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The Context

December 4th 2017

The Context

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Inside this week's edition:

Know the Flows

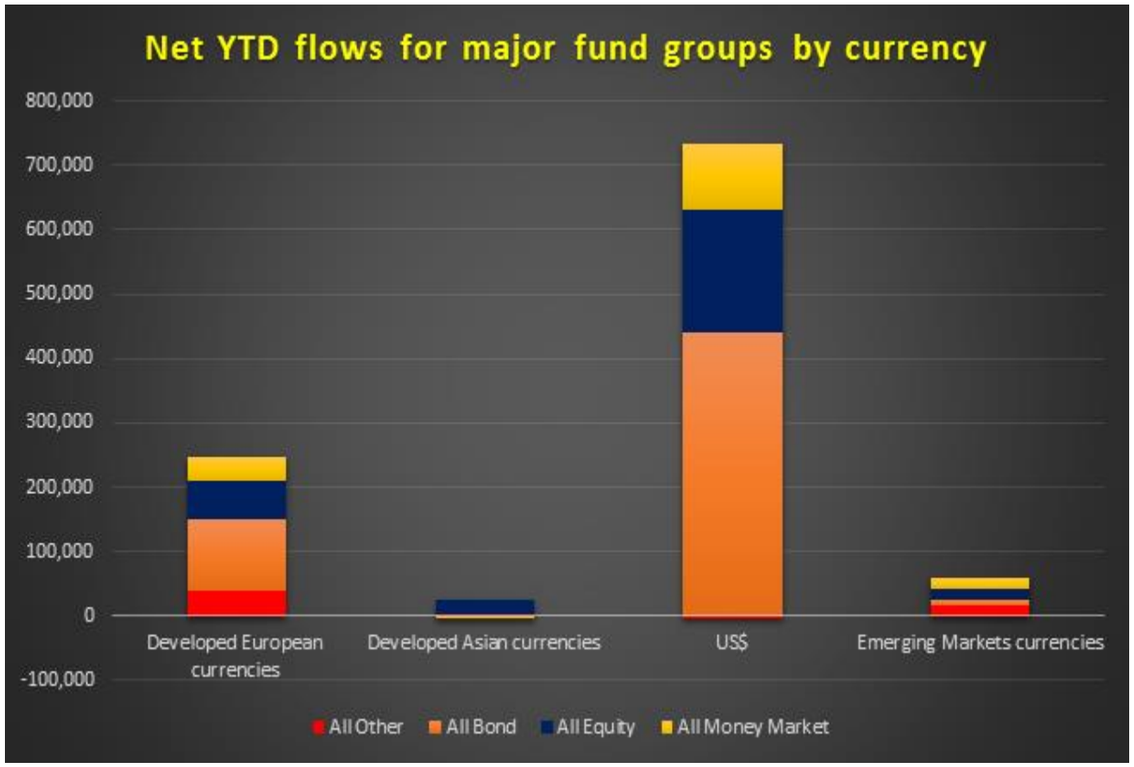
By Cameron Brandt, Director of Research

The final week of November found investors weighing a number of important questions as they look ahead to 2018. The answer to a few, such as the US Federal Reserve's next move on interest rates, seem clear. But most are not so easy to answer. Will China successfully keep its domestic credit markets in check and limit environmental damage while maintaining economic growth? Has populism shot its bolt in Europe? Will oil prices stabilize at the higher levels they have climbed to? Can Republicans pass a tax reform bill and lift the debt ceiling by the end of the year? Will North Korea take a step too far in its confrontation with the US?

Fund flows during the week ending November 29 suggest that investors are more inclined to see the glass as half full. **Europe**, **US**, **Korea** and **China Equity Funds** recorded solid inflows, as did **Emerging Markets Equity** and **Bond Funds**. Redemptions from **High Yield Bond Funds** moderated and **Municipal Bond Funds** attracted fresh money for the 19th time in the 22 weeks since the beginning of July.

Overall, EPFR-tracked **Equity Funds** collectively took in another $7.8 billion, **Bond Funds** absorbed a net $5.3 billion and flows into **Money Market Funds** topped $28 billion with **US Money Market Funds** recording their biggest weekly inflow since 4Q13.

When year-to-date flows are broken down by major currency groups, European and emerging markets investors have committed significant sums to **Balanced** and **Alternative Funds** (categorized as other) while Developed Asian investors favor **Equity Funds** and US investors have driven the record-setting flows - over $575 billion with a month to go - that have gone into **Bond Funds** this year.



At the single country and asset class fund levels, flows into **Mexico and Australia Equity Funds** climbed to 51 and 178-week highs respectively and **France Bond Funds** recorded their biggest inflow in nearly five months while redemptions from **South Africa Equity Funds** hit levels last seen in early March. **High Yield Bond Funds** extended their longest outflow streak since 1Q16 and **Mortgage Backed Bond Funds** their longest inflow streak since a 23-week run came to an end in mid-3Q16.

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Hawkish Inputs, Steeper Outputs

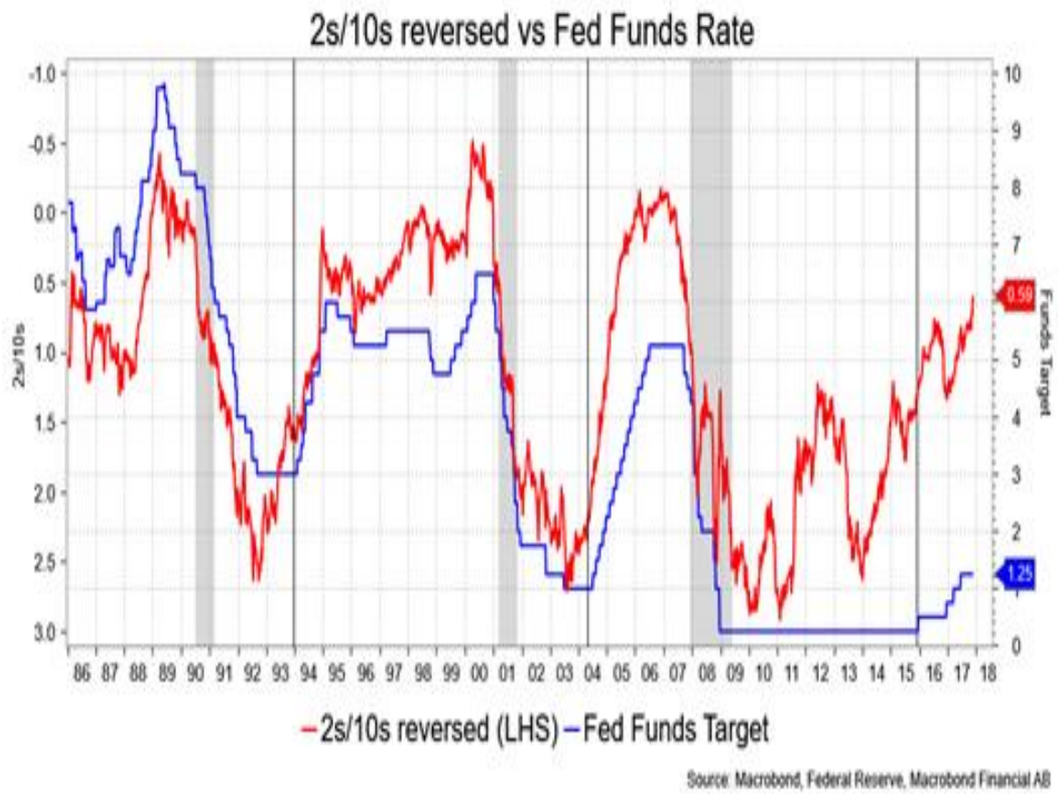
By David Ader, Chief Macro Strategist

In a week laden with provocative headlines ranging from another North Korean nuclear test, GOP progress on the tax bill, more sexual harassment stuff (Garrison Keillor?!? Lake Wobegon hid some secrets!), Bitcoin @ 10,000, Tillerson out talk, Trump saying government shutdown is good for him, and splitting nuances between Powell and Yellen, the themes of steady long rates and shape of the yields remain rather the dominant market declarative. From a rate perspective, 10s and 30s are challenging what had been a narrow range while 2s grudgingly lift to 1.78% on hawkish Fed words.

Such price activity warrants the hope that things are coiling, as in a spring about to burst forward. This is tempting as ever narrowing ranges don't last, but it's the direction of that burst that is the real question. I think the break out the curve is to revisit recent highs, at least, and favor the short end which heretofore has done a good job of discounting the Fed. Viscerally, I find myself favoring downside - meaning higher yields. I 'get' the curve's behavior that's contained the longer end:

- inflation remains low,
- the Fed hasn't backed away from further rate hikes,
- new information in the form of the supply cycle where Treasury hopes to keep the current average maturity of debt stable,
- which means more front-end issuance relative to long issuance than we expected.
- in the spirit of flogging a dead horse, given the relative performance of stocks versus bonds this year, year-end rebalances seems about right,
- there is a reasonable risk that if the tax 'reform' boosts the economy, the Fed will likely hike per their own dot-plot expectations, i.e. a bit more than the market believes,
- other central banks are still buying bonds.

What's missing from those items is the flattening yield curve, and low rates, telling us a recession is on its way. Robin Wigglesworth, who wins the award for the best last name in journalism, wrote in the FT "Yield curve faces test of its predictive powers" and came up with various challenges to the rule of the thumb that the flattening yield curve relays something about slower growth ahead.



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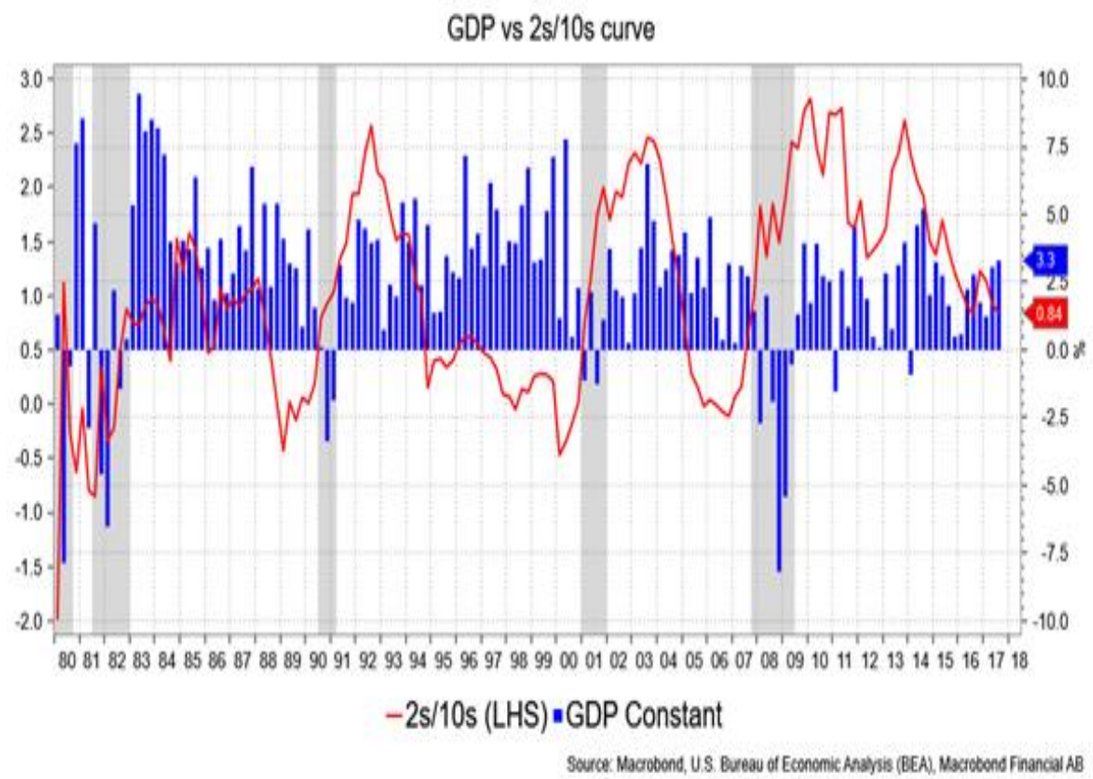
Hawkish Inputs, Steeper Outputs – cont'd

It is, of course, too soon to dismiss the curve's predictive abilities specific to slower growth ahead, but bear in mind *the distance between a flattening curve and a recession can be measured in years.*

Further, a flattening curve does generally presage slower growth, but slower growth does not always presage a recession. Indeed, it seems evident that in the quarters immediately before a recession, when the Fed's hiking has stopped, the curve anticipates the real slowdown and starts to steepen.

In short, the curve in items 1-7 above is telling a lot of things, many of which are new or unique to this cycle. It may not be predicting a slowdown or recession, but it certainly is telling us something about the cycle. Wigglesworth cites a 56-page SF Fed study (https://goo.gl/k455zA), Interest Rates Under Falling Stars, by Michael Bauer and Glenn Rudebusch. The abstract effectively says that the 'equilibrium real interest rate' (r*) and 'perceived trend in inflation' (pi*) are treated as constants in determinants of the yield curve in macro-finance models, however adjusting for changes within macrotrends, i.e. *not* treating them as constants, alters estimates for risk premiums in bond yields among other yield diminishing ideas. They write "expectations about the level of inflation must have played an important part in pushing down bond yields" and "as inflation expectations have stabilized, our estimate of the equilibrium real interest rate has exhibited a pronounced decline."

To wit, there's more to the curve than traditional omens of a recession and so understanding those factors continues to make the curve an elemental tool in making rate decisions.



This is an excerpt from Ader's Musings. For the full article, please click HERE.

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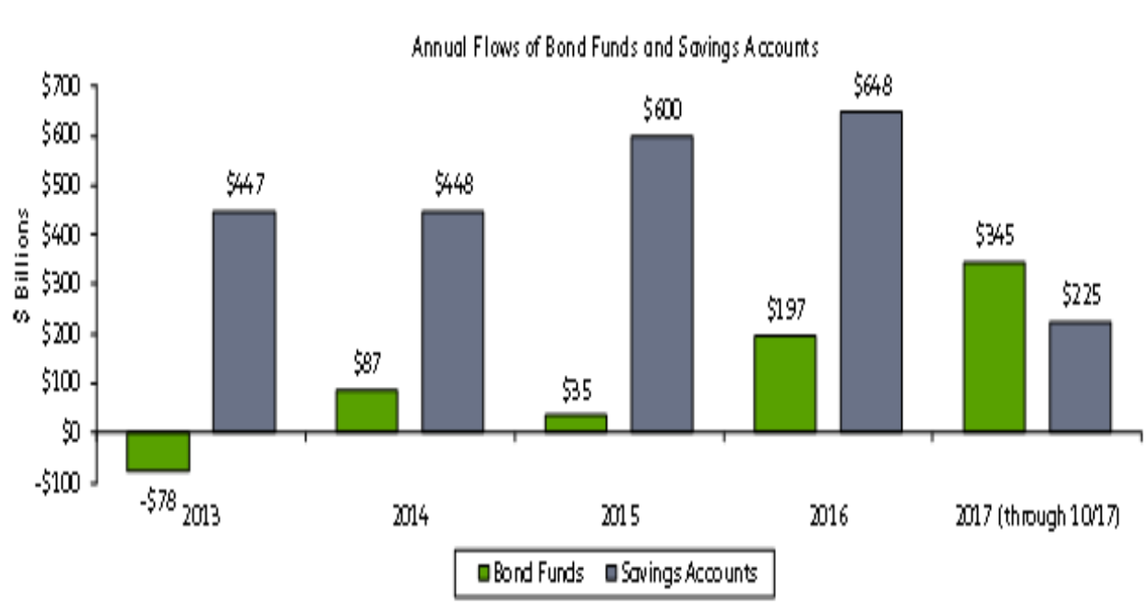
Investors Seem Convinced Fed Almost Finished Raising Rates

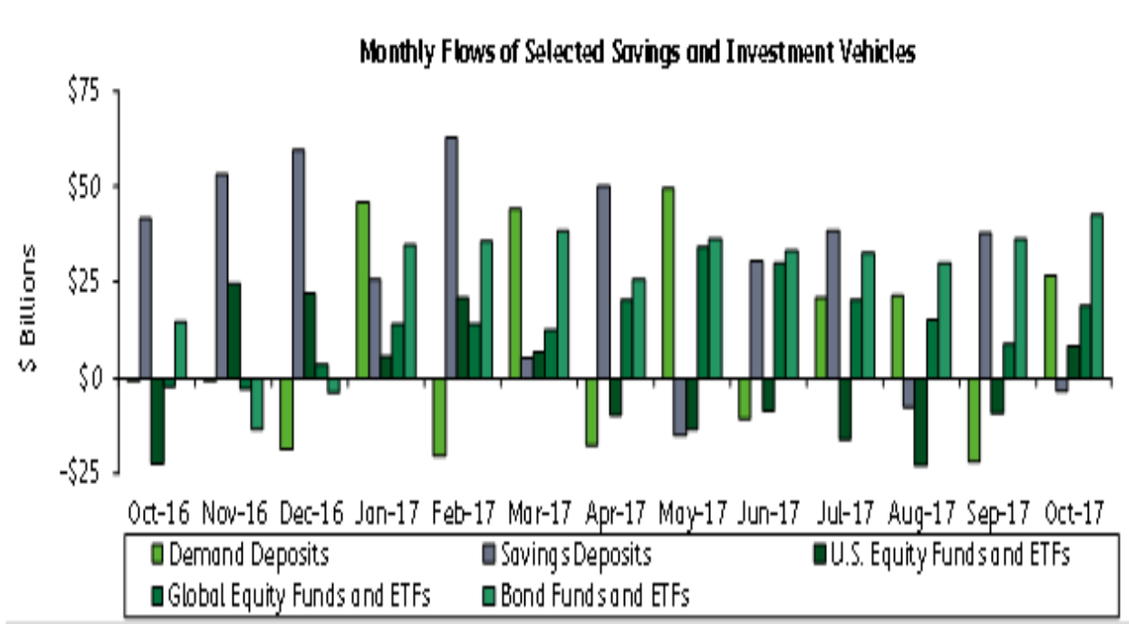
By David Santschi, CEO TrimTabs

Market participants are likely to be unprepared if the Federal Reserve raises rates more than a couple more times. Flow data indicates that investors have been pouring money into bond funds this year and losing interest in bank products with the exception of certificates of deposit.

Demand for bonds was extremely heavy this year through October despite historically low yields and poor performance. The inflow of $42.4 billion last month was the biggest monthly inflow since October 2009 and the tenth consecutive monthly inflow exceeding $25 billion. This year's inflows have averaged $34.5 billion per month, up from $7.2 billion in 2014, $2.9 billion in 2015, and $16.4 billion in 2016. This year's inflow is set to be among the three highest on record.



Inflows into savings accounts have fallen sharply even though yields have been rising. The outflow of $3.4 billion in October was the third monthly outflow in the past six months. This year's average monthly inflow of $22.5 billion is down from the average of $37.4 billion in 2014, $50.0 billion in 2015, and $54.0 billion in 2016. This year's inflow is set to be the lowest since 2007.



Undervalued Gbp Ready For Big Pre-Year-End Charge?

By Tony Nyman, Head G10 FX

Even the options market has turned less pessimistic on the Pound and Brexit negotiations.

One-month risk reversals are in spiking mood from recent 59 bp lows in favour of puts, to -11 bp (see graph below). That period of course covers the purportedly key EU summit on December 13/14 and this market is a good indicator of current sentiment and clearly the bearish mood has lightened.

On Tuesday, *The Telegraph* reported that both EU and UK sources confirmed that a Brexit bill agreement-in-principle had been reached over the EU's demand for a Eur 60bn financial settlement ahead of a crucial meeting Monday (December 4th) between UK PM May and EC president Juncker.

Next, Wed, *The Times* wrote that the two parties are close to an agreement on another of the potential stumbling blocks - the Irish border. As a result, EU leaders are said to be preparing to offer a two-year transition deal as early as January, which means hopefully no Hard Brexit.

GBP/USD gained 2.5% on the news, breaking above the psych 1.3500 mark for the first time since late September. We have been suggesting for much of the quarter that the Pound could play catch-up and finish the year at 1.37/1.38 if all goes well with Brexit negotiations.

Similarly, highly valued IFI contact and BMO's Gallo told us that on a long-run basis, the trade-weighted GBP is already cheap on a number of metrics - where Gbp trades relative to the UK's twin deficit fundamentals, see graph below, CPI-adjusted PPP and productivity-adjusted PPP - and the path of least resistance due to any type of market-friendly political developments is therefore up. The Canadian bank targets 1.40 and beyond within the next 6-12 months.

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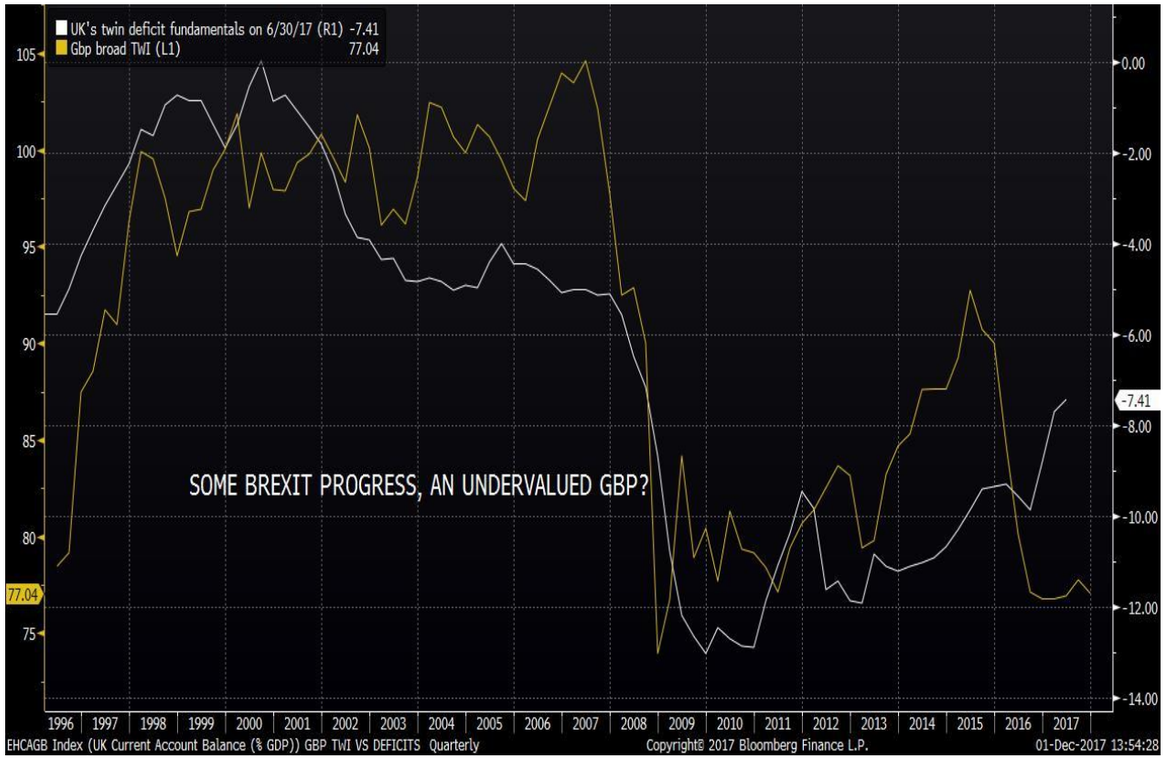
Undervalued Gbp Ready For Big Pre-Year-End Charge? Cont'd



However, before we start betting forcefully on 1.37/38 or even higher we cannot help but pour some caution on proceedings:

There is still no confirmation of the Brexit bill deal and the likes of EU's Barnier continues intermittently to add less than conciliatory remarks.

It's still fairly quiet on the ECJ and EU expats living in the UK rights, one of the big three hurdles to talks.

Even on one obstacle overcome, Ireland, we cannot ignore the reports that senior DUP officials have threatened to bring down the UK government over Brexit and possible platitudes to Dublin.

The previous warning shot is a reminder that the Cons/DUP 'deal/understanding' hangs by a thread and if May is seen to be caving in to all EU demands then this could lead to a split in her party, (more) in-fighting with the Hard Brexiteers and ultimately the collapse of the administration.

A collapse of the government could pave the way for a Corbyn Labour government. A hard left administration would kill investment, send the high-earners fleeing abroad and lead to the unions interfering with business (CapX) as well as a run on the Pound (his words!). Morgan Stanley, meanwhile, argue a Corbyn government is much more scary from an equity perspective than Brexit.

Sure, that's the doom monger scenario, but why go too long of Gbp in this environment? Particularly when the likes of the Fed is about to hike again and in H1 2018 (Usd) and the EZ economy outperforms that of the UK (Euro).

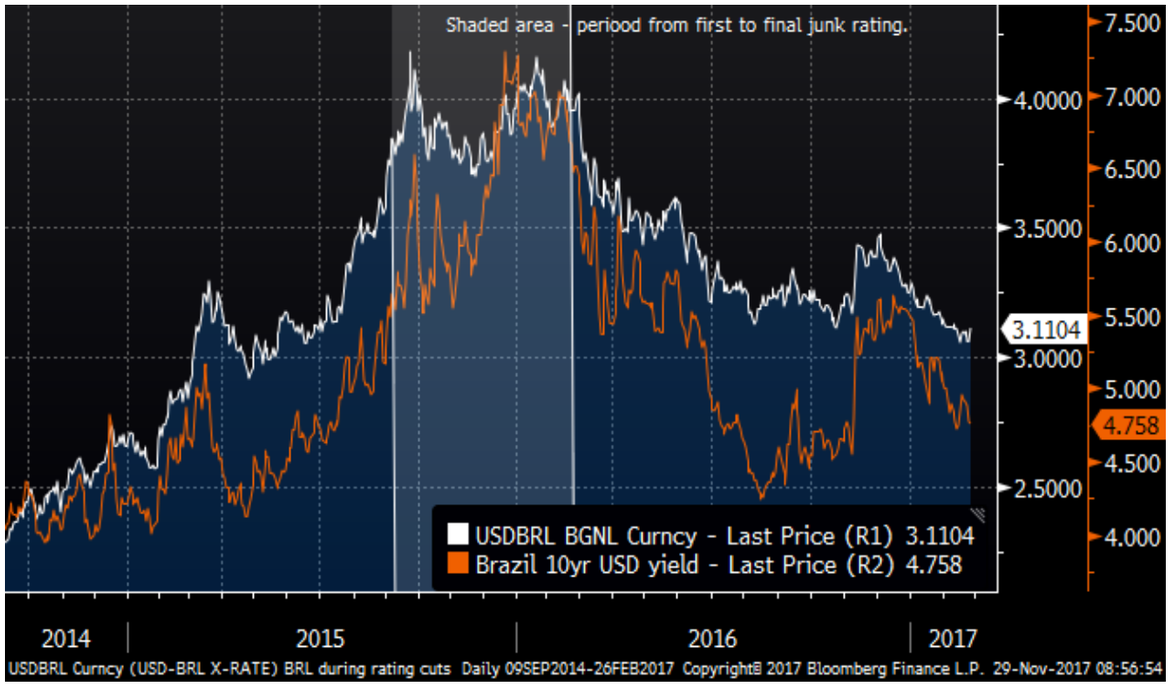
Would you like a full G10 FX Week report? Please contact sales@informagm.com if interested.

Impact of South Africa Downgrades Limited

by Chris Shiells, Managing Analyst, Emerging Markets

So the rating reviews are over and S.Africa is now the not so proud holder of junk local currency ratings from Fitch and S&P. However, with Moody's holding fire on its decision to downgrade S.Africa until after the February 2018 budget, SA has had a stay of execution from being booted out of the Citi World Bond Index and, after an initial knee jerk slide, local assets have rallied sharply.

In fact, recent history suggests that the market reaction on a rating downgrade to junk is generally short, sharp and followed by a recovery, as demonstrated in Brazil between Sep-2015 and Feb-2016.



Looking so far at what has happened in S.Africa, it is not quite following the same pattern. In the build-up to the Fitch junk rating and first S&P cut (of foreign currency rating to junk) on 3rd April this year, S.African assets were recovering from a huge sell off at the end of 2015.

The impact on S.African markets from the threat of junk ratings in the lead up to April and after the event was not as severe as the historical norm. However, as mentioned there remains the threat of a final rating downgrade and expulsion from Citi's World Bond Index. This may result in passive forced selling of USD7-16bn of bonds, according to a host of estimates. Interestingly, when looking at bond fund flows, it would appear that appetite for funds with a mandate to invest in South Africa improved following the ratings downgrades from S&P and Fitch back in April.

Impact beyond financial markets

Brazil's downgrade to junk resulted in ca USD6.2bn in forced selling of bonds, and the country is still rated two notches below investment grade by all three ratings agencies. The graph below highlights bond fund flows have failed to recover since.

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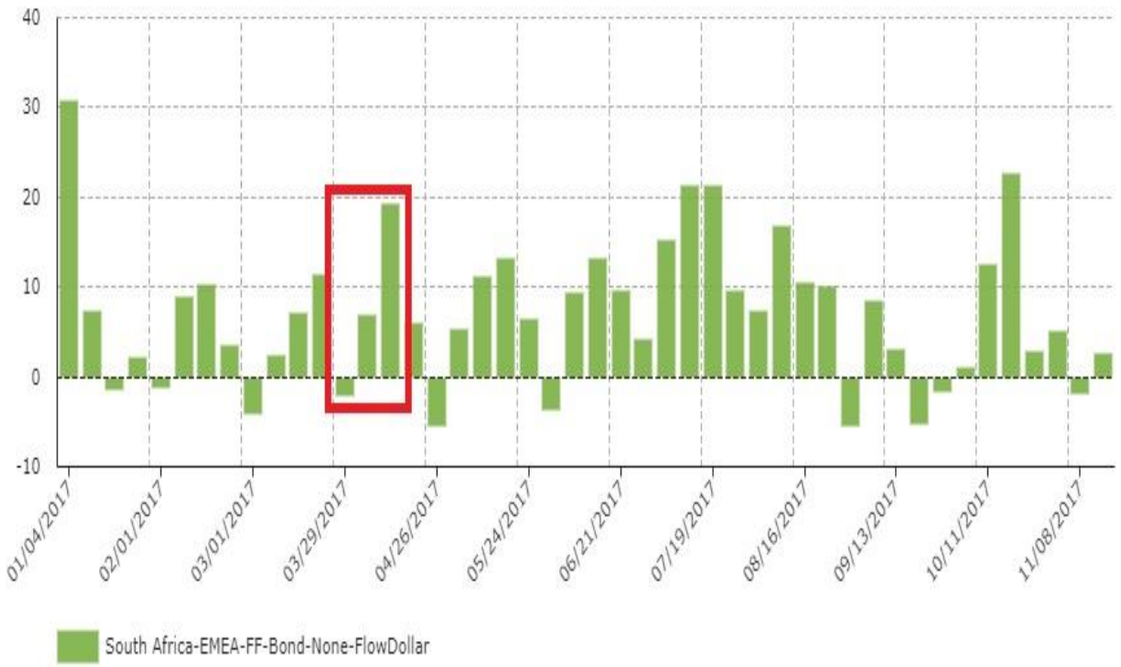
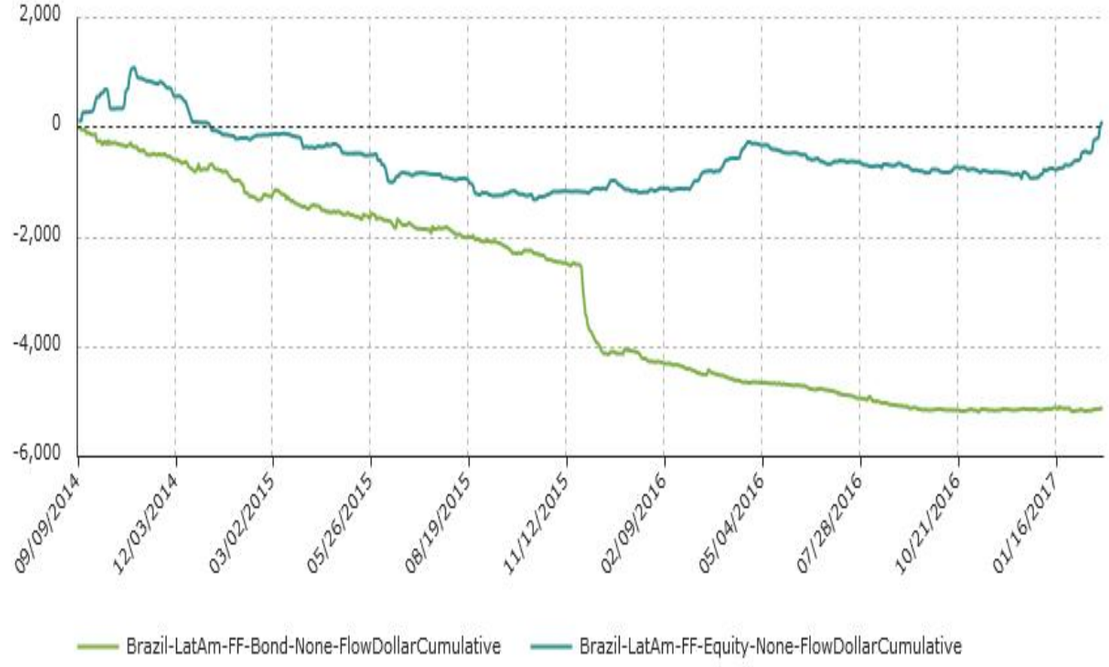
Impact of South Africa Downgrades Limited – cont'd





However, as the graphs above demonstrate the impact on financial markets is fleeting, and SA focused bond funds have not yet suffered any sharp outflows.

So should we be looking at the real economy? Once a country is downgraded, the short term impact on the real economy can be quite sharp. There is usually a rise in government and bank funding, an increase in inflation and a subsequent deterioration in fiscal balances. Some fiscal adjustment is normally needed, which further adds to the negative impact on GDP growth. Recall, Brazil stayed in recession for two years after its downgrade as it struggled with structural reforms and is still battling to get its finances in shape.

S.Africa has been given time by Moody's, it now must prove it can commit to stabilising debt levels, get to grips with the management of SOE's, which are a big risk to government expenditures, and also put in place economic reforms that sustain faster growth.

According to S&P's own numbers, it takes eight years on average to regain an investment grade rating. Taking Hungary as an example; the country was downgraded to junk in 2011 but upgraded to BBB- late in 2016 due to a much improved economic growth outlook. So it will be a slow path to redemption for S.Africa, but one that has to start now.

This an excerpt from the full report which can be viewed HERE.

China's Yuan Will Likely See Moderate Depreciation in 2018

by Tim Cheung, Riki Zhang

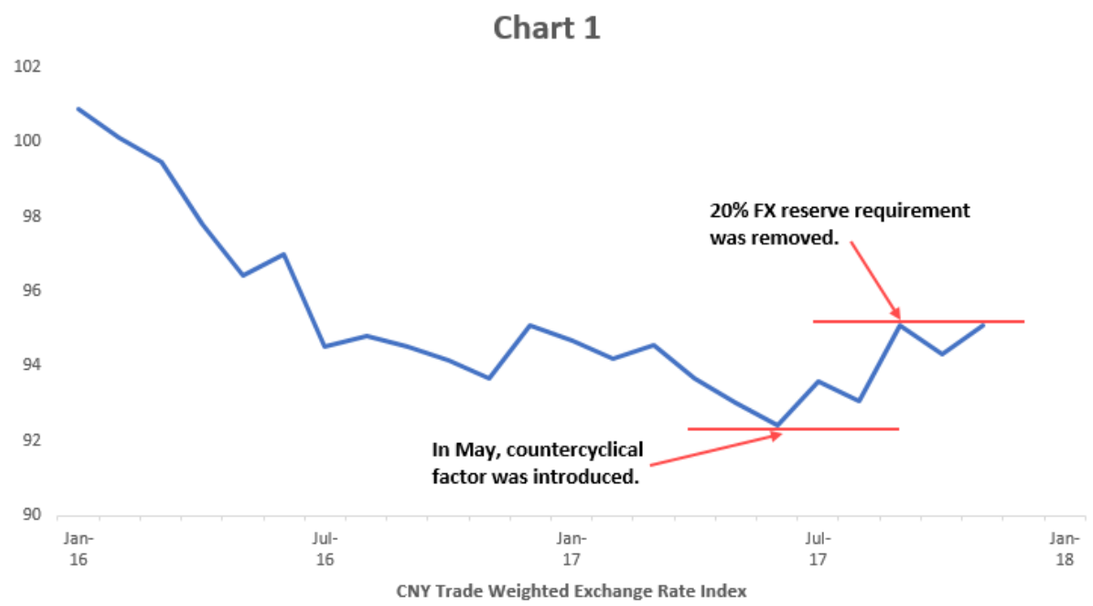
The year 2017 was a very good one for Chinese asset markets. We saw a strong rebound of the CNY FX against the USD as well as the Shanghai Composite Index's upward revisit of the 3400 level. The only area that proved unexpectedly disappointing was a sustained slide of government bond prices, due to the government's increased efforts to regulate asset management products and clamp down shadow banking activities.

Despite the year drawing to a close, the government did not slow down the pace in financial deleveraging. In mid-November, the banking regulators issued a consultative document of the first comprehensive set of rules governing the asset management industry, particularly shadow banking activities.

China's President Xi, after having his position as the country's top leader strengthened further in the 19th Party Congress, will likely accept a bit more of a slowdown in the economy, as a price for the continuation of financial deleveraging. As such, we expect China to resume a modest GDP growth deceleration in 2018 to 6.4-6.5%.

As far as CNY FX is concerned, stability will remain crucial, though further currency appreciation might already be no longer desirable in the eyes of the policymakers. The removal of the 20% FX reserve requirement imposed on commercial banks in September allowed onshore corporates to hedge against CNY depreciation risk at lower costs. That, to a certain extent suggested PBOC was ready to accept a certain degree of currency weakening after the CNY appreciated more than 7% against the USD in the first nine months of the year.

It is worth noting that in order to enable the export sector to contribute some compensation for a slowdown of the internal demand, due partly to financial deleveraging; it is not unreasonable for Beijing to have a mild bias towards a weaker trade weighted RMB next year. However, we suspect any weakening of CNY in 2018 will happen only gradually and the regulators will continue to use the counter cyclical factor (chart 1) introduced in May, to guide the market sentiment if necessary.



Specifically, we wouldn't be surprised by a gradual slide of the CFETS CNY index back to the 93 level in 2018. In contrast to the CFETS CNY index, the USD/CNY will have its performance more determined by the broad-based direction of USD. If the USD sees more of a rebound on successful US tax reform, we might see the USD/CNY's upward revisit of 6.80 in 2018.

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Malaysian Ringgit Still Looking a Relatively Cheap Buy

By Tim Cheung, Riki Zhang

In the course of improved EM Asia FX flows over the past 2-3 weeks, the MYR appears to have become the second best performer, just after the KRW, in the EM Asia FX bloc. That, to a certain extent, is attributed to the "encouragement" given by Bank Negara Malaysia (BNM).

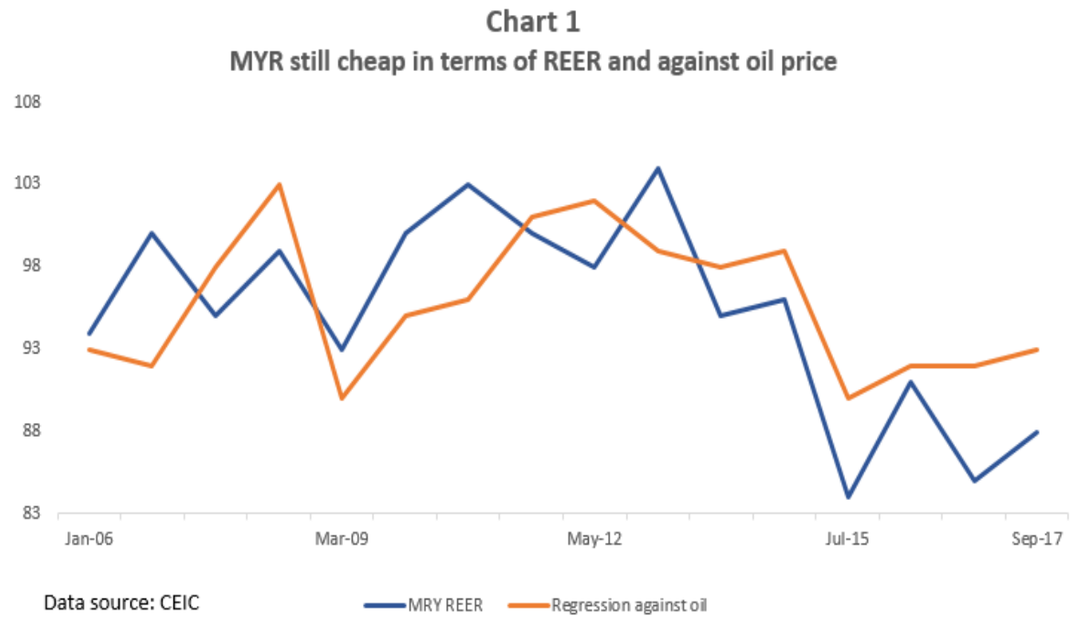
In contrast to other central banks, BNM seems to be the only one in the region that openly welcomes a home currency appreciation.

BNM governor said in a speech in the middle of November, "MYR does, to some extent, reflect Malaysia's economic fundamentals. The fact that the MYR's recent recovery coincided with strong domestic data releases suggests that. Nevertheless, in a global financial market that is driven by short-term developments, MYR exchange rate can veer in unexpected directions and reach levels that far from reflect economic realities. Unfortunately, most of these movements are not driven by facts, but perceptions. In MYR's case, I would call it misperceptions".

In contrast to Bank of Thailand which would like to see a weaker THB, BNM obviously hopes to see a stronger MYR to reflect Malaysia's economic realities.

Despite the recent MYR rallies, data suggest the real effective exchange rate (REER) of MYR has risen only 3% from its all-time low in December 2016, and is still 7% cheap to Brent at around USD63 per barrel (Chart 1).

Besides this valuation, another factor that is supportive of the MYR is BNM's monetary stance. The recent BNM's hawkish shift has increased the likelihood of a rate hike as soon as at its next meeting in January.



There is a very good chance that inflation in Malaysia will hit 4% very shortly before retracing slightly to somewhere close to 3.5%. No matter whether the retracement will occur or not, there is no doubt that inflationary pressures in Malaysia are already strong enough to justify an immediate rate hike.

Growing inflationary pressure, arising mainly from higher oil prices, might be one of the major reasons why the BNM hopes to see a stronger MYR. An appreciation of MYR definitely helps reduce the pass-through from higher oil prices to inflation.

In our view, the MYR can appreciate further to 4.00 against USD and 275 level against KRW by the end of Q1 2018 on the back of the BNM's monetary stance which is turning hawkish and her preference for a stronger currency to curb inflation.

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GBP/JPY – Builds Under 151.94 Ahead of Further Significant Recovery Gains

Technical Analysis by Martin Jones

- Pressuring continuation resistance at 151.94/152.86, following the earlier up-leg from 139.31
- A strong recovery structure exists and the 13 and 52 week moving average positioning supports
- Above 151.94/152.86 will confirm the next phase higher towards 158.75 (50% retrace of 195.88-121.61 cycle)
- Just above here lies 160.19 (24 June 2016 spike high) which shields 162.45 (equality of 121.61 to 148.46, from 135.60).
- Losing the higher platform at 146.96/98 is required to dampen/delay the immediate tone

Resistance Levels		
R5	160.19	24 June 2016 spike high
R4	158.75	50% retracement of 195.88 to 121.61
R3	155.00	Psychological
R2	152.86	21 September 2017 current cycle high
R1	151.94	1 November 2017 high
Support Levels		
S1	146.96	9 September 2017/28 November 2017 lower continuation
S2	143.91	12 September 2017 low
S3	141.20	5 September 2017 higher low
S4	139.31	24 August 2017 cycle low
S5	138.68	12 June 2017 cycle low

STRATEGY SUMMARY

Stay long or buy into dips for gains, through 9.8906, towards a medium-term equality target at 10.2240. Suggest placing a stop under 9.4296 or 9.2973.

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