October 10, 2014

Fed douses hopes of policy normalization

By dispelling the illusion of a potential normalization of U.S. key rates, the publication of the FOMC minutes served as the rain on the global capital markets' parade. The market's bluff, which consisted of fearing the Fed would take a hawkish turn while hoping it would do just that (thus lending weight to the theory of a U.S. economy strong enough to forego the Fed's easy money policy), has been unmasked. The Fed will not change the direction of its monetary policy in the foreseeable future and, as we expected, this scenario raises a number of questions:

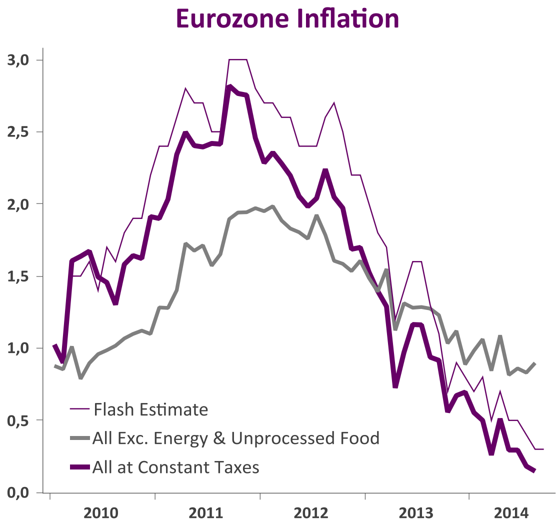
1) **On the fundamental economic situation,**
2) **On the credibility of the consensus that long-term interest rates would rise and the dollar would see a healthy appreciation.**
3) **On the foundation of hopes developed on the markets and therefore their valuations.**

That the market reaction has been negative to this point is entirely understandable.

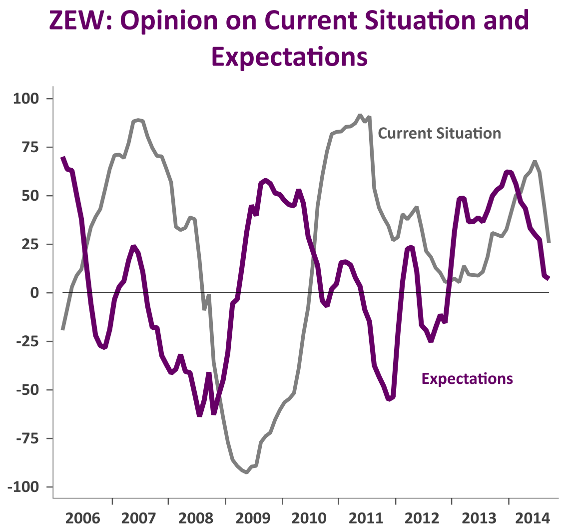
No quick turnaround in sentiment given light agenda

Next week's economic agenda does not offer much hope as to the possibility of easing current concerns. In the euro area, annual inflation continued to fall (to 0.3% according to initial estimates) further highlighting the dire straits we find ourselves in. German wholesale prices will also be watched closely and could very well follow the downtrend in recent months. Last week, agricultural prices confirmed the trends currently at work.

The results of the ZEW survey in Germany are expected to confirm the downfall begun several months ago, which will not come as good news either. Although the current conditions may stabilize, before falling further later in the year, anticipations about inflation will most likely break the zero bar starting this summer, which is a harbinger of bad economic data and the IFO poll to be published later this month.



Sources: RichesFlores Research, Macrobond



Sources: RichesFlores Research, Macrobond

No data is expected from China and U.S. numbers (quarterly corporate earnings, retail sales, Philly Fed and New-York ISM), although probably still encouraging, could very well be not enough to change the general consensus or to restore confidence in the global outlook.

Barring a seismic economic surprise in the next few weeks, markets will have to look to policymakers for a lifeline. In this regard, there are several possibilities that could arise:

- Not much is expected out of the Fed, save perhaps an extension of QE for another few months should sentiment become more worrisome than it already is today on the capital markets ahead of the next FOMC on October 28th and 29th.

- Mr. Draghi will likely have little extra leeway prior to the next ECB meeting in early November. Investors will be hanging on his every word. Is he ready to brandish the bazooka needed to really impress the markets? And there's the rub!

- Policies are heating up in Europe where Germany and the European Commission are working together on a possible program to stimulate investment. A wave of announcements is likely in the coming weeks but there have been no details as to the type and size of the potential measures at this point.

Pending fiscal and monetary news, investors are likely to remain skittish.

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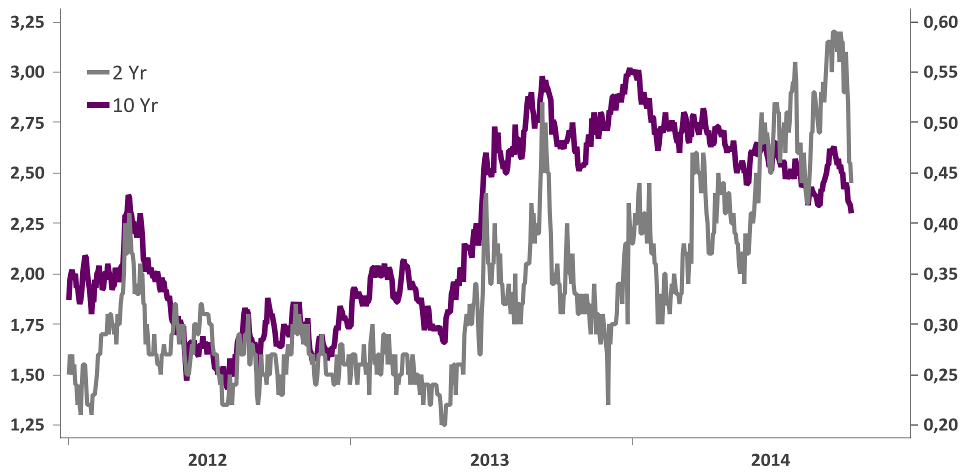
Risk aversion likely to dominate in near term

Persistent appetite for bonds.

The move to reposition on U.S. bonds is expected to continue, particularly on the shortest maturities (less than 5 years), yields on the two-year are significantly higher than they ought to be given the lack of a Fed rate hike. Our forecast is for a ten-year around 2.10-2.30% to December in line with a drop in the two-year of around 30 basis points.

US Bond Yields



Sources: RichesFlores Research, Macrobond

The long-term interest rates in core European countries could also shrink even more. Our scenario predicts 10Y bunds bottoming out at 0.8% to the end of the year, i.e. 10bp lower than where they are today. At this point, French yields seem capable of following the trend. The situation for southern countries is more critical but could be protected by forthcoming ECB T-LTROs and ABS purchases.

Oil down, renewed interest in gold

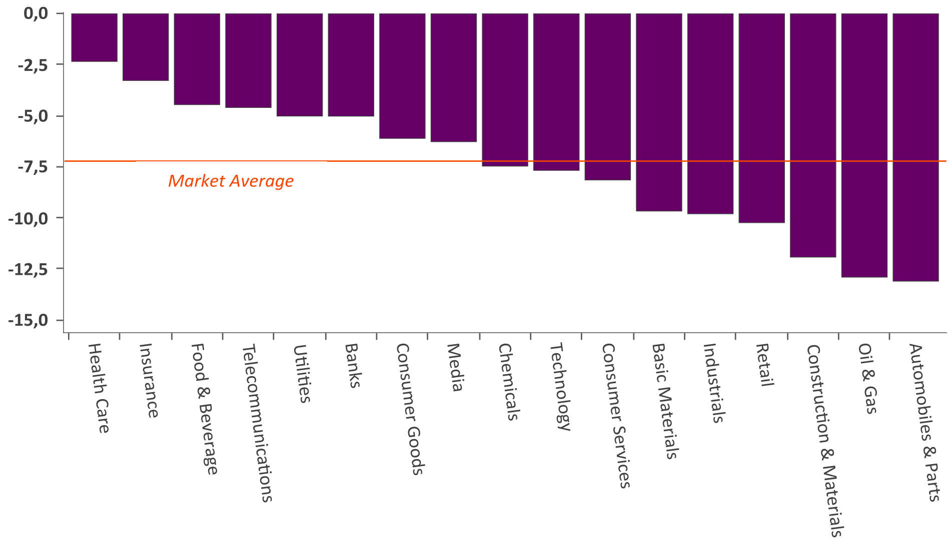
The acceleration in the drop in oil prices is poised to continue against the backdrop of fresh concerns over the medium-term global economic outlook. Our scenario stays the same: brent at $90/barrel with $75 being the low-end figure (see "*Clouds gathering for risky assets*" from May 2014).

Precious metals, which have taken a battering in recent months by higher long-term interest rates, have become attractive once again despite the low level of inflation around the globe.

Oil reflation

The correction in recent weeks has weighed particularly heavily on the most cyclical stocks listed on the exchanges, which is a trend that could very well continue. The effects of falling commodity prices on activity and margins in the sectors that are most exposed to commodities could, however, gradually become a game changer. Cheaper energy prices are a major component in purchasing power. Hypothetically, if oil falls to $80/barrel, energy prices could dip 10% per year before springtime in Europe, which would be the equivalent of a 1% shot in the arm for households' purchasing power. If this materialized, and we see the probability as being fairly high, the outlook for consumption would be improved and the deflationary pressure that is currently weighing on companies in the consumption sectors (retail, services, hotels/restaurants/leisure) would ease. Ironically, a sharp drop in commodity prices, particularly in energy, could therefore be effective in countering falling margins and creeping deflation.

Sector Performance of EUROSTOXX Since September 4, 2014



Sources: RichesFlores Research, Macrobond

Such developments could take time before taking shape. At this point, we continue to be very reserved on the outlook for the equity market, particularly industrial stocks and, by extension, the German market.

Relative Performance of the Dax, Jan. 2013=100

Sources: RichesFlores Research, Macrobond

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