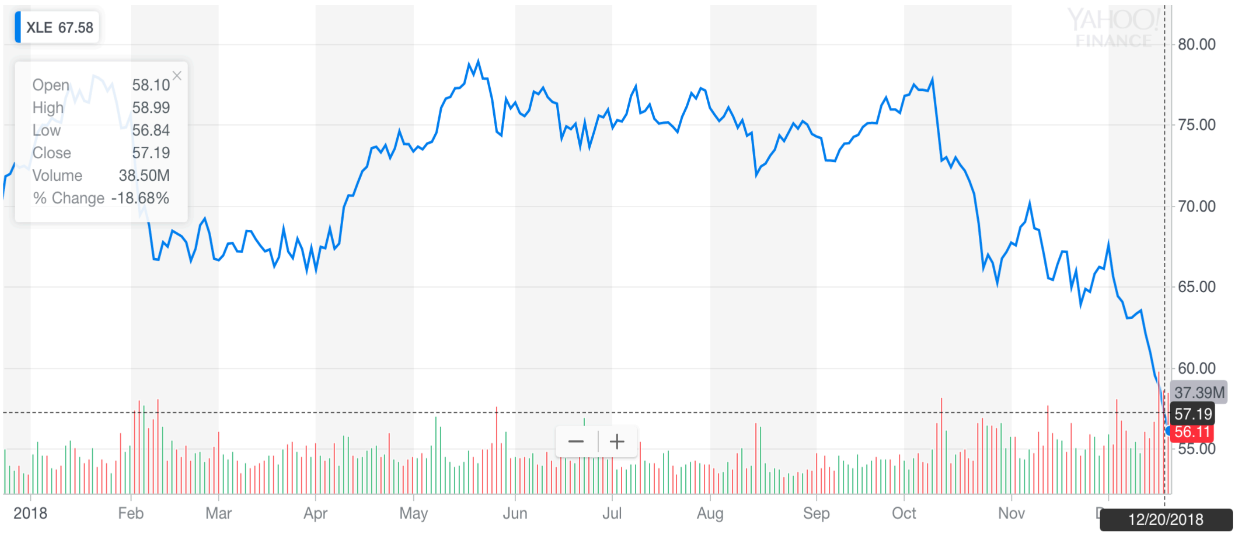



*Figure 80: SPDR Energy ETF XLE daily chart (Source: Yahoo Finance)*

The SPDR Energy ETF XLE has been trending downwards since mid-October and is currently down -18.68% year-to-date.


*Figure 81: WTI crude oil daily chart (Source: Yahoo Finance)*

This has been largely been fueled by the sharp fall in crude oil prices from its $76.4 high on 3rd October 2018 to the 52-week low of $45.42 as of 21st December 2018 (33% drop).

Given the uncertainty over the global crude oil market, a safer play for investors would be to invest in the Clean Energy Sector instead. ETF such as the Invesco Solar ETF (TAN) and iShares Global Clean Energy ETF (ICLN) could be worth looking at since both products are down 26.7% and 10.7% respectively year-to-date and will likely get a boost under a Democratic House that supports renewable energy and climate change.

### 5. Industrials Sector

While there is bipartisan support for government spending on infrastructure, it is extremely unlikely that the Democratic House will allow the Republican to pass the infrastructure bill without some form of quid pro quo. An infrastructure bill has been a key agenda of Trump's campaign and signing it into effect will be seen as a huge political victory for President Trump and therefore hurt the Democratic Party's chance of winning back the Presidency in 2020. The extent to which bipartisan support could be coming from the Democratic side would be based on how much the Republican-controlled Senate is willing to roll back the GOP tax cuts passed in 2017. However, President Trump may not be willing to reverse those tax cuts in fear of alienating his political base which was in favour of huge tax cuts. With a rising interest rate environment and the looming trade war undercutting many corporate earnings in Q3 2018, the industrials sector remains to be poised for a continued bearish run.


*Figure 82: SPDR S&P XLI ETF daily chart (Source: Yahoo Finance)*

Investors may consider shorting the SPDR S&P XLI ETF, which is already down -15.24% year-to-date.

### 6. Marijuana Sector

With the legalisation of Cannabis in Canada and several states in the US, attention has been turned to the eventual legalisation of Cannabis on the Federal level. With the firing of Attorney General Jeff Sessions, who has an anti-cannabis stance, tailwinds are starting to build up for this industry.

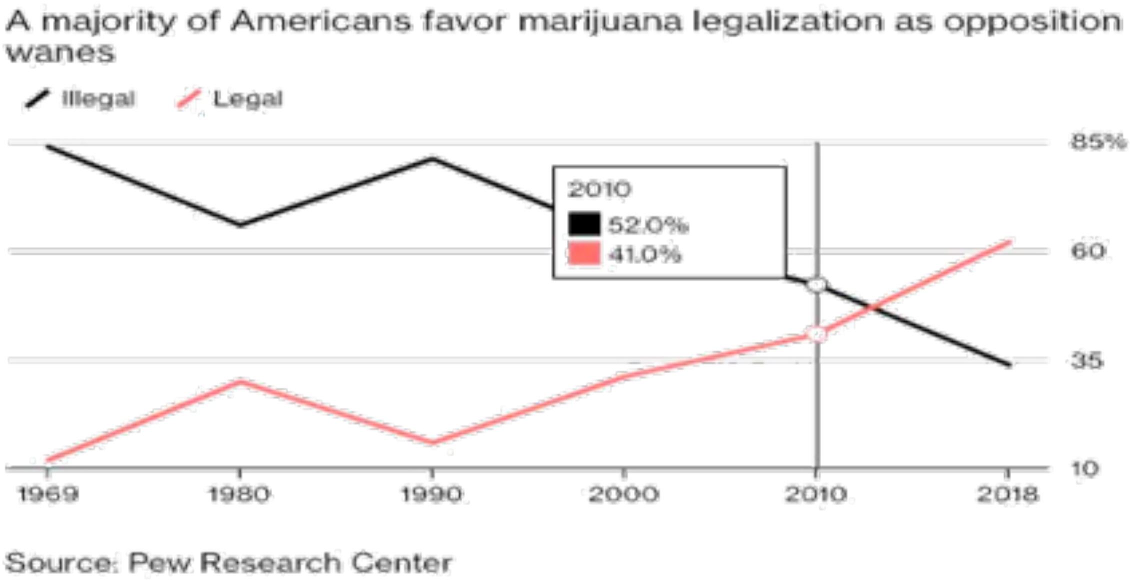



*Figure 83: US annual support builds of marijuana (Source: Pew Research Center)*

With an increasing percentage of Americans favoring marijuana legalisation, we could expect to see Congress debating this in time to come. It is widely believed that Congress will seek clarity on banking rules to help close the valuation gap between US stocks and their Canadian counterparts in an attempt to increase funding for this sector. Given the tax benefits that Congress could potentially capture in this emergent industry, we can expect marijuana stocks to be bullish in time to come as more states permit the use of medical and recreational cannabis and push the US towards an eventual legalisation at the Federal level.

FX TRADE IDEA: LONG USDJPY – BUY


*Figure 84: USD/JPY daily chart (Source: Tradingview.com)*

While there has been a pullback in USD/JPY from the end of Sept due to the strong resistance level at 114.00, key support levels in the channel has been established. From a 6-12 month perspective, the SMA shows support for growth. This constant growth can be attributed mainly to the Fed's relatively hawkish stance on monetary policy, and its outlook on current interest rate hikes (prospective 2 hikes in 2019). On the other hand, the Bank of Japan (BOJ) is set to keep interest rates level at -0.1%, as it pledges to keep monetary policy steady. The divergent monetary stance from the BOJ (dovish) and Fed (hawkish) would provide strong fundamentals for the USD/JPY to increase in the long run.

**Entry: 110.00**

**Stop Loss: 108.00**

**Take Profit: 116.82**

Key technical support levels have been established at 110.00 and 108.00. In the short term, the US dollar remains under downside pressure against the Japanese Yen, with the pair trading at the lowest level since October this year. The pair may have reached its short-term objective, as the latest decline extended beyond the 111.10 level. RSI and MACD indicators have also reached oversold levels. Over the short term, a technical correction towards 111.70 to 112 is in the pipeline. For short term investors, they might consider buying/longing as stochastic crosses the 10.00 mark, where the stop loss will be placed at the 110.00 level while the take profit will be at 112.000.

Our long-term outlook is still bullish as currency pair is still on an upward trend. There might be a potential breakout if bullish pair manages to break the strong resistance point. In that case, the stop loss will be at 116.82, with the stop loss at the previous support of 108.00.

Summary

While financial markets have moved into correction territory towards the end of 2018, the US economy remains fundamentally strong with its strong GDP growth projections, all-time low unemployment rates and stable inflation. As we navigate through 2019, several headwinds to growth will take center stage. On the monetary policy front, the Fed will have to be surgical in its approach to rate hikes to avoid pushing the economy into recession. US debt will also come into the spotlight once again when the deadline for Congress to debate the debt ceiling comes in March 2019. Geopolitical concerns will continue to weigh on global market sentiment unless a peaceful resolution can be worked out between US and China. As the country head into the possible end of the 11-year stock market bull run, 2019 might prove to be a difficult year for equities. The downward revision of global GDP growth, companies earnings, rising interest rates, rising wages, yield curve flattening, geopolitical uncertainty and the return of volatility will continue to generate negative sentiment and contribute to a fragile financial market that may spillover to the real economy. Despite strong fundamentals in the underlying economy, the tides may turn against the US if capitulation results in global contagion and lead to a surprise recession. Barring the risk of capitulation and breakdown in economic fundamentals, we remain overweight on the US.

# CANADA – OVERWEIGHT

Canada has one of the world's most stable economies. Ranking 10th globally in economy size, it has a good mix of primary, secondary and tertiary industries. Like other developed economies, the tertiary service industry is a huge driver of Canada's economy, accounting for close to 70% of its GDP. Yet, a significant focus is also placed on primary, resource-intensive sectors, such as logging, fishing and mining. Canada also has a large oil and natural gas sector - 3rd largest in proved oil reserves behind Venezuela and Saudi Arabia and 6th largest oil producer globally. The Canadian manufacturing, capital-intensive industries are, similarly, highly developed, ranking amongst the top few global players in the manufacture of products such as automobiles and aircraft.

With respect to Canada's economic integration with the rest of the world, the economy is highly interdependent with that of the US. Importing US$319.6 billion of Canadian goods annually, the US is Canada's largest export partner (76% of total Canadian exports in 2017), followed by China (4.3%) and the UK (3.2%).

Bank of Canada normalising interest rates whilst remaining careful

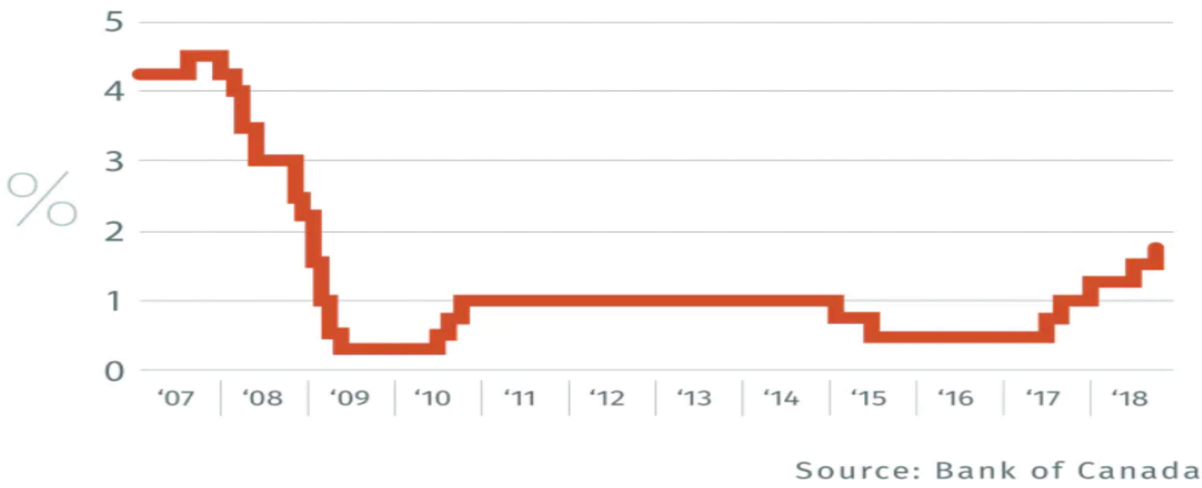



*Figure 85: Canada's key overnight interest rate (Source: Bank of Canada)*

The Bank of Canada's benchmark interest rate as of December 2018 is 1.75%. The central bank cut rates aggressively during the last two major economic downturns and is now in the midst of a process of normalising rates back to neutral levels of 2.5-3.5%. Since the summer of 2017, the bank has raised its benchmark rates 5 times as the economy has heated up - with modest growth, a positive job market, and core inflation around its target of 2%. The economy is operating near full capacity and hence, no longer requires external stimulus. On 5th December 2018, the central bank left its benchmark interest rate unchanged at 1.75% as widely expected, after hiking 25 bps on the previous meeting. This remains the highest rate since December 2008.

Policymakers say interest rate hikes in the future might be necessary to keep inflation at its target 2%. Future rate hikes are also said to be dependent on factors such as domestic consumption, the bank's assessment of the economy's capacity, oil price shocks, and trade policy developments. Yet, given the context of global trade tensions, the uncertainty surrounding the actual impacts of the new United States-Mexico-Canada Agreement (USMCA), oil's recent low prices as of the time of writing, and the increasing possibility of major economies being in their late business cycles, has the Bank of Canada remaining cautious on its monetary policy stance. As compared to previous rate hikes, the central bank has entered a state of greater data-dependency for its future rate hikes. This means that monetary policy in the near future remains cautiously executed, heavily dependent on data on inflation, GDP and wider trends as they unfold.

Modest growth, Controlled inflation

This is in line with Canada's modest growth - real GDP in Canada is expected to grow by 2.0% in 2018 and 2.2% in 2019.

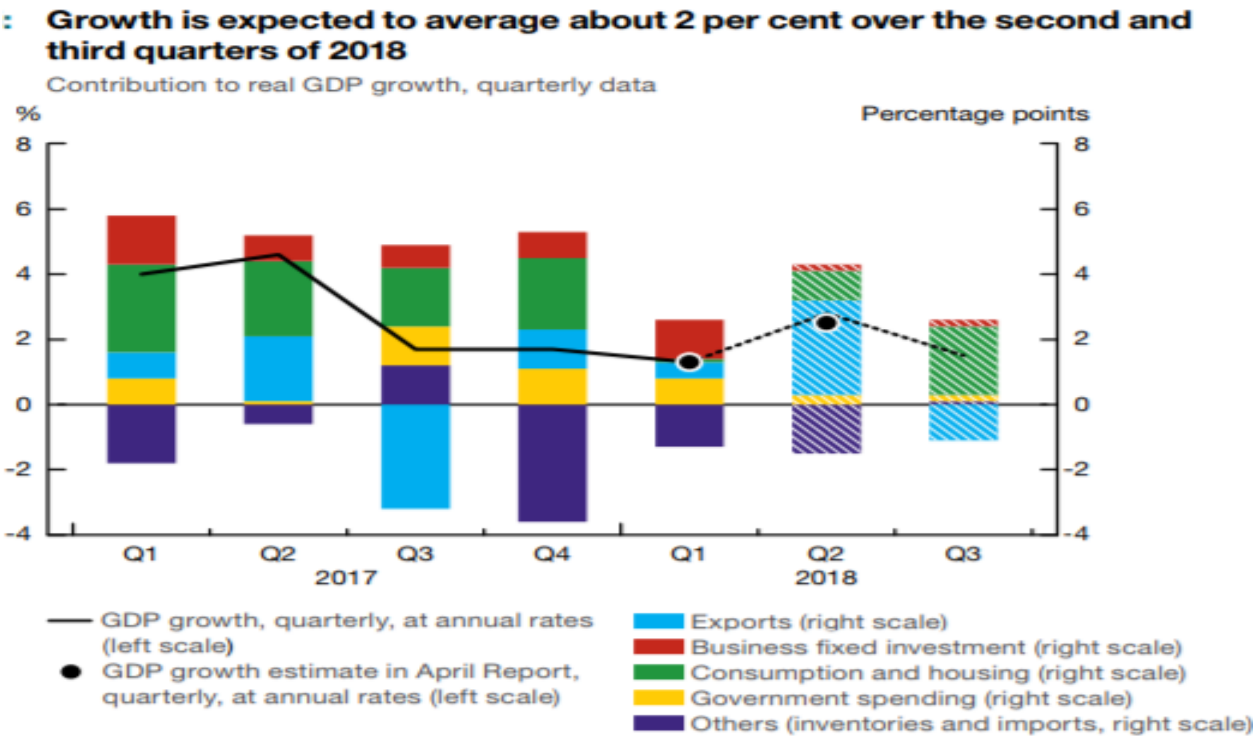



*Figure 86: Canada's quarterly real GDP growth composition breakdown (Source: Bank of Canada)*

Meanwhile, the drivers of growth are shifting: compared to 2017, the contribution from household spending in 2018 is forecasted to be smaller, while the contributions from exports and business investment are anticipated to be larger. Consistent with Canada's Central Bank projections, economic activity will be supported by continuing solid foreign demand (as explained in the next section of the analysis).

The Canadian economy continues to operate near full capacity, and GDP is expected to expand slightly faster than normal, CPI inflation is forecasted to be 2.3% in 2018 and 2.0% in 2019. Inflation is expected to be above 2% in the near-term, driven up by temporary factors such as the impact of different minimum wage increases across several Canadian provinces. Accordingly, once prices have fully adjusted to assimilate the effects of these factors, the associated upward pressures on inflation is projected to fade.

Trade Front: Decreasing current account deficit, USMCA impacts

Canada's current account balance is forecasted to be a deficit of US$52.22 billion in December 2018 as reported by the International Monetary Fund - World Economic Outlook. Compared to historical figures, whereby Canada's current account balance recorded a deficit of US$63.9 billion in 2017 and US$65.3 billion in 2016, this represents a further decrease in the current account deficit - an improvement in the current account balance. In terms of the composition of trade, Canada's top 3 goods exports are energy, motor vehicles and consumer goods. The breakdown of the exact values in $B/$M are as follows:

GOODS EXPORTS, 2017

| PRODUCTS | VALUE of Exports ($B) | CHANGE of Values (%) | CHANGE of Volumes (%) | CHANGE of Prices (%) |
|---|---|---|---|---|
| Total, all sectors | 549,511 | 5.4 | 1.0 | 4.4 |
| Agri-food & fish | 33,167 | 4.3 | 3.7 | 0.6 |
| Energy | 95,104 | 32.8 | 8.2 | 22.7 |
| Metal ores & minerals | 18,287 | 12.1 | 7.6 | 4.2 |
| Metal & mineral products | 63,704 | 10.9 | 2.1 | 8.6 |
| Chemicals, plastics & rubber | 34,861 | 3.3 | - 1.8 | 5.3 |
| Forestry, building & packaging | 42,805 | 3.9 | - 2.3 | 6.3 |
| Industrial machinery & equipment | 34,591 | 6.8 | 7.2 | - 0.4 |
| Electronic & electrical equipment | 27,497 | - 0.9 | - 0.2 | - 0.7 |
| Motor vehicles | 92,820 | - 5.3 | - 3.8 | - 1.6 |
| Aircraft & other transport equipment | 21,923 | - 4.8 | - 4.6 | - 0.3 |
| Consumer goods | 69,888 | - 5.3 | - 3.4 | - 2.0 |

*Figure 87: Canada's composition of trade by sectors (Source: Bank of Canada)*

Considering this against the context of the new USMCA, the Canadian economy finds itself impacted in several of these critical areas by some of the changes made. The industry most impacted by the USMCA would be the automobile industry. For instance, under USMCA, 75% of automobile parts must now be made in the US, Mexico or Canada to qualify for zero tariffs - up from 62.5% under NAFTA. Automobile industry experts believe that, since the new rules increase labour and compliance cost higher in North America than in other parts of the world, automobile prices will rise. Car selection may also decrease due to the increased costs. On the positive side for Canada, there will be no car tariffs on Canada's exports of automobile parts and final products to the US.

The second most impacted industry would be the dairy industry. Under the USMCA, US dairy farmers will be able to gain entry to a bigger market share in Canada, as the USMCA places restrictions on the amount of dairy products Canada can export as well as eliminates Canada's Class 7 dairy products (powders, proteins, formulas) pricing scheme, allowing the US to capitalise on this by selling these products to Canada without surcharge prices.

Thirdly, the pharmaceuticals industry would be significantly impacted too. US drug companies can now sell to Canada for 10 years before facing generic competition, up from NAFTA's 8-year production. However, a major point to note is that most of these new rules will not start until 2020. Hence, the pricing in of these factors is likely to be gradual, as new developments with respect to the specific implementations of these rules unfold. An emphasised clause of the USMCA also states that all countries involved will review the USMCA after 6 years, to determine whether they are agreeable to a renewal of this trade deal.

Moving forward, global trade tensions remain the biggest risk to Canada's economy over the next 6 to 12 months. Most of the new rules that come along with the new USMCA will only start in 2020 and the way it gets implemented will determine future developments within the Americas region. This could weigh on business investment and export growth, with its impact possibly amplified considering that these two areas are becoming increasingly larger components of Canada's GDP.

## FX TRADE IDEA: LONG USDCAD – BUY


*Figure 88: USD/CAD daily chart (Source: Tradingview.com)*

The slight bullish outlook over the projection period can be attributed to a few factors.

Firstly, in terms of monetary policy, given that Canadian monetary policy is projected to be less hawkish than US monetary policy over the next 6 to 12 months, the interest rate differential trend between the two currencies will favour the USD more. This is because investors, seeing the greater, or more rapid, interest rate increases in the US compared to Canada in future, as we project, may choose to move more of their money into the US market to generate a higher return on their assets.

This will cause some future demand for CAD to lower in favour of the USD, causing the USD to rise against the CAD moving forward. Even after considering the likely probability that the static, current interest rate differential is already priced in, this is notwithstanding our expectation that the Federal Reserve remains equally if not more committed to raising interest rates than the Canadian central bank in the next 6-12 months, hence favouring a long USDCAD.

Secondly, in terms of trade, considering that the new USMCA, on balance, brings about more changes that favour the US rather than the other way around as explained above, the Canadian economy is also likely to be impacted negatively, in favour of the US. For example, under USMCA the US now has greater access into Canada's dairy market and drugs industry, contributing to economic growth for the US over Canada, by and large increasing demand for the USD over the CAD. Hence, the USMCA will prove to be a tailwind for a rising USDCAD.

Thirdly, considering the most important new shock facing the Canadian economy as of mid-December 2018 - low oil prices – the Canadian central bank can be possibly veered off its path towards higher interest rates. This is because low oil prices, if sustained, might affect the Canadian energy sector's future investment plans and increase the chances of layoffs in the energy sector. This affects

GDP and unemployment rate negatively, especially after considering the significance of the energy sector in Canada's economy. Hence, recent low oil prices present a significant risk to both Canada's economy as well as interest rate hike plans moving forward - thus putting downward pressure on the CAD and favouring a long USDCAD.

Lastly, against the larger context of widespread risk-off sentiments - which is likely to continue into our projection horizon, the USD is in a sweet position as a safe-haven currency. Should risk-off sentiments increase, due to events such as intensifying global trade tensions or heightening fears of a late business cycle, the USD is likely to strengthen - including against the CAD, as investors rush to buy US treasuries (denominated in the dollar) traditionally viewed as risk-free. On the other hand, should global trade tensions intensify, Canada will be comparatively more negatively affected than the US, as it depends more on exports and trade.

Yet, it is important to note some of the headwinds to a rising USDCAD. Considering that Canada's trade deficit position is improving, demand for the CAD is likely to be improved upward considering this factor alone. Moreover, a fundamental point to note is that, at the end of the day, the economies of the 2 countries are highly interdependent (as explained above), hence any overperformance or underperformance by one is likely to have accompanying repercussions on the other. Hence, given the base-scenario of no unforeseen, drastic policy changes and events, a big movement on one currency against the other seems unlikely - and the movement of USDCAD is likely to be rather gradual. Finally, global trade tensions also serve as a major source of uncertainty, and accordingly, our projections cannot yet account for these uncertain factors.

Hence overall, the tailwinds for a stronger USDCAD over a 6 to 12 month horizon are strong. As explained, we believe that these tailwinds are likely to be more significant and relevant than the possible headwinds to a stronger USDCAD. Hence, our recommendation will be to long USDCAD.

**Entry: 1.341**

**Take Profit: 1.362**

**Stop loss: 1.330**

From the perspective of technical analysis, based on the daily charts, the USD/CAD has been on a gradual, steady uptrend since January 2018. The yield-to-date return as of 21st December 2018 is 7.41%. Given the RSI of 70.51 as of 21st December 2018 (overbought), and with RSI staying above 50 since mid-October 2018, the market is overall bullish on USDCAD.

We recommend entering the long USDCAD trade at 1.341, right after the USDCAD has re-tested and bounced back up from the support level established by the lower band of the latest channel - confirming the upward trend. That being said, should USDCAD re-test the support level and break it, we recommend closing the trade at 1.330, right after support is broken to limit losses. After the trade is entered, a reasonable exit point - or take-profit level - will be at 1.362.

All in all, we believe Canada to be relatively overweight over the projection period. However, the context of recent times presents significant challenges to both Canada's economy and the Canadian dollar moving forward, such as prolonged trade tensions, risk-off sentiments and the ensuing low price of oil recently. Hence, on balance, specific to the trade of USD/CAD we recommend a buy position, as the tailwinds to a rising USDCAD are stronger than its headwinds as mentioned above.

## MEXICO – OVERWEIGHT

According to the IMF, Mexico's GDP is expected to grow at a rate of 2.1% in 2018 and 2.3% in 2019., as shown in the figure below. With net exports representing 48% of Mexico's GDP and the trade-to-GDP ratio at 78% in 2017, Mexico is heavily reliant on their trading partners for economic growth. The US is Mexico's largest importer and exporter. 46% of Mexico's imports are from the United States and 80% of Mexico exports go to the US.

Some of the key industries in Mexico's trade industry are the production of automobiles and vehicle parts (24.8%), electrical machinery and equipment (20%) and oil (5.5%). Mexican major production industries are dominated by food and beverages, tobacco, chemicals, iron, and vehicles. Its labor force consists of 13% agricultural workers, 26% industrial workers and 61% service workers, contributing to its reliance on tertiary and secondary industries.

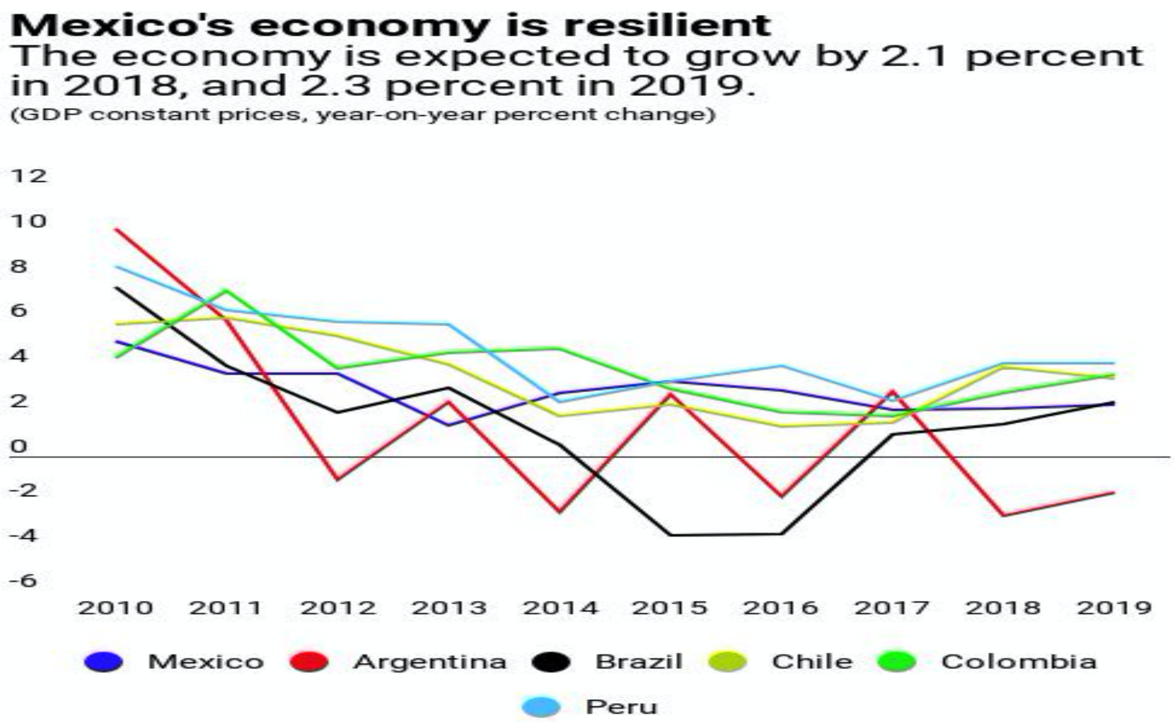



*Figure 89: Mexico's annual GDP growth vs. other emerging markets (Source: International Monetary Fund)*


*Figure 90: Mexico's trade flows composition (Source: The Observatory of Economic Complexity)*

<u>Peso remains weak despite slowing inflation and hawkish monetary policy</u>


*Figure 91: Relationship between Mexico's Peso, CPI and interest rates (Source: Bloomberg)*

As of December 2018, The Bank of Mexico – or Banxico – has kept its benchmark interest rate at 8.25%. Over the past 2 years, rates have been rising gradually from 4.29% in 2016 to 8.25% today, making it the highest rate observed in the past decade. Rate hikes have allowed the central bank to control inflation as the CPI fell from 6.7% in January 2018 to 4.6% in December 2018. Despite the rate hikes, the current inflation rate is still above the 3% target. Moving forward, Banxico forecasted that inflation will drop to 4.5% by the end of December 2018 and fall even further to 3.7% in 2019. With an improvement in growth outlook that will raise inflationary concerns, the central bank is expected to raise rates for the next 2 years to fight inflation.

Despite the rate hikes in the past 2 years, the Mexican Peso has been depreciating rapidly against the US dollar from $0.06 US/peso to $0.05 US/peso in this holding period. Despite the rate hikes over the past 2 years, the Mexican Peso has been depreciating rapidly against the US dollar from $0.06 US/peso to $0.05 US/peso in this holding period. The weak peso is causing problems for Mexico's economy since they have close to $271 billion in US denominated debt (60% of total debt) that is getting increasingly more expensive.

This problem is exacerbated as the Fed continues to maintain its hawkish monetary stance and is slated for 2 more rate hikes in 2019. On top of that, negative sentiment of the peso in recent years has led to capital flight from the currency and this may trigger further depreciation, which would make it harder for Mexico to service its US denominated debt.

Inflation still persistent despite slowdown in Mexico's GDP growth

Due to poor growth in Mexico's primary sector and its services industry, Mexican growth in the 2nd quarter of 2018 came in at -0.2%. One of the main reasons for the fall in Mexico's growth was US President Donald Trump's import tariffs of 10% on steel and 25% on aluminium imports from Mexico. Other than trade, the services sector also experienced a slowdown in growth that contributed to falling in economic growth in the 2nd quarter of 2018.

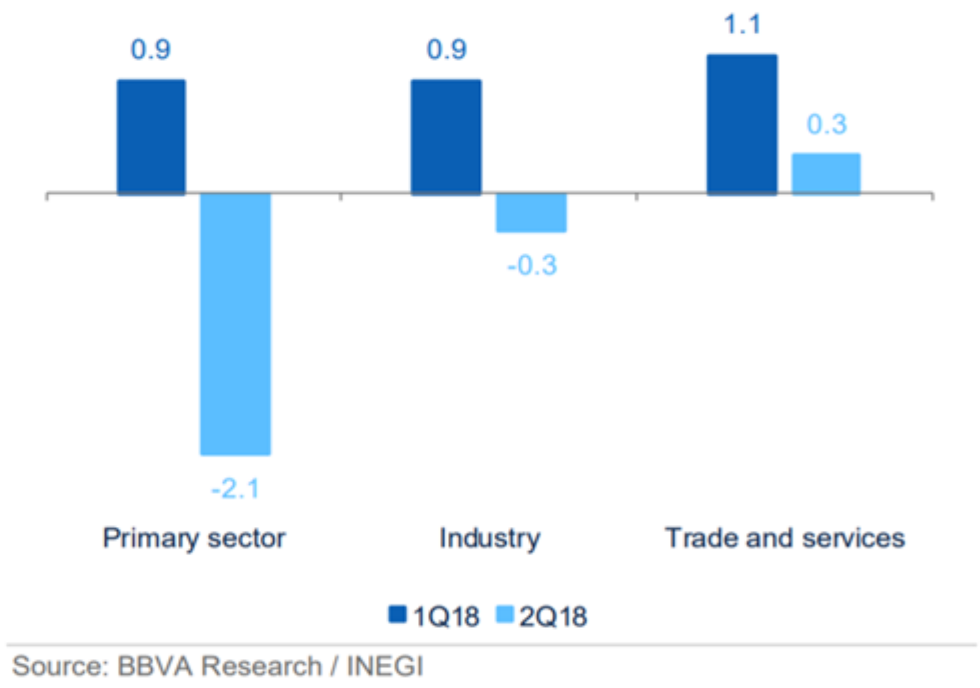



*Figure 92: Mexico's GDP by economic sector, QoQ% change (Source: BBVA Research)*

In the upcoming months, the outlook of Mexico's economy is heavily dependent on US tariffs on Mexico's steel and aluminium imports. If the US continues to place import tariffs on Mexico's metal industries, Mexico's economy would be negatively affected.

One of the main reasons for rising inflation over the past few months was due to rising energy costs. The increase in gasoline and electricity prices by 20% compared to last year contributed to the steady increase in inflation from 4.5% to 4.7% over the past 6 months.

The weakening of the Mexican peso, caused by uncertainty amidst USMCA negotiations and continuous Fed rate hikes also contributed to the upward pressure of gasoline prices and other fuel prices as it becomes more expensive to import energy from major energy producers such as the US, contributing to cost-push inflation.

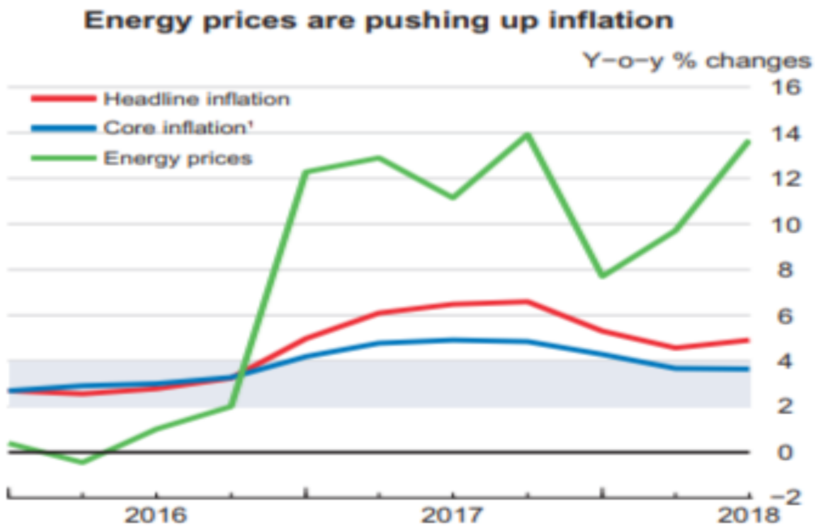



*Figure 93: Mexico's inflation rates vs. energy prices, YoY% change (Source: OECD)*

Due to increases in electricity cost and seasonal high food prices, consumer prices rose more than expected in November 2018. Consumer Price Index rose 0.85% in November according to the National Statistics Institute, pushing inflation to 4.72%. Until inflation converges towards the central bank's 3% target, it is likely that further rate hikes will be expected in 2019.

<u>USMCA and removal of metal tariffs</u>

Mexico's current account deficit amounts to about 1.6% of its GDP. US tariffs on Mexico's metals have negatively affected Mexico's exports which mostly consist of the production in the automobile industry which includes automobile parts. The new USMCA agreement has ensured minimum wages and increased protection for workers in Mexico's automobile industry. However, the 25% tariffs on steel and 10% duties on aluminium have not been changed despite the new agreement. This has made automobile production more expensive as the new agreement suggested that automobile parts have to be made from the 3 countries to qualify for tariff exemption. The existing tariffs would look to reduce Mexico's growth due to Mexico's heavy reliance on the automobile industry which makes up 75% of Mexico's exports. In light of the USMCA, the US is looking to boost its size of the credit line that is made available to Mexico in times of need. The increased credit line allows Mexico to borrow up to $9 billion compared to $3 billion under the previous NAFTA agreement.

Looking forward, the USMCA has contributed to a more stable peso as the peso was experiencing major swings due to the uncertainty of the agreement. The finalization of the new agreement could potentially look to review the current US tariffs on Mexico steel and aluminium which has negatively impacted its economic growth.

During the G-20 summit, the US president also announced that he would be terminating the NAFTA agreement and is looking to start the 6-month process of either implementing the USMCA or revert back to pre-NAFTA trading rules. If USMCA does not get implemented as planned, Mexico will continue to face the problem of farmers losing their jobs. Due to NAFTA, Mexico lost 1.3 million farm jobs as the removal of tariffs on agriculture caused Mexican companies to export agriculture products below cost prices. The poor performance of the primary sector would bring about worse living conditions and lower GDP growth in the country. We believe that the failure of the implementation of the USMCA would have an adverse effect on the peso as Mexico agriculture industries look to be exposed to high levels of competition once again.

New Leadership in Mexico

Andres Manuel Lopez Obrador, Mexico's first leftist leader in decades attracted investors with his market-friendly approach such as pro-investment policies and taking on monopolies that stifle competition during his campaigns. Before he took office, he announced that he would cancel the $13 billion airport project that was backed by the nation's wealthiest businessmen. The nation's biggest infrastructure project was scrapped after almost 70% of the nation voted against the building of the new airport, in addition to potential cases of corruption and the high cost of maintenance required. Instead, the Mexican authorities chose to build two new runways and improve the infrastructure of the two existing airports.

This decision greatly undercut investor confidence in the Peso and caused it to tumble by 4.2%, one of the worst event-driven declines since the election of US President Donald Trump. JP Morgan Chase & Co analysts also cut their prediction for Mexican growth from 2.4% to 1.9%. Kathryn Rooney Vera, the head of global research at Bulltick Capital Markets also stated that scrapping the project would ruin international and local investor's confidence, causing the peso to further depreciate. She added that the rising inflation that forced Banxico to increase interest rates amidst the slow economy further hinders foreign investments.

To help shore up investors' confidence, the Mexican government hopes to repurchase the airport bonds by buying back up to $1.8 billion of the $6 billion in debt issued for the airport. Potential bondholders are incentivized by increasing consent payments to $10 per $1,000 principal, adding new default triggers and promising to protect them from lower rates of passenger charges at the current Mexico City Airport. The government is looking to avoid paying all $6 billion in bonds which might lead to a potential default in bond payments. If investors start to increase confidence in the Mexican government by purchasing the new airport bonds, it would help to increase the strength of the peso as this will pave the way for future foreign investments for a longer-long-term outlook. With investors being satisfied with the buyback offer, as seen from the figure below, it seems that the government is succeeding in achieving their goal of increasing investor's confidence.


*Figure 94: Investors reaction to buyback offer (Source: Bloomberg)*

In other developments, President Obrador recently unveiled a plan in December 2018 to raise $8 billion in investments to construct the country's seventh oil refinery starting March 2019. With new facilities, it looks to increases Mexico crude processing capacity by 340,000 barrels per day. The goal of the nation's new refining system looks to boost fuel self-sufficiency and ending long-term declines in oil output as Mexico's oil output is facing a 14th consecutive yearly decline. This new facility is projected to increase Mexican oil output to 2.4 million barrels per day by 2024.

President Obrador looks to increase foreign investments through the new production plan as he has called a hiatus on oil auctions until foreign companies start to express interest in the new refinery project. Moreover, the government is looking to increase the budget of Pemex, Mexico's state-owned oil company budget, by 75 billion pesos for 2019. This is to allow improved operations and increase oil production. The new oil refinery project would look to bring about foreign investments into the country and help boost investor confidence in the country's economy.

US President Trump and his border wall

On 18th October, the US threatened to close its border with Mexico using military force. President Trump is looking to prioritize the immigration problem over the finalization of the USMCA. As President Trump continues to threaten the construction of the border wall, it causes the peso to weaken against the dollar, allowing for a bullish outlook for USDMXN. He lashed out at the Democrats on the issue of border security where the party's congressional leaders aimed at avoiding a partial government shutdown. As the Democrats are against his demands to fund the project, US President Trump cannot legally take funding from Congress to build his wall. This has escalated tensions between both parties as Trump tweeted that the Democrats has been 'pulled so far left' that they do not want border security and that the Democrats 'want open borders for anyone to come into the United States which brings about large-scale crime and disease'.

Lack of Congressional support had driven President Trump to partially close the government to discuss wall funding unless he gets more than the $1.3 billion that Democrats are willing to give him for the wall even though it cost $5.6 billion to build it.

Looking back, each time President Donald Trump has threatened to build the border wall, the peso had weakened. For instance, when military intervention was threatened to build the border wall, the peso fell to its lowest level against the dollar in nearly a year and a half to 20.4. Moreover, as the US shut down occurred on 21st December, USDMXN dropped to 19.82 from the previous day 20.09. Moreover, as the US government shut down occurred on 21st December, USDMXN dropped to 19.82 from the previous day 20.09. Given the uncertainty over whether the wall will eventually be built, tensions are running high and this may result in downward pressure on the peso in the short term.

FX TRADE IDEA: LONG USDMXN – BUY


*Figure 95: USD/MXN daily chart (Source: Tradingview.com)*

With both the Fed and Banxico having a hawkish stance on monetary policy, the movement of the USD/MXN pairing will be more dependent on the general sentiment of each currency. At the time of writing, the peso continues to move on a strong downtrend against the dollar due to the negative sentiment that is driven by the actions of its new President. At the time of writing, the peso continues to move in a strong downtrend against the dollar due to the negative sentiment that is driven by the actions of Mexico's new President. With inflation still far from the target range of 3%, rate hikes can be expected to be more aggressive and over a longer-term period for Mexico as compared to the Fed. As such, on a relative basis, fundamental factors support a stronger dollar relative to the peso.

**Entry: 19.65**

**Take Profit: 20.70**

**Stop Loss: 19.35**

Major support levels at 20.19 that has been tested throughout the month and broken as prices fell. Major resistance at 20.53 has also been tested throughout the month. With a consistent upward trend, the pair is looking to test the key resistance level at 20.53. The currency pair is looking towards a potential bullish run after the 50-day moving average crossed the 200-day average as reflected from the golden cross from the chart above. Moreover, with the RSI consistently having been between the 40 to 75 range in the past 6 months, with the 40 to 50 zone acting as support levels, signaling an uptrend and consistent bull run from the pair. A bull flag has been spotted as the price increased on 7th November and trading volume remained low. The bull flag as reflected on the chart shows the potential continuation of the bull run.

However, due to fundamentals, prices are looking to be volatile and there might be a bearish run for prices. Short-term investors can look to capitalize on the bearish run by shorting the pair by entering at major resistance levels at 20.53 and exiting at key support level at 19.65. In a longer term, the pair is looking towards a bullish outlook as we believe that there is still steam for the bull run as evinced by consistent RSI between 40 to 75 and with the golden cross from the moving averages. Thus, long-term investors can look to enter the market at key support level at 19.65 and look to take profit at 20.70. If USDMXN breaks support level and looks to test previous key support at 19.20, we recommend closing the trade at 19.35

On the downside risk, a directional reversal in the USD/MXN downtrend could happen if investors start to regain confidence in the peso if geopolitical concerns like the border wall concerns die down or Mexico is able to negotiate for better steel and aluminium trade agreements. Investors should pay close attention to developments in macro conditions and adjust their trades accordingly.

Summary

Looking into 2019, with Bank of Mexico looking to maintain its hawkish stance, it would look to keep inflation down. However, increasing electricity costs have managed to counteract the rate hikes. With Mexico President Lopez Obrador eagerly looking to uphold his promises of a more business-friendly approach which aided in his presidential victory, investors continue to remain doubtful of his presidency which would weaken the demand for the peso. Mexico continues to face steel and aluminium tariffs that look to hinder growth given that the US is not willing to reduce the current tariffs with the USMCA in place. In addition, the US continues to threaten the peso through US President Trump's threats to build the wall. With existing issues of lower export growth, poor investor sentiments and hawkish inflation policy stance, we expect the peso to remain weak in 2019. Thus, we recommend a buy on the currency pair as the peso is looking to weaken relative to the dollar in the 6-12 month timeframe.

# WTI OIL – NEUTRAL

The WTI Oil is one of the most important commodities in the world. It is commonly used as a benchmark in oil pricing. Crude oil is valuable as it is mostly used for producing gasoline, fuel for cargos or powering factories and making electricity. The United States contributes to 13% of the world's crude oil production with an average production of 11.3 million barrels per day, followed by Saudi Arabia at 12.8% at 10.4 million barrels per day and Russia at 12.6% at approximately 10.6 million barrels per day, as shown per figure below. Other important countries that contribute to crude oil production are Canada at 3.6 million barrels per day and Iraq at 4.4 million barrels per day. The Organization of Petroleum Exporting Countries (OPEC) is one of the world's most important organisations in charge of crude oil production. They have contributed to a total of 1,214 billion barrels in 2017 which takes up about 82% of the world's oil production. One of the key countries in OPEC is Saudi Arabia, which is the de facto leader of OPEC and contributes to more than half of OPEC oil production. However, US is expected to overtake OPEC as the main crude producer in the upcoming years as shale oil facilities continue to develop.

| | | 2018M8 | 2018M7 | 2018M6 | 2018M5 | 2018M4 | 2018M3 | 2018M2 | 2018M1 |
|---|---|---|---|---|---|---|---|---|---|
| 1 | United States of Americ... | 11,345.52 | 10,929.87 | 10,672.37 | 10,463.90 | 10,475.00 | 10,461.35 | 10,248.25 | 9,994.55 |
| 2 | Russian Federation | 10,654.34 | 10,654.34 | 10,472.07 | 10,345.86 | 10,347.44 | 10,322.13 | 10,298.40 | 10,274.67 |
| 3 | Saudi Arabia | 10,412.00 | 10,288.00 | 10,489.00 | 10,030.00 | 9,868.00 | 9,907.00 | 9,935.00 | 9,983.00 |
| 4 | Iraq | 4,460.00 | 4,460.00 | 4,360.00 | 4,360.00 | 4,360.00 | 4,360.00 | 4,360.00 | 4,360.00 |
| 5 | Canada | 3,571.24 | 3,746.57 | 3,562.96 | 3,660.41 | 3,592.63 | 3,656.94 | 3,605.39 | 3,516.81 |
| 6 | Brazil | 2,525.45 | 2,583.32 | 2,598.90 | 2,615.87 | 2,607.80 | 2,566.87 | 2,628.64 | 2,626.35 |
| 7 | Nigeria | 1,997.00 | 1,853.00 | 1,783.00 | 1,832.00 | 1,965.00 | 1,945.00 | 2,009.00 | 1,997.00 |
| 8 | Mexico | 1,830.98 | 1,852.68 | 1,858.03 | 1,879.63 | 1,897.91 | 1,875.74 | 1,906.80 | 1,937.64 |
| 9 | Norway | 1,521.44 | 1,546.56 | 1,511.48 | 1,334.19 | 1,537.45 | 1,543.42 | 1,595.37 | 1,656.98 |
| 10 | Angola | 1,481.00 | 1,455.00 | 1,448.00 | 1,486.00 | 1,498.00 | 1,496.00 | 1,498.00 | 1,562.00 |
| 11 | Venezuela | 1,448.00 | 1,469.00 | 1,531.00 | 1,533.00 | 1,505.00 | 1,509.00 | 1,586.00 | 1,769.00 |
| 12 | Kazakhstan | 1,411.95 | 1,584.79 | 1,558.02 | 1,613.08 | 1,560.47 | 1,565.06 | 1,580.34 | 1,535.58 |
| 13 | Algeria | 1,062.00 | 1,064.00 | 1,054.00 | 1,040.00 | 979.00 | 966.00 | 1,036.00 | 1,013.00 |
| 14 | United Kingdom | 823.31 | 895.98 | 836.64 | 904.52 | 1,005.98 | 890.86 | 939.60 | 1,013.28 |
| 15 | Indonesia | 778.22 | 733.33 | 782.11 | 779.07 | 776.21 | 780.09 | 787.33 | 768.46 |
| 16 | Azerbaijan | 710.37 | 718.46 | 728.16 | 737.00 | 744.37 | 726.06 | 736.21 | 743.89 |
| 17 | India | 697.92 | 695.04 | 715.23 | 721.92 | 722.92 | 730.08 | 725.67 | 714.24 |
| 18 | Qatar | 612.00 | 619.00 | 622.00 | 601.00 | 578.00 | 616.00 | 539.00 | 621.00 |
| 19 | Malaysia | 606.04 | 675.42 | 661.45 | 641.10 | 636.63 | 662.43 | 665.00 | 681.06 |
| 20 | Ecuador | 530.00 | 523.00 | 517.00 | 516.00 | 517.00 | 511.00 | 513.00 | 513.00 |

*Figure 96: Top 20 oil-producing countries from 2018 (Source: Knoema)*

<u>US Sanctions on Iranian Oil</u>

On June 2018, the US pulled out of the Iran nuclear deal and ordered all its allies to stop importing Iranian oil by 4th November 2018. The US is looking to impose sanctions on companies who buy, ship or insure shipments of Iranian oil after 4th November. Due to US sanctions, Iran has experienced a fall in oil production by 1 million barrels per day. Fitch solutions expect Iranian oil exports to drop by more than 1.3 million barrels per day by the end of 2019. As compared to the early part of 2018, Iran exported 2.7 million barrels per day which is equivalent to 3% of daily global consumption. The sanctions would trigger a dramatic shortfall in global supply, creating upward pressure on oil prices. Thus, the negative supply shock would contribute to a potential bullish outlook as Iran, who used to be a major player in oil production experiences a fall in oil production.

| | 2016 | 2017 | 1Q18 | 2Q18 | 3Q18 | Aug 18 | Sep 18 | Oct 18 | Oct/Sep |
|---|---|---|---|---|---|---|---|---|---|
| **Algeria** | 1,090 | 1,043 | 1,014 | 1,026 | 1,059 | 1,057 | 1,057 | 1,054 | *-4* |
| **Angola** | 1,718 | 1,634 | 1,562 | 1,493 | 1,472 | 1,462 | 1,512 | 1,533 | *22* |
| **Congo** | 216 | 252 | 306 | 324 | 317 | 317 | 318 | 324 | *5* |
| **Ecuador** | 545 | 530 | 515 | 519 | 528 | 530 | 528 | 525 | *-3* |
| **Equatorial Guinea** | 160 | 133 | 134 | 127 | 124 | 124 | 123 | 131 | *8* |
| **Gabon** | 221 | 200 | 195 | 182 | 184 | 186 | 184 | 186 | *3* |
| **Iran, I.R.** | 3,515 | 3,813 | 3,817 | 3,818 | 3,604 | 3,609 | 3,452 | 3,296 | *-156* |
| **Iraq** | 4,392 | 4,446 | 4,441 | 4,480 | 4,629 | 4,642 | 4,654 | 4,653 | *0* |
| **Kuwait** | 2,853 | 2,708 | 2,704 | 2,708 | 2,798 | 2,803 | 2,797 | 2,764 | *-33* |
| **Libya** | 390 | 817 | 991 | 889 | 892 | 955 | 1,054 | 1,114 | *60* |
| **Nigeria** | 1,556 | 1,658 | 1,780 | 1,653 | 1,711 | 1,723 | 1,768 | 1,751 | *-17* |
| **Qatar** | 656 | 607 | 593 | 602 | 609 | 616 | 595 | 609 | *14* |
| **Saudi Arabia** | 10,406 | 9,954 | 9,949 | 10,114 | 10,422 | 10,404 | 10,502 | 10,630 | *127* |
| **UAE** | 2,979 | 2,915 | 2,850 | 2,873 | 2,982 | 2,969 | 3,018 | 3,160 | *142* |
| **Venezuela** | 2,154 | 1,911 | 1,545 | 1,383 | 1,242 | 1,240 | 1,211 | 1,171 | *-40* |
| **Total OPEC** | **32,851** | **32,623** | **32,394** | **32,190** | **32,573** | **32,637** | **32,773** | **32,900** | ***127*** |

*Notes: Totals may not add up due to independent rounding.*
*Source: OPEC Secretariat.*

*Figure 97: OPEC members oil production (Source: OPEC Secretariat)*

Even with the sanctions being put in place, the US has granted waivers to 8 countries to allow them to temporarily import oil from Iran. These temporary waivers have prevented Iran oil production to hit zero and allowed Iran to produce approximately 1.6 million barrels per day. However, these exemptions are only temporary as US Secretary of State Michael Pompeo is looking to cut all imports of Iranian oil to zero. As negotiations are ongoing, it would be unlikely that Iranian oil exports will hit zero as these 8 countries shown the need for Iranian oil. Looking forward, the negotiations would be unlikely to have much effect on supply outlook as OPEC and Russia has been increasing their oil production over the past few months to negate the negative supply shock in global oil production.

<u>US increasing oil stockpiles and oil production</u>

As of 21st December 2018, WTI crude prices have fallen 40% to $45.16 compared to its October's high of $76.90 per barrel. This is partly due to the increase in US oil stockpiles that have risen sharply over the past month. US crude stockpiles are up by 22.3 million barrels over one week. This was the biggest increase over a four-week period since 2015. In addition to increasing oil stockpiles, the US has looked to keep oil prices low with the improvement and advancement of technology from shale companies. This allowed for more oil extraction from shale formations which as contributed to 7.47 million barrels per day and continues to be one of the largest drivers in US oil production. The increase in US oil production and stockpiles allows for downward pressure on oil pressures due to increased supplies of oil.

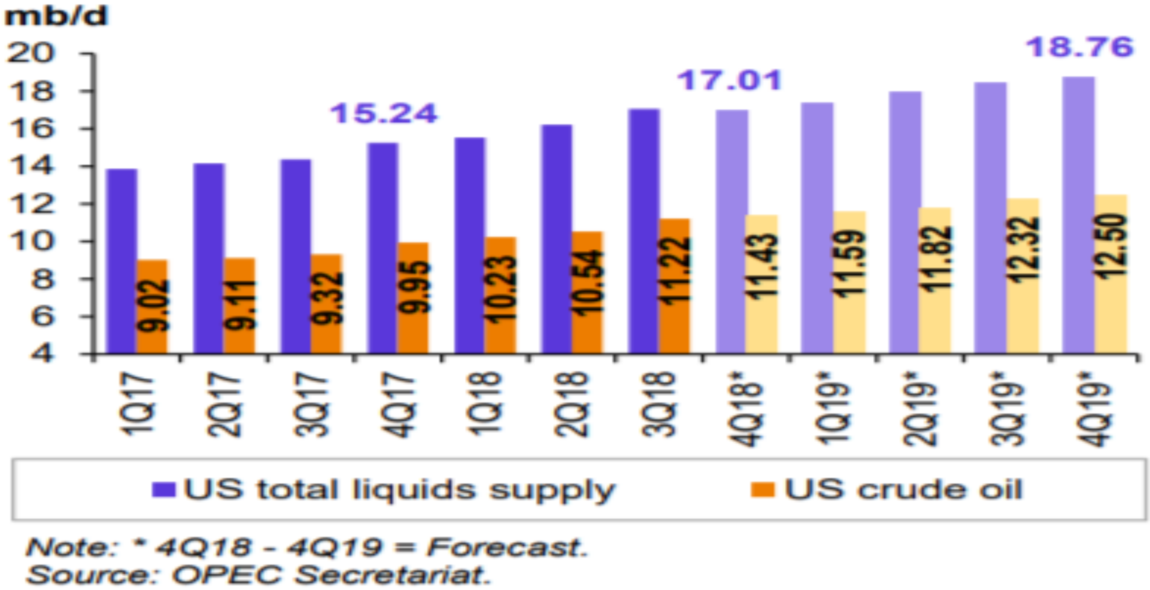



*Figure 98: US quarterly oil production (Source: OPEC Secretariat)*

The US continuous increase in oil production has managed to keep oil prices low as oil prices entered the bear market. On 2nd November 2018, US oil production hit an all-time high as domestic production hit 11.6 million barrels per day. This brings US expected average oil production at 10.7 million barrels per day at the end of 2018. The rapid increase in oil production is contributed by improved pipeline capacity in main oil production regions at the Permian Basin. The Plains All American Pipeline company has started to expand its Sunrise pipeline, allowing production to be 100,000 bpd higher. The Sunrise pipeline is the first to ease pipeline constraints at the Permian Basin. A second Plains All American Pipeline is also looking to start up in the third quarter of 2019, followed by as many as 4 new pipelines in the next 12 months. When these projects are completed, it looks to add up to 4 million bpd of additional pipeline capacity to move crude from the Permian Basin and Eagle Ford shale to the market by end of 2020. In addition, there are still many uncompleted wells in the above 2 areas of up to 5,175 uncompleted wells. These increased pipeline capacities will allow producers to increase output in the upcoming years that may override the supply cuts from OPEC and keep prices bearish.

The US has become a net oil exporter as it exported more crude oil and fuel than its imports for the first time on record as of 30th November. Throughout the week, they exported a net of 211,000 barrels per day due to the country's shale revolution. Shale development has allowed the US to become a major oil producer, giving the country the potential to account for roughly half of global crude production by 2025. With growth driven by shale fracking, they are expected to produce double its current output levels, reaching 9.2 million barrels a day by mid-2020s according to the International Energy Agency. Shale developments have catapulted the US into its status today as the top oil producing country in the world today. However, OPEC has forecasted US shale oil production to peak by late 2020s due to resource constraints and falling by 1.5 million barrels per day to allow OPEC to overtake as the biggest oil producer to meet slower demands due to increased fuel efficiency standards and a rise of electric vehicles. With strong US oil production, we believe that it would keep oil prices low bearish in a 6-12 month outlook due to Trump's goals for low oil prices.


*Figure 99: US crude inventories vs. crude futures (Source: Bloomberg)*

<u>Dampening of oil demand from China</u>

The ongoing US-China trade war will affect global demand for crude oil that would cause a bearish outlook towards oil prices. In June, Beijing threatened to slap 25% tariff on crude imports in response to US President Donald Trump's $50 billion levy on China imports. In addition of the $50 billion levy on China imports, an additional $200 billion worth of tariffs are placed on Chinese goods. The tariffs imposed by both countries as reflected in Figure 3 are likely to limit economic activity in China that can impact the competitiveness of US crude oil and petroleum products in China. China has started to experience the negative impacts of the trade war after consumers and producer price indexes fell due to poor confidence in the country's economic growth. Consumer price index fell by 0.3% compared to October 2018 while the producer price index fell by 0.2%. It was the first month on month fall in seven months as energy prices fell. Economic data from the first three quarters of the year suggested that many China provinces have fallen behind their annual GDP growth targets and are currently struggling to spur investments to meet growth targets by the end of 2018. Senior Analyst Abhishek Kumar at Interfax Energy in London stated that the trade war could also deter Chinese investments in the US energy sector and reduce Chinese demand for US crude oil. Being the world's largest oil consumer at 8.4 million barrels per day in terms of oil imports, the trade war would limit China demand for crude oil. In addition, the negative economic impact on China's economy would dampen its consumption of energy, causing a fall in global oil demand. However, as of 19th October

2018, Analysts at Interfax Energy reported that China demand for oil has been healthy despite the trade war. Oil demand has risen to a record daily high of 12.49 million barrels per day as China imports the oil from OPEC countries. However, Chinese investors are staying away from US crude as the trade war continues even though US Oil is a new important energy source to China refiners due to diversification from Middle East crudes. We believe that this creates a bearish outlook towards US Oil as the world's largest oil importer avoids the commodity. Even though China's oil demand continues to remain strong as they import their oil from OPEC, the trade war continues to contribute to low oil prices as China reduces their demand for US oil imports.

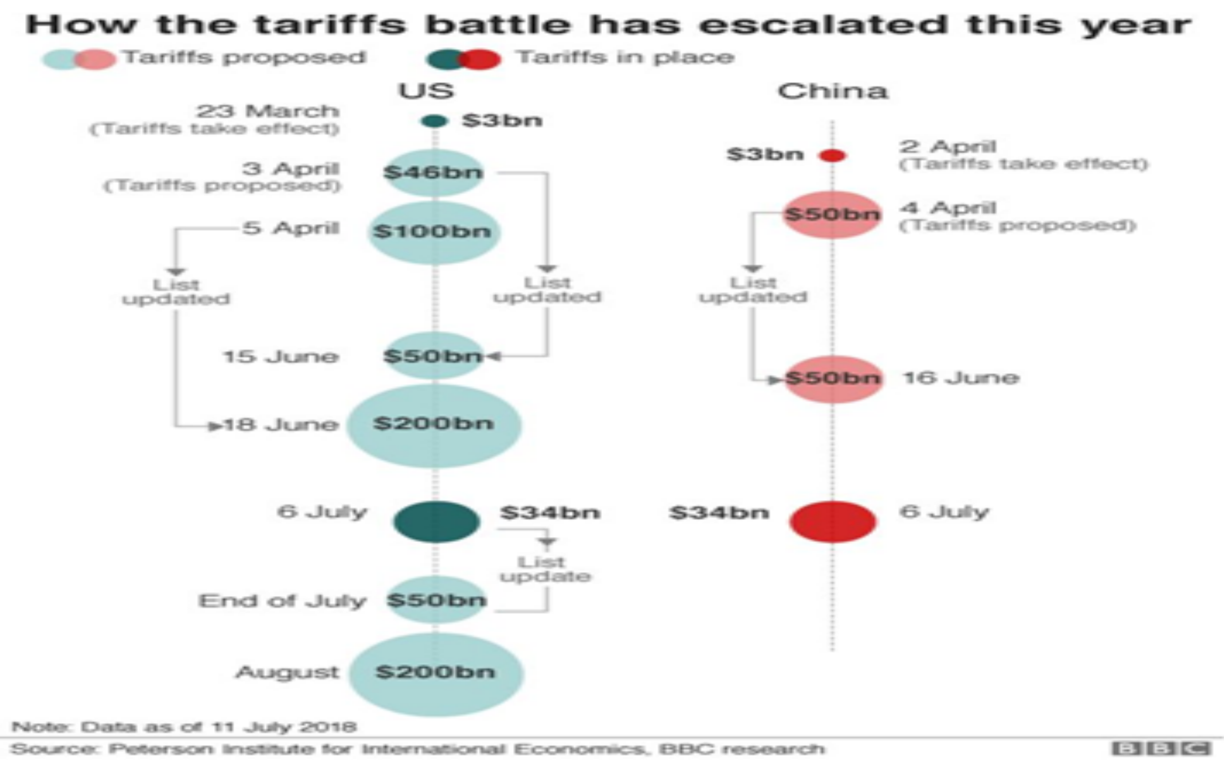



*Figure 100: Timeline of US-China trade war (Source: BBC Research)*

China's Commerce Ministry acknowledged for the first time that Beijing agreed to a 90-day cease fire with the US to allow trade negotiations to take place during the 2018 G20 Summit. The Trump administration has agreed to hold back on lifting tariffs on $200 billion of goods to 25% to 10%. The easing of trade tensions could allow US to export crude to China at full capacity again which would help boost global demand for US oil after China crude imports from the US came to a halt from 325,000 barrels per day in October 2018 due to the ongoing trade war. It has been reported that with the reduced risk of tariffs being imposed on oil imports, China's largest crude oil importer Unipec plans to resume US crude shipments to China by March 2019 which marks the end of the 90-day negotiating period between US and China. With expectations of China demand for oil imports to increase after the 90-day ceasefire period, we conclude that oil prices would expect a bullish outlook in a 6-12 month outlook as global demand is expected to increase.

OPEC looking to supply cuts as risks of depressed oil prices hurts member countries

Due to plummeting oil prices and signs of a global oversupply of oil, it brings oil producers such as OPEC to look to cut output. Saudi Representatives stated on Sunday that they are looking to reduce their oil exports in December. As OPEC's largest oil producer, Saudi's reduction in oil exports would cause a drop in global oil supply that may give rise to a more bullish outlook towards oil prices in the future. Mr. Khalid Al-Falih, OPEC's de facto head from Saudi Arabia has stated that they are looking to cut about 1.3 million barrels per day on the group level to ensure oversupply does not occur. In addition, Russia, the world's largest oil producer stated they were open to crude production cuts if OPEC reaches a consensus and they would adhere to the decisions. As part of the final agreement between OPEC+ members, Russia will curb its output by 230,000 barrels a day, while Saudi Arabia would be cutting down their daily production by 250,000 barrels. The Organisation would exempt oil production cuts to countries like Iran, Venezuela, Libya, and Nigeria given the economic strife in their countries. Commodity Analyst Giovanno Stauvno at UBS stated that OPEC's oil production cut that would also have to consider the potential slowdown in demand growth in 2019. Thus, the production cut would prevent oversupply, allowing for oil prices to rise in a mid to long-term outlook.

Amidst OPEC's decision for oil production cuts, Qatar has decided to leave the cartel after six decades. Qatar is one of the smaller oil producers in OPEC as shown in the table below, producing at an average of 610,000 barrels a day in the third quarter of 2018. As US President Donald Trump is constantly criticizing OPEC for high prices, a Qatari official stated that leaving OPEC would benefit the country both economically and politically. We believe that as Qatar leaves OPEC, they can now sell oil exports to the US at a lower price, allowing for Qatar to buy US goodwill. According to Qatari and OPEC officials, Qatar gave little advance notice of their exit of OPEC but has alerted US officials ahead of their official announcement. The decision to leave OPEC also sends a clear signal that the country no longer needs the cartel. With Qatar producing only a fraction of Saudi output, their absence is unlikely to have a huge impact on oil supplies.

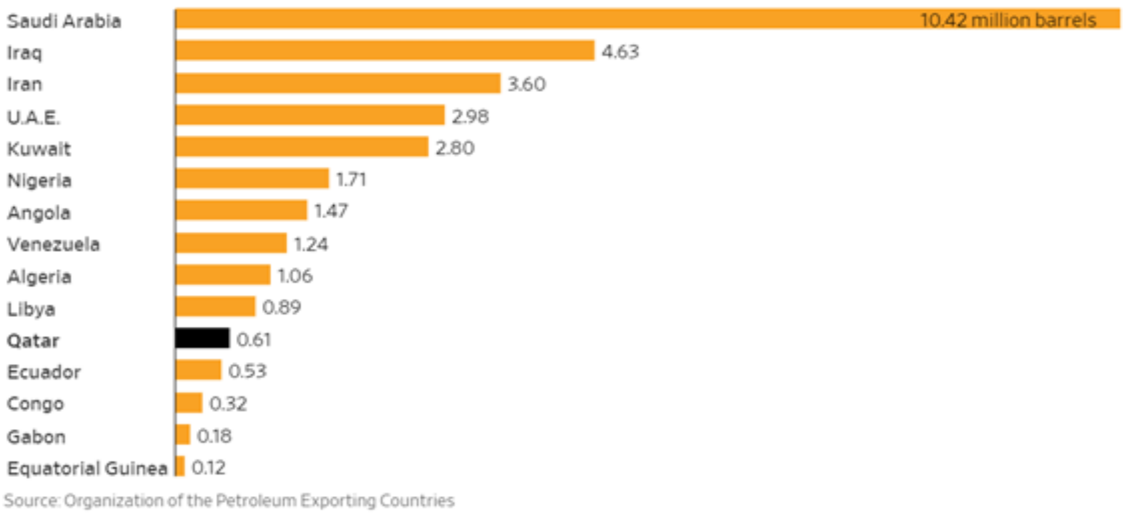



*Figure 101: 3rd quarter 2018 crude oil production per day (Source: OPEC)*

However, it would undermine OPEC power in the longer term. The absence of Qatar would signal to producers to rethink if they really need to be part of the cartel. Saudi Arabia has already started studying the possible effects on production and prices from the breakup of OPEC due to the global shift to alternative sources of energy. Mr. Sieminski, the president of Saudi Arabia's top funded think tank concluded that the absence of OPEC would lead to a more volatile price environment that would bring about negative effects on the global economy. Even though the study is currently still ongoing, there have been two scenarios that would most likely happen with OPEC's disband. One would be that oil producers would act competitively to fight for market share, which would drive up prices due to demand and supply factors and the other is that Saudi would attempt to leverage its massive oil output alone to balance global supply and demand to keep oil prices steady.

IMO 2020 effect on the Oil Market

On 1st January 2020, the International Maritime Organization (IMO) will enforce new emission standards designed to curb pollution that is produced by ships. Looking towards a goal of cleaner energy markets, IMO is set to ban shipping vessels using fuel with a high sulphur content higher than 0.5% compared to 3.5% at present. The most commonly used marine fuel is seen to have a sulphur content of 2.7%. The ban would look to reduce demand for crude which is known to have high sulphur content as the ban would cause global vessels to switch away from 3.5 million barrels per day of crude to other clean energy sources. The switch would create a negative demand shock which can look towards a bearish oil market given that the ban takes place. With cleaner energy usage, producers would look to more sustainable energy sources that cause demand for crude oil to fall, creating a more bearish outlook towards prices if the emission standards become fully implemented.

## COMMODITY TRADE IDEA: LONG WTI OIL CFD - BUY


*Figure 102: WTI oil daily chart (Source: Tradingview.com)*

With the expected oil supply cuts from OPEC to take effect as of January 2019, will prevent the potential oversupply of oil. We deduce that the production cuts from OPEC would significantly disrupt global oil supplies, causing a bullish outlook towards prices in a 12-month outlook. Moreover, as demand for US Oil from China is expected to increase due to the 90-day ceasefire period, it would contribute to bullish oil prices as China is known to be the biggest oil importer in the world. However, supply factors tend to outweigh demand factors when it comes to oil as China's oil demand change would be too insignificant comparing to a global scale. With oil supplies falling, oil prices would be expected to be bullish, supporting the idea for going long on WTI Oil.

**Entry: 45.50**

**Stop loss: 42.34**

**Take profit: 58.27**

Key resistance level identified at 76.71 at 3rd October 2018 which has not been broken throughout the year. Over the past month, major resistance at 54.09 which has been tested constantly.

Using the RSI, it hit oversold levels from 1st November 2018 to 31st November 2018, causing major resistance at 58.27 to be broken and followed by a bear run. The RSI also shows a potential trend reversal as displayed by the red line on the chart. As prices hit a new low at 49.75 on 30th November 2018, RSI failed to hit a new low, signalling a bullish divergence.

From the Stochastic, it also shows a potential trend reversal due to divergence. From the chart, the red lines show prices continue to hit new lows while the Stochastic increases as it leaves the oversold region. As the stochastic starts to move in a different direction, we believe that it can lead to a potential bullish reversal.

The MACD also shows a bearish divergence as the MACD made a new low on 30th November while prices failed to match accordingly as prices rose from 50.88 to 51.19. With the bearish divergence, we expect a potential trend reversal from a bear run.

Due to the volatility of current prices, short-term investors can look to short the commodity as they enter major resistance levels at 58.27 and exit at support level 49.70. With divergence spotted in the RSI and Stochastic, together with a double bottom, we recommend that long-term investors can look ride on the bull run and enter the market at 45.50 which is the next support level and long the WTI Oil, taking profit at resistance level 58.27. Stop loss would be at 42.34 which is key support level that has been tested over the past year. This is further supported by fundamentals as OPEC looks to reduce oil production which reduces supply and the increase in oil demand from China as trade war tensions reduce.

One of the major risks for trading the WTI Oil would be the volatility. With oil prices falling from near $80 per barrel to its current price at $52, it is hard to predict the trend of oil prices in the coming months. It has been President Trump's goal to keep oil prices low and with the improvement of shale technology, it has contributed to a major dip in oil prices. Even with OPEC's announcement of production cuts, there have not been significant movements in the oil market when according to demand and supply factors, oil prices should be steadily increasing. Thus, if the US continues to aim to keep prices low, they might continue to boost oil production despite the potential oversupply of oil prices, causing oil prices to remain low.

Moreover, in a longer-term outlook, due to new emission standards and demand for alternative fuels, it might cause global demand for oil to fall, causing the demand shock to have a significant impact on oil prices. As many countries have been looking into new energy sources and with the incoming IMO regulations, the negative demand shock might keep oil prices bearish.

With relation to demand factors, expectations for 2019 global growth has fallen. As global economic growth is the main driver for oil demand, the potential slowdown in global growth would cause a fall in demand for oil. Pessimism about global economic growth and geopolitical instability would look to push the oil market into uncertainty and given rise to a bearish run as global demand fall. In addition to fall in global economic growth, OPEC and IEA forecasted that global oil demand would experience a fall in demand growth for 2019. Coupled with a slowdown in economic growth, this would contribute to a potential bearish oil market for 2019.

We recommend being neutral when it comes to putting oil in one's portfolio as even though oil prices are expecting a bullish run due to the cutting of OPEC+'s output and better trade relations between US and China which can help boost global demand. Prices face the risk of US overproduction that can lead to an oversupply in terms of global oil production together with expected lower global demand due to expectations towards slower global economic growth and enforcement of new emission standards that dampen the demand for oil in a 6 -12-month outlook.

# UNITED KINGDOM - UNDERWEIGHT

The United Kingdom is a region in Europe that consists of England, Wales, Scotland, and Northern Ireland. Its national currency is the Pound Sterling (£) currently the world's 4th largest reserve currency behind the US Dollar, Euro, and Japanese Yen. It is currently the 5th largest economy in the world in terms of Nominal GDP and 2nd in the EU behind Germany. The United Kingdom (as of this moment) remains a member of the EU but has a unique arrangement as it is not a part of the Monetary Agreement. However, the UK held a referendum in June 2016, with the majority voting to leave the European Economic Area. This event has come to be known as 'Brexit'. The current Prime Minister, Theresa May, triggered Article 50, the breakup clause with the EU, in March 2017. This gave the UK 2 years to negotiate a Brexit deal with the EU and leave the bloc by March 2019.

The UK has one of the most globalized economies in the world and is dominated by the services (tertiary) sector, which accounts for about 80% of the country's total GDP. The financial services industry is of particular importance, with London being the largest financial center in the world. It is also the capital of the forex exchange market, contributing to about 40% of the roughly $5.2 trillion daily global turnovers. The economy is highly market oriented, with about 5% of the world's Fortune 500 companies headquartered in London. The aerospace industry is the 3rd largest in the world, with British companies like BAE Systems (2nd largest defense contractor in the world) and Rolls Royce (2nd largest aircraft engine maker in the world) having a major presence. The pharmaceutical industry also is a key part of the economy, home to GlaxoSmithKline and AstraZeneca – the 3rd and 7th largest pharmaceutical companies in the world respectively. In 2016, the UK exported £19.5 billion worth of pharmaceutical products and had a trade surplus in pharmaceutical products of £500 million. Foreign companies with a major presence include Pfizer, Novartis, Hoffmann–La Roche and Eisai. 20% of the world's best-selling prescription drugs in the world were developed in the UK.

The UK is a member of the Commonwealth of Nations, the G7, G20, International Monetary Fund (IMF), Organization for Security and Co-operation in Europe, World Bank, World Trade Organization (WTO), Asian Infrastructure Investment Bank (AIIB), and the United Nations (UN). As such, the UK is very much a global power and is very influential in the global economy. The Bank of England (BoE) and decisions by the current governor, Mark Carney, are scrutinized very closely by global financial markets.

<u>Low rates sustain recovery, but normalizing conditions keep markets on watch</u>

The UK maintains its own monetary policy and interest rates separate from the ECB, and the key decision lies with the Monetary Policy Committee (MPC) in the Bank of England which meets 8 times a year. In 2009, the Bank of England Base Rate (BoEBR) was cut to a historic low to 0.5% in order to counter the recession. This was followed by another quarter percentage point cut in the aftermath of the Brexit referendum. However, in August 2018, the BoE increased interest rates above this 'emergency level' for the first time in a decade back to 0.75%. This was after the economy resumed growth from a temporary soft patch in late 2017, which demonstrated the continued strength of the recovery. Domestic inflation pressures also contributed heavily to the decision to raise rates as the UK's inflation has been above the BoE's long-term target of 2% due to a significant fall in the value of the sterling since the referendum. The BoE is maintaining previous guidance that there will be further rate increases but has signaled that these will be 'limited and gradual'.

In the latest meeting in November, the MPC voted unanimously to maintain the rate at 0.75% for another month but revised the UK's growth forecasts downwards for the next two years. This was largely in line with economists' forecasts, and although rates are widely expected to move higher in the coming years, the timing remains unclear. The Bank noted that any changes will be dependent on the progress of Brexit. It should be noted that the Bank has indicated that it can either increase or decrease rates should a no-deal Brexit occur, and its position was re-emphasized by Mark Carney on 1st November 2018.

Investors should therefore heed caution and not assume that rates will automatically be lowered to counter a slowdown in growth if there is no deal. In fact, a no-deal Brexit would most likely cause the pound to plummet and may force a hiking of rates to prop up the pound and prevent inflation from shooting up even more. Taking a closer look, in the event of a no-deal Brexit, the Bank's model shows the base rate jumping to 5.5%. If there is a transitional arrangement to smooth the shock of a no-deal Brexit, the base rate is anticipated to reach 1.75%.

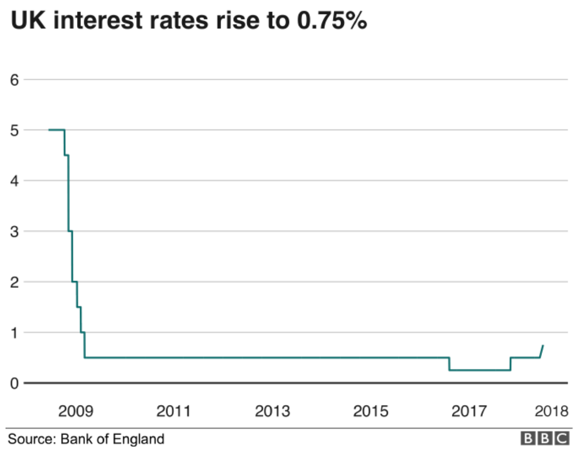



*Figure 103: UK annual interest rate (Source: BoE, BBC)*

The underperformance of the UK's GDP growth in contrast to the EU and US continue to be a concern as markets question the Bank's decision to raise rates despite the increasing uncertainty surrounding the Brexit negotiations. The reason for the Bank's hawkish approach is likely due to high CPI figures and strong recovery in the labor market which looks to be a significant factor in guiding the BoE decisions ahead.

Looking ahead to 2019, the Brexit negotiations continue to be the biggest influence on the outlook of credit conditions. The Bank's quarterly inflation report published in November notes that the MPC forecasts the base rate to reach 1.4% by 2021. Following that guidance, the base rate hits 1% in 2019. 2 to 3 rate hikes by 2020 are penciled in by markets at the moment, but things could very well change depending on the outcome of Brexit, with things looking increasingly dim. With a lack of clarity on a potential deal coupled with the US-China trade war, the Bank lacks the key weapon it needs if the UK were to crash out of the EU, with risks of a global recession edging higher and higher. Mark Carney has also intensified his warnings of the risks of a no deal Brexit, and investors would be wise to take heed.

Muddy growth continues with inflation pressures taking front seat

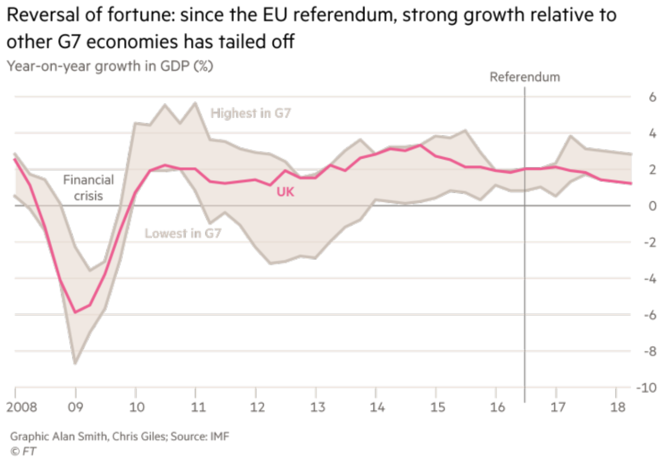



*Figure 104: G7 Year-on-year GDP growth in % (Source: FT)*

The UK's GDP has seen moderate growth since the referendum, but most economists agree it would have performed better to the tune of 1-2% had the Brexit "Leave" campaign not prevailed. In the latest November Inflation Report projections, the bank revised growth from 1.4% to 1.3% in 2018, and from 1.8% to 1.7% in 2019. Average growth over the forecast period is 1.75%.

Despite the record low rates has underperformed major G7 economies like France and the US at 2% and 2.8% respectively. However, consumer spending has been resilient, and that has been a major part of the recovery story as we enter the 4th quarter of 2018.


*Figure 105: UK's monthly GDP growth rate (Source: Tradingeconomics.com, ONS)*

Despite the support from consumer spending, the UK economy slowed significantly in August. According to the Office for National Statistics, the rate of GDP growth in August fell to 0% from 0.4% in July, missing economists' consensus of around 0.1%. Some have warned of a slowdown in momentum in the economy after strong growth in the summer due to the hot weather and World Cup. The weak data in August in 'normal' conditions has spurred warnings of similar weak economic growth in the months ahead, as concerns mount over the risks from a no-deal Brexit. The stagnation in August did not spare any corner of the economy, with only a modest improvement in output in the industrial sector attributed to mining and quarrying activity. The services sector, which accounts for more than 80% of the economy was flat with 0% growth. Manufacturing output fell by 0.2%, and construction output fell 0.7%.

The current projected annual GDP growth of 1.3% remains below the pre-referendum trend at about 2%, due to Brexit dragging down economic activity. This is likely to continue into the 4th quarter of 2018 and beyond as March 2019 nears. In fact, the International Monetary Fund recently downgraded UK growth forecasts for this year, and has revised the growth rate to 1.1%, down from 1.3%, as uncertainty weighs increasingly on trade and investment. Investors should expect the US-China trade war to have an impact on growth figures as well. It is clear that although overall sentiment has not turned negative, the simultaneous revising of growth downwards by the IMF and the BoE demonstrates the rising concern of a global slowdown.

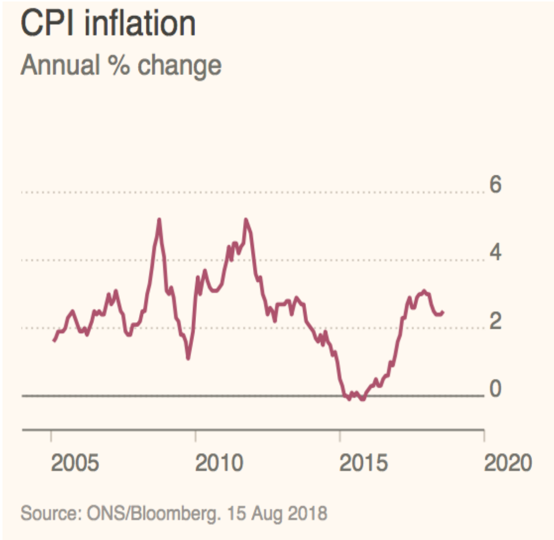



*Figure 106: UK's annual CPI % change (Source: Bloomberg, ONS)*

The Bank's long-term inflation target for the UK remains at 2% and is a key consideration in its decision making. In 2014 and 2015, the UK enjoyed exceptionally low inflation which was driven largely by falling oil prices and a strong currency. A supermarket price war which was ongoing helped to push down consumer prices even further as the CPI growth rate hovered around the 0% level. Since the referendum however, the value of the pound has fallen sharply, making imports costlier. Rising oil prices due to a squeeze in supply have also contributed to cost pressures, resulting in a rapid rise in CPI data.

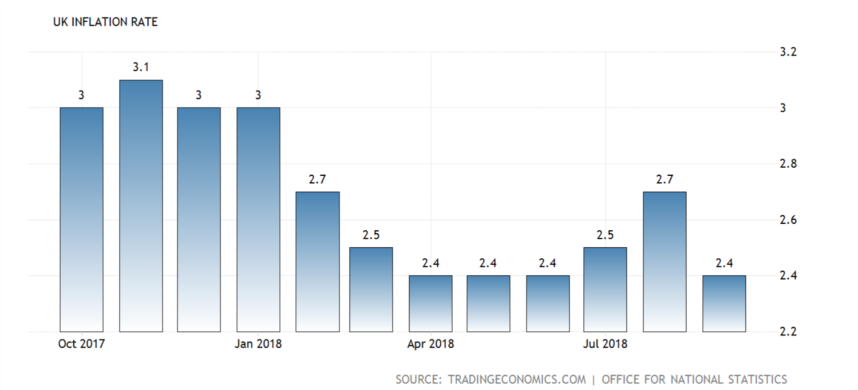



*Figure 107: UK's monthly inflation rate (Source: Tradingeconomics.com, ONS)*

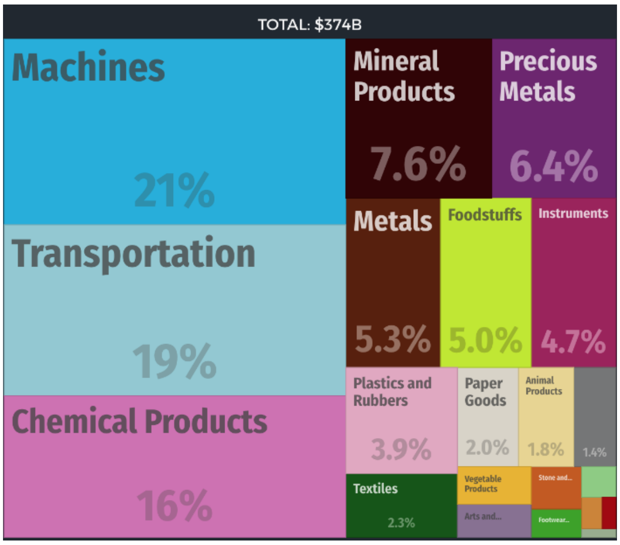
The inflation rate hit a 6-month high at 2.7% in August and surprised most who were expecting a drop. This put pressure on the BoE to further increase rates in order to prevent prices from spiraling out of control. Latest figures however show inflation easing in the month of September to 2.4%, mainly due to a fall in prices for food, transport, clothing, and recreation and culture.

In fact, the inflation rate hit a 6-month high at 2.7% in August, and surprised most who were expecting a drop. This put pressure on the BoE to further increase rates in order to prevent prices from spiralling out of control. Latest figures however show inflation easing in the month of September to 2.4%, mainly due to a fall in prices for food, transport, clothing, and recreation and culture.

Year-on-year, there was a slowdown in price growth for transport (5.6% vs 6.1% in August), namely transportation services (4.2% vs 6.4%); recreation and culture (3% vs 3.6%); food and non-alcoholic beverages (1.5% vs 2.5%); and furniture, household equipment, and maintenance (0.5% vs 0.7%). Prices also declined for clothing and footwear (-0.4% vs 0.3%) and miscellaneous goods and services (-0.3% vs -0.7%). However, inflation increased for housing, utilities, and other fuels (2.7% vs 2.3%), specifically for electricity (9.3% vs 7.4%) and gas (5.5% vs 4.3%) but was largely flat for restaurants and hotels (2.5%). This emphasizes the impact of energy on consumer prices.

In the latest Inflation Report, the MPC noted a tight labor market, with the unemployment rate at its lowest since the 1970s. Wage growth has outperformed expectations, rising to 3.1%. The projected pace of UK GDP growth is expected to be higher than supply growth at 1.5% a year, and the excess demand will push up domestic costs. External costs pressures are, however, projected to ease over the forecast period in part due to a recent fall in oil prices. Putting these movements in perspective, CPI is projected to remain above the long-term target for the majority of the forecast period, finally achieving the 2% level at the end of the third year. The bank continues to face a tough dilemma as a slowdown in growth coupled with above target inflation for the forecast period leave little room for error.

Brexit hanging in the balance as negotiators clash over the Irish border



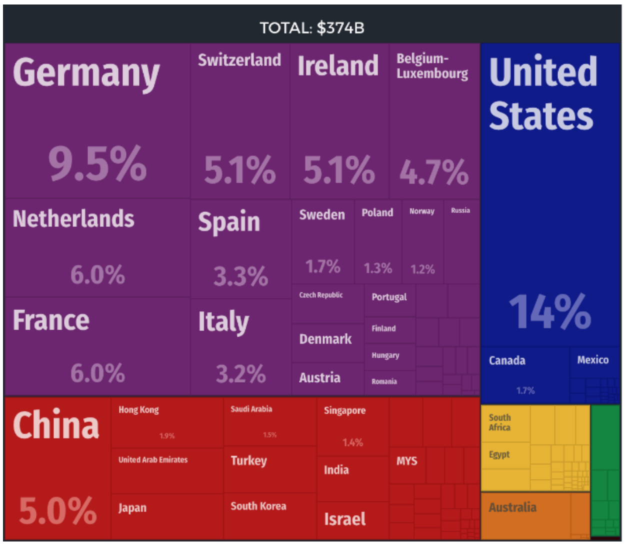
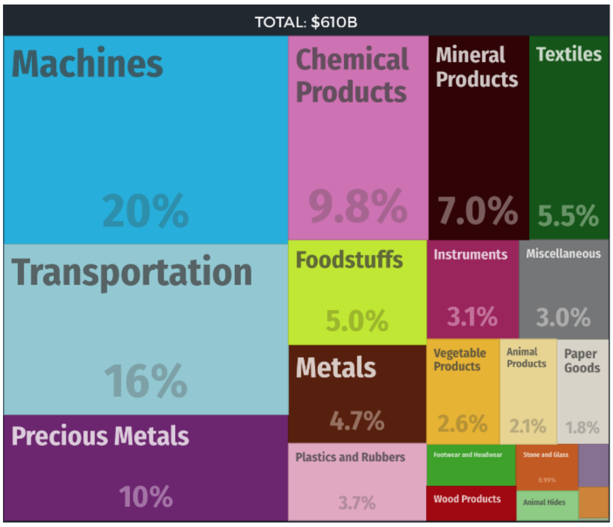




*Figure 108: UK's export composition breakdown (Source: Observatory of Economic Complexity)*

*Figure 109: UK's export partners (Source: Observatory of Economic Complexity)*



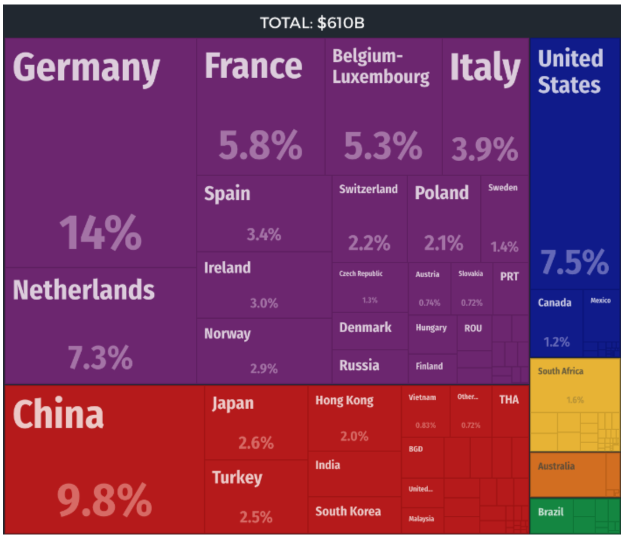




*Figure 110: UK's import composition breakdown (Source: Observatory of Economic Complexity)*

*Figure 111: UK's import partners (Source: Observatory of Economic Complexity)*

The UK's top trading partners from the EU are Germany (9.5% Export, 14% Import), Netherlands (6% Export, 7.3% Import), France (6% Export, 5.8% Import), and Belgium-Luxembourg (4.7% Export, 5.3% Import). The UK has maintained a current account deficit since the 1990s which can be attributed to a large trade deficit but has a positive capital account surplus due to its status as the top global financial hub with large inflows of investments and foreign ownership of domestic assets. The UK's top exports are machinery, vehicles, and chemicals and minerals, while its top imports are machinery including computers, precious metals, transportation, and chemicals.

The main story out of the UK has been the Prime Minister's wrangling with the EU over the deals of Brexit. Theresa May's Chequers Plan, which at its core seeks to maintain a "common rulebook" with the EU for all goods, meant the UK would retain access to the EU single market. However, this plan was rejected at the summit in Salzburg by EU leaders who said it 'would not work'.

The major pain point is the issue of the Irish border between the independent Republic of Ireland, part of the EU, and Northern Ireland which is part of the UK. Both sides agree that a hard border, which comes with physical security and customs checks, must be avoided, but cannot agree on how. This has resulted in the backstop impasse which has threatened to derail talks and is pushing the UK closer and closer to a no-deal Brexit.

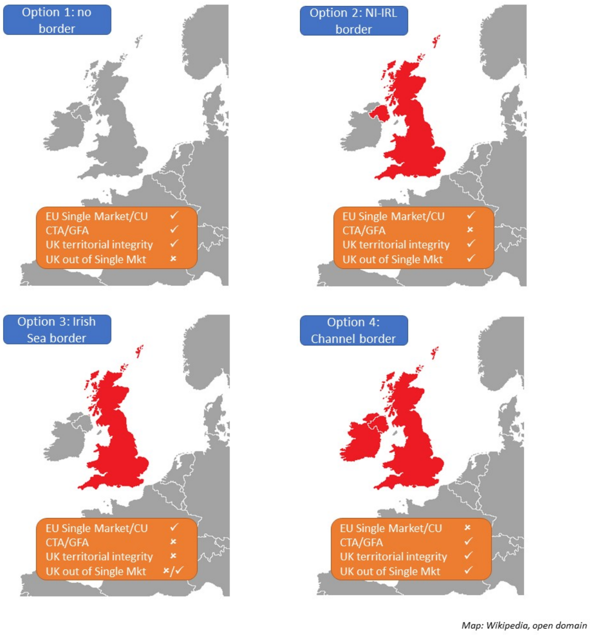



*Figure 112: Brexit backstop scenarios (Source: University of Sydney)*

The backstop is fundamentally an insurance policy which maintains a friction free border crossing, even if both sides are unable to come to a deal on trade and security. The EU has come to believe that would mean Northern Ireland staying in the customs union, effectively creating a customs border along the Irish Sea. Theresa May, and the DUP, which is propping up her minority government, has called a divergent customs arrangement in the UK wholly unacceptable as it would violate the Good Friday Agreement, but even then, cannot agree internally on its implementation. May, who has proposed the backstop covering the entire UK, has been rejected by her own conservative party as they are unwilling to be tied to EU rules for the long term.

The heavy trade between the UK and Republic of Ireland, the only land crossing between the UK and EU, has given rise to complex and intertwined supply chains. Any disruption to this critical trade link would not only result in a cascade of customs and security issues, but also risk a potential ratcheting of tensions between the separate Irish nations which have a combustible history. The issue has dampened the economic outlook significantly for the UK.

Brexit developments looked to have improved significantly, with Theresa May having secured the withdrawal agreement with the EU on 22nd November thereby avoiding a potential no-deal Brexit at the last minute. Yet, she faced intense backlash almost immediately as details of the deals were revealed. The agreement got through the House of Commons with difficulty, but the parliamentary vote remained the key test of her leadership. In fact, May's government was held in contempt for withholding the legal advice it got from the Attorney-General and was forced to release it in what was another humiliating blow. The increasing likelihood of her deal getting struck down by parliament finally saw her pulling the vote at the last minute, and triggered a vote of no confidence which she narrowly won by 200-117 on 12th December. The bearish sentiment strengthened as the EU Summit on the 12-14th December concludes that a re-negotiation of the Brexit deal is not a possibility. The chaos continues with no end in sight.

FX TRADE IDEA: SHORT GBPUSD


*Figure 113: GBP/USD daily chart (Source: Tradingview.com)*

The renewed pressure on the Cable has been relentless. After gaining approval from the EU on what looked to be a final Brexit deal, May encountered resistance almost immediately on her return to the UK. Her own party denounced the deal, and it always looked likely that it would be dead-on-arrival when it came to the parliamentary vote. May insisted the vote would not be delayed, then promptly pulled it at the last minute, which contributed to the triggering of a vote of no-confidence which she barely survived. Upon announcement of the agreement, the pound reached a high of 1.2928, but traded downwards over the next few weeks as the parliamentary dissent became clear. Upon news that the parliamentary vote would be delayed, the pound broke past the 23.6% Fibonacci support and hit a low of 1.2477.

**Entry: 1.2640**

**Take Profit: 1.2500**

**Stop Loss: 1.2680**

The YTD return on the Sterling is -2.14%, which hit a high of 1.4377 on 14 April and a low of 1.2662 on 17 August. Weakness in the pound is expected to persist as markets soak in the reality of an increasingly possible no-deal Brexit. It is currently trading at 1.2625, significantly below the 50 SMA and slightly below the 23.6% (1.2642) level. The downward trend is likely to continue as renegotiations have been rejected by the EU, and a breakout below the low of 1.2477, a significant support level, will likely cause bears to gain the upper hand.

The Bank's continued guidance of 'limited and gradual' rate increases over the next two years could potentially provide some support for the pound. In light of strong inflation pressures, further depreciation of the pound would be unwelcomed as the Bank seeks to rein in inflation in line with long term targets. Downward pressure on the pound is material.

RISKS

Theresa May returned from the EU summit in Brussels on the 14th of December which saw her offer of renegotiating a better deal flatly rejected by the EU. Leaders from various countries and EU Commissioner Juncker have said that the agreement is 'not open for renegotiating', leaving her caught in an untenable position.

News on Brexit remains the major driver of currency movements for the foreseeable future as even expected performance in the economic data failed to drive the pound meaningfully. As we draw closer to March 2019, the government and central bank have begun sounding the alarms of a no-deal Brexit, and businesses have been preparing as such.

We believe the market has underpriced the fact that Theresa May has promised to quit after Brexit, as there is a lack of strong candidates to take the reins of what will most likely be a tumultuous exit, deal or no-deal. Jeremy Corbyn has no love from investors, and Jacob Rees-Mogg, currently one of the most vocal Brexiteers from the Tories, has signaled support for Boris Johnson, hardly a confidence boost for investors as well. Previously, we believed a no-deal Brexit was expected to be unlikely but have now adjusted our position and duly warn of the worst-case scenario as turmoil continues. Downside risks are material.

FTSE 100


*Figure 114: FTSE 100 daily chart (Source: Tradingview.com)*

The FTSE 100, informally referred to as the 'Footsie', is a share index comprising of the top 100 companies listed on the London Stock Exchange (LSE) with the largest market capitalization. The index is seen as a reflection of the performance of companies that are regulated by company laws in the UK. The YTD return for the FTSE 100 is roughly -12%, and reflects the pessimism currently permeating the UK. Unimpressive performance of the economy has done no favors for the index, and after hitting a high of 7903.5 on 22$^{nd}$ May, it has traded downwards, mostly below the 100 SMA, a key technical support. A bullish reversal failed to maintain the breakout of the level towards the end of September due to failed negotiations and the RSI has been in and out of oversold levels in October. Looking ahead, expect continued underperformance from the index due to Brexit and increasing concerns about the slowdown in the global economy.

ETF TRADE IDEA: SHORT iShares MSCI United Kingdom ETF

**Listed on: NYSE ARCA**

**Ticker: EWU**

**Expense Ratio: 0.49%**

The iShares MSCI United Kingdom ETF aims to track the results of an index composed of UK equities. It covers the UK market, and provides the investor exposure to both large and mid-cap stocks in the country. The fund covers a wide range of industries from financials, energy, consumer staples, healthcare, materials, and industrials. Almost all industries are represented in the fund, and thus it represents a view of the country as an investment. The Top 3 largest holdings are HSBC HOLDINGS PLC (6.72%), ROYAL DUTCH SHELL PLC (6.20%), BP PLC (5.93%). The YTD returns are -10.88% and the annualized returns on a longer-term basis is 1Y (2.32%).


*Figure 115: iShares MSCI UK ETF (Source: Tradingview.com)*

**Entry: 28.8**

**Take Profit: 27.6**

**Stop Loss: 30.0**

EWU has relatively underperformed many other of its peers, mainly due to significant roadblocks in Brexit. After the referendum, growing confidence in a synchronized global growth saw a gain of 40% from post-Brexit lows of 27.60 in June 2016 to a two year high of 38.05 in January 2018. Since then however, the fund has dropped 19% from its peak due to growing concerns of an end to the bull rally coupled with the increasing risk of a no-deal Brexit. The fund has been trading in a downward channel since May, and is currently trading below its 200 SMA, pushing the RSI close to oversold levels as the global stock rout sweeps through equities. Investors have been pulling funds out of the UK as March 2019 draws near, and with the heightened turmoil, expect the bearish sentiment to remain strong as businesses and government alike brace for the worst. The next support level is expected to be at 27.59, the 0% Fibonacci retracement level from the previous bullish trend.

## CONCLUSION

The economic outlook for the United Kingdom has not been this murky in a while. With the withdrawal date drawing closer and Theresa May losing her grip on her own party and Brexit, no matter the outcome, investors should proceed with heightened caution. The expected resignation of Theresa May will throw another spanner in the works, with no clear successor. Expect sentiment to weigh heavily against fundamentals, as the trade war continues to roil markets, and the recent arrest of Huawei’s CFO, renewed turbulence in Brexit, and the wrapping up of Robert Mueller’s probe into Russian interference in the US election.

# SWITZERLAND – NEUTRAL

A small country of only 8 million people, Switzerland boasts the 20th largest economy in the world. Switzerland's economy has long been renowned for its impressive and highly developed service sector, with its prestigious banks gaining the country an impressive reputation in its financial industry. Within Europe, Switzerland is known for its neutrality and stability, which lends aid to the Swiss Franc (CHF) being a safe-haven currency.

Not a member state of the European Union, the Swiss National Bank (SNB) conducts monetary policy independent of the European Central Bank (ECB). The Swiss central bank acts in accordance to its dual mandate of price stability and economic growth. Monetary policy is implemented by steering the interest rate level on the money market, with the three-month Swiss franc Libor serving as its reference interest rate. The SNB uses open market operations and the interest rates on call deposits to influence the money market rates. The SNB will also intervene in the foreign exchange market if necessary, in order to influence the value of the currency, history has shown a tendency for the SNB to react to unusual strength in the Franc.

The SNB conducts monetary policy assessments each quarter, which results in an interest rate decision, the publication of a medium-term conditional inflation forecast and a target range for the three-month Swiss franc Libor.

The country is a net exporter, with exports making up 66% of GDP. Some of the major sectors that make up the economy are Chemical Products, Precious Metals and Instruments. Switzerland's major trading partners include the EU and Asia, taking up 45% and 37% of exports respectively. The service sector makes up 70% of Swiss GDP, a majority of Switzerland's exports being high tech finished products.

<u>SNB to hold rates amid strong economic conditions</u>


*Figure 116: Switzerland interest rate (Source: Tradingeconomics.com)*

On 13th December 2018, the Swiss National Bank reiterated their commitment to continue expansionary monetary policy during their quarterly monetary policy meeting. Interest rates remain negative, with the benchmark rate remaining at –0.75%, in line with market expectations and the target range for the three-month Swiss Franc Libor unchanged between –1.25% and –0.25%.

The SNB has taken a dovish stance over the past two years, as the Eurozone struggles to kickstart its economy. Loose financial conditions have expanded the money supply over the past few years, giving a kick start to the Eurozone and Swiss economies. The promising growth shown presents the question of whether there is a potential withdrawal of liquidity on the table.

The SNB also noted that they will remain active in currency intervention. The Franc has appreciated noticeably since the previous monetary policy assessment in June. The sustained negative interest rate policy - commonly known as NIRP - and willingness to intervene in the foreign exchange market signals a commitment to ease pressure on the franc.

The SNB has stuck with their current year inflation forecast of 0.9%, whilst cutting their 2019 inflation forecast to 0.5% from 0.8%, and 2020 inflation forecast to 1.0% from 1.2% in the previous meeting. Lack of inflation fears mean the SNB is unlikely to raise rates, especially since growth in the Swiss economy has only just started to pick up. Inflation forecasts for 2019 and 2020 are all well below the target rate of 2%. As a result, the SNB is likely to keep CHF low as a strong CHF and its effect on exports is likely to have a material impact on GDP.

Even though Switzerland has to normalize their interest rate, at some point strong growth in the economy and low inflation means that the SNB is likely to leave the target rate unchanged for the near future. A rate hike will likely be on the agenda only after the ECB has raised rates, and hence estimate that the SNB will only begin hiking interest rates closer to 2020.

Uncertain global growth filters down to Swiss economy


*Figure 117: Switzerland annual manufacturing PMI (Source: Tradingeconomics.com)*

Switzerland is reporting strong PMI numbers, and growth continues to remain positive. the economic signals for the coming months are expected to remain favourable. Supported by ongoing expansionary monetary policy in the advanced economies and improved labor markets, the global economy is likely to continue to grow. However, following strong growth in previous quarters, the SNB expects growth to slow slightly. Swiss PMI remains at a historically high level, although these levels have tended to precede downturns in the economy. Liquidity indicators still signal a moderately positive outlook on the economy.

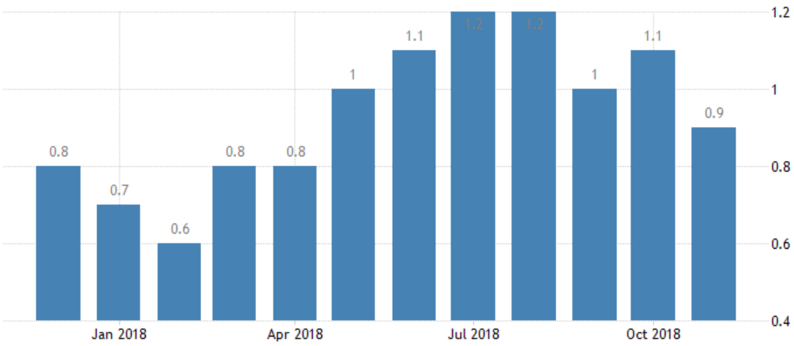



*Figure 118: Switzerland monthly inflation rate (Source: Tradingeconomics.com)*

The SNB expects Swiss growth to be around 1.5% for 2019, just as inflation shows sign of slowing, reflecting a slowdown in the economy. Global trade tensions have shaken the Swiss economy, and it remains to be seen how much further conditions may worsen.

<u>Tapering growth on Trade War?</u>

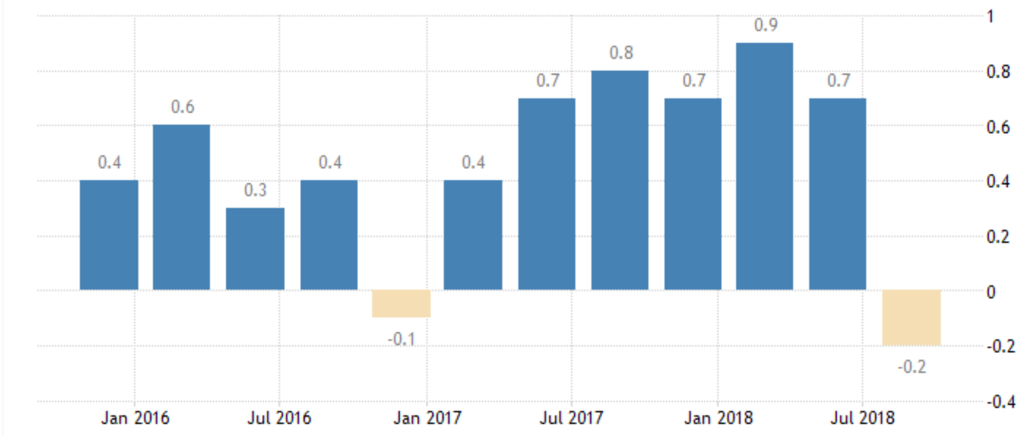



*Figure 119: Switzerland quarter-on-quarter GDP growth rate (Source: Tradingeconomics.com)*

The Swiss economy however, has contracted -0.2% for Q3, against the consensus forecast of 0.4%. This has interrupted the strong growth seen throughout the last five quarters of 0.7% growth. The contraction was largely due to weakness in exports, hit by the slowing growth in Europe and global trade tensions. As a small, open economy, rising global trade tensions are likely to have a significant impact on the Swiss economy, with the Franc likely to be hit hardest if a full-scale trade war breaks out.

The trade war rhetoric presents a potential risk to the Swiss economy as protectionist policies could further dampen and cause a contraction in global trade. The Swiss economy would be hit particularly hard as exports contribute to two-thirds of Swiss GDP. It will also be of interest to see how the SNB reacts to a rise in the Franc, as it is highly likely that the SNB will not cut their benchmark interest rate, which is already the world's lowest at -0.75%.

Overall, Swiss GDP figures continue to report positively, growing at an annualized 2.4% in Q3. This was due to improving capacity utilization and declining unemployment, which is at its lowest rate in almost a decade and expected to continue falling. Leading indicators suggest the economic outlook in Switzerland remains favourable, just slightly below the SNB forecast of GDP growth between 2.5% and 3% for the current year.

The SNB is unlikely to take drastic measures in terms of monetary policy on the backdrop of strong global growth, although the strength of the CHF is something that needs to be monitored. Geopolitical risks may cause the franc to spike, hitting Swiss exporters in the same manner as 2015. The consensus is that the SNB is unlikely to raise rates before the ECB, in addition, the strong growth numbers have not significantly accelerated ahead of the SNB's expected range. The likelihood of the SNB re-evaluating an earlier rate hike is likely to be low amidst these conditions.

<u>FX OUTLOOK: USD/CHF – NEUTRAL</u>

The Federal Reserve's latest decision to continue tightening monetary policy whilst shrinking its balance sheet reinforces the trend of increasing yields in the US10Y and fed-funds rate. The path of monetary policy laid out should continue to attract capital into the US bond market, increasing demand for the dollar, whilst the SNB continues to retain its ultra-loose monetary policy, putting downward pressure on the Franc. On the surface, it may look fundamentally good to be long USDCHF. However, we remain neutral on the USDCHF pair due to global trade uncertainty.

Economic indicators signal that the economy is not close to overheating, which likely kicks the can of a rate hike somewhere further down the road. The Swiss economy is heavily dependent on global growth, as the global economic outlook remains unclear, the path of Swiss central bank actions may come to take market participants by surprise. Furthermore, the risk of safe haven capital inflow putting upward pressure on the Franc is something to consider.

However, the USDCHF pair remained relatively stable even as the US markets fell 7% in October. The recent correction has shown the USD and JPY to be the currencies investors are fleeing to as global volatility rises. The market reaction may point to the CHF's reduced role as a safe haven currency, making the risk of upward pressure on the CHF less likely. This perhaps signals the strong confidence the market is placing in the continued rise of the dollar. Considering the above scenario, a market selloff may actually act as a catalyst to widen the spread between the USDCHF pair.


*Figure 120: Spread between US 3Y and 5Y yields (Source: Bloomberg)*

With the uncertainty of Brexit, Italy and the Euro currency regime, a fear driven rally could cause the Franc to appreciate sharply. Furthermore, the currency is likely to outperform US Dollar denominated assets in a cyclical downturn. With the recent Inversion of the 3-year and 5-year US yields, we are likely in the early innings of a cyclical downturn. With the recent inversion of the 3-year and 5-year Treasury yields, we are likely in the early innings of a cyclical downturn.


*Figure 121: USD/CHF daily chart (Source: Tradingview.com)*

1.0095 has acted as a strong resistance for the pair since the start of the year. The pair has recently bounced off its 100-day moving average, rising to the 0.9973 level before retracing to the 0.9989 level. Although the pair is in an uptrend, we would advise exercising caution, instead waiting for a breakout against resistance at the 1.0095 level before entering the trade with a tight stop loss just below resistance. However, as the price-action of the pair over the year has traded within a range, investors may also consider shorting near the 1.0050 level on a failed breakout and taking profit near the 0.9850 levels.

The potential catalyst from a trade war and subsequent safe haven capital flows would make shorting the USDCHF pair an attractive trade due to the positive risk-reward skew. However, it is still recommended that investors take caution as the central bank has already sent strong signals of their intention to intervene and push the Franc down in the event of a strengthening Franc.

The Swiss economy's reliance on global trade comes as a particular concern in a precarious time for the global economy in the face of slowing growth and global trade tensions. These threaten to destabilize the positive economic conditions seen in the past year, which would have previously been on track to allow Switzerland to normalize interest rates. The continuation of the Swiss' NIRP as global growth falls may drive a huge build up in debt, which may eventually lead to a deleveraging and economic stagnation in the future.

## FRANCE – UNDERWEIGHT

France has the 7th largest economy in the world in terms of GDP and is one of the founding members of the European Union (EU). Regionally, it is the 3rd largest economy in Europe, behind only Germany and U.K, accounting for 14.9% of EU GDP in 2017. Its national currency, the Euro (€), is currently the world's 2nd largest reserve currency behind the US Dollar.

The French economy is developed and heavily dependent on its services and manufacturing industries. Its services sector accounts for 78% of national GDP and employs 70% of the population. The French service industry continues to grow at a steady rate, driven by a booming tourism & fashion industry and bolstered by the large numbers of multinational companies that have established regional headquarters in Paris. Coming in at a distant second, the manufacturing sector accounts for 19% of the GDP and employs 14% of the population. Major manufacturing industries include electronics, automobiles, aircraft, textiles and chemicals. However, this sector is beginning to experience a decline due to competition arising from newly industrialized countries. Agriculture makes up the smallest part of the economy, accounting for only 2% of the French GDP. However, over one-third of all agricultural land in the EU lies within the French border and it is the world's second largest agricultural exporter after the United States. It exports a wide range of products in this sector such as wheat, fruits, dairy products and wine. As such, the agriculture industry makes up a good portion of French exports and is a key part of the broader economy.

France is a major power globally, playing a role in overseeing global peace and security and it is one of five members in the exclusive UN Security Council. Additionally, France is one of the founding members of the European Union, and is a member of G7, North Atlantic Treaty Organization (NATO), Organization for Economic Co-operation & Development (OECD) and World Trade Organization (WTO).

<u>Low interest rates spur growth but concerns remain around looming recession</u>

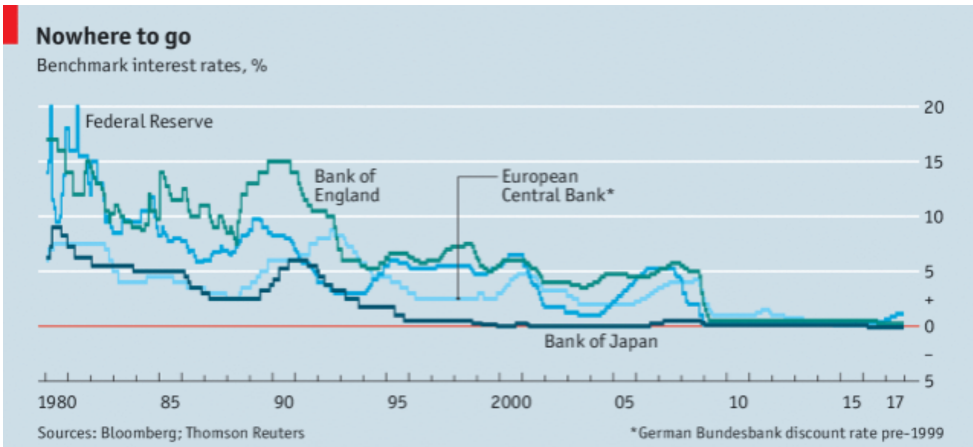



*Figure 122: Central Bank annual interest rates (Sources: Bloomberg, Thomson Reuters, The Economist)*

France's interest rate follows that of the European Central Bank's (ECB). The current deposit rate is -0.4% while the refinancing rate is 0%. ECB interest rates have been dovish, staying at 0% since early 2016. However, with economic growth and inflation figures stabilizing at healthy levels, the ECB announced during its last meeting on 13th September that it will likely end its large scale asset purchase program by the end of 2018 but will maintain low interest rates at least through 1H 2019. Meanwhile, interest rates will hold steady for the time being.

While the low rates have stimulated growth and kept inflations at relatively healthy levels, in 2018 GDP growth of the EU in a low interest rate environment has underperformed that of the U.S despite the Federal Reserve's policy of gradual interest rate increases. The reason why the ECB is still dovish despite growth stabilizing in the EU is the issue of high sovereign debt many EU members such as Italy and Greece are facing. While major European economies such as Germany, France and Poland have forged ahead, other parts of the EU are struggling mightily.

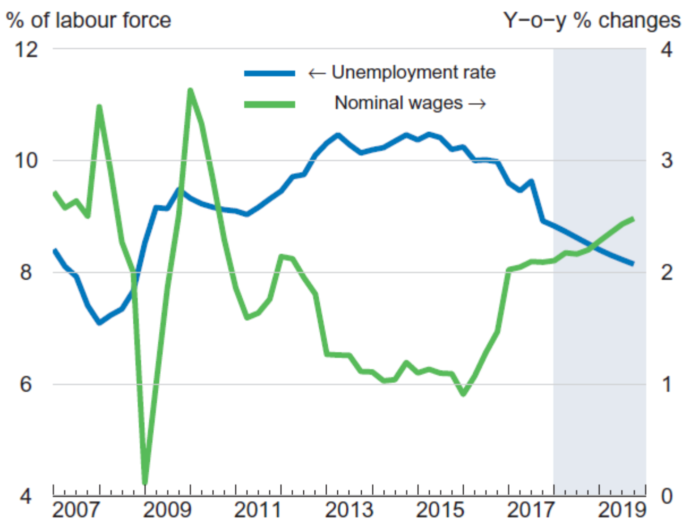
Going forward into 2019, we can expect trade war tariffs and increasing U.S interest rates to take full effect, presenting some headwinds for global economic growth. Should there be an economic downturn in 2019 and interest rates are already low, the only additional fiscal stimulus will have to come from quantitative easing through bond purchases and increasing public spending, which can cause inflation levels to spike out of control and will put France and the EU even further in debt.

Robust growth and healthy inflation going forward


*Figure 123: EU quarterly GDP growth rate (Source: Tradingeconomics.com)*


*Figure 124: France quarterly GDP growth rate (Source: Tradingeconomics.com)*

France's economic growth in 2018 has been solid at over 2%. The forward view going into 2018-19 is that the pace of growth will slow to slightly below 2%. Prior to that, its growth was significantly slower than the EU average and although its economy has improved, the rate of growth is still slightly below the EU average. The growth that we have seen can be attributed to a strong export market and booming business confidence. Furthermore, the corporate tax cuts and low interest rates will continue to support business investment growth. The labor market reforms and reduced labor taxes should boost job opportunities and lift household consumption.




1. Maastricht definition.
*Source:* OECD Economic Outlook 103 database.

*Figure 125: France wage and unemployment year-on-year % change (Source: OECD Economic Outlook)*


*Figure 126: France quarterly inflation rate (Source: Tradingeconomics.com)*

| | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 |
|---|---|---|---|---|---|---|
| | Current prices EUR billion | Percentage changes, volume (2010 prices) | | | | |
| **GDP at market prices** | 2 153.3 | 1.0 | 1.1 | 2.3 | 1.9 | 1.9 |
| Private consumption | 1 186.9 | 1.4 | 2.1 | 1.3 | 1.2 | 1.6 |
| Government consumption | 515.8 | 1.1 | 1.2 | 1.6 | 1.4 | 0.7 |
| Gross fixed capital formation | 469.7 | 0.9 | 2.7 | 3.8 | 3.7 | 4.0 |
| Final domestic demand | 2 172.4 | 1.2 | 2.0 | 1.9 | 1.8 | 1.9 |
| Stockbuilding[1] | 23.5 | 0.3 | -0.1 | 0.4 | -0.3 | 0.0 |
| Total domestic demand | 2 195.8 | 1.5 | 1.9 | 2.3 | 1.5 | 1.9 |
| Exports of goods and services | 621.8 | 4.0 | 1.9 | 3.3 | 3.9 | 4.2 |
| Imports of goods and services | 664.4 | 5.5 | 4.2 | 4.1 | 2.6 | 3.9 |
| Net exports[1] | - 42.6 | -0.5 | -0.8 | -0.3 | 0.3 | 0.0 |
| *Memorandum items* | | | | | | |
| GDP deflator | _ | 1.1 | 0.2 | 0.7 | 1.2 | 1.5 |
| Harmonised index of consumer prices | _ | 0.1 | 0.3 | 1.2 | 1.9 | 1.5 |
| Harmonised index of core inflation[2] | _ | 0.6 | 0.6 | 0.6 | 1.1 | 1.4 |
| Unemployment rate[3] (% of labour force) | _ | 10.4 | 10.1 | 9.4 | 8.7 | 8.3 |
| Household saving ratio, gross (% of disposable income) | _ | 13.9 | 13.6 | 13.8 | 13.5 | 13.4 |
| General government financial balance (% of GDP) | _ | -3.6 | -3.4 | -2.6 | -2.3 | -2.5 |
| General government gross debt (% of GDP) | _ | 120.3 | 123.5 | 121.9 | 122.0 | 121.9 |
| General government debt, Maastricht definition (% of GDP) | _ | 95.6 | 96.7 | 96.7 | 96.8 | 96.7 |
| Current account balance (% of GDP) | _ | -0.4 | -0.8 | -0.6 | -0.5 | -0.4 |

1. Contributions to changes in real GDP, actual amount in the first column.
2. Harmonised index of consumer prices excluding food, energy, alcohol and tobacco.
3. National unemployment rate, includes overseas departments.

*Source:* OECD Economic Outlook 103 database.

*Figure 127: France annual economic data (Source: OECD Economic Outlook)*

Due to economic growth and inflation picking up, the ECB has indicated that it will end its quantitative easing program in the year ahead. This will lead to an eventual increase in interest rates and reduced availability of cheap cash in the market. Inflation in the latest quarter slowed for energy and services while deflation for manufactured products deepened. The recent rise in crude oil prices along with tax hikes on tobacco and energy have increased inflation at the start of 2018. More recently, inflation has been driven by fresh food and tobacco, whose prices are up 11.2% and 16.8% month on month in September respectively. The OECD projects that we will see lower levels of inflation in France in 2019. The harmonized index of consumer prices (HCIP) is expected to decrease to 1.5% in 2019, down from 1.9% in 2018 on the assumption that crude prices will decrease from $80/bl.

A major event that can invigorate the French manufacturing industry and the overall French economy is the trade war between the U.S and China. As tariffs on American products come into play towards the end of 2018, Chinese consumers could be driven away from their American suppliers and towards European producers. For example, in the aviation industry, Xiamen airlines so far has only operated Boeing aircraft in its fleet but is beginning to consider Airbus planes. Hence, although the trade war will hurt consumer and producers across the world, the French manufacturing industry could stand to be a benefactor of such geopolitical events.

Export market to improve but trade deficit won't be reversing anytime soon

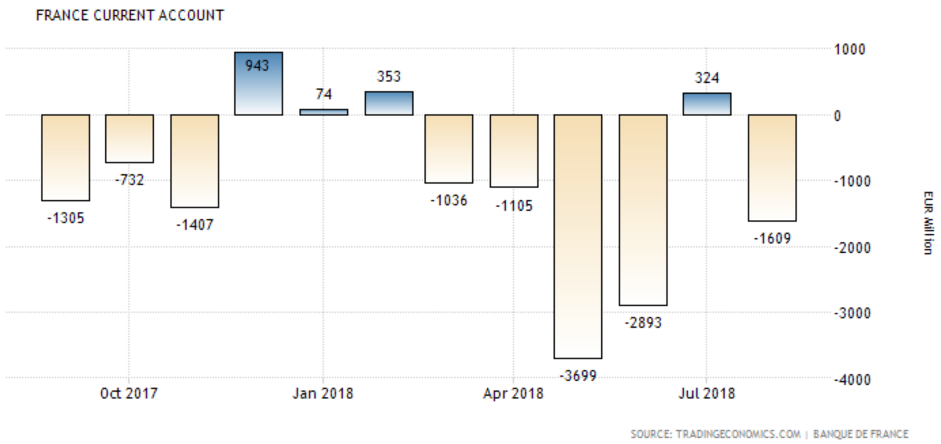



*Figure 128: France monthly current account balance (Source: Tradingeconomics.com)*

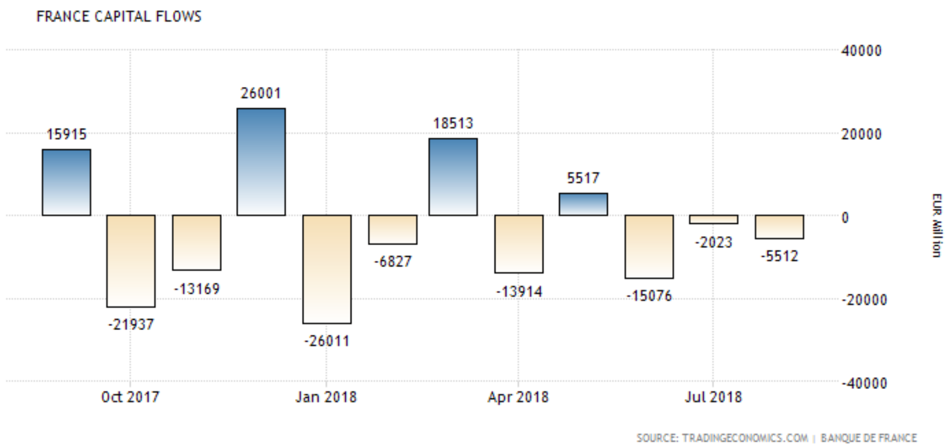
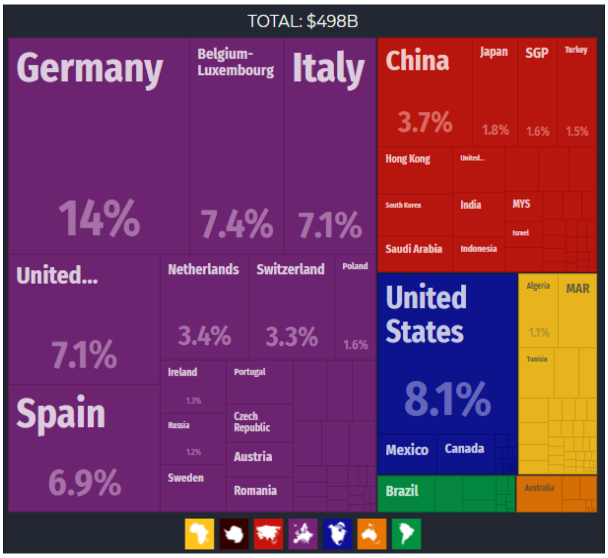



*Figure 129: France monthly capital flows (Source: Tradingeconomics.com)*

France has an annual trade deficit and it has a negative net capital flow so far in 2018, implying that money is flowing out of the country - this could be from a decrease in foreign ownership of domestic assets or from the increase in ownership of foreign assets or a combination of both.



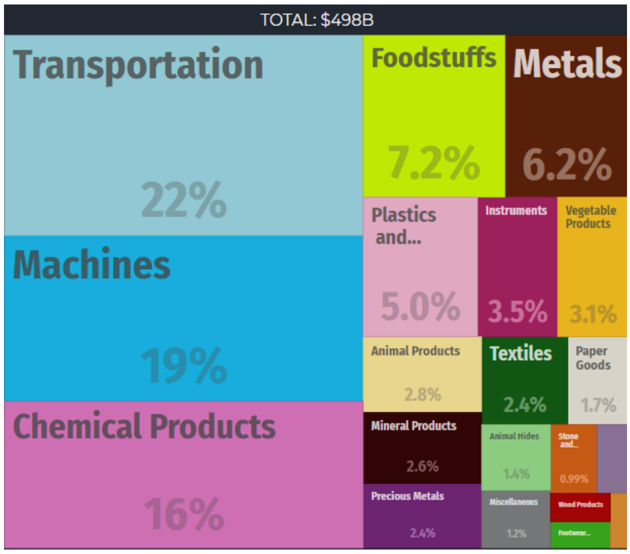
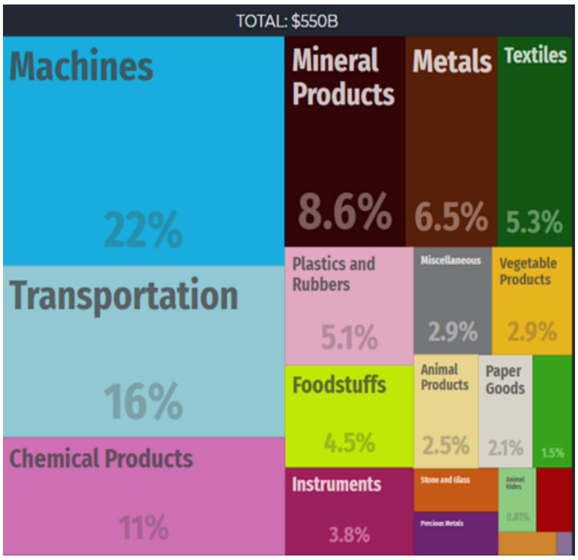




*Figure 130: France's export composition breakdown (Source: Observatory of Economic Complexity)*

*Figure 131: France's export partners (Source: Observatory of Economic Complexity)*



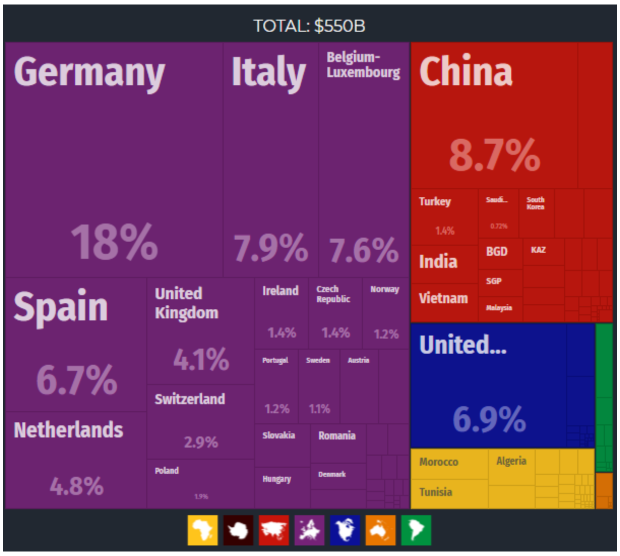




*Figure 132: France's import partners and import composition breakdown (Source: Observatory of Economic Complexity)*

In 2016, France exported US$535B and imported US$624B worth of goods and has had a negative trade balance for 15 years. Top trading partners of France are Germany ($77.4B), Spain ($40.2B), Italy ($39.7B), United States ($38.4B) and Belgium ($36.3B). France's largest import partners are Germany, China, Italy, Belgium and the United States in descending order. Main exports of France come from the manufacturing sector, they include aircraft, packaged medicaments, cars and gas turbines. Major imports of France are cars, aircraft parts, crude oil, packaged medicaments and refined petroleum. As it is a part of the EU, France is part of the free trade agreements the EU has negotiated. Also, due to the interconnected economy of Europe, France's interests are heavily invested in the upcoming Brexit as well as the ongoing Italian debt crisis. The fate of the British workforce in France and French employees residing in Britain heavily hinges on the EU and U.K reaching a deal for Brexit.

The Gilet Jaune Movement - Popular discontent with President Macron

The movement began on 17th November as a demonstration against the rising price of fuel, that when combined with the increased taxes on diesel, pushed pump prices to record highs. The protests soon gave way to a generalized outcry against in their opinion President Macron's pro-rich economic policies.

In an effort to quell public displeasure, President Macron on 10th December announced concessions that include raising the minimum wage, abolishing taxes on overtime pay and on pensions. However, this will send France's budget deficit to 3.5% of GDP, higher than the previous target of 2.9% and over the 3% limit imposed on members of the eurozone. The yellow-vest protests could potentially threaten to reverse changes President Macron has already made to labor law, taxes and the national rail company - although the concessions mean President Macron risks a dispute with the European Commission and increases France's borrowing costs, this is necessary to dispel the yellow-vest protests and allow him to push on with his reforms.

FX TRADE IDEA: SHORT EUR/USD


*Figure 133: EUR/USD daily chart (Source: Tradingview.com)*

EUR/USD has been largely range bound in 2H 2018 after a depreciating significantly against the dollar in 1H 2018. The price movement in the first half of the year is due to the strength of the U.S economy and the Federal Reserve's increasing interest rates, which has led to capital inflow into the

U.S, strengthening the dollar. Meanwhile, despite the ongoing Italian debt crisis, the ECB plans to end quantitative easing by end of 2018 remains on track, interest rates are expected to be increased halfway through 2019 and will remain very low. In the 6-month to 1-year lens, we can see the interest rate difference between the EUR and USD increase further and will send the EUR/USD further down.

**Entry: 1.1337**

**Take Profit: 1.0850**

**Stop Loss: 1.1512**

The risks and drawbacks of holding a short EUR/USD trade are that if the EU economy outperforms that of the U.S and the ECB pushes forward interest rate hikes, we could see the euro strengthen significantly against the dollar. Even in downturns, such as the 2008 financial crisis, the EUR/USD depreciated significantly as assets went towards safe havens such as gold, the Swiss franc, the Japanese yen and the U.S dollar.


*Figure 134: iShares Euro Stoxx 50 UCITS daily chart (Source: Tradingview.com)*

A possible way to mitigate or hedge against this risk would be to enter a long position in an ETF tracking the Euro Stoxx 50 such as the iShares EURO STOXX 50 UCITS.

## CAC 40


*Figure 135: CAC40 daily chart (Source: Tradingview.com)*

The Cotation Assisteé en Continu, also known as the CAC 40 is a benchmark index that tracks 40 of the 100 largest market cap stocks on the Paris Bourse. On a year-to-date basis, the index is down 6.50%. Up to the end of September, the CAC 40 was still up 3% YTD and unlike its German counterpart, most of its components did not seem to be affected by trade war sanctions. However, in October 2018, global confidence waned, leading to large corrections across all markets. With Euro Stoxx 50 down by slightly more than 10% YTD, the CAC 40 has shown greater downside resilience compared to the broader European market. As global growth slows due to tightening interest rates and effects of the U.S-China trade war manifests itself in the global financial markets, we can expect volatility to continue.

ETF TRADE IDEA: SHORT iShares MSCI France ETF

**Listed on: NYSE ARCA**

**Ticker: EWQ**

**Expense Ratio: 0.49%**

This ETF covers the French stock market, holding the stocks of many French multinationals and conglomerates in industries such as Energy, healthcare, luxury goods, industrials, financials and consumer staples. Largest holdings include TOTAL (9.58%), SANOFI (6.77%), LVMH (5.71%), AIRBUS GROUP (4.38%), BNP PARIBAS (4.13%) and LOREAL (3.79%). Year to date returns are at 2.86% while in the longer term, 5-year returns, and 10-year average annual returns are 5.8% and 4.8% respectively. Over 50% of the holdings comprise of multinational corporations with large parts of their businesses coming from outside the EU, as such a slowdown in other markets will influence this ETF as well.

Recently, lost confidence in the Chinese markets and reduced consumption of luxury goods have led to LVMH losing 14% of its market capital in the month of October alone.


*Figure 136: iShares MSCI France ETF daily chart (Source: Tradingview.com)*

**Entry (Short): 28.27**

**Take Profit: 25.29**

**Stop Loss: 29.70**

EWQ has been trading in an upward channel for the past 10 years. In view of recent news and market tremors, the ETF has broken areas of resistance such as the 200-day moving average and new lows have corresponded to new lows in the RSI. Going forward into 2019, growth is expected to slow due to rising interest rates around the world, including that of the ECB as it ends its quantitative easing. As such, the upward trend EWQ has experienced has most likely come to an end and should see a downtrend in the next few months. When it reaches the bottom of the channel in the next few months, we can expect heavy resistance and should look out for signs of reversal based on market fundamentals.

# GERMANY – UNDERWEIGHT

Germany is the largest economy in Europe. With the 5th highest Gross Domestic Product (GDP) in the world, Germany's economic performance has been impressive, with growth rising to 2.5% in 2017. Accounting for 21.3% of the Euro area economy in 2017, Germany exports a large portion of the world's most complexed products to manufacture, hence known as the economic powerhouse of the eurozone. They are also the founding member of the European Union and Eurozone.

<u>Dovish Interest Rates Eating into Capital Funds</u>

Earlier this September, the Governing Council of the European Central Bank (ECB) has decided that the benchmark interest rate on the main refinancing operations to hold steady, remaining unchanged at 0.00 as seen from the charts below. The ECB cut the rate below zero four years ago, aiming to boost lending and growth by making it relatively more attractive for households and firms to spend more.

However, with almost one in five German companies having their banks charge negative interest rates, Germany's social security funds are slowly but surely eroding. With Germany's booming economy, taxpayers are paying more in social welfare contributions than ever before. As the social funds grow, negative interest rates instituted by the ECB also means that their returns are diminishing. The state pension fund lost €49 million last year with below zero interest rates eating away at its capital. Interest rates are expected to remain dovish, with the bank stating its lack of plans to raise interest rates until next summer at the earliest. In the meantime, capital funds are set to suffer.

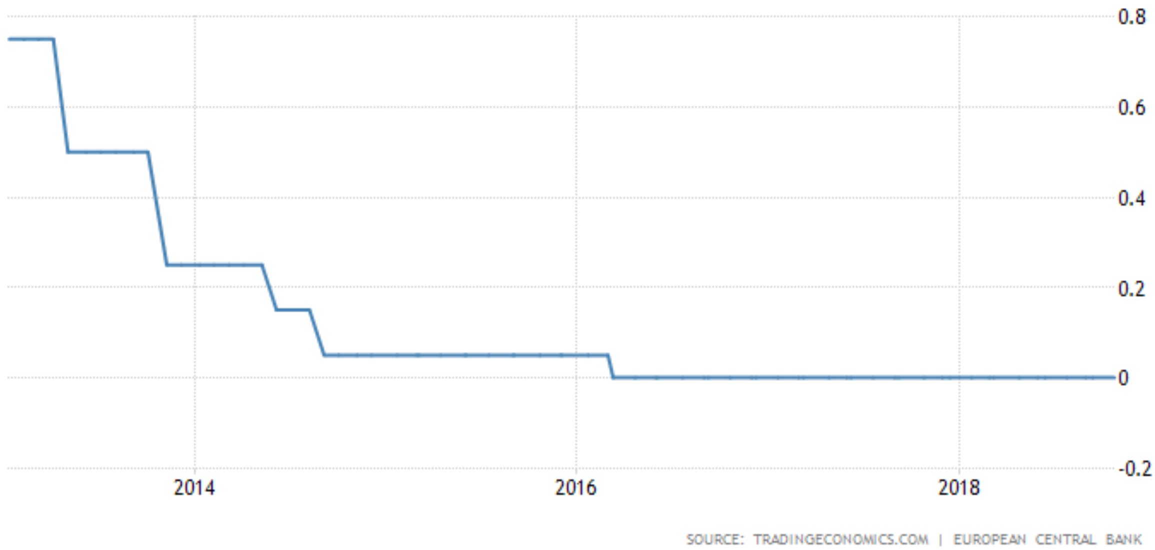



*Figure 137: ECB annual benchmark interest rate (Source: Tradingeconomics.com)*

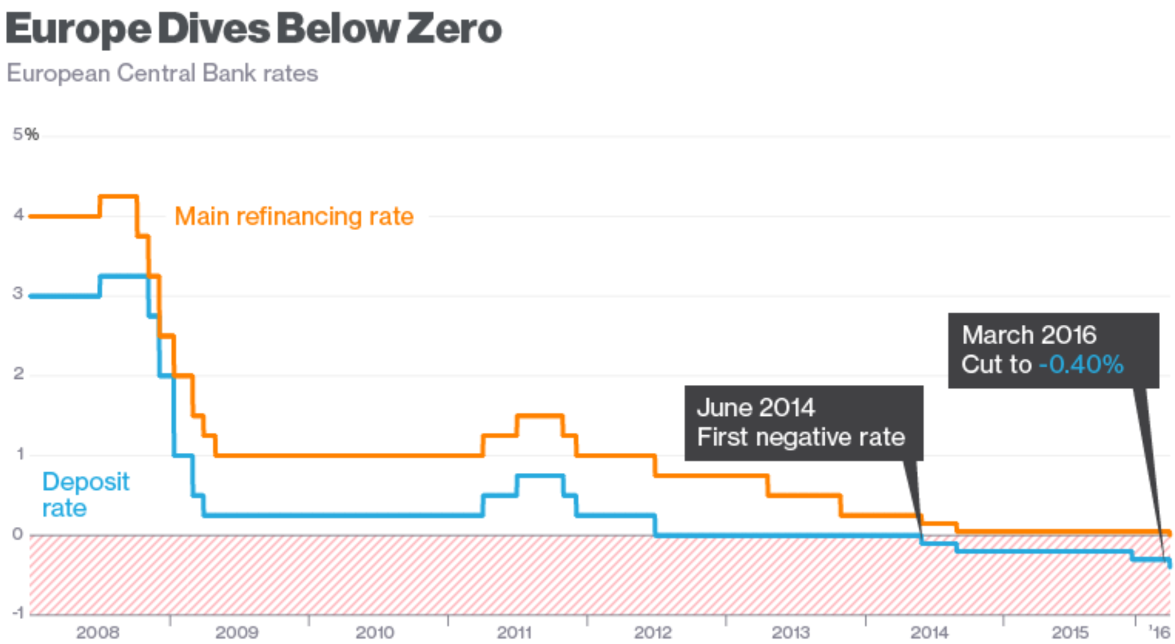



*Figure 138: ECB annual interest rates going below zero (Source: Bloomberg)*

<u>German Economic Growth: Stronger than Expected</u>

The German economy GDP growth was confirmed at 0.5% on quarter in the three months to June of 2018, following a 0.4% growth in the previous period. Solid domestic demand was seen to be the reason for this positive outlook, with household consumption and state spending as the largest contributions. Household expenditure was supported by elevated consumer confidence thanks to the rising income expectations. Looking at the third quarter, consumer confidence edged down in August with rising cost pressures, but business sentiments increased on improving business expectations. Moreover, the composite Purchasing Managers Index (PMI), an indicator of economic health for the manufacturing and service sectors, rose for a third consecutive month. This signals continuous improvement of the German firms' operating conditions which translates to greater private consumption.

Germany also received a silent boost through the quantitative easing effects from the European Central Bank (ECB). The ECB has been pumping stimulus into the Eurozone economy by buying €30bn of assets each month for the past two years. This was reduced to €15bn a month after September and is scheduled to end completely by the end of 2018. With Germany as the biggest economy in the Eurozone, they have received the largest proportion of ECB's bond-buying.


*Figure 139: Germany quarterly GDP growth rate (Source: Tradingeconomics.com)*

However, ongoing global trade tensions and political risks could potentially cloud the positive growth outlook. Germany's decade-long economic upswing is threatened by the United States' higher tariffs on Europe's imported cars, a move that would hit Germany's flagship industry hard. Germany's GDP is now expected to grow 1.9% this year, instead of the previously forecasted 2.3%. If the German economy was given the chance to expand at its potential growth rate without such interruptions, we predict considerably higher growth for the German economy. While domestic demand is set to continue supporting the German economy, mounting protectionist tendencies and international trade conflicts will create uncertainty and definitely hurt all economies involved.

Germany's annual inflation rate increased to 2.3% in September 2018 from 2% in the previous month and in line with the preliminary estimate. It was the highest inflation rate since November 2011, as prices of services, energy and food increased at a faster pace. Energy prices climbed 6.6%, food prices up 2.6% while services inflation was milder at 1.6%. German inflation surpassed the target set by the ECB for the eurozone in June, the second month in a row it has done so, lending support to the ECB's decision to close its bond purchase scheme at the end of the year.

With Germany facing the lowest unemployment rate, highest CPI, increasing inflation and low interest rates, painful memories of the 1930s hyperinflation come to the fore. Germany's economy is so propped up by the negative interest rates and the glut of quantitative easing money that the ECB is fast pushing the boundaries of credibility. As export orders surges, the industry is working overtime and wage pressures are inevitably picking up. Germany's biggest trade union, IG Metall, is threatening all-out strikes unless employers meet demands for an inflation-busting 6% pay hike this year. Inflation is a huge risk that threatens Eurozone stability.


*Figure 140: Germany's monthly inflation rate (Source: Tradingeconomics.com)*

<u>World's Largest Current Account Surplus</u>

Germany's current and capital account surplus narrowed to EUR 15.3 billion and EUR 14.5 billion in August of 2018 respectively, as seen in the charts below. With Germany on track to record the world's largest current account surplus for the third year in a row, it is no doubt that German is doing well externally. This is largely the result of its trade balance, with exports expected to exceed imports by EUR 265 billion at the end of this year. Since 2011, Germany's current account surplus has been consistently above the European Commission's indicative threshold of 6% of gross domestic product which, if it is continuously exceeded, can entail policy recommendations.


*Figure 141: Germany's monthly current account balance (Source: Tradingeconomics.com)*


*Figure 142: Germany's monthly capital flows (Source: Tradingeconomics.com)*

Germany's major trade partners include the United States, China, the Netherlands and France. The top exports of Germany are Cars ($154B), Vehicle Parts($58.1B), Packaged Medicaments ($50.5B), Planes, Helicopters, and/or Spacecraft ($34.1B) and Human or Animal Blood ($17.8B).

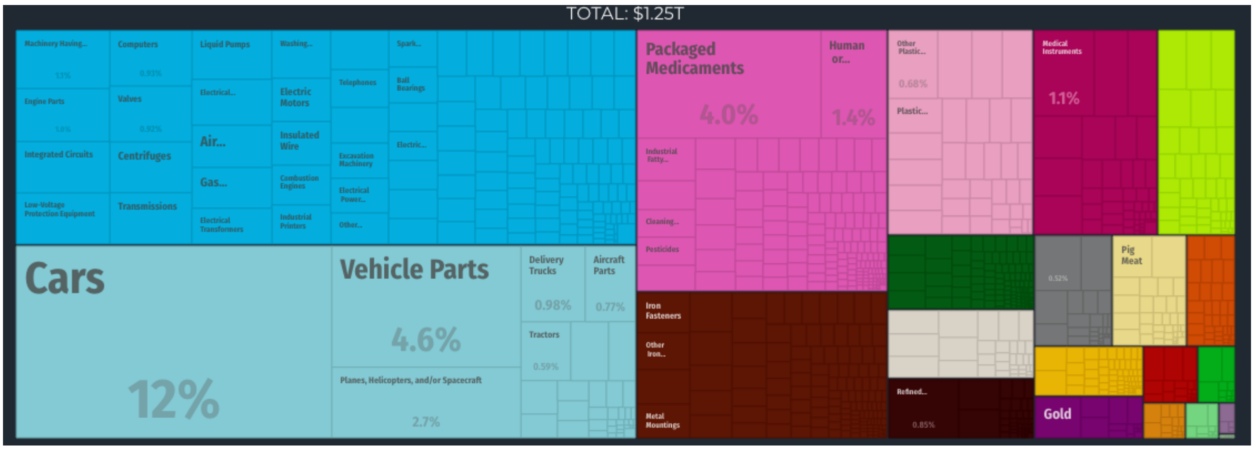



*Figure 143: Germany's export composition breakdown (Source: Observatory of Economic Complexity)*

Additionally, their top imports are led by cars and vehicle parts, which represent 5.37% and 3.86% of the total imports of Germany respectively.

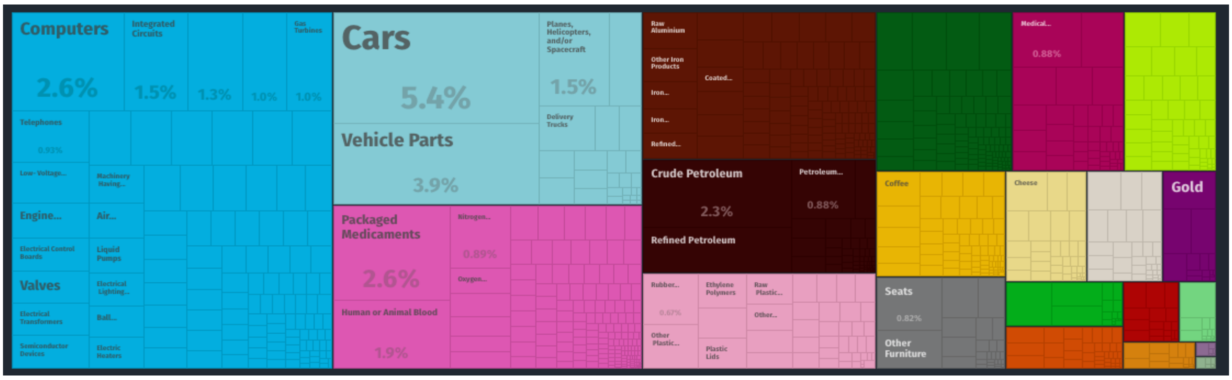



*Figure 144: Germany's import composition breakdown (Source: Observatory of Economic Complexity)*

The EU has already concluded agreements with numerous countries; others are pending. All 28 EU states, including Germany, is involved in the European-Canadian Economic and Free Trade Agreement (CETA), a free trade agreement (FTA) between the EU and Canada. The FTA was signed back in end 2016, and provisionally applied since 2017, eliminating 98% of the tariffs between Canada and the EU. Canada is already an important partner for Europe – and vice versa. Around 9.5% of Canada's foreign trade is with the 28 EU Member States, and German small and medium-sized firms are already investing a lot in and exporting a lot to Canada – thereby safeguarding jobs and prosperity in Germany. With CETA in place, their economic relations will become even more intense. Additionally, the EU also sees a trade agreement with South America's Mercosur by the end of this year, with negotiations and trade talks already in the midst. Behind closed doors, the Transatlantic Trade and Investment Partnership (TTIP) is also a major new deal being negotiated between the EU and USA.

## FX TRADE IDEA: LONG EUR/GBP


*Figure 145: EUR/GBP daily chart (Source: Tradingview.com)*

The GBP has been under some immense selling pressures with the rising risks for a hard Brexit. GBP markets are faced with an unprecedented set of political risks. With the exit of Britain from the EU, Britain can no longer enjoy the lowered trade taxes, causing the loss of confidence in them. Layered on top of these is the uncertainty connected with the PM's weak position and the potential that the next UK government could be more left-wing than any since the 1970s. From the perspective of a currency, a weak government is typically a negative factor. With the uncertainty on Brexit, they have been depreciating significantly against the Euro.

**Entry: 0.87499**

**Take Profit: 0.90504**

**Stop Loss: 0.86392**

We should hence enter the trade at 0.87499, where it hits the long-term support, catching the bullish trend. Once it hits the resistance from the Fibonacci retracement at 0.90504, we should take profit. Stop loss would be placed just below the short-term support line at 0.86392.

RISKS

However, the risk is the uncertainty of what would happen after the Brexit occurs with unconfirmed plans proposed by PM. It now lies in Britain to see how they are able to execute their plans moving forward. If they manage to regain investors' trust, the sterling is sure to appreciate again. But as of now, with high uncertainty over the next 6 months and Brexit only taking place in May 2019, we believe that Euro would remain stronger than the pound. Further depreciation of the pound should be observed and the bullish momentum is expected to stay.

ETF TRADE IDEA: LONG iShares MCSI GERMANY INDEX FUND

**Listed on: AMEX**

**Ticker: EWG**

**Expense Ratio: 0.49%**

This ETF covers the Germany stock market. As of July 2015, EWG has its funds invested in 60 German stocks. iShares MSCI Germany top holdings allocates 22% to consumer cyclical, 15.7% to financial services, 15.5% to health care, 14.2% to basic materials and 11% to industrials. The fund's holdings are highly concentrated with well-known and established companies, such as Bayer AG, Daimler AG, BASF SE, Siemens AG and Allianz SE. These amount up to 37% of EWG's holdings. The top 10 holdings of the company account for 57.5% of the total assets invested. iShares MSCI Germany demonstrated a 10-year standard deviation of 23.9%, experiencing higher than average volatility due to EWG's high exposure to cyclical sectors such as financial services, consumer discretionary and industrials. However, they also yield returns at 7.05%, which is slightly higher than the comparable return of 5.64% of MSCI Europe Index.


*Figure 146: iShares MSCI Germany ETF daily chart (Source: Tradingview.com)*

**Entry: 24.34**

**Take Profit: 31.04**

**Stop Loss: 23.00**

EWG has been trading within a downward channel, with RSI hovering around the low 30s and long red candlesticks indicating significant selling pressures. This is due to the recent market rattles and volatility which left stock investors reacting in alarm. With the MACD crossing below the signal line indicating a bearish trend and RSI in oversold conditions, we should hence enter the trade at 24.34 where a possible reversal upward trend can be seen. Once it hits the resistance at 31.04, it then signals us to take profit.

With Angela Merkel's quitting as a party leader, it is now up to her successor to make Germany fit for the future. Under Merkel's legacy, Germany has experienced record-low unemployment rates and budget surpluses. However, some of Germany's biggest economic issues have also surfaced, with decaying infrastructure and the auto-industry's electric-car struggles becoming more evident. As technological advances and the number of Germans 25 and under getting driving licenses declining 28% in the past decade, 114,000 German automotive jobs are threatened to be eliminated by 2035. Germany's once-envied network of roads, bridges and railways are also decaying due to decades of underspending. We believe that Merkel's approach in running Germany has sidelined major economic initiatives that left a growing list of challenges for the next chancellor.