

Quarterly Update

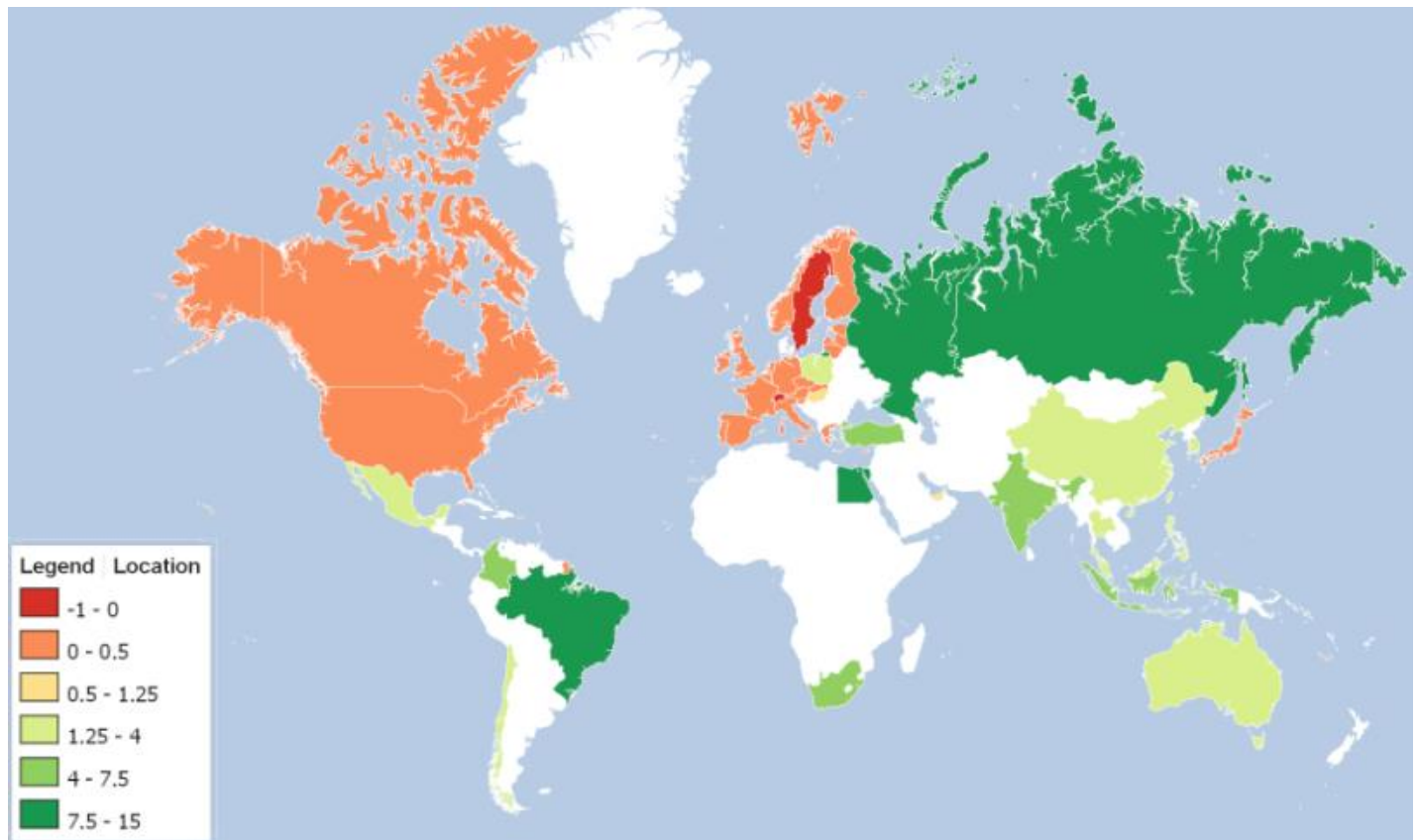
ETF Securities Research and Roubini Global Economics

What Happens When U.S. Interest Rates Rise?

Our global growth baseline is an unsynchronised expansion, with pockets of recession, but a great deal depends on how the U.S. economy copes with the coming increase in interest rates.

- Our first key theme for our Q4 update is monetary policy divergence, with the Federal Reserve's forthcoming rate "normalisation" front and centre for investors, even as other central banks, notably the Bank of Japan and the European Central Bank, continue to ease. Our expectation is for a December Fed "lift-off", but the risks of a later hike are significant.
- Our second theme is Europe's internal and external challenges, with the refugee crisis, the rumbling Greece calamity, the possibility of "Brexit" and elections in Spain (just one manifestation of the Eurozone's toxic politics) dovetailing to create huge uncertainty around the European project.
- Third, is the question of whether emerging markets are victims of their own success, with a long period of robust performance failing to spark the necessary adjustments and reforms to allow that to continue.

Heatmap: Roubini's end-2015 Nominal Policy Rate Forecasts (%)



Source: Roubini Global Economics

Key Macro Theme 1: Our Fed Call and its Implications

We now see the December FOMC meeting as the likeliest time for the first Fed hike, but recognise there is a high risk a delay, depending on inflation performance and financial-market conditions.

Fed Will Hike in December, Unless...

If there are no new surprises, Fed officials have given ample notice that a 2015 rate hike is on the cards. The September Summary of Economic Projections showed that 13 of 17 FOMC members expect to raise rates this year—a clear majority, even if that number dropped from 15 in July. Those forecasts were made in full knowledge of the current economic outlook and financial conditions, so, absent unexpected bad news, the FOMC will hike this year. Various Fed officials including Chair Janet Yellen are on the record favouring such a move.

Arguments offered by Fed officials for hiking rates include:

- Monetary policy involves long lags, so waiting to hike until inflation nears the 2% target risks an overshoot.
- Slamming on the brakes to regain control over inflation is more costly to the economy than starting early and moving gradually, and moving early means moving now.
- The Fed's policy goals are nearly achieved, while the Fed is still in an extremely stimulative stance.
- Easy monetary policy can induce asset bubbles, which can damage the economy when they collapse. As Fed officials are not confident in macroprudential tools for dealing with bubbles, it is prudent to “lean against the wind”.

Risks to December

With doves losing the debate as it stands, a further delay in Fed rate hikes depends on new developments. The [September FOMC statement](#) and Fed chair Janet Yellen's comments in her press conference both highlighted financial conditions and risks from overseas as key to the near-term policy outlook. Yellen also said deteriorating conditions outside the U.S. make domestic labour-market performance more important to the Fed's inflation goal. That combination of concerns gives us this list of conditions for delaying Fed rate hikes into 2016:

- Unresolved problems in China create substantial risk of further trouble for the rest of the world.
- Fragile emerging markets risk further capital flight, and weaker currencies and demand add to disinflationary pressures.
- The U.S. labour market may be cooling already, lessening its contribution to future inflation.
- Core inflation remains weak, with core PCE (the Fed's preferred measure) well below core CPI.
- An oil price plunge could push core PCE below 1% (energy prices feed into services, such as airfares).

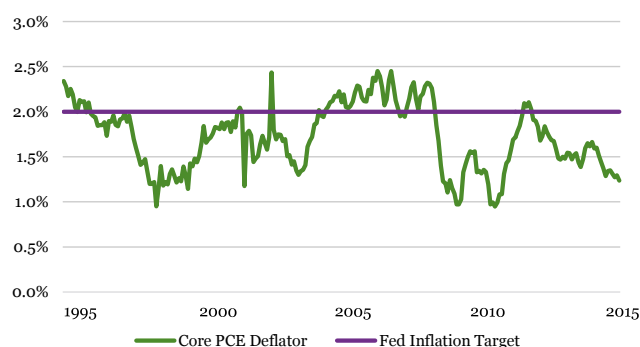
- Higher-cost oil investment (shale, offshore) could slump.
- Further Dollar strength could lower the path of inflation and reduce domestic growth.
- Budget and debt ceiling debates conjoin in December.

Global Implications

The approach of Fed hikes has already slowed, and even reversed capital inflows into emerging markets. In aggregate, we see emerging-market currencies and the shorter end of the emerging-market curves as the asset classes most vulnerable to the rise in U.S. rates, but country selection remains critical. Our Resilience to Fed Normalisation Indicator, which assesses the resiliency (or vulnerability) of different emerging markets to the Fed's upcoming policy shift (and their ability to benefit from the strong U.S. demand that a Fed hike implies), shows substantial regional and cross-emerging-market divergence.

Mexico and the Philippines display a higher capacity to cope with Fed hikes. India is the only country to have seen a meaningful increase in resilience since the “Taper Tantrum” in 2013. Brazil, Chile, Colombia and Indonesia all remain vulnerable to Fed hikes due to their domestic vulnerabilities. None of these countries have much scope to benefit from U.S. demand either.

Figure 2: U.S. Core Inflation Below Target and Falling



Source: U.S. Bureau of Economic Analysis, Roubini Global Economics

What to Watch

- **Key Signpost 1—Inflation.** The FOMC needs to be “reasonably confident” it will achieve 2%.
- **Key Signpost 2—Unemployment.** “Some further improvement” is needed in the labour market. Given the recent weaker labour-market prints, this bar is rising.
- **Key Signpost 3—Financial conditions.** A hiking cycle with VIX>20, stocks dropping and credit spreads widening? Not very likely.

Key Macro Theme 2: Europe's Internal and External Challenges

Europe remains in the middle of a very difficult transition, with diverging aims making it hard for the continent to reach a stable equilibrium, even within organised “clubs,” such as the EU or Eurozone. The Greek, Ukrainian and refugee crises are a testament to this difficulty.

Refugee Crisis Illustrates EU's Deficiencies

Europe's refugee crisis is just a small part of the global refugee crisis. It seems likely to last for a few more years and intensify further. The EU has traditionally treated this as a public order issue that could be delegated to recipient countries, particularly Italy and Greece, and is one of many examples of how the EU and Eurozone struggle to come up with policies to share common problems; instead, leaving those problems to individual states.

Although the number of refugees entering the EU is small relative to the size of the EU's population (some 500 million), popular sentiment in most European countries is by and large anti-migrant, especially towards non-Europeans. They are an easy target in the context of very high unemployment rates (particularly among the young) and anaemic real wage growth. Even citizens of the relatively strongly growing UK are now broadly anti-migrant, let alone citizens of economically weaker EU member states. Cultural and religious prejudices add to the anti-migrant resentment, and populist and protest parties of the far right are rising in the polls.

Meanwhile, the EU will try to survive the crisis and “muddle through”, as it always does. Refugees already in the EU are likely to be redistributed across the region (some countries, such as the UK, have opted out), relieving a fraction of the burden weighing on Italy and Greece. And we believe countries will use migration as a “bargaining chip” for other negotiations, whether on fiscal flexibility, structural reforms or even debt relief, as in the case of Greece. A country willing to accept more refugees will feel entitled to receive leeway on other fronts, especially fiscally. For example, if Italy and Greece continue to shoulder the heaviest burdens, they are likely to be given additional fiscal space or more time to adopt reforms.

Europe at Risk of Disintegration

The refugee crisis is just one of the formidable destructive forces to which the “European Project” is now subject. These can only be contained for some time, and need decisive political action from those who want to induce or force further European integration. “Accidents” triggering break-up risk could happen anywhere, at any time.

For example, pro-independence parties won a majority of seats in the Spanish regional election in Catalonia on September 27, which could snowball into a more generalised political crisis in Spain, where the left-wing Syriza-like Podemos has become a

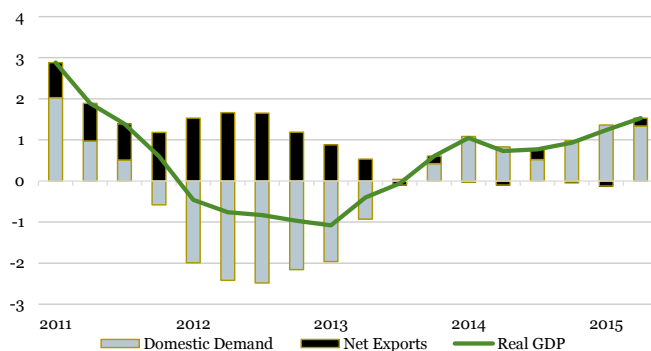
serious contender. Equally, in Italy, if Prime Minister Matteo Renzi fails to get parliamentary approval for his proposed reform of the Senate, a return of the pernicious political instability of the past could choke off Italy's economic recovery.

Meanwhile, the rise of Jeremy Corbyn to the Labour Party leadership in the UK increases the risk of “Brexit,” with Labour's support for staying in the EU perhaps no longer as rock solid as it has been, although the new leader has decided to placate the rank and file on this issue, for now.

All this indicates Europe is still in the middle of a very complicated transition that will change its shape over a number of decades. Whether this will be towards greater integration or disintegration will depend on policy makers and politicians.

We currently regard the return of nation states (a “downside” scenario) as more likely than the introduction of a full-fledged transfer union (implying greater integration, but also a more flexible internal organisation), both being risk scenarios flanking the baseline of continued “muddle-through.”

Figure 3: Domestic Demand Is Supporting Eurozone Growth as External Demand Fails to Pick Up (% y/y)



Source: Haver Analytics

What to Watch

- **Greek tragedy:** The ongoing risk of a “Graccident” or even a “Grexit.”
- **Spain's election:** The December general election could see a lurch towards anti-system parties.
- **“Brexit”:** The risk of the UK leaving the EU is real, with the Labour and the Conservatives both struggling with Eurosceptic elements.

Key Macro Theme 3: Are Emerging Markets a Victim of Their Own Success?

A long period of robust performance raised the bar for emerging markets, but little was done in the good times to prepare for the downturn.

Have Emerging Markets Reached Bottom?

After the global financial crisis, emerging markets generally had space to stimulate their economies by monetary and fiscal means, and strong growth, especially compared with developed markets, attracted a lot of easy money. However, these trends built up balance-sheet vulnerabilities (debt levels) that have contributed to slower growth and weaker asset performance.

Given the considerable weakening of nominal and trade-weighted real exchange rates in emerging markets over the past few years (particularly sharp in recent weeks), and the fact that such large cumulative losses have previously marked a “bottom”, it is tempting to look for an upturn in emerging-market FX, if not to ask whether a contrarian “long” stance could ultimately prove hugely profitable.

We believe a secular rally will not materialise for a long while. The balance of risks points to further weakness of fundamentals over the next year, and low yields (in absolute terms, even if they look better compared with developed markets) will, in the medium term, punish emerging-market currencies.

Emerging markets’ policy adjustments in late 2013 and early 2014 focused on allowing depreciation and limited rate hikes, sometimes extending to reining in fiscal largesse, scrapping wasteful subsidies and other sensible moves. Although these efforts were particularly impressive in Indonesia and India, they have proved insufficient in the rest of the “Fragile Five”; the responses were either short-lived (Turkey), unambitious (South Africa) or almost solely monetary (Brazil).

The commodities glut resulted in terms-of-trade shifts that required sizeable depreciation in countries, such as Colombia, Russia and Malaysia, but, overall, little was done to improve current account deficits, let alone attract foreign direct investment. Moreover, the weakness in oil prices allowed many consumers (Turkey, India and South Africa) to coast without making reforms, deferring adjustment. Although few emerging-market sovereigns have much external debt, private-sector debt has risen rapidly.

Inflows Will Slow or Reverse

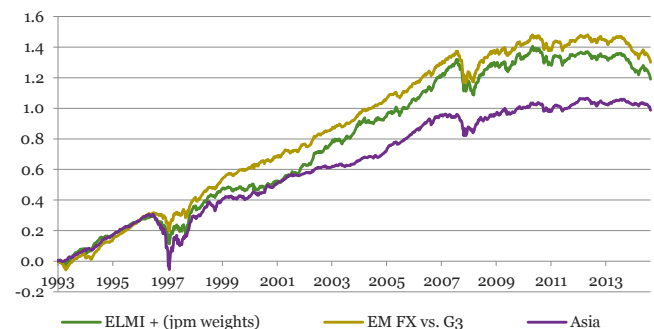
The quantitative easing era in particular has seen huge portfolio inflows—close to \$200 billion per year, mostly into debt. Equity flows have been steadier, with inflows surging to \$75 billion in 2014. In 2015, “mayhem” in Russia, Brazil, China and elsewhere has cut these flows in half, bringing them down

to “only” \$11 billion a month, according to the IIF.

Although this domestic currency borrowing can be seen as a triumph—having deepened local capital markets and reduced local currency and default risk—it is one of the vulnerabilities we have worried about since the late 2013 emerging-market mini-crisis. The pressure on FX markets as portfolio flows slow (let alone reverse) has proven to be a major risk, which led to large sell-offs during the global financial crisis and periodic panics in 2011-15.

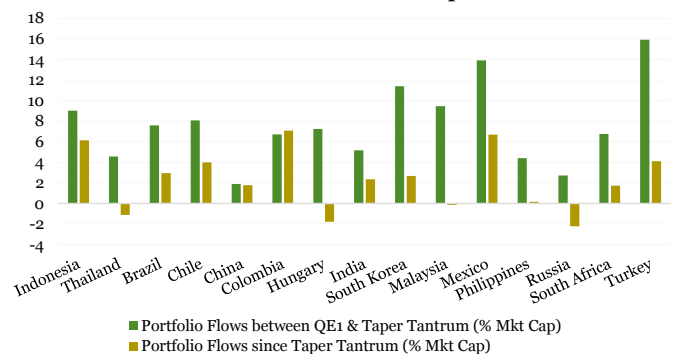
Recently, approaching Fed rate hikes, a commodity slump, and a sudden, if modest, weakening of the renminbi have caused a slow-motion train wreck that does not yet appear to have run its course. The cumulative losses of over 15% are similar to the losses in the Asian crisis of 1997-98 and the 2008-09 global crisis, but the exchange rate moves have been far less sharp. Going forward emerging-market FX could remain under moderate pressure.

Figure 4: EM FX—Cumulative Losses Large but Slow and Partly EUR-Driven (total return, log-scale)



Source: JPMorgan, Bloomberg, Roubini Global Economics

Figure 5: Capital Inflows Have Slowed Since 2013's Taper Tantrum (% of market cap)



Source: Haver Analytics, Roubini Global Economics

Surveying the Major Economies

United States

The U.S. has recovered from its Q1 slowdown and is on its way to moderately robust full-year growth of 2.6%, which would be the strongest result since well before the Great Recession.

Growth will run a bit faster in H2 than H1, as the benefits of employment growth and low energy costs boost household incomes and the oil-sector drag on investment diminishes.

Core inflation remains near cycle lows and will remain so even as the Fed prepares to begin hiking. Weak core inflation will limit the hikes to a slow pace, with a risk of lengthy pauses.

There is downside risk to the U.S. outlook from overseas. Weaker growth abroad would be a drag on U.S. exports through trade, and on inflation through the Dollar and commodities. We see growth slowing, unlike consensus.

Eurozone

The Eurozone is cyclically rebounding, but risks to the outlook are now more tilted to the downside. Turning the expansion that began in 2013 into a stronger structural recovery will be tricky without fiscal support and more investment.

Germany and Spain remain the main growth engines. Italy and France are benefitting to varying degrees from a cyclical upswing, but their growth rates will remain low (albeit perhaps higher than their current potential).

Inflation will remain subdued due to the lagged effects of the past Euro depreciation, lower oil prices and abundant spare capacity. We expect the European Central Bank to expand its asset-purchase (quantitative easing) program if the outlook deteriorates. True to form, this is likely to be late, as the Bank tends to react rather than be proactive.

The political environment remains challenging. Upcoming elections could generate headwinds if new governments do not continue adjustment plans and anti-system parties gain.

Emerging Europe

Diverging monetary cycles in the U.S. and Eurozone and low commodity prices will sharpen regional differences. Eurozone-linked economies, including the CE3 (the Czech Republic, Hungary and Poland), will benefit from the Eurozone's recovery and the European Central Bank's quantitative easing, as lower yields help finance investments and drive net export growth.

But low energy prices and the weak Ruble will lead to a 3% contraction in Russia this year and only a weak recovery next year. In Turkey, political worry and the weak Lira will keep consumption and investment depressed, and in turn growth.

In the CE3, despite stable currencies (versus the Euro) and low commodity prices, headline inflation will probably rise, due to closing output gaps. In Russia, inflation of around 10% in 2015 should subside in 2016 for the reverse reason. In Turkey, slowing growth is likely to be balanced out by a weaker Lira, resulting in headline inflation of 7% in 2015-16.

We expect policy divergence across the region. In the CE3, rates should remain stable, with an easing bias in Hungary. Russia, though, will probably slow its easing, and Turkey may start tightening in early 2016, after the Fed.

Asia/Pacific

China's transition radiates uncertainty through Asia and the world. By making greater use of the market to allocate real goods and now, financial assets, China is adding more volatility into its economy. "Managed turbulence" is our baseline.

That is unavoidable volatility but unwanted, contributing, along with the determination of policy makers to achieve too high a GDP growth rate, to lower investment and commodity prices across the region.

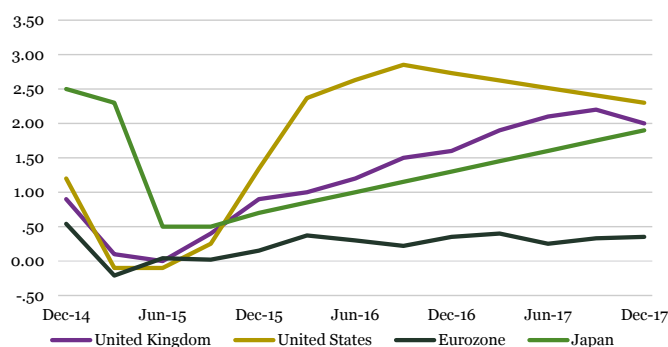
The hardest-hit economies are those with a high reliance on the Chinese market and trade (such as Hong Kong, Singapore and South Korea) and/or little room for countervailing macro policies (most of the Association of Southeast Asian Nations).

Latin America

The global environment remains unsupportive for Latin America, with external shocks battering already shaky domestic fundamentals. The region looks set to be the weakest-performing emerging-market segment in 2015 and 2016.

FX has helped absorb the commodity-based terms-of-trade shock, with most currencies now looking more fairly valued. Brazil and Colombia look vulnerable to some extra FX weakening given the poor quality of financing. Argentina looks set for a sharp FX adjustment next year, and there are high odds of a Venezuelan "credit event".

Figure 6: Stuck at Zero Rates, With Energy Prices Tumbling, Large Economies Struggle to Hit Inflation Goals



Source: Haver Analytics, Roubini Global Economics

Asset-Class Implications: Fixed Income

Developed-Market Rates

As we expected, G4 sovereign bonds have recovered from the sell-off at the end of Q2, with macro fundamentals eventually kicking market-related factors out of the driver's seat.

Our narrative for this asset class remains broadly intact: Long-term bonds in the U.S. and UK will be vulnerable to monetary-policy normalisation, while those in the Eurozone and Japan will continue to enjoy central bank support.

We have pushed back our "lift-off" targets for the Fed and Bank of England (to December 2015 and February 2016, respectively). As a result, we have lowered our projection for the U.S. 10y yield (to 2.3% at end-2015 from 2.5%).

UK 10y gilts will continue to follow Treasuries (along a lower trend), with the spread between them likely to remain around 30 bps. However, we expect considerable divergence at the front end, and maintain our call for 2y spreads to widen by more than is priced in as Fed rate normalisation begins.

Long-dated bund yields remain far above the lows (around zero) touched earlier this year, hovering closer to the midpoint of the 0-1% range we expect to prevail over the next few years—a reflection of the ongoing cyclical recovery and reduced deflation fears in the Eurozone.

We have revised our end-2016 target for the 10y bund yield up to 0.6% from 0.5%. Lower Treasury yields and higher bund yields imply slower 5y yield spread-widening.

Emerging-Market Rates

Despite some divergence, the next 12 months promise to remain challenging for emerging-market economies and assets amid rising U.S. rates, low commodity prices, sluggish growth, tepid trade and softer capital inflows.

Some near-term catalysts could provide a reprieve, including firming commodity prices and stabilising sequential growth in China due to delayed Fed hikes.

Nonetheless, daunting economic and debt hurdles are likely to restrain any rally. Despite our caution on emerging-market assets, we prefer longer-dated bonds to FX, and see benefit in avoiding countries with excessive exposure to China and commodities, poor financing quality and high inflation.

External debt is susceptible to the U.S. curve repricing, with investment-grade spreads still too low to be attractive—we see negative return for EMBIG.

Brazil, Turkey, Colombia and Malaysia should underperform. Despite the FX hit, the longer ends of most local yield curves look better positioned for a modest rise in U.S. yields and

declines in trend growth at home.

Developed-Market Credit

U.S. and UK spreads have been widening steadily for over a year due to a combination of factors: Deteriorating fundamentals, large supply and, more recently, financial-market volatility and heightened emerging-market risk.

We maintain our negative view on U.S. investment-grade credit, but we are more negative on European investment grade, with spreads at just half U.S. levels.

We remain neutral on U.S. high yield, as higher spreads (630 bps for the asset class overall; over 1,000 bps for the troubled energy sector) price in rising default risk over the next few years. Investors will need to absorb issuance and fallen angels.

Conditions remain fairly benign outside of commodity-related sectors, but the leverage cycle is fairly long in the tooth, with creditworthiness deteriorating even before the Fed makes its first rate hike.

Interest costs will only go one way (at least for a while) and, if earnings prove weak, spreads have further room to widen.

U.S. investment-grade spreads and European spreads (both investment grade and high yield), in contrast, are still tight and have been less affected by turbulence in emerging markets. M&A and buybacks will keep the supply pipeline at full blast.

The ongoing quantitative easing programs at the European Central Bank and Bank of Japan may explain some of this divergence, but the risk-adjusted return on European investment-grade credit still looks awful (not as bad as when spreads were at 40 bps, pushed lower by 10y bund yields at nearly zero), although corporates are hardly releveraging.

Figure 7: Sub-Zero Shadow Funds Rate—What an 'Emergency Policy Stance' Looks Like to Fed Hawks



Source: Fed Board of Governors, Wu and Xia (2004), Roubini Global Economics

Asset-Class Implications: Equities

Global Equity

The macro outlook has turned negative for global equity, with uncertainty around our baseline rising significantly. We now see a 30% likelihood of an adverse scenario, and our upside scenario has nearly vanished (5%).

Despite the market correction, valuation still does not offer much cushion against that uncertainty. 2015 looks more like a flat/down year rather than the mid-single-digit returns we expected in December last year.

Developed Markets

Under our baseline, we expect the S&P 500 to end this year at 2050, down from our previous view of 2150. For 2016, we have revised our forecast down to 2150 from 2200—we expect a 5% gain over the next 12-18 months.

Our 12-18 month downside scenario remains 1500 and our upside scenario is 2300, with the balance of risks skewed to the downside, although recession risk remains low.

We have trimmed our 2015 earnings per share target to \$119 from \$122, driven by weaker-than-expected oil prices. This lower earnings-per-share growth outlook, coupled with pressure on multiples stemming from policy and macro uncertainty, drives our S&P 500 forecasts.

The higher volatility and China risks undermine our positive views on Eurozone and Japan equities, but we still see this as a risk scenario and maintain our baseline positive view.

In Japan, the momentum behind structural reforms (the so-called “Third Arrow” of Prime Minister Shinzo Abe’s policy program, “Abenomics”) have been a key supporting factor for Japanese stocks since last year, from the Transatlantic Trade and Investment Partnership (TTIP) to governance.

We expect more support for Japanese equities on the back of continued progress on this front. Market-price action suggests investors are optimistic about reform prospects, especially for domestically focused firms, with those undertaking shareholder-friendly measures outperforming.

A reduction in cross shareholding, a key element of governance reform, should support Japanese equity overall, with domestic firms benefiting in particular.

We maintain our long-standing positive view on Japanese equity (Yen hedged) versus MSCI World, although we acknowledge the downside risk from the turbulence in China.

Emerging Markets

Although the European Central Bank’s quantitative easing and the Bank of Japan’s so-called quantitative and qualitative

easing are supportive of emerging-market assets, the approaching Fed rate hike and weak commodity prices (oil and base metals) adversely affect their financing costs and earnings. We now expect emerging markets to underperform MSCI World.

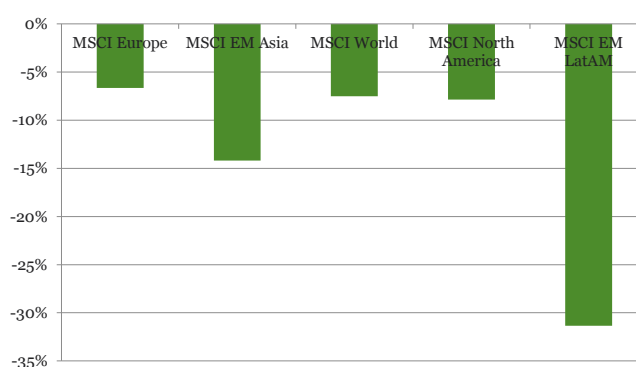
Lower valuations are offset by weak earnings, debt issues and a host of external and domestic risks, indicating that emerging-market equity will underperform developed-market equity.

Corporate defaults and banking problems that will lead to dilution and/or bailouts have not yet peaked.

Within the emerging-market universe, we prefer South Korea and Mexico, which are exposed to U.S. demand.

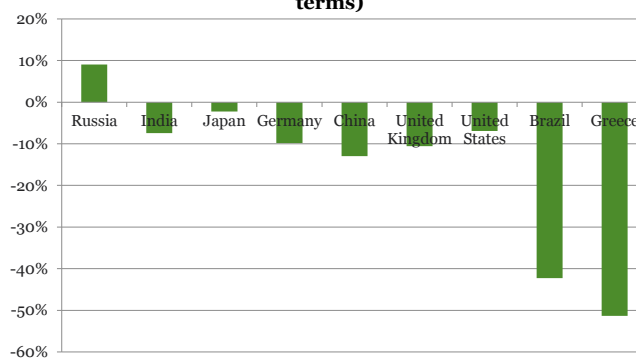
Over the past few months, we have downgraded our view on the outlook for Turkish equity to negative on the back of a higher risk of Turkey losing its investment-grade status; we have moved our views on Polish and Russian equity to neutral from positive, on election uncertainty and weak oil prices, respectively; and we have moved our outlook on Thai equity to neutral from negative, on the back of monetary easing and accelerated infrastructure investment.

Figure 8: Total Returns by Region Year-to-Date (USD terms)



Source: Bloomberg

Figure 9: Total Returns by Country Year-to-Date (USD terms)

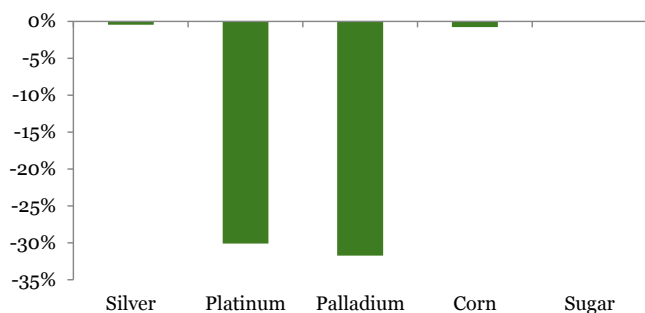


Source: Bloomberg

Asset-Class Implications: Commodities

Commodity supply is being cut back after five years of continuous negative price performance. A number of commodities from copper, platinum, corn and even sugar are likely to be in a supply deficit this year. That will help eat into inventory that has built up over the years.

A Number of Commodities Enter a Supply Deficit in 2015



Source: GFMS, Johnson Matthey, USDA, ETF Securities

Oil will remain in a supply surplus until at least the middle of next year, but the wheels are turning in the right direction, with upstream capital investment being cut back severely in the wake of the drop in oil price over the past year. Organization of the Petroleum Exporting Countries (OPEC), will however continue to produce at a breakneck pace as it strives to gain market share.

We identify several shocks that could move commodity prices. Beyond the macroeconomic risks, that could see interest rate increases postponed (which would be gold price positive), weather risks could shock some commodities. We are currently in the most severe El Niño since 1997. Should history be a guide for the future, we could see corn, cocoa and sugar prices rise, while coffee, soy and US natural gas prices are likely to fall.

Summary of agricultural price expectations

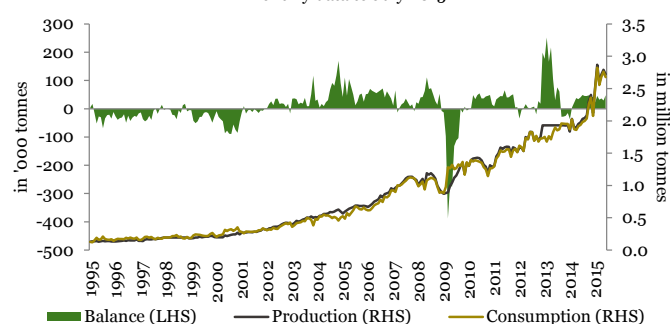
Price Projection	Overall
Arabica Coffee	↓
Sugar	↑
Cocoa	↑
Wheat	↔
Soybean	↓
Corn	↑

Source: ETF Securities

Less progress in supply cuts have been made in aluminium and certain other base metals that see their supply heavily driven by China's production decisions. While China started the year committed to economic reform that would see markets play a

more decisive role in decision making, a number of mishaps (notably the country's stalled attempts at injecting market dynamics into the equity market) has made progress in this regard disappointing.

China Aluminium Balance

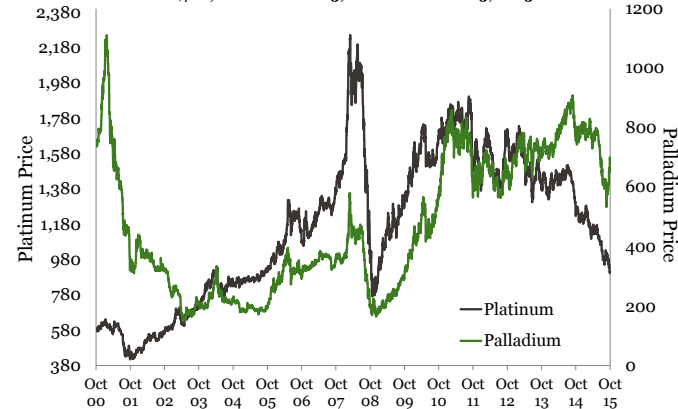


Source: World Bureau of Metal Statistics

US dollar appreciation is likely to cap commodity price gains in the final quarter of this year, although any disappointing data in the US could paradoxically be commodity price positive if rate rise expectations are pushed out further.

The Volkswagen emissions scandal revealed on 18 September caused a sharp divergence in sentiment resulting in platinum's premium over palladium trading at its lowest level in 13 years. Despite an improvement in the demand outlook for platinum from jewellery and investment, negative sentiment for platinum continues to weigh on prices. While fears of a consumer shift in preference for gasoline cars, buoyed by robust US auto sales have helped palladium reverse its downward trend.

Platinum's premium vs Palladium trades at a 13 year low



Source: Bloomberg, ETF Securities

Asset-Class Implications: Foreign Exchange

The debate over the outlook for rates and central bank stimulus (alongside uncertainty over the Chinese economic growth path) continues to be the dominant driver of G10 currency pairs. As a result, volatility remains a key fear for investors across asset markets and currencies have not been overlooked.

Nonetheless, currency volatility has moderated and we anticipate more subdued volatility levels in Q4. We expect underlying growth and policy fundamentals to sway market sentiment as investors focus on the underlying economic outlook for the global recovery in the coming months.

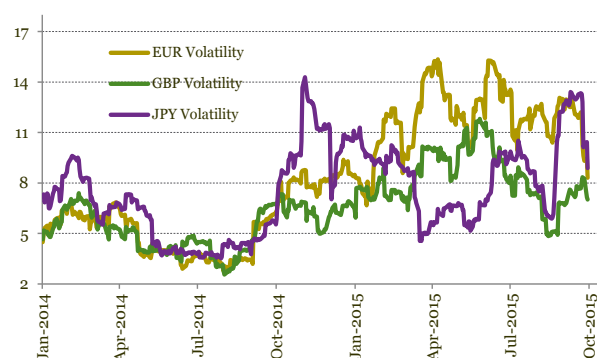
Low oil prices are keeping inflation measures subdued globally and this will encourage many central banks to continue their aggressive easing stance toward year end and into 2016. Indeed, it is only the US Federal Reserve that we expect to tighten policy this year.

A result of the benign inflationary environment, central bank accommodation will continue to be a feature of the currency landscape for the foreseeable future. Policy rates will remain low or negative to support economies and this will predictably exert continued downward pressure on exchange rates. Currency wars will therefore remain a consequence of such stimulatory central bank policy, whether or not it is a stated direct policy objective or not.

Currency adjustments will help improve international competitiveness for countries significantly exposed to global trade and encourage import competition. We remain structurally bullish on the US Dollar in the medium term, expecting tighter policy by year-end.

The Euro, Yen and Norwegian Krone are likely to be the underperformers as growth outlook remains subdued and central banks firmly in stimulus mode. Low rates and the flood of liquidity is likely to keep these currencies under pressure and 2016 could see further easing of policy to support growth and lift inflationary expectations. Any tightening of policy is not expected ahead of 2017 at the earliest.

Currency volatility moderates



Source: Bloomberg, ETF Securities

USD: Rates to (finally) move higher

FOMC members seem torn as to when to hike rates, with several members appearing comfortable with 2015 as the appropriate time to tighten policy, while others feel that this year would be too early.

See-sawing market expectations of when the US central bank will raise benchmark rates has kept the US dollar largely rangebound against major currencies. But it has been a wide range and while currency volatility has declined, USD trading has been choppy.

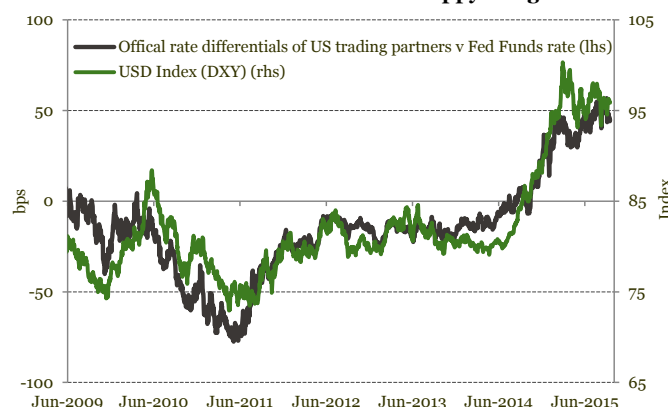
After some expected consolidation, the US Dollar looks primed for further gains in the Q4 of 2015 as the US Federal Reserve embarks on its long anticipated tightening cycle.

We expect the next leg of the USD's rally will be driven by the continuation of the US economic recovery and investor expectations for tighter policy from the Fed, in stark contrast with those for other major central banks. Currently the market is almost pricing in a rate hike for early 2016. Economist estimates are slightly more hawkish.

The Fed has been balanced in its communication with investors, noting that the economic recovery remains solid enough to justify the beginning of policy tightening this year. There is stronger evidence of wage growth alongside rising household spending. In turn, the strengthening economic environment has seen inflation indicators begin to improve. A gradual and well communicated tightening cycle combined with the Fed maintaining a healthy balance sheet is unlikely to derail the US recovery, but it should keep the USD well supported.

The USD Index has consolidated and has moved broadly back in line with interest rate differentials in recent months. Accordingly, we feel that any weakness is an opportunity to again establish long positions.

USD Consolidates in Choppy Range



Important Information

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