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The Context

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The Context

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Inside this week's edition:

Know the Flows

By Cameron Brandt, Director of Research

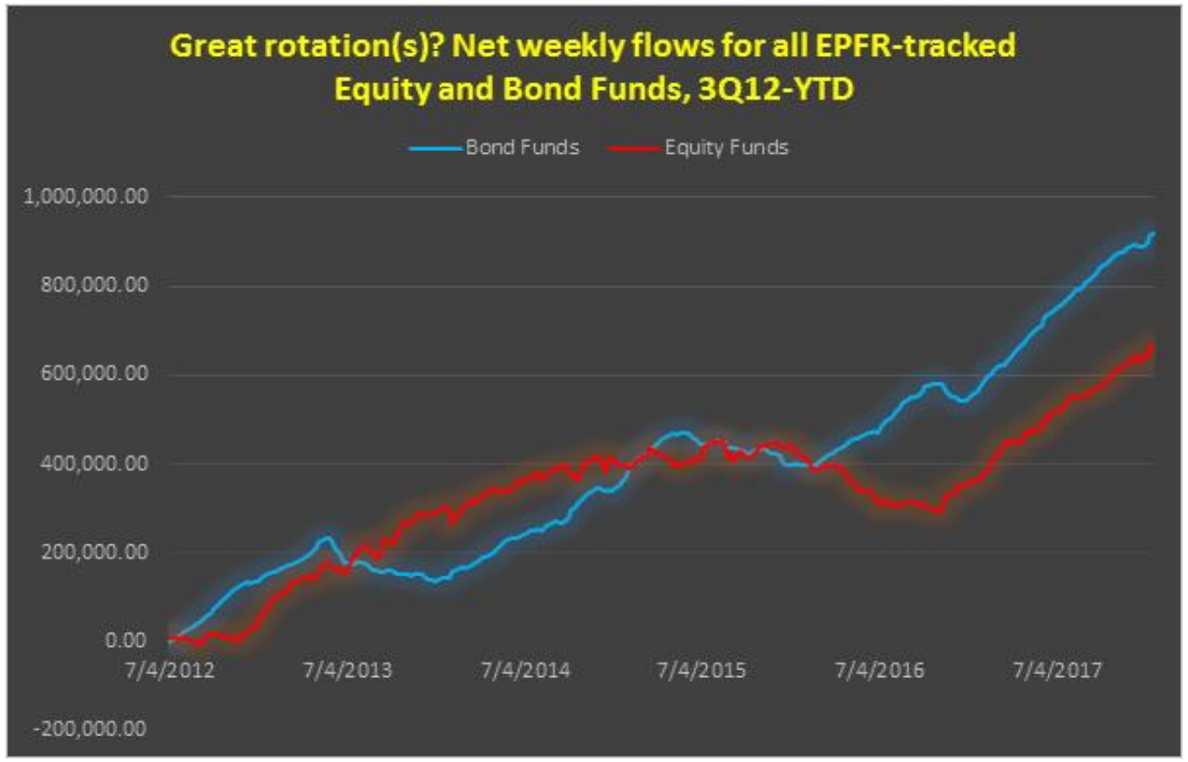
Having posted their biggest collective inflow in over six months during the week ending January 10, EPFR-tracked **Equity Funds** absorbed another $23.8 billion going into the second half of the month as key global equity indexes continue to post multi-year and record highs. That is their best start to a year since 2013, when the more than $40 billion absorbed by this fund group during the first 17 days of the year fueled talk of a 'great rotation' from **Bond** to **Equity Funds**.

In contrast to the previous week, when flows as a % of AUM were in the same ballpark, commitments to **Bond Funds** were well off the pace for **Equity Funds** - +0.11% vs +0.22% - during the seven days ending January 17. Investors retained their appetite for **Emerging Markets Funds**, with both **EM Bond** and **Equity Funds** attracting over $3 billion as they extended inflow streaks stretching back to the first half of December.

The week saw a milestone for **Exchange Traded Funds (ETFs)** , with the collective AUM for those tracked by EPFR moving north of the $5 trillion mark.

While keen to get broad exposure to the global growth story, investors showed much less appetite for individual markets. Furthermore, the single **Country Fund** groups that did attract new money in mid-January were frequently dedicated to smaller markets.

At the single country and asset class fund levels, **Vietnam Equity Funds** chalked up their second inflow record in the past four weeks, **Malaysia Equity Funds** extended their recent run of inflows and commitments to **Russia Equity Funds** climbed to a 50-week high. **Inflation Protected**



Bond Funds took in fresh money for the 13th consecutive week as they posted a new inflow record and flows into **Convertible Bond Funds** hit an 11-week high, while **High Yield Bond Funds** posted outflows for the 10th time in the past 12 weeks.

Fourth quarter earnings, the impact of the US tax reforms and a broad recovery in the global economy were among the factors that sector oriented investors were chewing over going into the second half of January. **Financials**, **Industrials** and **Technology Sector Funds** all took in over $600 million during the week ending January 17 while **Real Estate Sector Funds** recorded their biggest outflow since late October.

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Join The Bond Bear Crowd

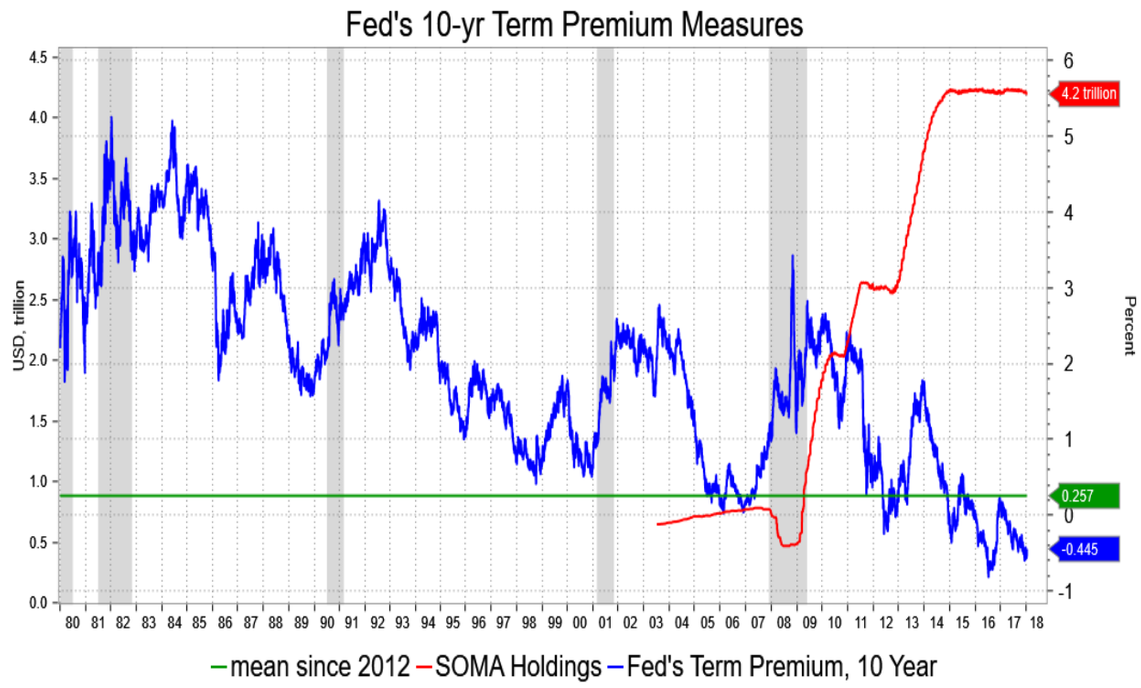
By David Ader, Chief Macro Strategist

Curious, have you come across anything recent about *bonds yields rising?* A Google search on "end of bond bull market" pulled up 13.3 million articles about that in 0.45 seconds. A search on "bond bear market" came up with 11.4 mn. In context, anything related to bond bull or market came up with 1-4 mn references. I guess that cat is out of the bag, huh?

An article, more a blurb, in the *WSJ's Heard on the Street* put it succinctly last Tuesday with the headline "In Treasury Market, There Are Reasons to Expect Trouble." It starts off saying 3.5% 10s is doable by the end of the year. Behind that potential are 1) the price action so far this year, 2) the behavior in TIPS on the back of gains in oil, various wage hikes and bonuses in 'celebration' of the tax cuts, 3) the acknowledged 'dubious' reports about China buying less and 4) the BoJ buying fewer JGBs. There's more. It talks about 5) 'undigested' factors like more bond issuance to deal with the expanding deficit, 6) the White House's stance on trade and how that might raise import prices while reducing demand for US assets. Finally, it tackles the term premium, negative, simply rising to zero (from -45 bp). Add all that up and they say 3.5% is 'within reach.'

And that's all good and fine and all, and I, too, am somewhat in the bearish camp though not to 3.5%. That level implies a steeper curve, sharply so, assuming the Fund's rate closes near 2% and change.

I'm not knocking what they wrote at all. However, I didn't read anything *new*. I didn't have chance to read all of the 13mn Google finds on the end of the bond bull market, but enough to give me the gist of that matter. To items 1-6 I can add the 7) the softer tone to the dollar, amidst 8) better global growth, which is provoking 9) tighter monetary



Source: Macrobond, Federal Reserve, Federal Reserve Bank of New York

policies and less QE in most of the G7. What I'm saying is we know all this and have for a while and that the price action that starts the new year, which is seasonally habitually bearish even in bull markets, is not necessarily a prologue, especially when risk assets - read stocks - are also subject to all of the above. Sauce for the goose and all that. The point is you can't confidently talk about 3.5% 10s without asking what that means for stocks. Or you shouldn't.

Which, of course, brings up relative valuations. The spread between 10s and the S&P 500 dividend yield is about 60 bp. If 10s were to rise 100 bp and assuming that yield on the S&P 500 was steady, the spread would be 160 bp (check my math if you like). 164 bp is the mean since 2000 and 14 bp is the mean since 2012! My point, is that push 10s up and they look quite attractive to stocks surely. 3.5% would be, I think, a gift next Christmas if 10s get there, but let's not get too greedy.

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

Market Participants Highly Unprepared for Rise in Borrowing Costs

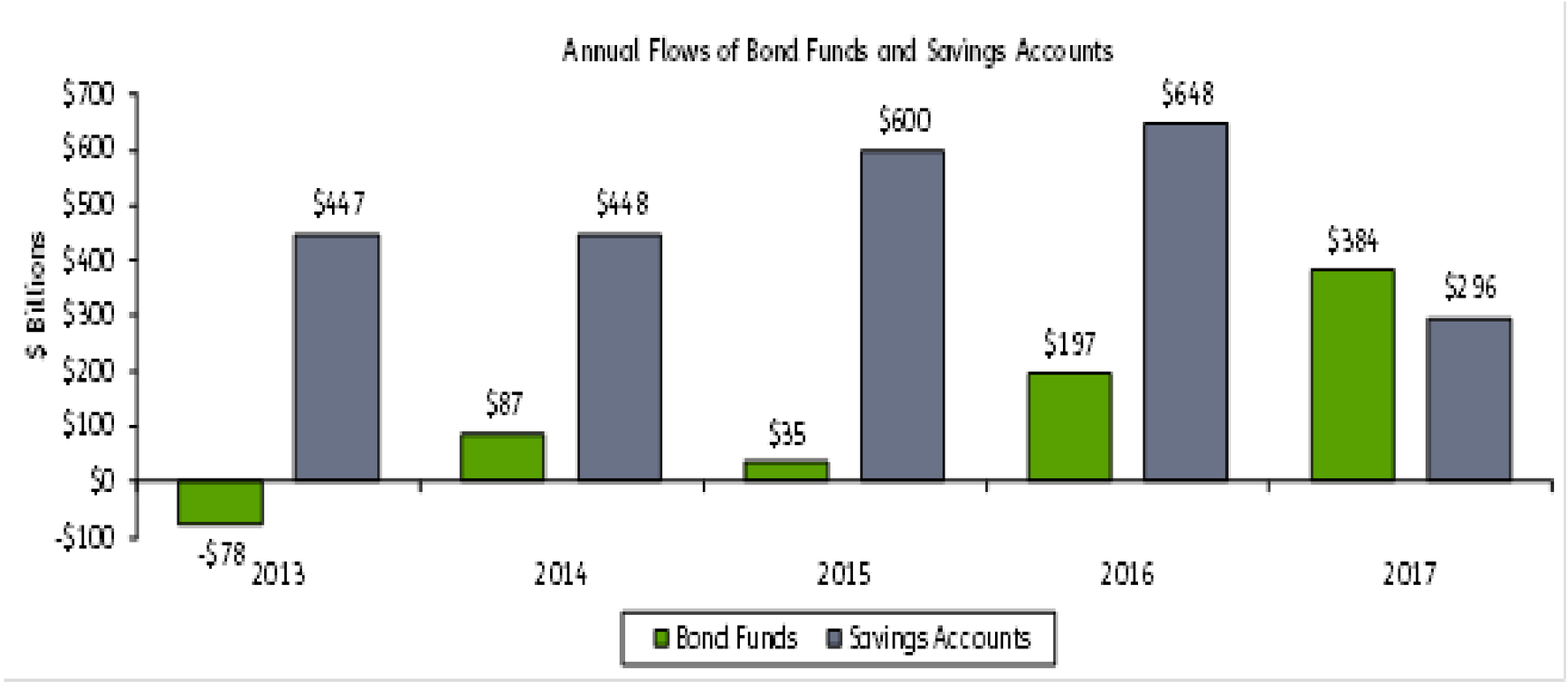
By David Santschi, CEO TrimTabs

Bill Gross recently opined that bonds are heading into a bear market. While we are not making a similar call, we would point out that market participants seem highly unprepared for a rise in borrowing costs.

Inflows into savings accounts fell sharply last year, while bond inflows spiked, even as asset price inflation surged, wage inflation was the highest in five years, U.S. consumer price inflation reached at least 2% y-o-y in eight out of 12 months, and the Federal Reserve not only started to withdraw liquidity but contemplated additional rate hikes. If the Fed is not as close to the end of its latest tightening cycle as the consensus thinks, the markets could be in for a nasty jolt.

Inflows into savings accounts plummeted to $296 billion last year, the lowest level since 2008, when savings account inflows reached $221 billion. Inflows slumped even as savings account yields increased (the highest-yielding savings accounts now yield less than 100 basis points below 10-year Treasuries with no duration risk). Before 2017, savings accounts had taken in at least $400 billion per year from 2009 to 2016, with inflows topping out at $648 billion in 2016.

While interest in savings accounts diminished in 2017, bond fund inflows swelled despite historically low yields and poor performance. Bond funds took in $384 billion last year, the highest inflow since 2009, when bond funds hauled in a record $419 billion. Last year's inflow was up sharply from $35 billion in 2015 and $197 billion in 2016.



ECB: Too Soon To Call A Change

By Rachel Bex, Senior FX Analyst

At the last ECB meeting in December, Draghi refused to adhere to calls from various council members to mark a definitive end to the QE program after September, instead sticking to his pledge to keep the possibility of further bond purchases open-ended.

But following the release of some hawkish December meeting minutes earlier this month, so a fierce debate has swung into action over just what Draghi will deliver in terms of forward guidance at the January 25th ECB decision - a debate which is currently proving crucial to sentiment surrounding the Eur.

In those minutes, a revelation that the ECB might consider a gradual shift in guidance from early 2018 sparked the start of a huge Eur rally, which subsequently took Eur/Usd some 3.3% higher, through the prior 1.2092 multi-year top to fresh three year highs of 1.2323 so far.

The ECB also saw some comfort in wage dynamics, while there appears to be increased confidence inflation pressures will eventually take hold (despite latest projections of just 1.7% in 2020). Recall, December EZ CPI was in line with consensus to the relief of many, but still well below target at just 1.4% y/y and 0.9% y/y for the core.

Given this inflation pullback, it will likely be too soon for Draghi to justify shifting his guidance, particularly after three "sources" recently warned the ECB is unlikely to ditch a pledge to keep buying bonds so soon as rate setters need more time to assess the outlook for the economy and the Eur.

As the January decision looms, ECB members are getting their penny's worth in about recent Eur gains. Villeroy called it "a source of uncertainty", and urged the ECB to monitor the impact of FX moves on import prices, while also reminding all QE scenarios beyond September are pure speculation.

Nowotny suggested that the Euro exchange rate "must be observed", while Constancio reminded that while the ECB doesn't target the exchange rate, there is a concern about "sudden movements which don't reflect changes in fundamentals". To this, he also cited the fact that inflation declined slightly in December.

It's thus looking increasingly likely that the CB will wait until at least March before shifting tone regarding on bond purchases, if only to avoid further unwanted currency strength.

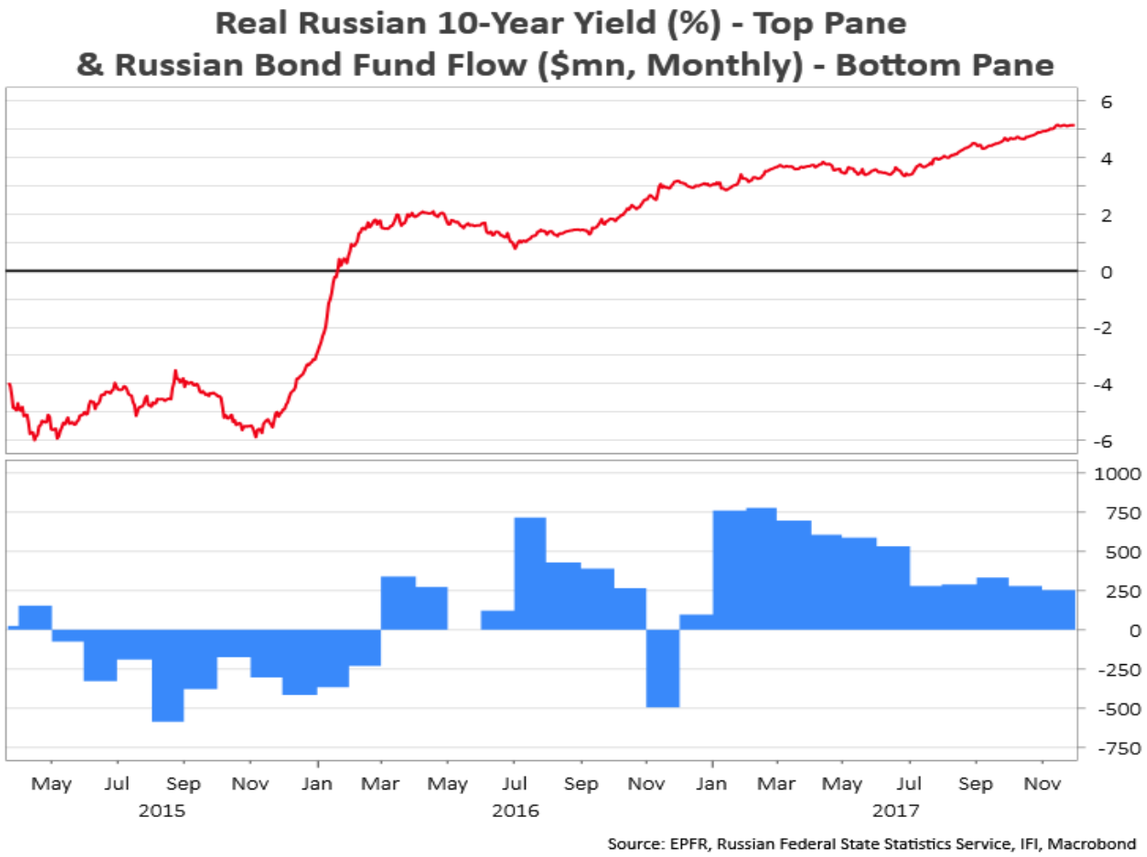
ECB's Coeure, who recently stated that growth in the European area should no longer be described as a recovery, but instead an outright expansion. Should this strong EZ growth story garner traction once again at next week's ECB meeting, so players may well choose to extend Eur/Usd's upside run.

Waiting for US Decision on Russian OFZ Sanctions - Buy Whatever The Outcome

By Chris Shiells, Emerging Markets Managing Analyst

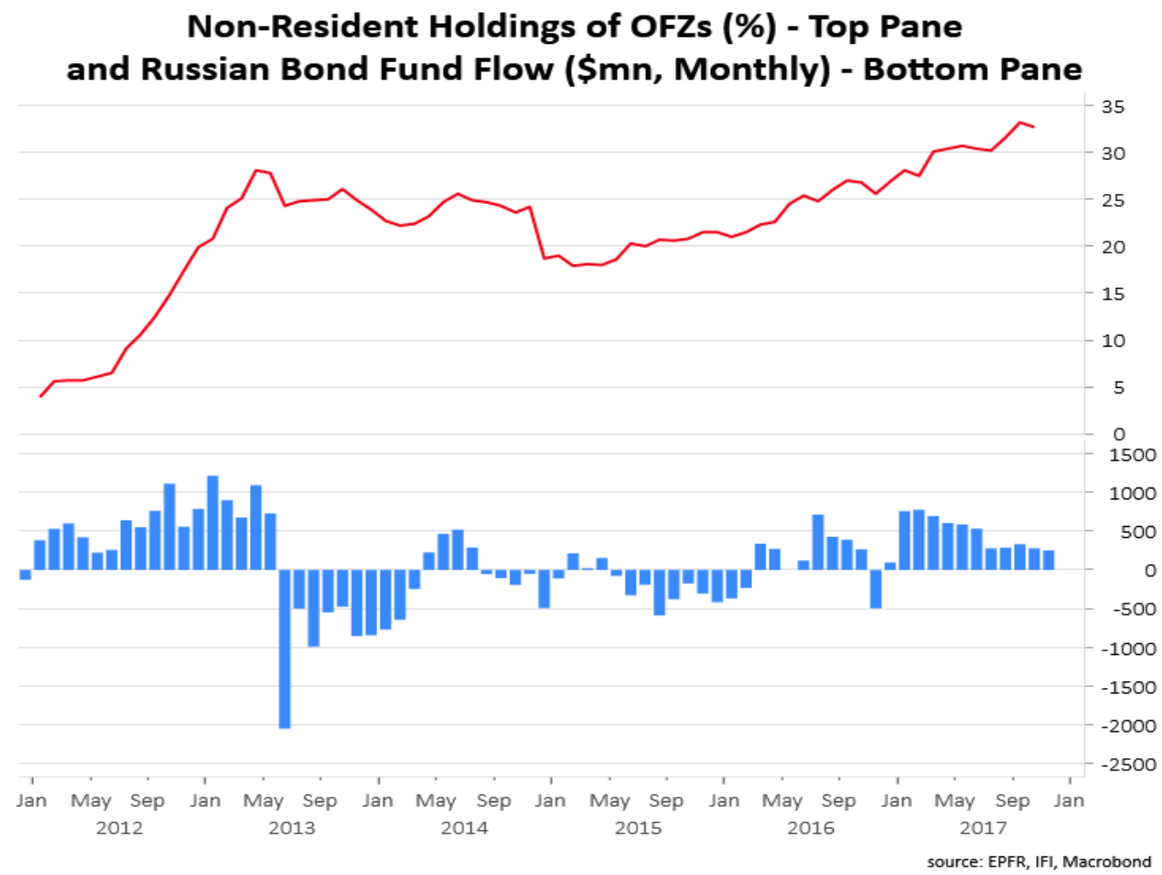
The US Treasury must submit a report in Q1 2018 on the impact of expanding sanctions to cover Russian sovereign debt and it has been reported that it will be issued on Jan 29. This would be the first step in imposing restrictions on buying OFZs.

If sanctions are put in place, what will be the impact?



Russian sovereign debt markets have become more dependent on foreign capital inflows, driven primarily by Russia's world leading real yield, which has helped rejuvenate flows into Russian debt, as evidenced by EPFR country flow figures. The graph above shows that the pre-2016 negative real yields were accompanied by 10 consecutive periods of monthly net outflows and how the subsequent recovery in real yields has helped to rejuvenate net inflows

According to official CBR data, non-residents now own 32.7% of all OFZs in circulation (as of end of Oct-2017), whilst not abnormal for emerging market sovereigns, it has increased from below 20% at the beginning of 2015.



The graph above shows that during previous periods in which major new sanctions were placed on Russia, (the 2014 sectoral sanctions in response to conflict in Ukraine), the reaction has not been too severe. Foreigners reduced their holdings of Russian assets gradually over several months (7% between July-October in 2014).

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Waiting for US Decision on Russian OFZ Sanctions - Buy Whatever The Outcome … cont

Interestingly, the “taper tantrum" of 2013 caused a sharper reaction (non-residents reduced their OFZ holdings by 13%), as did the CBR's massive emergency rate hike in December of 2014 (holdings reduced by 23%).

The EPFR data also shows a much larger and sustained reaction in flows to Russian bond funds during the taper tantrum, than during the sanctions episode. Thus it is clear that monetary policy normalisation in the US and domestic monetary policy reaction carry more risks for OFZs.

It has been speculated that if the US decides to move forward with sanctions on Russian sovereign bonds that this could lead to a 50-150bp surge in yields and together with a slump in the Rub, could force the CBR to raise rates by as much as 250bp, thus marking an about turn from the path of monetary easing.

However, this would be the initial knee-jerk reaction, and as Russian OFZ auctions are well supported by core-domestic demand from banks, extending sanctions on sovereign debt should not threaten budget deficit financing. The Russian Finance Ministry's fiscal consolidation policy to reduce the deficit to 0.8%/GDP also makes the Russian budget less vulnerable. There is also an expectation that the CBR and Finance Ministry will use their vast range of instruments at their disposal to respond to the immediate negative reaction. These instruments include FX interventions, key rate hikes (as mentioned), FX repo and swaps to provide liquidity, and the CBR has even mentioned OFZs repurchases (in the most negative scenario).

In the medium-term, it is expected that investors would use the OFZ sell-off as an opportunity to buy value, which is what happened after 2014. As we mentioned, Russian local currency bonds offer world beating real yields and in the current environment this remains key for international investors.

What if the Treasury report avoids OFZ sanctions?

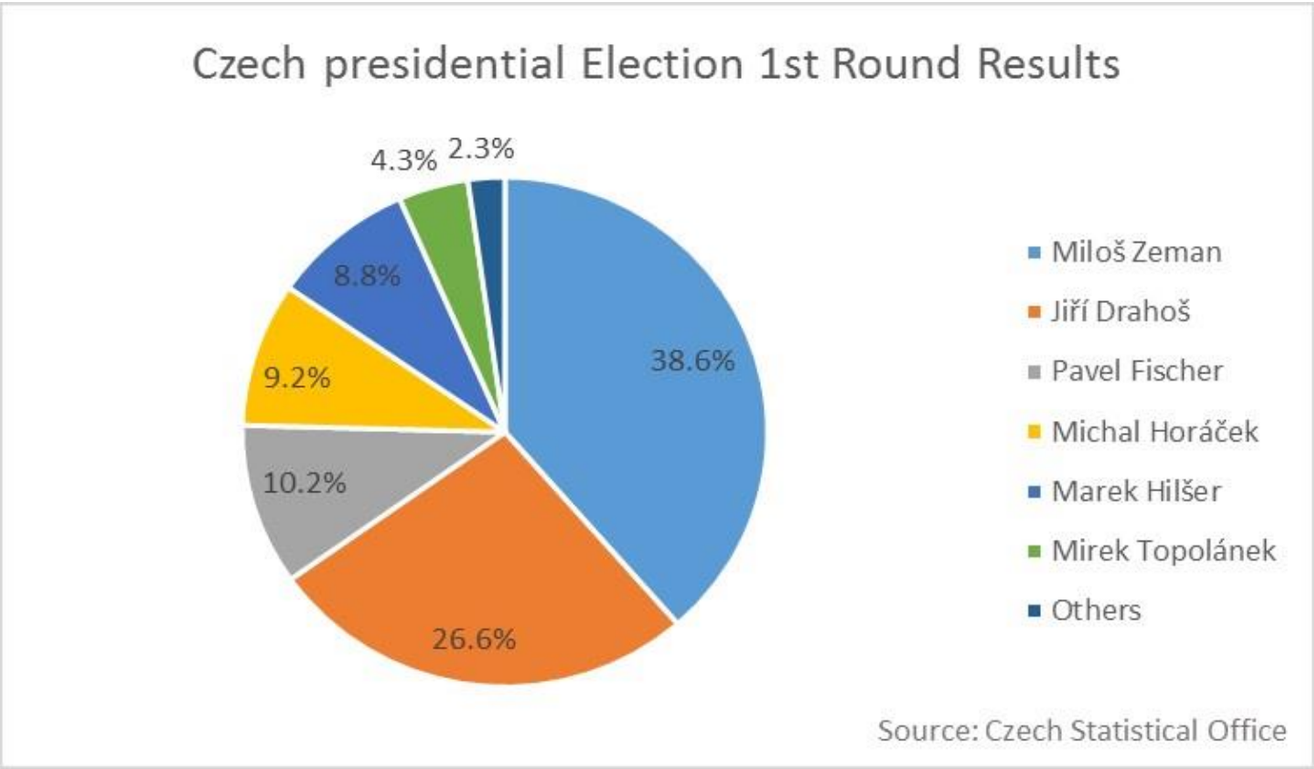
We expect that this scenario would see a fresh wave of additional demand for Russian assets, thus offering scope for further strengthening of the RUB and OFZs. BOAML has suggested that S&P could even decide to upgrade Russia's sovereign credit rating to investment grade when it assesses the country on February 23. It believes sanction uncertainty is the main constraint on lifting the sovereign rating out of junk territory this year. Russia is rated one notch below IG at S&P and Moody's (BB+/Ba1), though its 5 year CDS has long been trading at levels that imply the country should shake off its junk rating - currently at the lowest since 2008, around 109bp, and more than 500bp below its circa 6-year peak reached in early January when S&P gave the sovereign its first sub-investment grade rating in a decade.

Koruna Shrugs Off Politics Amidst Potential Presidential Upset

By Robert Graystone, Emerging Markets Analyst

CZECH POLITICS is set to remain in the spotlight for the foreseeable future - **PM BABIS**' ANO minority government lost a confidence motion in parliament (78 votes to 177) last week, and although **PRESIDENT ZEMAN** has said that he will give Babis a second chance to form a government, he himself faces stiff competition in the Presidential election runoff which is scheduled for January 26-27.

The incumbent, with 39% of 1st round votes, faces **DRAHOS** in the second round; the chemistry professor drew 27% of the first round vote, but has been endorsed by four other candidates who account for over 30% of the remainder. Additionally, a poll that was taken before the first round results were published has been cited on Actualne.cz and shows Drahos securing a very narrow victory (50.8%-49.2%).



The possibility of a second term for President Zeman increases the risk that the Czech Republic will carve out closer ties with Russia and pivot away from the EU, so this chance of a Drahos victory should support Czech assets. However, it is important to bear in mind that the role of President is mostly ceremonial, but Zeman has stretched these limited powers somewhat during his time in office. There is more than just the presidency at stake though, as it remains unclear whether or not Babis will be given a second chance to form a coalition/minority government if Zeman loses to his opponent Drahos, and this could lead to further political uncertainty.

Broadly speaking, we maintain the stance set out in back in November - economic fundamentals and CNB tightening should keep the Koruna supported over the medium/longer-term despite politics. Recall, hawkish comments sent **EUR/CZK** sharply lower on Tuesday and there is still scope for another 25bp hike at the CNB's February meeting, though soft inflation figures for December supports a more cautious stance.

LQD ETF Index Sinking but HYG Still Range Trading

By Jamie Vosper, Senior Derivatives Analyst

High yield & Investment grade funds suffered among the heaviest redemptions in the week to 18th Jan with JNK (SPDR Bbg Barclays High Yield) seeing $1.1bn worth of outflows over the period while HYG & LQD (iShares iBoxx HY Corp & iShares iBoxx Investment Grade Corp) losing $850 & 870mn resp.

Looking at the indices, the high yielders ended flat/a fraction higher Fri and remain well entrenched in the trading ranges established since mid-Oct, indeed, as seen in the next chart they are currently hovering around mid-way point of these extremes but the investment grade fund (see above) shed 0.3% to 119.77, the softest close since 119.72 on the 7th July last year. In the latter, the 119.50 (6th July low) & 119.47 (50% Fibo) support levels appear crucial, a confirmed breach below could well prompt an eventual move to around 118.74. Recall back on 20th Dec we suggested the recent technical double top could indicate a pull-back to 119.78 may ensue. Turnover in HYG Fri was steady at 14.4mn vs a 15 day average volume of 14mn while LQD changed hands 6.8mn times vs the 6.1m 3 week avg.

In long-term fund flows, both HYG and LQD have seen hefty outflows over the last seven weeks of $2.9bn (HYG) & $2.2bn (LQD) although the investment grade fund remains well ahead over the last 12 months (up $8.33bn versus -$2.2bn for HYG).

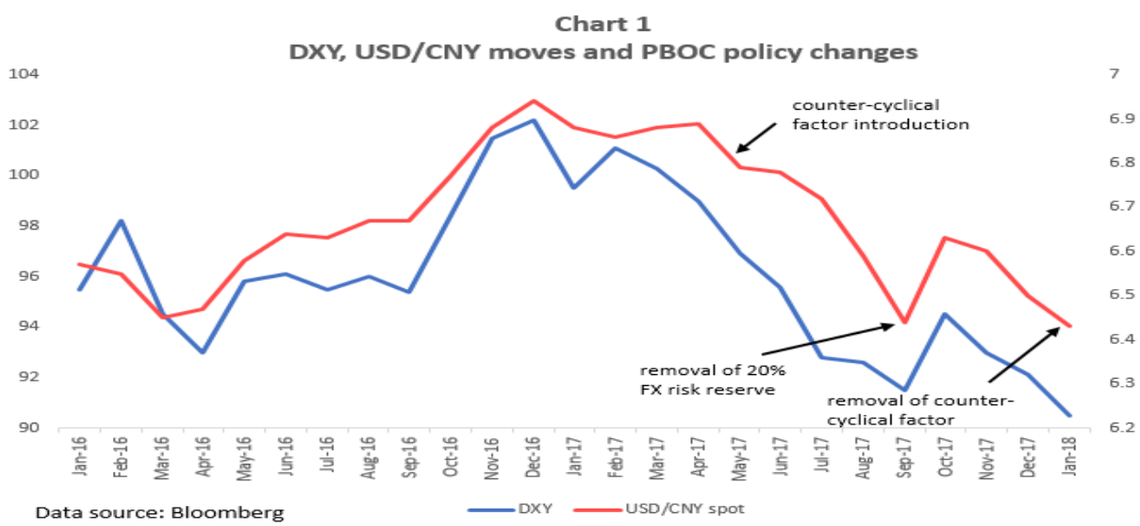
Asia FX Strategy: Who Are Going To Be The Winners In Q1?

By Tim Cheung, IGM Head Of China; Riki Zhang, Analyst

Instead of establishing a bottom, the USD index extended its weakness as soon as the new year started. Admittedly, the risk now lies for further USD weakness. However, sentiment is extremely skewed and data from a couple of major houses suggests that USD short positioning against G10 is already quite heavy and stretched.

As far as **EM Asia FX** is concerned, we expect the regional currencies, except PHP, will see further appreciation against the USD, though performance differentiation between them could be quite notable. Lately, some hedge funds have been fond of using the low-yielding KRW and TWD to fund the EM Asia FX longs. As a result, both currencies have recently weakened against other EM Asia currencies, except the PHP.

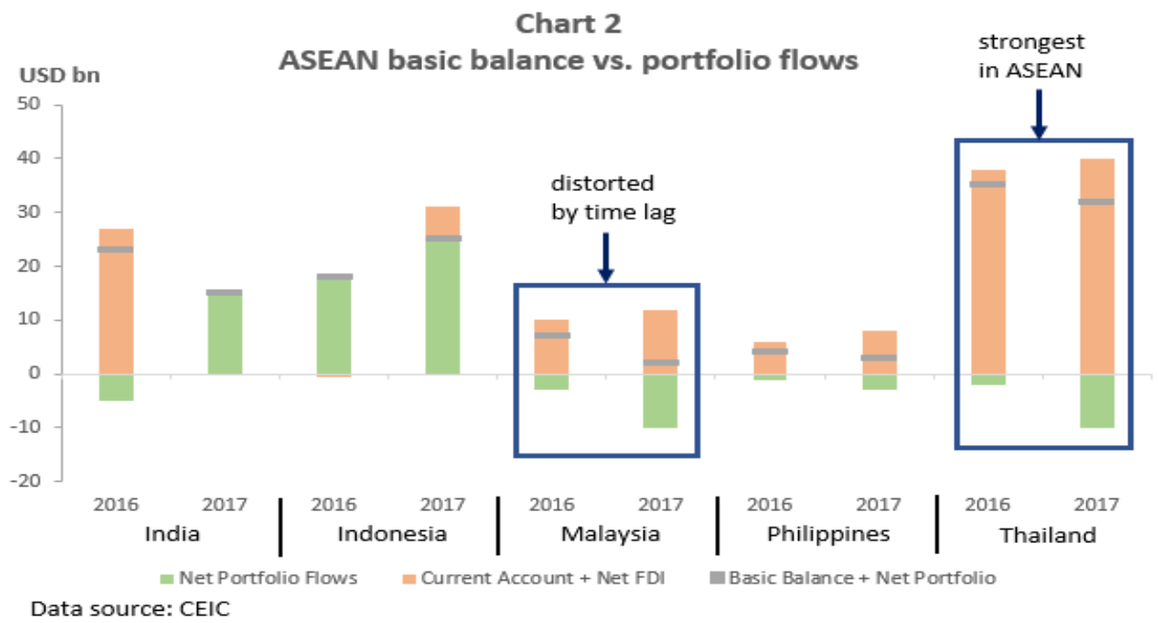
Over the rest of Q1, we reckon **CNH** will be the outperformer in North Asia on its more attractive carry and central bank's policy bias in favour of currency appreciation. The latter has been particularly evident lately because the PBoC, surprisingly, has kept allowing the CNY to appreciate (chart 1) after announcing a suspension of the use of counter-cyclical factors in the USD/CNY fixing mechanism.



In **ASEAN**, we think **THB** and **MYR** will be outperforming on better fundamentals. THB strength is underpinned by its 9%/GDP current account surplus. Thailand's central bank is likely to continue managing THB with intervention, but we doubt it will stop the THB appreciation.

Chart 2 shows THB has much stronger aggregate balance in the ASEAN region. Meanwhile, MYR stands out because economic growth has surprised to the upside and the recent rise in oil prices supported.

Due to the time lag, Malaysia's trade balance is unlikely to show positive momentum on higher oil prices until Q2. Needless to say, another positive for MYR is the success of selected companies, such as MAHB, DRB-Hicom and IJM, to secure Chinese investments. Though Malaysia's aggregate balance (chart 2) currently is not much stronger than the Philippines'.



However, we are inclined to believe it is a result of a time lag preventing the current account and FDI to effectively reflect higher oil prices' positive impact on Malaysian exports and the increase in Chinese investments respectively.

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AUD & NZD Bulls Prepare For Possible Central Bank "Smackdown"

By Tian Yong Woon, IGM Fundamentals Analyst

Against the USD, the Antipodes (AUD & NZD) have seen a rather good start to the year, extending late-2017 rallies as per the chart below:

A similar story can also be told when measuring the Antipodes' gains on a trade weighted basis, albeit with some paring of recent gains seen in the NZD:

On these gains, the Antipodes are once again creeping into dangerous territories especially with the 1st 2018 meetings for the RBA & RBNZ just around the corner on 6 February and 8 February respectively.

Let's take a look at what happened to the respective Antipodean currencies when their issuing central banks stepped up on jawboning campaigns last year, and how vulnerable the Antipodes are looking to a possible "smackdown" again this year.

The Australian Dollar

The (arguably) great AUD "smack-down" came about on 21 July last year when the RBA's Deputy Governor Guy Debelle delivered a sore refute to previously held hawkish interpretations of the RBA's July 2017 meeting minutes. The RBA's Debelle said that "no significance should be read into the fact that the neutral rate was discussed" and that "the fact that other central banks increase their policy rates does not automatically mean that the policy rate here needs to increase". There was also considerable jawboning from Debelle saying that a rising AUD is not welcome and that it may complicate the economy's adjustment. Since then, the AUD's pre-"smackdown" surges lost steam as the market's previously held hawkish narrative of the RBA abated and as jawboning of some degree started to become somewhat of a mainstay in the RBA's post-meeting statements and minutes.

Continued p13

AUD & NZD Bulls Prepare For Possible Central Bank "Smackdown"...cont'd

Fast forward, AUD/USD has since reclaimed lost ground and has once again crept up towards the 0.8000 handle from which it was previously talked down. The risk now lies in the RBA once again, from 6 February, attempting to curb excessive surges in the currency.

The New Zealand Dollar

The NZD saw a more direct "smackdown" last year when then-RBNZ governor Graeme Wheeler explicitly reminded the markets that FX intervention capability was always an open option to the RBNZ and that the CB would like to see a lower exchange rate. Following these remarks, the NZD saw a fresh extension of previous selloffs against the Usd with yet another steep wave of selloffs seen beginning just before the NZ 2017 general elections. This when the then-opposition Labour Party was seen to have a real fighting chance of winning which in turn also drove fears surrounding the RBNZ (this time, on the possible impacts of RBNZ reform).

Similar to the AUD, NZD/USD has too reclaimed lost ground with the pair now creeping towards the level from which it was talked down, at about 0.7337. The risk is that the RBNZ will, from 8 February, verbally seek to curb what may be deemed "excessive" surges in the currency.

Concluding Remarks

While the risk of a fresh wave of currency jawboning by the RBA and/or the RBNZ is very real as their 1st 2018 meeting outcomes gradually rotate into focus, there is also a risk that said jawboning does not materialise/escalate or that a materialisation/escalation of jawboning does not translate to any material broad-based depreciation of the AUD and the NZD.

After all, much of the Antipodes' recent surges have got much to do with a weakening USD and trade-weighted measures of the currencies reveal that post-"smackdown" losses still have some room to go before being fully pared. Also, we may also find ourselves seeing the Antipodes in a state of "exuberance" and even ignoring the RBA's and/or the RBNZ's attempts to jawbone the currency if there are any material and fundamental bullish shifts to the markets' narratives (e.g. case for near-term rate hike is substantiated by data, central bank comments).

To conclude, while there remains little to unhinge the Antipodes' recent run in the near-term if current underpins persist, Antipodes bulls should err on the side of caution when the 1st 2018 RBA/RBNZ meetings in February slowly rotate into focus.

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EUR/USD – A Longer-Term Perspective

Technical Analysis by Andrew Dowdell

- Bulls are now on the verge of reclaiming the 200-month MA (approx. 1.2430 - near former swing lows).
- The monthly MACD study is trending strongly higher and is now crossing above its 0 line.
- Further gains are anticipated, with 1.2886 eyed next ahead of 50% of the 2008-2017 fall at 1.3190.
- This level also coincides approximately with the upper boundary of a 9+ year falling channel.
- Short-term dips should attract fresh buyers near the Sep 2017 former high at 1.2092.
- Bears need to trade back through the Jan 1.1916 low to stall the advance.

Resistance Levels		
R5	**1.4940**	4 May 2011 high, near the 25 November 2009 high at 1.5144
R4	**1.3993**	8 May 2014 high
R3	**1.3862**	61.8% of 1.6038-1.0341 fall
R2	**1.3190**	50% of 1.6038-1.0341 fall
R1	**1.2886**	15 October 2014 high
Support Levels		
S1	**1.2092**	8 September 2017 high
S2	**1.1916**	9 January 2018 low
S3	**1.1554**	7 November 2017 low
S4	**1.1119**	20 June 2017 low
S5	**1.0341**	3 January 2017 low

STRATEGY SUMMARY

Look to buy for gains toward 1.3190. Exit longs on breach of 1.1916.

IFI Research's global team of Technical Analysts constantly look for interesting patterns in prevailing price action of a broad range of currency pairs, fixed income and commodity products. We will highlight the most compelling on these pages. For information on the full spectrum covered, please contact your Account Manager.

EURO 10-Year Yield – Awaits a Recovery Extension Targeting 0.682/0.737

Technical Analysis by Ed Blake

- Broke up out of the 5mth, 0.280/0.518 range and extended through a 9½yr falling trendline to threaten 0.619.
- Firming daily/weekly studies suggest a clearance of 0.619 targeting clustered resistance by 0.737.
- This consists of 4 December 2015 high, a 20½mth rising trendline and the former 0.280/0.518 range target.
- Some over-extended daily studies suggest increasing risk of a corrective pullback, however, the recent 0.466/0.514 upside gap should contain corrective dips allowing a resumption of the broader yield recovery.

Resistance Levels		
R5	0.986	13 July 2015 lower high
R4	0.822	1 September 2015 high
R3	0.737	4 December 2015 high, nr 20½mth trendline (0.754) & 0.280/0.518 range target (0.756)
R2	0.682	16 December 2015 lower high
R1	0.619	2017 high – 12 July, near 2018 peak at 0.608 posted 12 January
Support Levels		
S1	0.514	11 January 2018 low, gap high, near former 9½ year tentative falling trendline at 0.533
S2	0.466	9 January 2018 high, gap low
S3	0.380	27 December 2017 higher low
S4	0.280	11 December 2017 higher low
S5	0.225	14 June 2017 higher low

STRATEGY SUMMARY

Buy into any near term corrective dips as we await an uptrend extension through 0.619 targeting 0.682 then clustered resistance by 0.737. Place a stop under recent the recent gap low at 0.466.

IFI Research's global team of Technical Analysts constantly look for interesting patterns in prevailing price action of a broad range of currency pairs, fixed income and commodity products. We will highlight the most compelling on these pages. For information on the full spectrum covered, please contact your Account Manager.

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