SAXO BANK

TradingFloor·com Insights

# Quarterly Outlook

Q3 · 2014

## Energy's shadow

*STEEN JAKOBSEN, Chief Economist*

**"Energy prices remaining elevated could be the thing to upset the applecart as, if Brent Crude averages USD 130/barrel during Q3, then world economic growth will slide"**

## Welcome to Saxo Bank and TradingFloor.com's Insights 2014 Q3 Outlook

Energy's shadow looms large this quarter as a potentially fearful conflict in Iraq unfolds.

The immediate impact of the militant Sunni march on Iraq's oil fields can be counted in the cost of barrels lost to the ravages of war, but the longer-term uncertainty is likely to have a far more damaging impact on markets.

While global markets have stuttered, the stability of the oil price in the last few years has been a relative comfort. An escalation of tensions in Iraq can of course be met with a ramp-up in production from other OPEC members – albeit not without placing considerable pressure on OPEC kingpin Saudi Arabia – and the US too can, if Congress gives the nod, turn the taps on given its game-changing shale revolution.

But this is a fine line. If oil prices burst through to the upside this quarter, the ramifications would certainly spill over into other markets and eventually trigger reduced growth prospects.

Throw into the mix the ongoing difficulties in Ukraine and the dangers in trying to reinvent the art of Kremlinology as a means of predicting Russia's next move, the likelihood of a price surge happening only becomes more probable.

The globe needs an energy solution. Without that, another year of promising growth will be wasted.

Kim Fournais
Co-founder and CEO of Saxo Bank

Lars Seier Christensen
Co-founder and CEO of Saxo Bank

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CONNECT WITH LARS: 

# Contents



# On the edge

**Unless something is done urgently to correct our dangerously imbalanced system that favours a privileged minority, we're in a mighty jam indeed.**

*by STEEN JAKOBSEN, Chief Economist*

Writing this from South Africa I just realised I have been to every continent in the world and the conclusion is this: I meet extremely smart and capable investors, CEOs and traders in every single country I go to, but they all face a terrible macro environment. The world continues to have great micro structures and a horrible macro environment.

My Bermuda Triangle of Economics theory (high stock market valuations, low employment, low productivity) continues to gain traction because of entitlement transfers and the 80/20 rule. The 80/20 rule states that 20 percent of the economy, the listed companies and banks, get 100 percent of the credit and political capital available.

Meanwhile, the 80 percent is suffocated through banks being unable to lend to them because of excessive bureaucracy and frequent late payment of invoices by governments.

This means the credit due to the 80 percent is transferred to the listed companies, effectively lowering their cost of capital by 100 to 200 basis points, which of course makes the higher stock market valuation "reasonable". This entire system is kept in place by blind faith in **quantitative easing** and the notion that stocks are the only investment.

This quarterly outlook reflects this mood perfectly – Mads Koefoed in his macro piece remains positive that US growth will come after a disastrous Q1 (-2.8 percent); Peter Garnry sees stocks outperforming bonds; John Hardy sees a slightly weaker US dollar and a need for higher volatility; Ole S. Hansen reckons the price of oil will remain elevated but in a range, while gold will be under pressure but also in a range.

But what would be the catalysts should the consensus view fail to materialise? China's property market and its high refinancing needs could be one such trigger.

France and/or Germany falling off the cliff in terms of economic growth because of the significant slowdown in exports to Asia could be another.

Finally, energy prices remaining elevated could be the thing to upset the applecart. If Brent crude averages USD 130 a barrel during Q3 then world economic growth will slide. Ironically, the one element that spurred any growth at all in the US in Q1 was consumption – but consumption of…. energy!

Higher energy is a tax on consumption – a consumption which is under pressure globally from higher food and energy prices and through the absence of wage increases. Disposable incomes continue to be eroded and herein lies the bigger risk.

Consumers are smart people – unlike governments, they realise when they need to rein in consumption. The people stopped listening to politicians and policymakers a long time ago and for good reason.

In January the **International Monetary Fund**, the World Bank, the European Central Bank, the **Federal Reserve** and most bank economists were falling over themselves in the rush to proclaim 2014 the Year of Recovery.

"Europe looks vulnerable, budget deficits are rising and political backroom deals are being struck to expand timelines and fiscal deficit corrections"

Fast forward six months and now, on the cusp of the second half of the year, Europe instead looks vulnerable, budget deficits are rising and political backroom deals are being struck to expand timelines and fiscal deficit corrections. The US needs 2.8 percent growth in Q2 just to hit a zero growth rate for 2014, and Asia continues to believe it can engineer a soft landing – an impossible task tantamount to turning a super-tanker around in a river.

No. As someone who travels on the ground in 35 countries in an average year, the lesson and outlook is simple – a correction needs to happen to reset the world economy. Enabling the transfer of money from the 20 percent back into the 80 percent is a critically urgent task because otherwise we will face another decade of **Japanisation** TF. Consensus believes that a little bit of growth is enough for happy days.

I think that ignores the bigger picture: failing is the ultimate motivation for new beginnings. The mandate for change is created through trial and error. I like to say that world policymakers are Insane Successful Experts! This is using the definition of those three words by my three favourite people:

Insanity as defined by Einstein is: "Keep repeating the same experiment expecting different results."

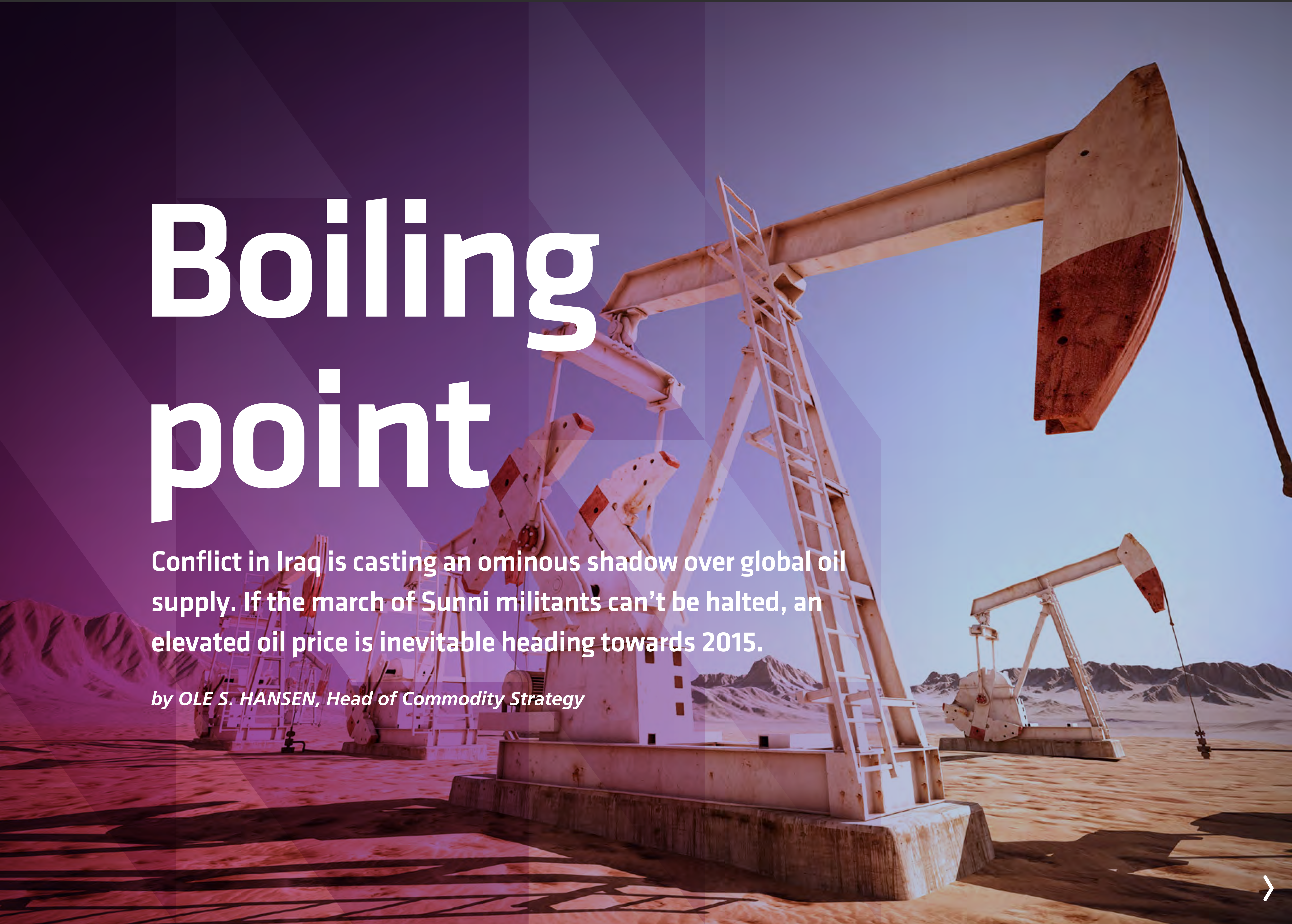
Success defined by Churchill is: "Success is the ability to go from one failure to another with no loss of enthusiasm."

Expert defined by Niels Bohr is: "An expert is a person who has made all the mistakes that can be made in a very narrow field."

Yes, the world and its mother have become insanely successful experts, at least in their own eyes. Complacency reigns supreme. TF

*Watch Steen talk about his Q3 forecast*

**CONNECT WITH STEEN:**



# Boiling point

**Conflict in Iraq is casting an ominous shadow over global oil supply. If the march of Sunni militants can't be halted, an elevated oil price is inevitable heading towards 2015.**

*by OLE S. HANSEN, Head of Commodity Strategy*

Commodities finished a strong first half ahead of the pack with both bonds and equities struggling to keep up. Individual events across several key commodities helped trigger this outperformance.

Adverse weather, especially in the US and Brazil, had a significant impact during the early parts of the year. Disruptions also hit the supply of platinum group metals and nickel. Finally, geopolitical worries have re-emerged first in **Ukraine** TF and most recently with the outbreak of violence in Iraq.

Developments in Iraq, a key global supplier of crude oil, will attract most of the focus as we move into the second half of 2014 and it will most likely ensure that global oil prices will remain elevated in the near term. Strong demand is usual at this time of year once the driving season across the northern hemisphere reaches full throttle and demand for cooling in many emerging markets has also raised demand for energy.

On that basis, current worries about Iraqi supply disruptions combined with the now chronic, disruptions from Libya and embargoed Iranian oil will continue to offset the otherwise promising outlook for non-OPEC supply growth, especially from the US.

## Conflict in Iraq

**Iraq** TF has become a key OPEC producer during the past couple of years, particularly after the sharp drop in exports from Libya and Iran. The current rise of Sunni militant group ISIS and the violence it has left in its wake has so far not had any impact on the key oil producing regions of the Kurdish controlled north-eastern Iraq and the Shiite controlled south.

But with 3.3 million barrels of daily production at stake, the market remains very nervous. Iraq’s importance as an oil producing nation has risen especially because of the supply disruptions in Libya and the embargo against Iran which has seen the combined production from these two countries drop by around 2.4 million barrels per day since the Arab Spring began in late 2010.

“Iraq’s targets now look unreachable which raises even further the pressure on Saudi Arabia to increase production to avoid oil markets becoming too tight”

Meanwhile, Iraqi oil production has risen by almost one million barrels per day and up until now, the government has been very bullish on the prospect for even higher production over the coming months and years.

Iraq's targets now look unreachable which raises even further the pressure on Saudi Arabia to increase production to avoid oil markets becoming too tight, especially during the next quarter which is a period of peak demand, not least in the Kingdom itself. Saudi Arabia would prefer oil to stay in a USD 95-110/barrel range, which we may not see again until Q4.

## Supply disruptions

We envisage the risk of a cut to Iraq's output to be slim, but even if we should see the situation stabilise, the multiple supply disruptions elsewhere and the ongoing worries related to Ukraine which could still trigger additional sanctions against Russia, should keep oil prices elevated.

For that reason the price of **Brent crude** TF is likely to remain elevated above USD 110 USD/barrel, the average price since 2011. Any realised supply disruptions could trigger a move back above USD 120/barrel although this is most likely to be short lived as emergency measures such as a release from the Strategic Petroleum Reserve would compensate.

The biggest downside risks stems from the elevated speculative net-long positioning held by hedge funds which, during June, reached a new record high on both WTI and Brent crude.

But with all supply disruptions unlikely to be solved at the same time, violent plus USD 22 sell-offs like those witnessed in 2011, 2012 and 2013 are unlikely, at least not during the current quarter. Gold has now spent the last year trading sideways following what was the first major correction in more than 12 years. Money managers and traders have reduced their focus on the yellow metal with better opportunities having presented themselves in other **commodities** TF and asset classes.

The general confusion as to where we go next has triggered a drop in holdings of exchange traded funds backed by physical gold to a five-year low, while speculative positioning in the futures market remains relatively light. As a result, volatility fell to a multi-year low during the second quarter with several geopolitical tensions failing to attract increased buying from a safe-haven perspective.

The future path of US interest rates remains one of the key drivers for gold coupled with market worries about the impact on gold when we eventually move from tapering to tightening. As the chart below shows, the longer-term relation between gold and inflation-adjusted US bond yields has remained strong.

Given the current consensus that the US Federal Reserve will begin to tighten sooner rather than later, that may add some additional upside to bond yields, thereby further removing the appeal of a non-coupon or interest paying asset such as gold.

## Gold rangebound

We do, however, feel that most of these expectations are already known knowns and that most of those investors who wanted to get out of gold, and silver for that matter, have already done so. A recent survey among economists found that they all believed that the near-term direction for US bond yields were higher.

Such a one-sided expectation calls for caution and recent history indicates the performance of **gold** during the months of July and August has been overwhelmingly positive.

We therefore conclude that this, together with continued geopolitical uncertainty, will leave the price range bound for another quarter with the outer boundaries currently being 1,185-1,420 USD/oz.

The expected continued recovery in global activity will, however, present the metal with a challenging final quarter of 2014.

The outlook for silver has increasingly been turning more favourable with both investment and industrial demand showing signs of support. The downtrend from the 2011 high just below 50 USD/oz was broken during June and this leaves silver in a better position than gold to make further gains. We prefer this metal from both a relative but also an absolute perspective.

"... geopolitical uncertainty will leave the price rangebound for another quarter with the outer boundaries currently being 1,185-1,420 USD/oz"

*Watch Ole talk about his Q3 forecast*

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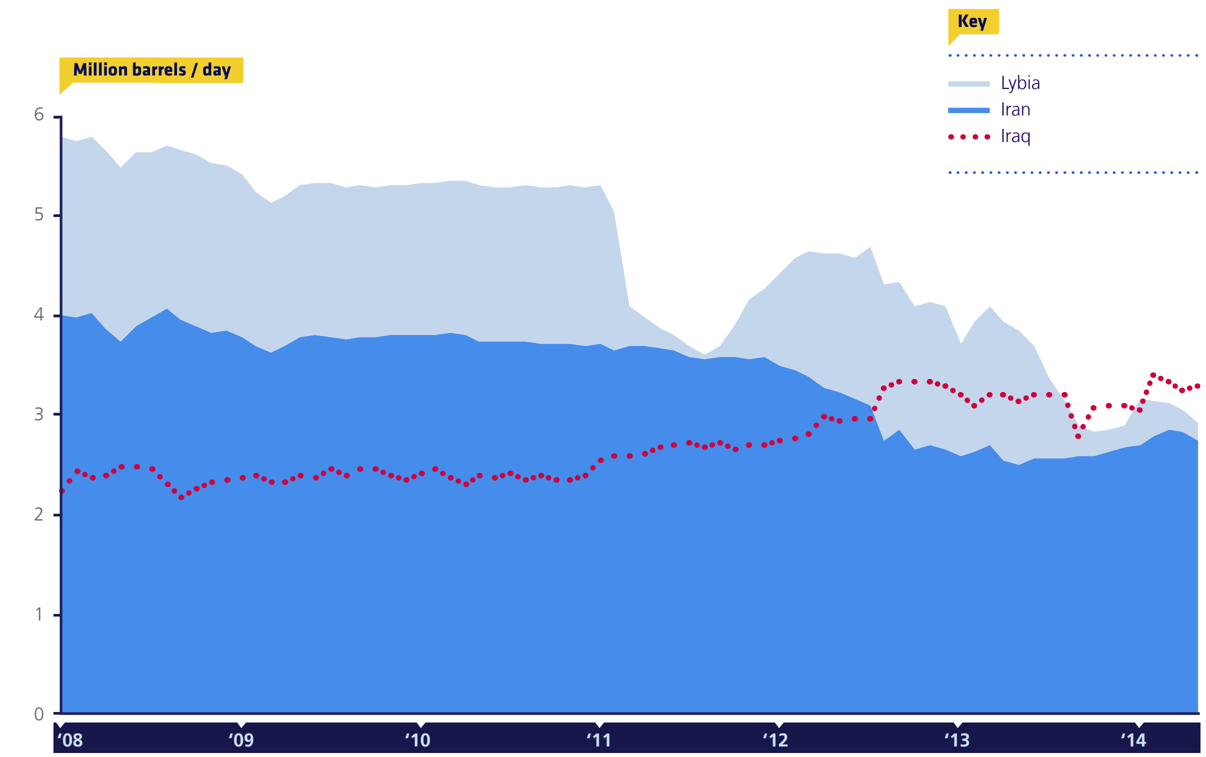
## GRAPHIC 1

### Rising Iraqi production helped off-set Libya and Iran

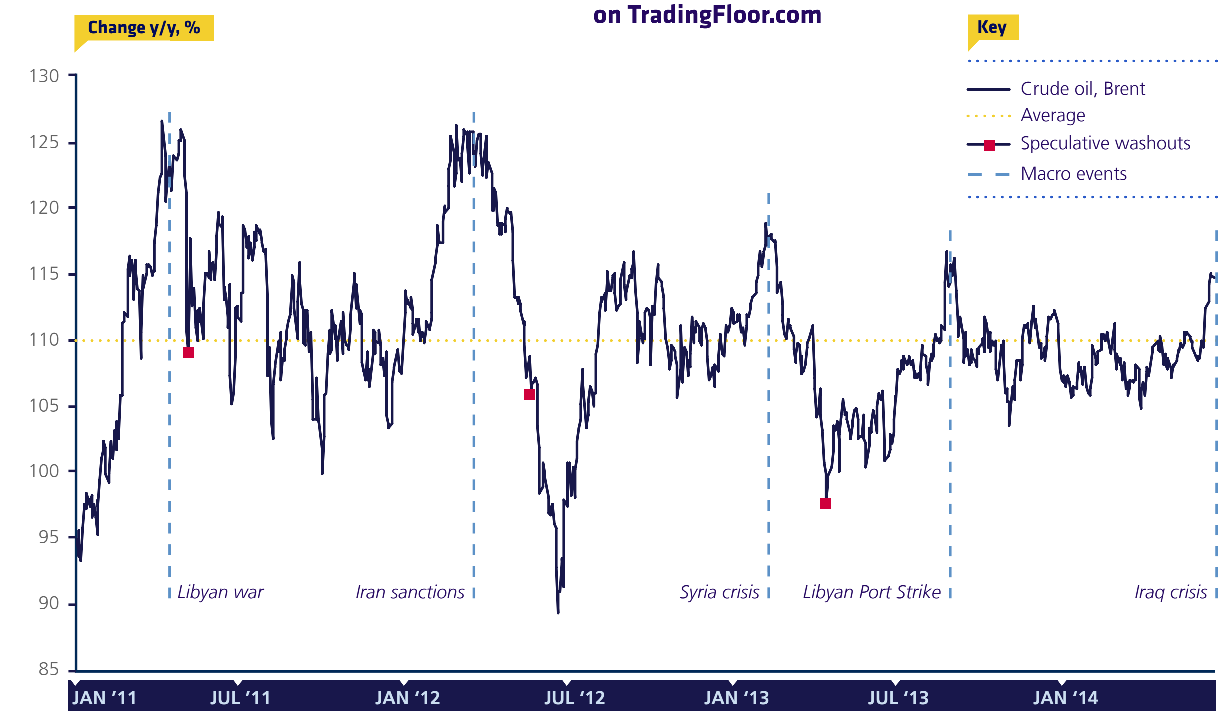



## GRAPHIC 2

### Brent crude oil peaks and troughs

TF

**Click and trade the** US Crude September 2014
**on TradingFloor.com**




Source: OPEC, Bloomberg, Saxo Bank

## GRAPHIC 3

### Gold and 5-year US real rates

TF

**Click and trade the** XAUUSD
**on TradingFloor.com**


## TABLE 1 - Energy

| Upside risks | Downside risks |
| --- | --- |
| Multiple geopolitical events: Iraq, Libya, Iran and Ukraine | Increased global supply from rising non-OPEC production |
| Steep backwardation attracting increased investment flows | Excessive net-long investor positioning |
| Seasonal tightness at a time of elevated supply risks | The subsequent negative impact on demand from a geopolitical price |
| High demand from China as it continues to increase strategic reserves | An (unlikely) rise in Libyan production and exports |

## TABLE 2 - Precious metals

| Upside risks | Downside risks |
| --- | --- |
| A major correction in global stock markets | Rising bond yields |
| Strong physical demand from CB and retail | Subdued inflation outlook |
| Geopolitical events/worries | Rising growth expectations |
| Seasonally, a time of positive price developments | The dollar reverting back to strength |

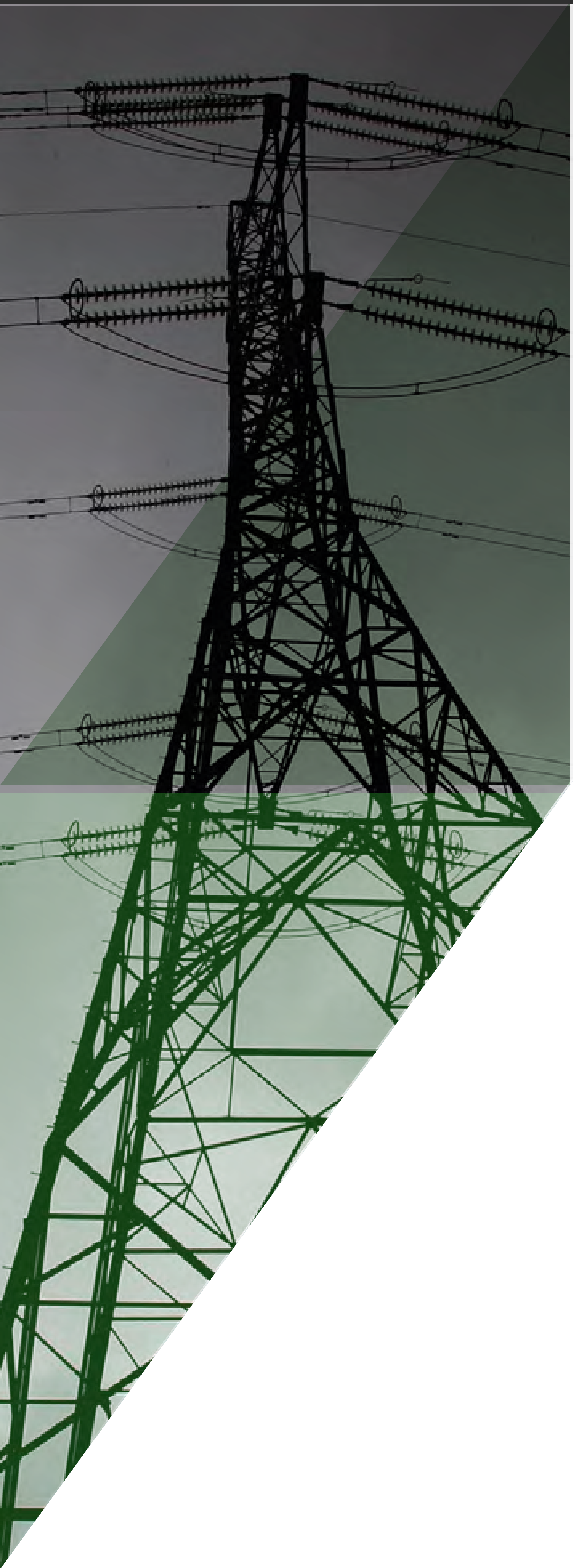
## TABLE 3 - Commodities

| Upside risks | Downside risks |
| --- | --- |
| Geopolitical events/worries | A stronger dollar and higher interest rates |
| Rising manufacturing activity filters into higher demand for raw materials | EM countries adjusting to lower growth and lower demand |
| Backwardation increasing demand from investors | Accelerating production catching up with demand |

# Power conundrum

**As US consumers open their wallets and their EU counterparts shrug off the blues, the case for a continued global economic recovery remains intact. But looming dangers – including the Iraq imbroglio and rising oil prices – could temper the pace of the upturn.**

***by MADS KOEFOED, Head of Macro Strategy***



Following a wobbly start to the year the world's two largest economies, the US and China, have picked up a bit of pace while the Eurozone recovery progresses modestly and the UK continues to surprise with strong growth. Taking into account the easing off of fiscal austerity in Europe and the US, and the overall improvement in foreign trade, the case for stronger growth this year and into 2015 looks intact. However, geopolitical tensions and the uprising in Iraq have helped push crude oil above USD 115 per barrel.

Although this price rise is negligible in the greater scheme of things, a northwards extension could keep the lid on growth globally over coming months. Our global **GDP** TF forecast has been revised down a bit to 2.6 percent this year compared with 2.4 percent in 2013, and is mostly a reflection of weaker first-quarter growth – particularly in the US. In 2015 global growth is expected to rise somewhat to 2.8 percent.

## Energy volatility to disrupt global economy

The ISIS-led uprising in Iraq has sent the price of Brent crude oil higher following a first half of 2014 where the price ranged tightly between USD 105 and 110 per barrel. Since May, the futures price has jumped roughly 5 percent – and 6 percent compared with the 2013 average. While not yet enough to disrupt the global economy meaningfully, the recent surge in oil prices bears watching and cannot continue for too long without having a more pronounced effect.

Simplifying matters a bit, a rule of thumb says that a permanent increase in oil prices of USD 10 per barrel lowers economic output by a quarter of a percent, highlighting why the current increase is unproblematic. The last run-up in the price of oil from mid-2010 to the spring of 2011 amounted to more than 70 percent and yet global growth was a sturdy 2.9 percent in 2011. We do not expect supply globally to be affected by the current commotion in the Middle East and hence expect any further increase in oil prices to be of a temporary nature and not signalling a permanent shift away from the average price that has prevailed since 2011 of around 110 per barrel.

Oil is not the only energy commodity with the potential to disrupt the economy, at least regionally. The ongoing tensions between Russia on the one side and the US and the EU on the other could damage morale among businesses and consumers.

The **Eurozone's** TF nascent recovery could suffer from a further escalation as its economy is heavily dependent on Russian energy. For now, the impact is primarily regional and affects the Ukrainian economy in particular. In terms of a resolution, the interdependence of the Russian and Eurozone economies remains the key argument in favour of a non-disruptive outcome.

## US back on track

A harsh winter and weakness in the housing sector ensured that the US economy got off to a poor start to the year with economic output down around 1 percent quarter-on-quarter (annualised). Our projected economic improvement this year may have been temporarily derailed, but is now firmly on track with most economic indicators pointing north in Q2, including **nonfarm payrolls** which have rising by more than 200,000 per month in the first half of 2014, and reached and surpassed the pre-recession high from January 2008 in May.

Even housing has seen a modest uptick with building permits up an estimated 15 percent in Q2 following a decline of 21 percent in Q1.

Our case for a stronger US economy rests squarely on the shoulders of the consumers. Private consumption has endured a prolonged period of sub-par growth following the Great Recession as households repaired balance sheets by deleveraging.

With both credit and households' net worth rising again, consumption is expected to grow faster following an increase of 2.0 percent in 2013.

This outlook has so far been confirmed by data available for 2014 with consumption up more than 3 percent. This is not impressive compared to previous expansions, but is a noticeable improvement on recent years. The current expansion has lasted five years and in that timespan, consumption has climbed 2.4 percent per year on average for a total of 12.3 percent compared with 16.8 percent in the 2001 recession.

"The current expansion has lasted five years and in that timespan, consumption has climbed 2.4 percent per year"

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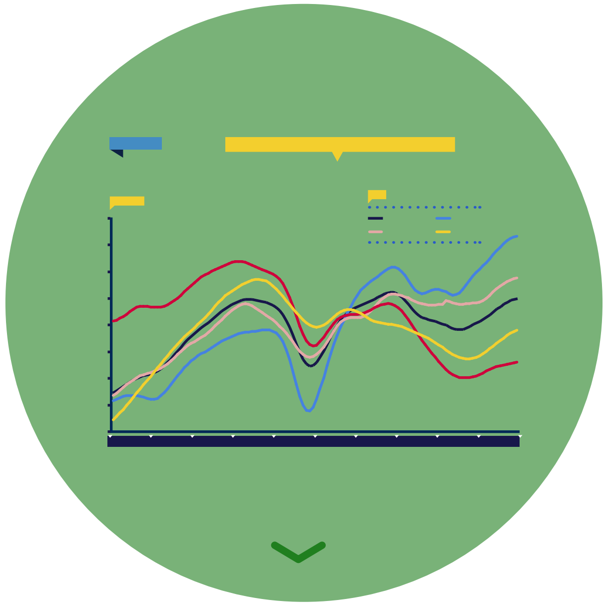
Sharp increases in mortgage rates in the spring of 2013 coupled with rising house prices saw the **housing market** TF hit the brakes in the second half of 2013 and the doldrums continued into the first part of 2014. The annual change in building permits has dropped to single digits, and the outlook for housing is more subdued than in 2011-13.

We do, however, continue to expect the housing recovery to continue, and not just because of a normalisation of mortgage rates following the spike last year, but also because the fundamentals for housing point to further gains. Households' balance sheets have improved, sales of new homes remain well below normal levels and household formations have increased. In addition, continuing, if more modest, house price appreciation helps further boost balance sheets.

Therefore, the housing sector should continue to lend a hand to the economic expansion in the second half of the year and into 2015.

I expect US economic growth to accelerate to 2.2 percent this year and further to 3 percent in 2015. The weakness in Q1 has depressed the full-year growth rate but is now firmly behind us. Consumers will push this US expansion to new heights.

**Click here to see Mads' data dashboard**



"Consumers will push US economic expansion to new heights"

## Moderate Eurozone recovery proceeds

The Eurozone, meanwhile, continues to progress at a modest pace with economic growth expected to edge up to 1 percent this year and further accelerate to 1.5 percent in 2015 in the wake of 2013's 0.4 percent contraction. Though austerity still rankles with consumers, the actual impact on the economy is lessening both in the private and the public sector. Deleveraging still has a way to run and this will ensure a subdued recovery not just in 2014 but into next year too. On the other hand, it is quite clear that the Eurozone's prospects are better than they've been in a long time.

**Unemployment** TF has begun a modest but sustained decline from the September 2013 peak of 12 percent to 11.7 percent currently and we project a full-year reading of 11.5, which is below the consensus estimate of 11.7 percent. Wages are rising in real terms, and substantially less fiscal pressure on peripheral member states means that Eurozone-wide public sector spending should rise faster than the 0.1 percent of last year.

Though the pace of structural reform is still inadequate in several member states, including France and **Italy** TF, this will not be an issue in the short term where calm markets and better economic data are the rule. Growth is therefore expected to proceed at a steady (if unimpressive) rate of 0.2-0.3 percent per quarter and 1 percent for the full year. The current bout of disinflation running through the Eurozone is partly temporary and partly structural in nature, and with downward pressure from energy depressing prices, inflation should accelerate later this year from an annual pace of 0.5 percent in May.

The June European Central Bank meeting resulted in a string of new easing measures designed to kickstart bank lending to companies and lift the Eurozone out of disinflation.

The injection of liquidity into the banking system will help support growth, but also could have unintended consequences, specifically if countries desperately in need of structural reform relax in the belief that the ECB will do the heavy lifting for them. TF

*Watch Mads talk about his Q3 forecast*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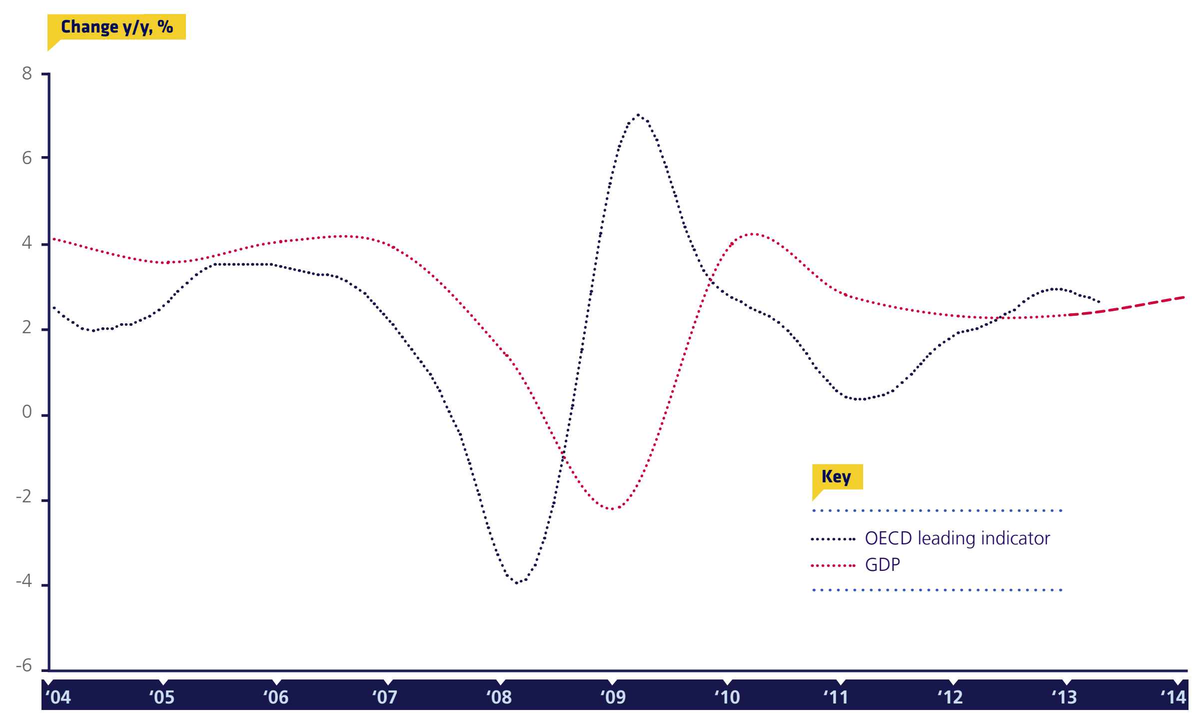
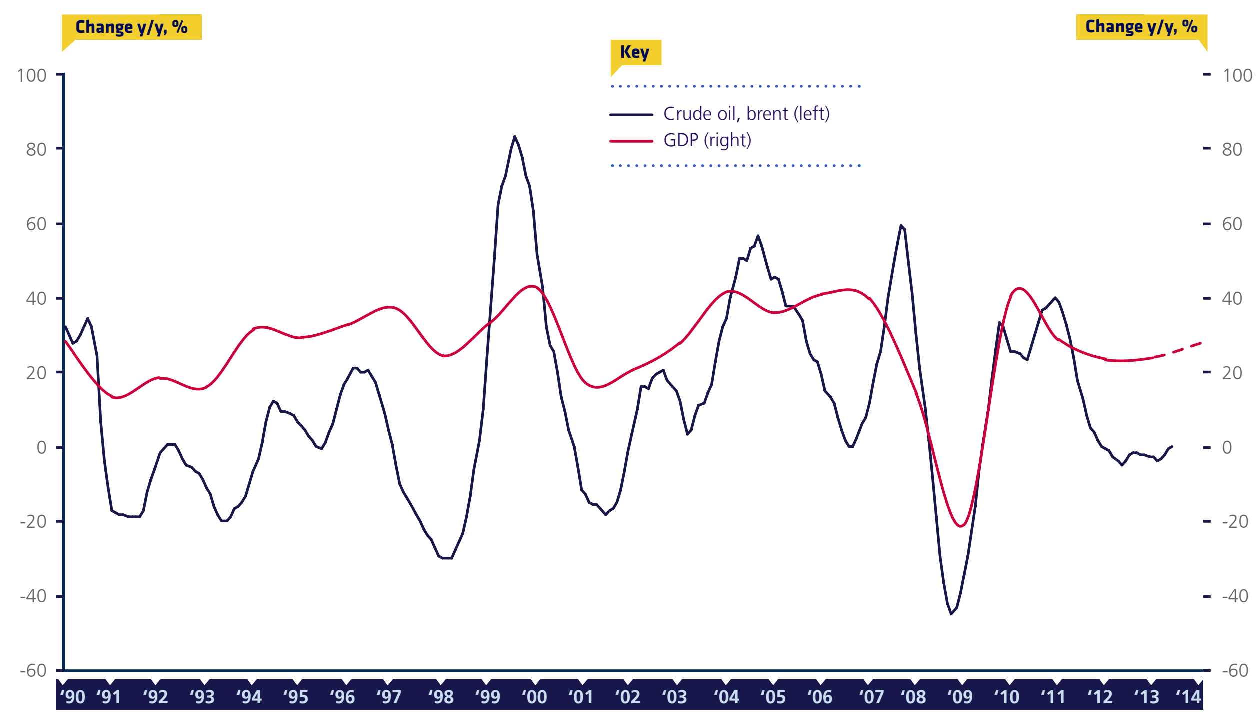
GRAPHIC 1

OECD global leading indicators




GRAPHIC 2

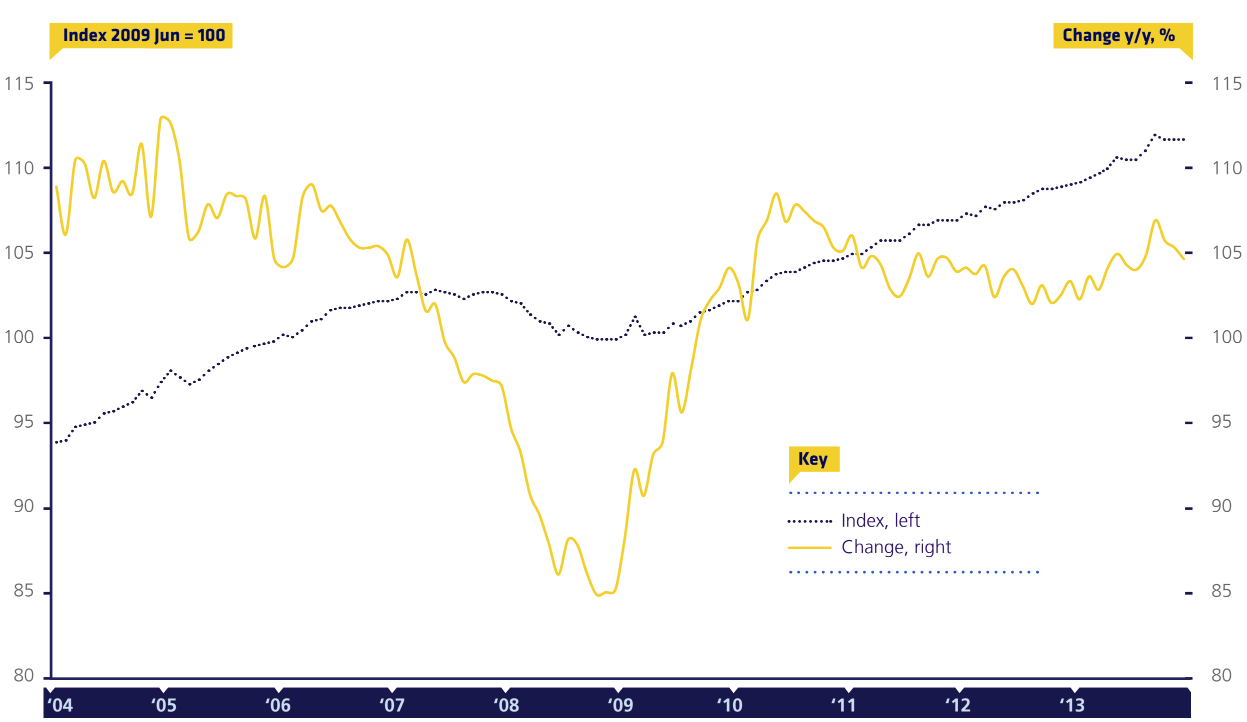
Brent crude oil prices




Source: Bloomberg, Saxo Bank

GRAPHIC 3

US private consumption expenditure




GRAPHIC 4

Euro area leading indicators

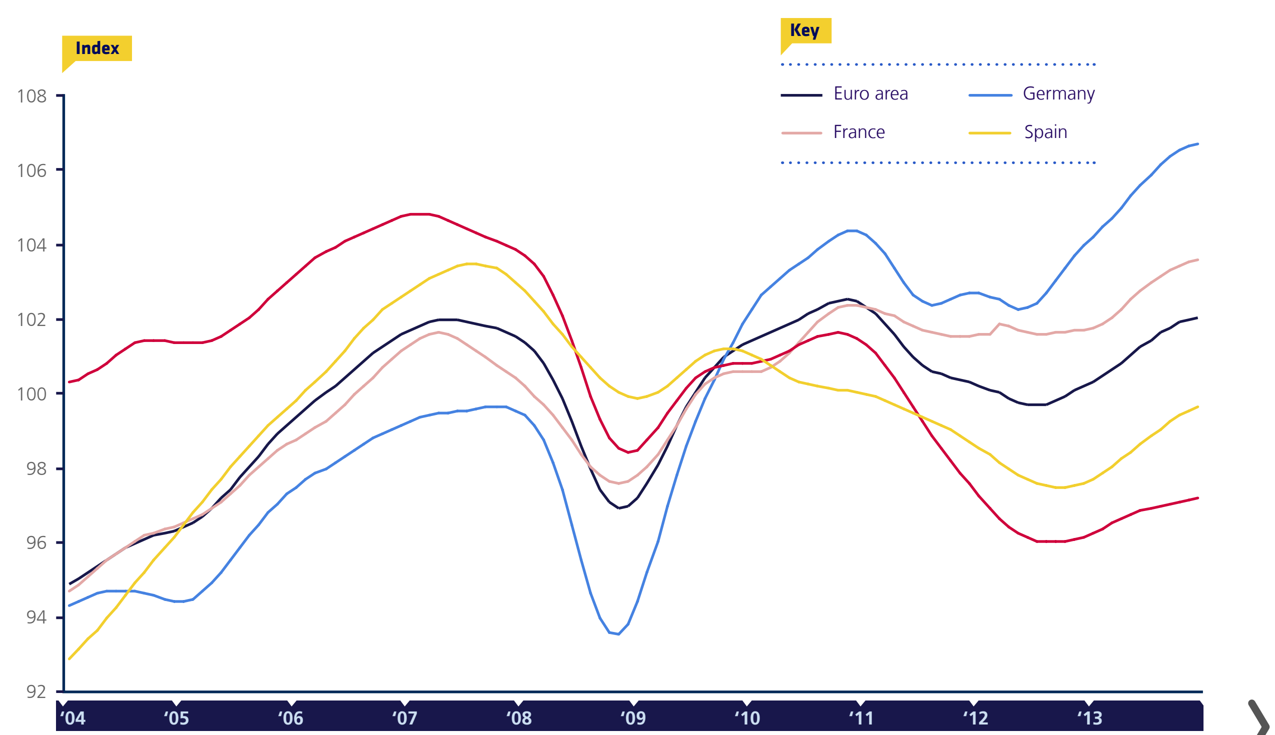


Table 1

## Growth of GDP in % for 2013, 2014* and 2015*

- 0.4
1.0
1.5

Austerity measures fade, boosting both private and public spending.

Structural reforms still lacking in some parts. Geopolitical tensions may hamper growth.

7.7
7.2
6.8

Stronger global trade. Slight fiscal easing.

Concerns about credit growth will see authorities refrain from large-scale stimulus

1.5
1.4
1.0

More fiscal stimulus may be introduced as the government remains wary of an economic slowdown.

Structural reforms still lacking.

1.8
3.0
2.2

Government policies remain supportive.

Housing sector slows down materially.

1.9
2.2
3.0

Consumer in a strong position to drive growth. Investment pick-up.

A sharper-than-expected slowdown in the housing sector.

2.4
2.6
2.8

Less austerity, stronger consumer, and higher trade growth

A spike in energy.

1.3
0.7
2.0

Stronger foreign trade and higher energy prices.

Lack of reforms, lower commodity prices, geopolitical tension.

Key

GDP Growth 2013 GDP Growth 2014 GDP Growth 2015 Upsides Downsides

GDP (gross domestic product) is real, inflation-adjusted, year-on-year changes in percent. 2013 is actual/estimated while 2014 and 2015 are forecasts.

# Solar future

**Equities are still the best place to be but it's a decidedly mixed bag. Old-school integrated oil companies have underperformed and face headwinds in the form of ebbing demand and the arrival of shale gas. But the alternatives are worth a look, particularly solar power, where a very sunny future awaits.**

*by PETER GARNRY, Head of Equity Strategy*

## Equities to outperform bonds

Global **equities** remain attractive going into the third quarter with our global equity valuation model showing that valuation is still minus 0.2 standard deviations below the average observed since 1996. However, this valuation level is the highest observed since early 2008, indicating that global equities have come a long way since the collapse in valuations in the aftermath of the financial crisis.

The MSCI World Index is currently trading at a price-to-earnings (P/E) ratio of 18.7x compared to an average of 21.3x. The trailing dividend yield is current 2.5 percent compared to the average of 2.2 percent. As a result, equities are now fairly valued and are by no means in bubble territory. Based on our assessment that interest rates will slowly normalise over the coming years, equities still remain the most attractive asset class.

On a country level, our model continues to view Russia, China, South Korea, Singapore and Austria as the five cheapest equity markets in the world among the 44 equity markets we track. The most expensive equity markets are India, Mexico, Philippines, Indonesia and Greece.

As energy is our theme in this outlook we will look at two of the most interesting segments of the energy markets, traditional oil exploration and production (E&P), and alternative energy.

> "Equities are now fairly valued and are by no means in bubble territory"

## Integrated oils face headwinds

Global integrated oil companies have significantly underperformed in this recovery, having gained 85 percent since the bottom in 2009 compared to a 167 percent increase in the **S&P 500 index**. The 15 largest global integrated oil companies trade at a median 12-month forward P/E ratio of 12.1x compared to 16.1x for the S&P 500 so the industry trades at a significant discount. Most of the valuation discount can be explained by the lower return on capital and below-average growth rate.

Among major integrated oils, two stocks stand out as being relatively cheap, despite the regulatory risk and government ownership, as those two are Petrobras and Sinopec. Both trade at a low 12-month forward price-to-book (P/B) ratio relative to return on equity when comparing against other major integrated oils.

Click to trade the SP500.I on TradingFloor.com

"Integrated oils will likely underperform in the future due to slowing oil demand in most developed countries"

Click to trade the US Crude September 2014 on TradingFloor.com

Despite trading at a discount to the overall market and probably attracting the attention of value investors, we believe structural issues are at the core of the underperformance and valuation discount, and these structural headwinds will not disappear anytime soon.

Integrated oils will likely underperform in the future due to slowing oil demand in most developed countries. Even **China** is projected to see a material growth slowdown in its demand for oil. Increasing supply from the US, because of the shale gas boom, is also a main driver behind projected lower prices for oil which will further curb return on capital and slow down profit growth.

The major integrated oils are also struggling to raise production against a backdrop of delayed projects and rising development costs. Finally, governments around the world are pushing hard for alternative energy such as solar and provide subsidies for electric vehicles which will lower demand for oil in the long term.

## The future is solar

Solar energy has gone from an infant industry to a fast-growing billion dollar business with an impressive 36 percent annualised growth rate since 1995. In 2013, global cumulative installed megavolts rose by 40 percent to 141,885 MV. As the industry has grown capacity, technological progress has relentlessly pushed down average silicon solar module spot prices.

Module prices are down 65 percent since early 2010. This extreme downward pressure on prices is of course fuelling demand and increasing solar energy's competitiveness against other energy sources. This development is unparalleled in the alternative energy segment, but is also the driving force behind why we think solar energy will be the dominant alternative energy source of the future.

However, the rapidly declining prices in the years 2010-12 have caused casualties with falling share prices among most solar companies and their suppliers.

When prices decline 32 percent (as they did in 2012) it requires either an enormous increase in productivity or at least an equal increase in volume to stay profitable. This has proved difficult for many solar companies. But with module prices more stable in 2013-14, profit expectations are starting to turn positive for most players in the industry.

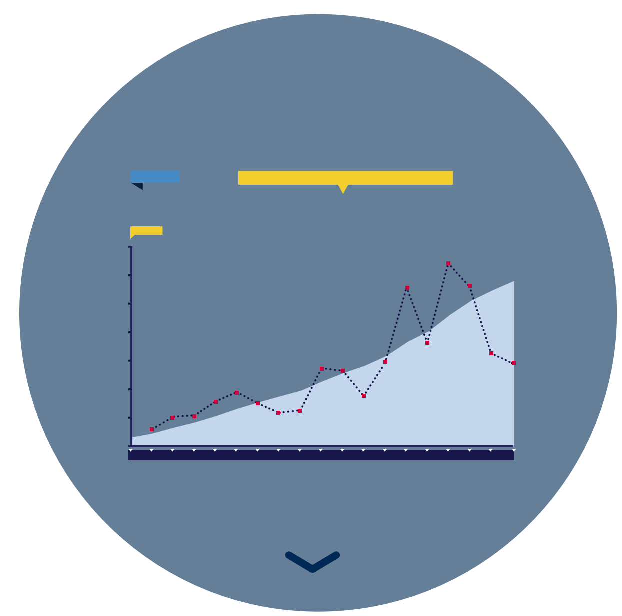
As the industry is extremely fast growing and technological progress is leapfrogging every year, it is impossible to predict just who will be the winner in this still-emerging industry.

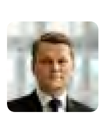
We are extremely bullish on solar **energy**, but as it would be premature to select the ultimate victor, we recommend that investors should acquire long-term exposure to solar energy through the Guggenheim Solar Energy Index ETF (TAN:arcx) that tracks the MAC Global Solar Energy Index.

This exchange-traded fund's holdings are spread across module producers, end-installation companies and suppliers further down the product chain.

*Watch Peter talk about his Q3 forecast*

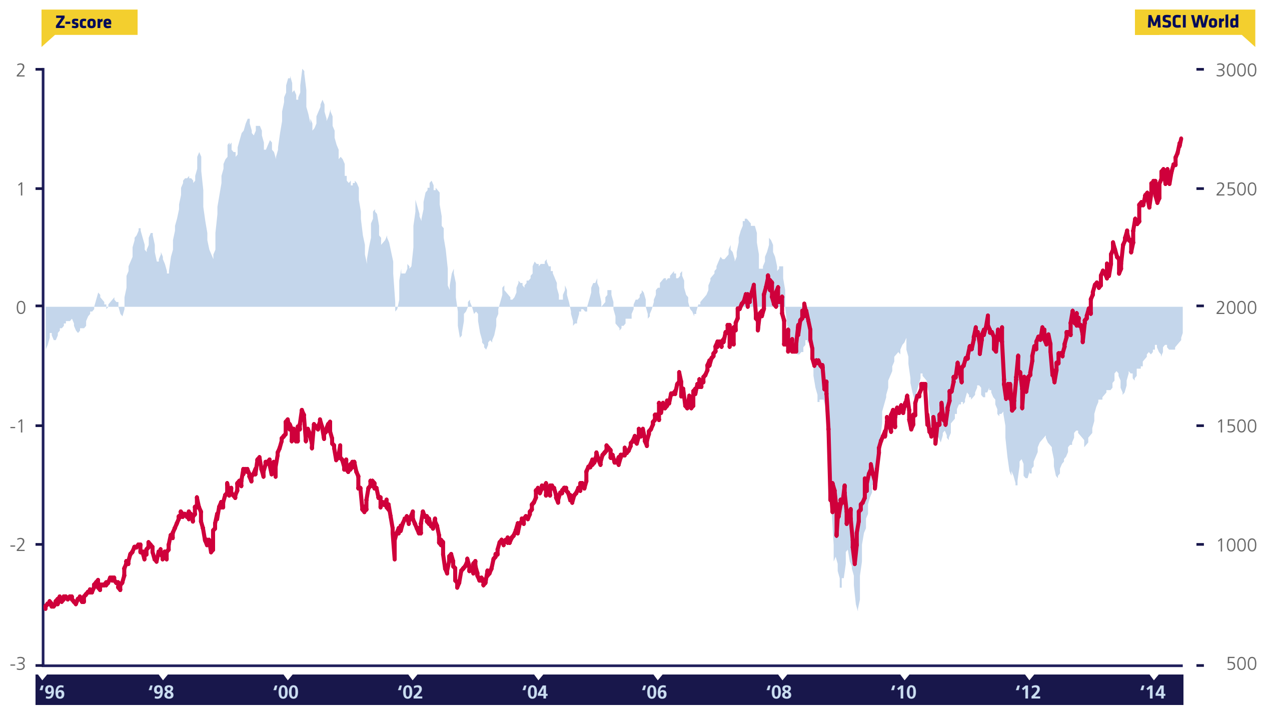
**Click here to see Peter's data dashboard**



**CONNECT WITH PETER:** 

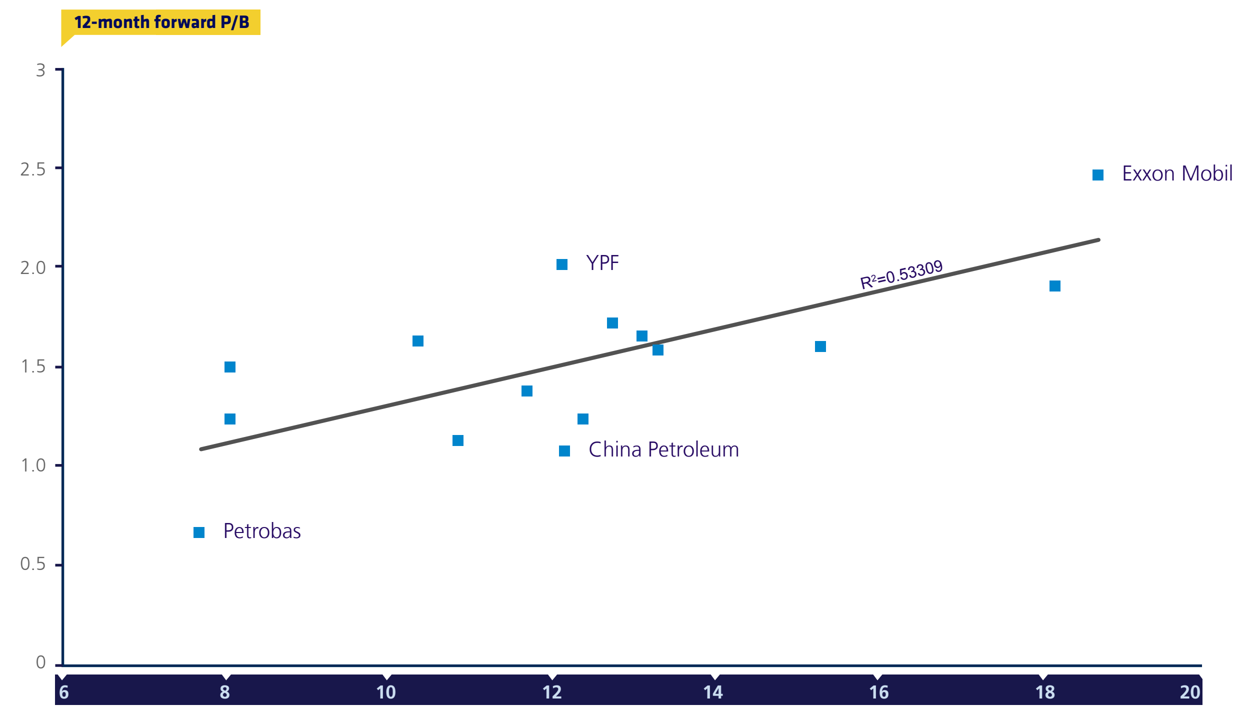
GRAPHIC 1

**MSCI World vs. historical valuation metrics**




GRAPHIC 2

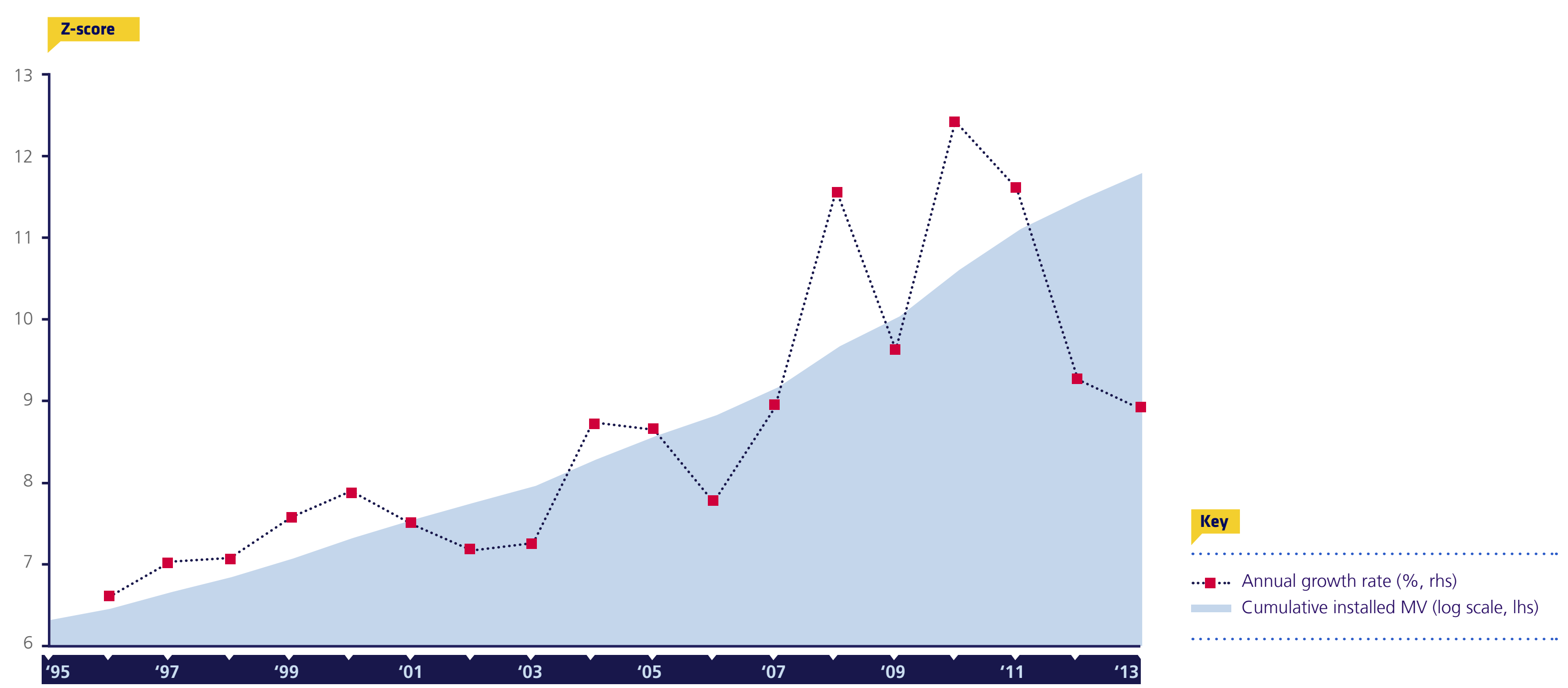
**Global integrated oil companies**




Source: Bloomberg, Saxo Bank

GRAPHIC 3

**Solar PV global cumulative installed capacity in MV**



# Storm brewing

The sense of crisis in energy markets on the back of the conflict in Iraq and the continued tension in Ukraine is yet to really spill over into forex markets. If it does, expect a tough time for currencies at the mercy of wild swings in energy prices.

*by JOHN J. HARDY, Head of FX Strategy*

The most notable development in currencies in the second quarter of this year was an ongoing lack of a clear trend in JPY crosses. The drop to all-time lows in options implied volatility for the major currencies, even as the European Central Bank launched significant new policy easing at its June 5 meeting. **Deutsche Bank's** TF broad measure of 1-month implied volatility in currency options dropped below 5 percent for the first time ever in June.

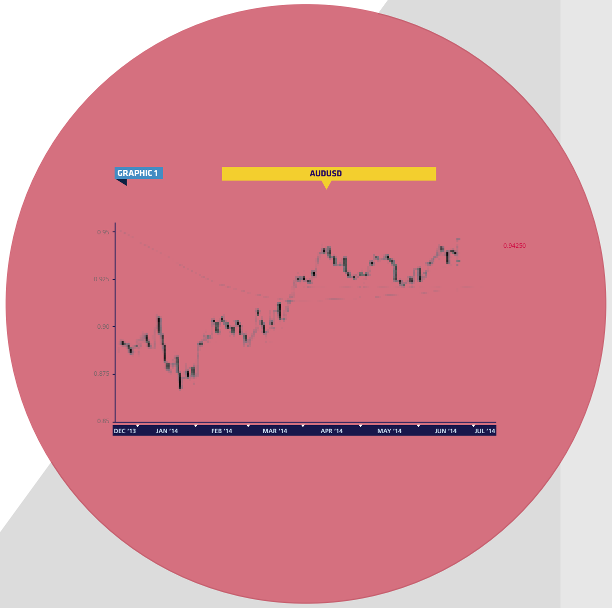
Much of the lack of volatility is on the general sentiment that central banks will forever have the market's back as well as the very well laid-out expectations for the US Federal Reserve's unwinding of its asset purchases and eventual, slow path of rate hikes.

Still, the lack of volatility is unlikely to continue much longer as the world's central banks are more out of sync that at any time in the last few years, and as tension mounts on whether the Fed is behind the curve in its policy mix.

On top of that, intense questions remain on the geopolitical and energy front and **emerging-market** TF risks abound as the Fed continues its ponderous, slow exit.

"Lack of volatility is unlikely to continue much longer as the world's central banks are more out of sync than at any time in the last few years"

**Click here to see John's data dashboard**



**A short rundown of the focus in Q3 for the five most heavily traded currencies**

USD - The June Federal Open Market Committee meeting saw a very dovish Fed that did nothing to suggest any potential acceleration in its tapering or eventual rate-hike trajectory. But the market is second guessing the Fed and is nervous that it may be getting behind the curve on inflation and even employment. As even the dovish Janet Yellen heavily emphasised at the June press conference, Fed policy risks remain two-way and this is likely to mean an intense focus and potential large reactions to key data points in Q3.

EUR - The ECB launched a major new policy initiative to bring liquidity to EU banks and various measures to prompt lending into the economy, including negative deposit rates and linking some of the cheap funding to banks' efforts to increase lending. The question in Q3 will be whether these measures are getting any traction, together with the shape of the ECB's measures to expand the asset-backed securities market. Meanwhile, banks will be cautious ahead of the Asset Quality Review and stress tests.

JPY - The Bank of Japan has more or less retained radio silence as the shine has come off Abenomics. The JPY has remained curiously resilient despite widespread complacency, enthusiasm for euro-based carry trades and higher US rates and the BoJ's largest-in-class QE programme. Is JPY to rally short term, therefore?

GBP - The market is almost fully pricing in a move at the November Bank of England meeting, which comes ahead of the quarterly BoE inflation report. But the pound will need constant good news to sustain its high level.

AUD - By late June, the 2-year Australia to US interest-rate spread was at its tightest since September 2013, and yet the market was bidding up **AUDUSD** close to its highest levels of the year.

This is a carry trade that shouldn't be happening and may be driven by reserve managers at central banks. Expect the Reserve Bank of Australia to get very noisy and even signal easing if Aussie fundamentals remain so-so or worse and if the exchange rate remains elevated.

## Quick peek outlook for the G10 currencies

USD - Potential for some weakness on ongoing complacency and if US releases don't surprise either way, but eventually showing strength as the quarter wears on.

EUR - Further weakening versus USD and GBP on ECB dovishness. Worrying, however, that the euro could bounce versus risky currencies if a bout of risk-off spoils the carry trades some time during the quarter.

JPY - Has been oddly resilient – suggesting strength before eventual weakening further out.

GBP - BoE hawkishness is getting very fully priced in – it may be resilient, but will be very vulnerable to any data disappointments.

AUD - To begin weakening again in Q3.

CHF - Very quiet, suggesting no strong divergence from the recent range.

NZD - In bubble territory – should be the highest beta currency in the event of risk aversion.

SEK - Riksbank rate cuts could see EURSEK move towards 9.25.

NOK - A surprise dovish turn could mean more weakness short term, but more fairly priced than SEK or NZD.




"The euro could bounce versus risky currencies if a bout of risk-off spoils the carry trades some time during the quarter"

## Energy considerations and FX

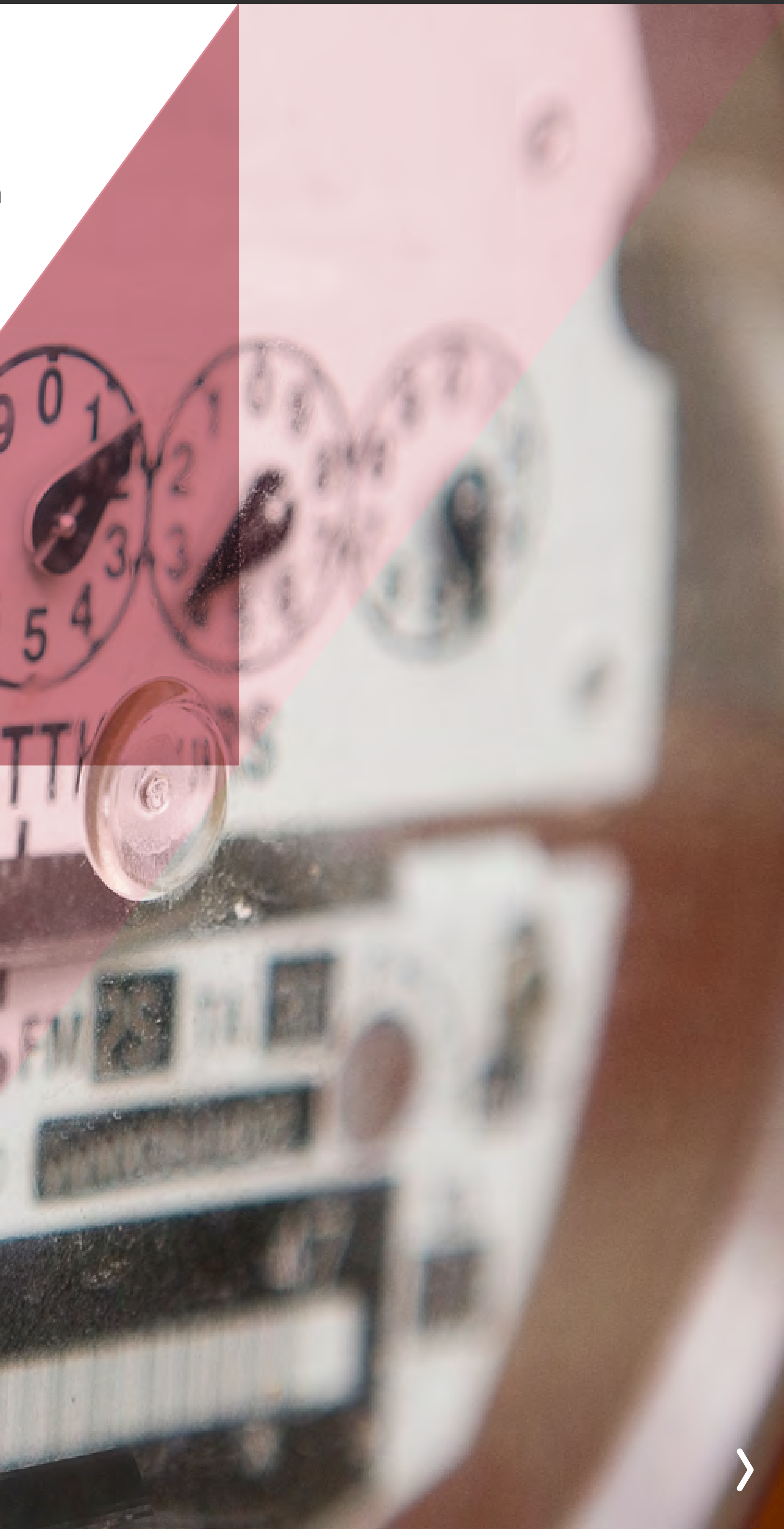
We've seen a considerable jump in oil prices on destabilisation in Iraq, but this jump in percentage terms is still relatively modest and we have to remember that we have just emerged from a period of unprecedented calm in oil prices, so the move will likely have to stretch much further for us to witness wider fallout and spillover into currencies.

The most negatively affected currencies in the event of a further surge higher in oil prices are countries that both rely the most heavily on energy imports and are the most energy-intensive in terms of units of GDP.

On that note, India, South Korea and South Africa appear especially at risk from energy intensity of GDP, while Turkey, Poland and **Hungary** are EM currencies extremely reliant on imports for the vast majority of their consumption.

While Europe and Japan are also highly reliant on energy imports, they are not included because the assumption is that very high oil prices would be negative for risk appetite and tend to favour more liquid currencies.

US has become far less dependent on energy imports than it was 6-8 years ago (imports down about a third) and far more of its imports are priced on the local crude benchmarks that might prove cheaper during a global supply crunch.



## Q3 trading themes

Below are a few trading themes based on the anticipated developments in relative central bank policy, growth prospects and energy market risks from here.

### Short EURJPY

EURJPY may be headed for a washout if risk appetite finally takes a beating in Q3 and on the realisation that the ECB will eventually have to move toward full scale QE by late this year or early next.

Eventually, the JPY is probably headed much weaker, but it might take a round of strengthening first to prompt another round of BoJ policy making. Reasonably compelling.

### Short AUD vs. USD and CAD

The RBA will likely lean very hard on any further AUD strengthening and the interest-rate spreads suggests the AUD is mispriced. AUDCAD is a relative value trade with the added twist that further upside in oil prices is a much steeper challenge for the heavily import-reliant Australia.

### Long NOKSEK on dips

This might be a controversial call (1.0970 as of June 20, 200-day moving average is 1.0800. Looking for 1.1200) given that Norges Bank is so concerned about the investment outlook for oil companies next year that it suggested it might cut the deposit rate if the GDP outlook worsens.

But traditionally, SEK is more leveraged to export markets and this trade could be one way to trade both for an upside surprise in additional and for SEK underperformance as the Riksbank may fret about growth worries and deflation risks and move to cut rates.

### Long MXNTRY

Look for 0.1700+ (0.1650 as of June 20). Mexico is an oil exporter, while Turkey relies on imports for some 90 percent of its oil consumption. Even without the oil angle, Turkey's emergency response to its currency weakening earlier this year (hefty rate hikes) will likely hit the economy hard over the next few quarters and have the market anticipating significant further easing of policy rates, reducing the carry advantage of holding the lira.

*Watch John talk about his Q3 forecast*

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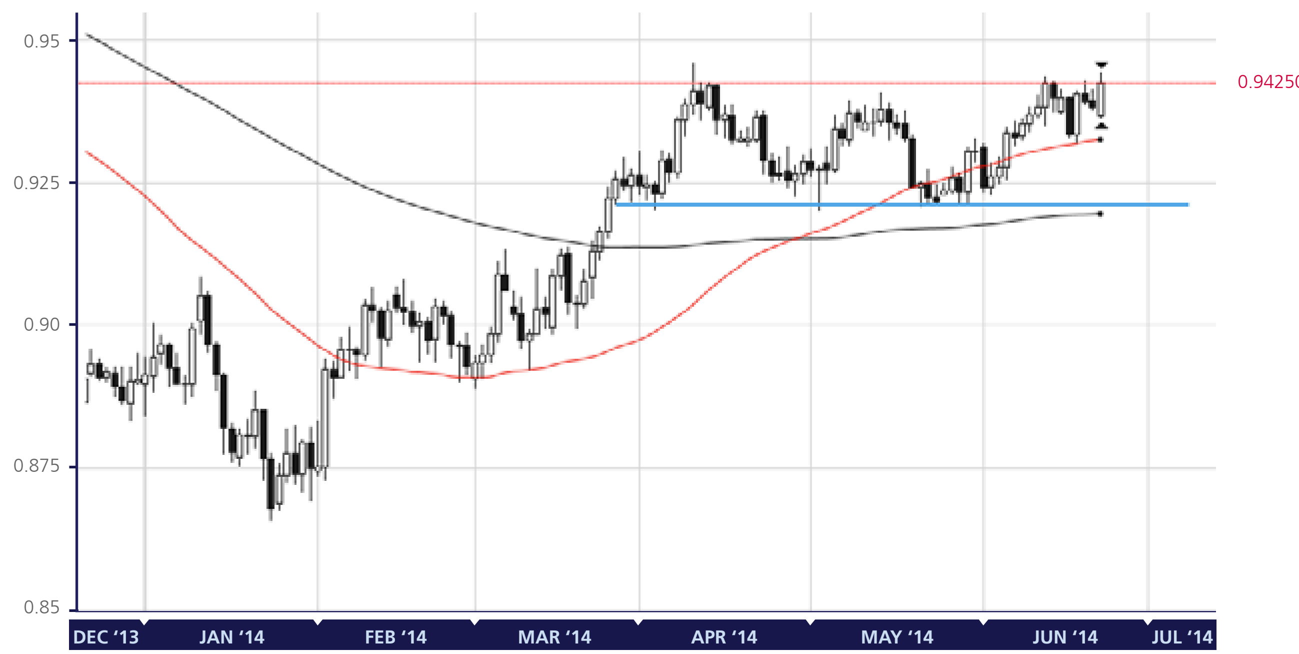
GRAPHIC 1

AUDUSD




TF Click and trade the AUDUSD on **TradingFloor.com**

**AUDUSD**

No technical weakness in AUDUSD in evidence as Q2 draws to a close, but interest-rate spreads suggest the pair should be near the lows for the cycle.

The key downside level is the range support at around 0.9200, which also coincides with the 200-day moving average.

A break below this level may open up for a try at the lows for the year below 0.8700 in the months ahead.

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