OUR ESSENTIAL TRADES for Q1

THE CREDIT GAP

MIND THE GAP
A fresh start

The start of a new year is always accompanied by a sense of optimism and renewed hope in what fate and our own hard efforts will bring our way. This is true both in our personal lives but also in our working lives and this year it seems to be particularly apt for those of us who work in financial markets.

The Federal Open Market Committee delivered the first US interest rate increase in almost a decade last month and sounded the gong for the beginning of the end of an overlong era of ultra-cheap money. This is the first definite cyclical switch we’ve had for years. For many young traders, it is also the only such hike they’ve experienced in their professional lives.

That’s all the more reason why we should be more vigilant than ever in the year ahead. US interest rates are of consummate importance for our positions but many other risks loom too.

The Eurozone economy, though slightly improved, remains fragile. Britain’s position inside the European Union is unsettled. Greece is still in economic deadlock while political deadlock is the emergent new theme in Spain. The Syrian war, the oil price collapse and the state of the Chinese economy are all profoundly troubling.

While each of us is ultimately responsible for our own trading decisions, it’s a good idea to seek inspiration elsewhere. That’s why I’ve asked our team of experts to come up with their best trading ideas for the year ahead. We all hope you’ll be inspired!

With best wishes for a happy and prosperous 2016,

Kim Fournais
Co-founder and CEO of Saxo Bank
This Quarter

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Co-Founder and CEO of Saxo Bank

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Mind the gap

This Quarter

by Steen Jakobsen
Chief economist

The start of a new rate-hike cycle will make this quarter tough for traders habituated to an accommodative backdrop, but the Fed’s commitment towards normalisation will ultimately be beneficial to us all.
Very few people, even in the financial markets, fully appreciate that the “price of money” is just about everything that matters for the economy.

Profit, growth, employment, budgets and inflation are derivatives of the price of money. Not that profit, growth and all the other metrics are not important, but they are a function of price of money, not the other way around.

The price of money, which of course is the interest rate, is the input to what remains a “Black Box” for every economist and for the economy. We know very little about the black box despite the fact that so much research has gone into this.

There is a reason why economics is often referred to as the dismal science.

Think about the recent “lower for longer concept” – an academic idea born from research on Japan’s recession, where interest rates - the price of money – have been kept artificially too low for too long. Theoretically this of course should have restarted the economy but it didn’t because the price of money needs to be allocated to the “marginal cost of capital”.

The two single most important things I learnt at university when I did economics are these:

Firstly, the price of money needs to be allocated to the marginal cost of capital. Money should flow to the investment and borrowers with the highest potential return. We have done the opposite – we are presently ending a period of allocating the highest marginal Nepotism’.

The second is Say’s Law. Supply creates its own demand. Demand is not given, it’s “created” through the price of money and innovation. Both concepts are the only thing you need to know about economics. Understand these two and you are better equipped than 90% of all economists.

The Q1 Outlook is focused on minding the gap – the net change of how money flows, how credit defaults act and how the market historically changes during Fed hike cycles.

I have been in this field since the late 1980s and I have only ever seen four rate hikes in my time as a trader and economist. In fact you can discount 1997 which was a single hike of 25 bps and hardly qualifies as a cycle.
A few pointers:

- The US Federal Reserve generally delivers what it promises. The market usually looks to second guess the central bank’s commitment to hiking interest rates to the dovish side, but the Fed tends to deliver what it promises and often more. This occasion is no exception either.

- US dollar strength is inversely correlated to the direction of interest rates. That is, the dollar weakens when the Fed hikes rates.

- The average default rate increased from typically below 1-2% to more than 10% in a full rate cycle accelerating the “cleaning out” process and negating poor investments.

But the main point is this – the increase in Fed funds normally brings to an end a period of “un-normal” times – often a speculative environment and certainly always a mal-investment period where money has been flowing to one or two parts of the economy for too long. Basically, the economy has not been allocating to the marginal cost of capital.

Q1 will be a tough start to the year with confusion, increased volatility, and a lot of second guessing of the Fed, but do also understand that going from un-normal times to a model of marginal cost of capital is good news.

When money flows more freely and is allocated by the market, everyone wins. No one loses except nepotunistic and lazy investors, but overall, Fed hikes are a sign of a healing, not a sickness.

The price of money has been rising for almost 18 months. Just now the “policy rates equal central bank rates”: This is Moody’s BAA – the lowest investment grade tranche.

Q1 will be a tough start to the year with confusion, increased volatility, and a lot of second guessing of the Fed, but do also understand that going from un-normal times to a model of marginal cost of capital is good news.”
Commodities endured a horrendous year in 2015 with oil’s well-documented fall off the cliff leading the way and there is only a glimmer of light at the end of the tunnel, at least for the early part of 2016.
Commodity markets remain challenged at the beginning of 2016. Since the interim peak in 2014, the Bloomberg Commodity Index has fallen in five out of six quarters and the second half of 2015 proved to be particularly painful. The index has returned to the lowest level since 1999 thereby completely wiping out all the gains accumulated during the China-led emerging-market boom years.

Spurred on by cheap USD funding and in order to meet increased demand from China and other growing economies, producers of raw materials went on an investment binge from 2009 to 2014. The result of this overinvestment in production together with a China-led EM slowdown and a stronger dollar have led to a vicious circle of falling prices and cost deflation from where the market, not least crude oil and industrial metals, have struggled to escape.

Oversupply can either be removed through higher demand or the supply side adjusting accordingly. Such an adjustment is particularly hard to achieve during an oversupply driven selloff as producers, wherever possible, ramp up production in order to defend revenues. We expect that the battle for market share eventually will lead to casualties among both metals and especially oil producers and this will help balance these markets during the second half.

The sharp price deterioration has brought the price of many key commodities down to or even below production cost and this will eventually help speed up the process of stabilising the market. Although suffering from falling prices, producers have also seen a falling cost of production through cheaper labour and energy cost.

These developments continue to prolong the slump.

**Crude Oil Skewered**

This quarter could be the worst in the cycle for beleaguered oil. The lifting of sanctions against Iran could boost exports, initially from oil held in floating storage and later by 500,000 barrels/day into an already oversupplied market. In the US, inventories tend to rise during the first four months and this could increase pressure on Cushing, the delivery hub for WTI crude oil futures.

The lifting of the 40-year old US export ban will not begin to push extra barrels into the global market for the foreseeable future. It will, however, help prolong the current period of low prices with more than 100 million barrels in storage eventually being pushed onto the global market when export economics becomes favourable.

Demand has responded to lower oil prices and 2016 is expected to be another year with strong growth. This combined with the expected slowdown in non-Opec production will eventually help balance the market. But at this stage the overhang of supply going into 2016 will keep prices under pressure for most of the year. The price therefore needs to trade at a safe distance below levels from where production, especially from US shale producers, would be able to pick up.

The art of forecasting was recently described by a former BP CEO as a fool’s game and with so many moving parts alongside fundamentals — politics and religion to mention but two — anything can happen over the coming months.

The most likely trajectory of oil, however, will be continued weakness into the first quarter with Brent crude oil likely to trade in a $35-40/b range with the risk skewed to the downside. As we move deeper into 2016, the market will begin to balance itself and it should support a move higher towards the $55-60/b area by year-end.

With Opec adopting a no-ceiling policy, crude oil’s best friend and biggest hope of a recovery lies in the hands of speculators who, during the fourth quarter, accumulated a record short position in Brent and WTI crude. Any slight change in the outlook could trigger a violent bout of short-covering similar to the one seen last August when the price jumped by 25% in just three days.

**Gold $1,000/Oz Flirtation**

The beginning of the first US rate hike cycle in nine years was finally called in December and that removed many months of uncertainty for precious metals. Before then the yellow metal had been under almost continuous selling pressure since 2012.

A rising dollar, low inflation, fading safe-haven appetite and finally the prospect of higher US rates were some of the key drivers behind the weakness.

Investors in ETF cut total holdings by 9% last year to the lowest since early 2009 while hedge funds for the first time on record accumulated a net-short position in the futures market. The first quarter will continue to pose a challenging environment for precious metals with investors most likely viewing higher rates in the US and continued quantitative easing in Europe and China as a dollar-buying opportunity.
The stress witnessed in the high-yield corporate and government bond markets may, however, help limit the upside for the dollar.

Much depends on the guidance that the Federal Open Market Committee will pass to the market over the coming months. The market’s projection of where US rates are heading are much less hawkish than the FOMC’s own projection so economic data will continue to be watched closely over the coming months.

The direction of the dollar, bond yields and inflation expectations will be the key drivers for gold and only when we see a change in current direction will investors begin returning to the yellow metal.

On that assumption we see downside risk for gold during the first quarter but limiting it to $1,000/oz before eventually recovering and rallying towards $1,200/oz at the end of 2016.

Silver has remained in the shadow of gold during the past few years but we are seeing support emerging.

Falling supply due to production cutbacks in other metals, of which silver is a by-product, combined with increased demand from the renewable industry could see the white metal outperform gold during 2016.

During the early parts of 2016, when the dollar is likely to be baring its teeth, we prefer to express this view through a dollar neutral gold/silver ratio trade.

Once the dollar stabilises and/or positive momentum returns to metals, this could be changed to a straight long position in XAGUSD.

### Crude oil

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<td>Bigger than expected decline among non-Opec producers, especially US shale</td>
<td>Increased supply from Iran and potentially also Libya</td>
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<td>The unwinding/reduction of a record short futures position</td>
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<tr>
<td>Opec cutting production, either bilaterally or coordinated with non-Opec producers</td>
<td>Resilient US production led by rising supply from the Gulf of Mexico</td>
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<td>Geopolitical event in one of the key oil-producing countries</td>
<td>A weaker yuan creating headwinds for cyclical commodities, including energy</td>
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### Precious metals

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<td>Increased stress in the high-yield debt market</td>
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Lifting off

Macro

by Mads Koefoed
Head of Macro Strategy

The Federal Reserve tiptoed its way into a new rate hike cycle last month and while a revved up US will absorb that with ease, it might be tougher for emerging markets.
There you have it – after more than a decade the Federal Open Market Committee has finally gone ahead and hiked its key policy rate by a quarter of a point. Not since June 2004 have markets and economies had to contend with a US central bank which is applying pressure to the brakes – however modest the pressure.

The rate hike implies not simply a higher cost of capital in the world’s largest economy but also a rate divergence between the US and the euro area with the latter stepping a bit more on the accelerator – via a lower deposit rate and extended QE deadline – in early December. How will the US economy fare in a hiking environment – and what about emerging markets?

The prevalent view seems to be that the US economy is now strong enough to handle rate hikes even if wage growth remains subdued. But it also seems to be that rate hikes will put downward pressure on the economy, which is understandable given that the basic idea is that when cost of capital goes up, investment and consumption goes down.

The Federal Reserve hikes rates to cool the economy in the face of climbing (projected) inflation. However, the current expansion differs from previous expansions. Eventually higher rates will cool the economy, but this is not necessarily a 2016 event and certainly not a Q1 event. Instead, we may actually see a shorter-term economic gain from higher rates.

By hiking the policy rate, the FOMC signals that the economy is robust, which could (and should) boost confidence among consumers and investors as well as improve banks’ margins and in turn, potentially loosen lending standards further. A slightly higher rate, on a mortgage, consumer credit or otherwise, will not hold back the economy. Rather, higher rates imply interest payments and hence less is actually needed to be saved by consumers to keep interest payments at an unchanged level.

Consequently, I expect the US economy to at a pace of around 2.5% this year, similar to last year, but crucially with smaller positive contributions from the temporary shocks of low oil prices and a stronger USD. Consumer spending will grow robustly at 3%, government spending will add mostly to activity too, and investment spending will hold up well.

It is simply too soon for higher rates to derail the US economy; and the FOMC may well hike rates at a faster pace than currently priced in the markets. Historically, markets have been too sceptical about the rate path in a hiking cycle and they are only pricing in an increase of 65bps over the coming 12 months.

The outlook for emerging markets, on the other hand, is bleaker and not simply because of the ongoing Chinese readjustment towards a more consumption-oriented economy.

Emerging markets, which account for a growing share of the world’s output, can expect growth to moderate further this year amid subdued domestic consumption and as USD-denominated debt becomes more expensive thereby curtailng investment. Weakness in the commodity spectrum is already hurting many EM countries and higher USD funding costs will only serve to dampen demand further while the risk of a new bout of high volatility in EM remains present.

China’s transition away from an export- and investment-led economy has as expected resulted in lower growth and this downward growth path will continue this year and beyond. Concrete-ly, growth is expected to ease to 6.3% this year, supported by the authorities’ interventions last year, which included several cuts to the key lending rate worth a combined 125bps.

These measures prolong the internal adjustment process, but promote growth in the short term, which is why our growth forecast is not even lower. No matter the exact size of the slowdown in China, it has ramifications outside of the Middle Kingdom as Chinese demand for commodities – metals in particular – has weakened. Excess supply remains abundant and as producers are only slowly reducing investment expenditures, prices of metals will stay low this year, putting pressure on producer countries.

The global economy will hold up in the face of the first US rate-hike cycle in a decade, but the outlook is skewed towards the advanced economies and away from emerging markets. The US consumer is well-positioned for further increases in spending amid declining unemployment and improving balance sheets, and in the euro area a moderate recovery continues, helped by the European Central Bank’s loose monetary policy and the weak euro.

The reform pace remains uneven and modest, but the cyclical factors will overpower this for now. China’s growth will moderate as will EM in general, but the strength of the advanced economies will overcome this. The ramifications of the rising cost of capital will vary across economies, but for now they will not be exclusively negative and hence global growth will inch higher.
Growth of GDP in % for 2014, 2015* and 2016*

**Brazil**
- GDP Growth 2014: 0.9
- GDP Growth 2015*: 1.5
- GDP Growth 2016*: 1.5

**China**
- GDP Growth 2014: 7.3
- GDP Growth 2015*: 6.7
- GDP Growth 2016*: 6.3

**United Kingdom**
- GDP Growth 2014: 2.9
- GDP Growth 2015: 2.3
- GDP Growth 2016: 2.1

**United States**
- GDP Growth 2014: 2.4
- GDP Growth 2015: 2.5
- GDP Growth 2016: 2.5

**Japan**
- GDP Growth 2014: 0.0
- GDP Growth 2015: 0.8
- GDP Growth 2016: 1.2

**Global**
- GDP Growth 2014: 3.4
- GDP Growth 2015: 2.9
- GDP Growth 2016: 3.0

**Key**
- GDP Growth 2014
- GDP Growth 2015
- GDP Growth 2016
- Upsides
- Downsides

GDP (gross domestic product) is real, inflation-adjusted, year-on-year changes in percent. 2014 is actual while 2015 and 2016 are forecasts.

**Brazil to bottom out in Q4?**

As we enter Olympic year, hosts Brazil could have a little bit more to smile about if it can swerve a China slowdown/stronger US dollar whammy.

[Read more...](#)

**European Bank view moves quickly into profit**

2015 was a tough year for European banks but some nimble footwork in and around last month’s central bank blitz saw this view deliver handsomely.

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Turning the screws

by John J. Hardy
Head of FX Strategy

The US Federal Reserve achieved its long-awaited liftoff by raising interest rates in December, so the outlook for global currencies now hinges on the expected pace and trajectory of the next Fed rate increases. A straightforward bet is for the USD to strengthen.
We saw a paradigm shift in the final days of 2015 as the US Federal Reserve finally delivered its first rate hike in more than nine years. After a series of awkward missteps in its forward guidance for much of 2015, Janet Yellen’s Fed finally pulled the trigger at the December Federal Open Market Committee meeting. Furthermore, its forecast of the pace of hikes in 2016 implies a fresh 25 basis points move at every other FOMC meeting on average (though the Fed has expressed a strong distaste for a “mechanical” tightening pace akin to the final years of the Greenspan era).

More than ever, now that the Fed is actively adjusting interest-rate policy again, the outlook for global markets and all currencies, major and minor, hinges on the Fed hikes to come and adjustments in the market’s anticipation of the pace of those hikes.

Much of late 2015 was spent nervously evaluating the implications of the Fed starting a new hiking cycle, no matter how shallow the anticipated pace of interest-rate adjustments. EM currencies were nervous at best and even imploded in some cases, including the oil-exposed Russian rouble and Kazakh tenge and the politically and economically troubled South African rand.

Then the December European Central Bank meeting sparked a wave of revulsion and carnage for euro shorts and USD longs when it failed to meet expectations for expanding the rate of its asset purchases and merely shaved another 10 bps off the negative deposit facility rate and extended the QE horizon by six months.

With this move in the bag, and with Eurozone recovery showing modest promise, we have a budding idea that the ECB’s QE will be finished after March 2017. Adding to the theme of a bottom in rate-cutting cycles were the Reserve Bank of Australia and Reserve Bank of New Zealand also expressing more neutral forward guidance.

The central bank of the world’s global reserve currency in tightening mode, especially with other major central banks expected to pull away from an easing stance, represents a tightening of global liquidity and therefore could mean far higher volatility in all asset classes in the coming year.

In such an environment, the market will be sensitive to incoming data and reward countries with improving fundamentals that can cope with less accommodative central banks. And rather than this driving a general risk-on/risk-off regime, we anticipate that the focus will be on how monetary tightening will impact the credit cycle, which is at very different stages among the G10 countries, as we discuss below.

This could mean that emerging-markets countries with the worst current account shortfalls will remain under pressure in 2016 if they don’t show clear improvement in their fundamentals – here we think of currencies like ZAR and TRY. But each EM currency/country is likely to be treated on its own merits, as failing to differentiate would make no sense given the vast array of sharply different challenges facing those markets. India, for example, faces an entirely different set of factors than Mexico, much less a commodity-dependent country like Russia.

A wildcard for 2016 will be the speed of China’s currency devaluation now that China has set loose the yuan to weaken against its new declared RMB Index. That would allow a significant weakening against the US dollar if the latter is stronger as China can claim it is focusing on its overall trade-weighted exchange rate defined by the RMB index. Look for USDCNY (and the tradeable offshore variant USDCNH) to devalue at least 2-3% in Q1.

**Breakdown for the G10 Currencies in 2016**

**The strong**

**USD** – A straightforward call is for USD to rise as the Fed is now leading the pack in unwinding the exceptionally easy policy of the years since the global financial crisis. The important point is that, if the US recovery is on any kind of solid footing, it doesn’t matter if the Fed funds rate is 0.50% or 1.50%, and the Fed will quickly need to drop the “gradual” if we see notable further tightening in the labour market in Q1. **Trading theme: Long USD vs. CHF, EUR, AUD and NZD.**

**JPY** – It may be too early for this call, which might be better for Q2 or beyond, but at some point in the New Year, there should be a kind of global liftoff as the world decides it can survive higher US interest rates, so the Japanese yen could pick up additional steam after a solid performance in Q4 of 2015. The market may at some point in Q1 begin to sniff out the Bank of Japan signalling a tapering of its enormous QQE programme as it shifts to other tools and reforms. Particularly pivotal for the JPY outlook will be the wage negotiations for next year. **Trading theme: Again, this call could be a bit early, so the preference will be to begin fading JPY weakness if USD/JPY trades to new highs, for example, or to express a view with long-dated options in AUD-JPY or GBPJPY.**

**The weak**

**AUD** – The main engine of the Australian economy – mining – has failed. So now the Australian economy is running on its auxiliary engine – the last phase of a housing and private debt cycle, or even bubble, that is likely to weaken or at least slow in 2016 on the fading impact of earlier rate cuts. A further devaluation of China’s currency and continued weak export demand from China remain risks for AUD. A wildcard kicker could be any move to stem the flow of foreign purchases of trophy Australian real estate, fed by capital flight from China.
NZD - This currency is ripe for further downside as global volatility picks up and punishes the less liquid currencies. In addition, New Zealand has bounced rather too vigorously in trade-weighted terms, and the RBNZ will lean hard on any further strength in Q1. In a longer-term perspective, NZD remains overvalued in real effective (inflation-adjusted) terms. The recent uptick in milk prices has been driven by NZD-negative factors – low supply due to drought – rather than due to increased demand, so the prospects for a dairy export-led resurgence may prove dim.

CHF – We may see little happening for the Swiss franc and another quarter of modest fluctuations in EURCHF if market volatility sees investors showing a preference to hold francs as a safe haven, but we could also see a pickup in Fed interest rate expectations spark a strong rally in USDCHF, punishing the most negative yielding of the major currencies.

NOK and SEK: The Norwegian krone may be in for a relative bounce in the quarter if oil bottoms out quickly in 2016, but both Norway and Sweden are at or near the cusp of their domestic private credit cycles that have driven large housing bubbles on ever lower rates. While rates cannot fall forever, Norges Bank is likely to be one of the few central banks to cut rates in 2016. But the Norwegian economy has rolled over in 2015, and the aftershocks of the oil collapse will take Norway some time to absorb.

The rest

EUR – We don’t expect the euro to be strong in Q1, and it could fall towards the lows and somewhat beyond against the USD. But the Eurozone economy could continue to improve in Q1 after reasonably solid improvements in Q4. The credit angle suggests few reasons for concern, though eventually the Eurozone will suffer a fresh round of existential risks with the next recession – and possibly before – as periphery problems in the likes of Greece and Portugal keep simmering.

GBP – Sterling is at the crossroads of our themes and is a difficult call for 2016. The market has treated the currency as a “USD lite” over the last 18 months on anticipation that the Bank of England would move more or less in line with the Fed, if with a bit of a delay. That theme could provide marginal support for sterling in early 2016, but there are offsetting negative factors. These include fiscal headwinds from the UK government leaning against growth prospects, simmering Brexit fears, and the fact that the BoE has at least one eye on the ECB’s QE in sending out somewhat dovish signals in late 2015. Finally, the UK has an enormous current account deficit that could be a drag on the currency in a higher-volatility environment.

CAD – A bottoming out and bounce in oil prices sometime early next year and exposure to the strong economy south of the border could see Canada’s prospects start to improve. CAD likewise could then outperform some of its peers as it has been a bit unfairly singled out for harsh punishment among the commodity currencies. Still, as with the other small DM countries, Canada faces a hangover from an overleveraged private sector and runs a large current account deficit, two negative factors for our credit-cycle theme.

“More than ever [...] the outlook for global markets and all currencies, major and minor, hinges on the Fed hikes to come and adjustments in the market’s anticipation of the pace of those hikes.”
Farewell free money

by Simon Fasdal
Head of Fixed Income Trading

Now the Federal Reserve has started hiking interest rates, investors are forced to understand that the era of free money is finally over. The first quarter of 2016 will be tinged with a definite “after-the-party” feeling for bond markets.
As we enter a new year, one topic will dominate the agenda and preoccupy investors the world over – the credit factor. And with interest rates lifting off from zero, the cost of credit will inform the performance environment both on the national level as well as on the corporate level.

This scenario will trigger divergence in bond markets across more than one metric: Divergence between corporates with disciplined balance sheets, and those without; divergence between countries that have seriously embarked on a journey towards necessary structural reforms, and those that have not.

**Emerging Markets Less Emerging**

In emerging markets, we will see more attention from investors on specific countries, ability to cope with a rising cost of debt and this will create a clear split among EM economies.

The "good" basket will consist of countries that have (i) a positive impact from lower commodity prices, and (ii) have better fundamentals/politics or a better growth story. These countries include Mexico, Chile, India, Indonesia and South Korea.

Any spillover to these countries from regional stress will be seen as a buying opportunity. In some cases the investment backdrop looks even more appealing if the local currency is under pressure because of EM basket membership.

Though still appealing in yield terms and for risk-hunting investors, Russia and Brazil will have hangovers in the New Year. Both countries have a negative impact from commodities (oil for Russia and iron ore for Brazil), low growth as well as a level of political risk that must be taken into account.

Our buy-on-dip approach in 2015 made Russian corporate bonds one of the most rewarding investment cases, and despite persistent turmoil, single-digit returns were possible for Brazil for investors closing positions intra-year. But 2016 should be viewed with more caution, and a bullish call on the more riskier tail of EM will be established when there is more evidence of a stronger macro case, possibly Q2.

**Game on in Europe**

The European Central Bank’s continued quantitative easing and an expected shallow path from the Fed will be supportive for European corporate bonds, with a selective approach.

The energy sector is the big question mark as the main theme of a continued low oil price will have a diluting effect on it and related credit in 2016. This justifies the current stressed levels we are seeing in high yield credit (Bloomberg USD HY Corporate Bond Energy Index all time high OAS of 1390).

On the other hand, a Q1 strengthening in oil prices will reward oil-related corporates and countries, as the risk premium highly discounts further trouble ahead.

Continued QE from the ECB combined with further improvement in the economy makes European high yield the preferred segment for potential spread compression.

The main takeaway is again, divergence. The attractiveness of industries and corporates with disciplined balance sheets will be further outlined in Q1. For instance we prefer airlines with robust balance sheets to the highly leveraged ones.

The overall assumption for European high yield is a higher event risk which results in a higher level of duress. This anxiety has rewards included, as some high-yield instruments will have unjustifiably high-risk premiums. We prefer medium to short maturities in the high-yield space.

**The Big Short**

Core yields in Europe have been pushed down by QE and the commodity-driven drag on inflation. There is good reason to believe that QE’s impact on European core bonds will be limited in 2016. First of all, we do not see that the ECB’s aim is to target longer bonds in Europe.

But more importantly, if we see a further strengthening in European inflation, a change in the commodity price sentiment or better times for the global economy, there will be an upward pressure on European yield levels, as certainly as gravity exists. On the other hand, we also recognise the risk of European core bonds trading with a gold grade premium (AAA), as the demand/supply for higher rated bonds is still in a structural imbalance. However, we do believe the pressure from a shift in the inflation sentiment will have a stronger case.

In the event of any economic upside surprise during Q1, it makes sense to add a short bund position in a portfolio context.

“As the Fed starts hiking interest rates, investors must understand that the era of free money is finally over”
We are in the eye of the storm – after the ECB’s overpromised and under delivered easing package, which resulted in an equity bloodbath and near-term crucifixion of euro shorts and just after the Fed’s much-anticipated first hike in close to 10 years. All of this comes right before we enter the Chinese new year of the Red Fire Monkey, a year that should be characterised by extra market mischief, ambition, movement and, yes, more volatility.
It’s been very challenging to navigate the markets in 2015. In an environment dominated by global macroeconomic developments, some of the best known and established macro hedge funds have been forced to close down. Going into 2016, things seem even less clear than in 2015. There are always opportunities, however, and many of our clients definitely shot out the lights in 2015 with great performance – kudos to them. Chance favours the prepared mind, fortune the bold, while consistent wealth generation requires preparation, boldness and risk management.

I approach 2016 cognisant that while the US dollar will be stronger by the end of the year, it will be less of a clear win across all currencies than 2015. I am tactically cautious in my positioning, with no screaming high conviction trades (yet), but with some views that should have shelf-life for most, if not all, of the New Year. So let’s rotate through the different asset classes and touch on volatility.

**Volatility is certain**

You want a long bias in volatility, particularly in equities. Dislocations and fragmentations will be even more strenuous in 2016 than in 2015, with geopolitical risk high on the agenda (e.g. National Front in France, US presidential elections) and with potential for a global economic slowdown in what is already a challenging environment. Further, I’d expect 2016 to see ripple effects from the bearishness in emerging markets and commodity markets starting to feed into the developed world.

I like the carry trade in commodity-linked currencies and am long the NZD and AUD, short the CAD and CHF. So whether we are talking gains in NZDCAD ($0.9100) (milk over oil), AUDCAD or NZDCHF (milk over cheese), or AUDCHF (crocs over clocks), I think there is good shelf-life in these trades.

I’ve been a bear on Canadian macroeconomic prospects for a while now. I think with most of the economy linked to energy, risks of an elevated housing bubble and huge consumer debt, not to mention the new government elected on a fiscal spending ticket, we could potentially see the Bank of Canada join the quantitative easing club in 2016. Remember it takes a long time for a paradigm shift to sink in, and the prospect of oil staying lower for longer is still not fully appreciated by people who have been through a multi-year bull market in oil.

The Swiss and the Swiss National Bank, meanwhile, will have to front run the ECB. And whether ECB president Mario Draghi admits it or not, it’s QE for life in the Eurozone – at least for the next 3-5 years.

Directionally I also think being long USDCHF (0.9846) offers one of the best potential trades for 2016, with the multi-year monthly chart showing a big break. From my perspective, even 1.10 is not an aggressive target to finish off the year. Also, as I’ve been telling our Asia-Pacific clients for a while now, I don’t think it’s even aggressive to think that the yuan could weaken to 7.00 to the dollar by the end of the year. It’s the natural pathway towards it being a free-floating global currency, with the recent inclusion in the SDR being a big tick in the box for China.

**EM equities bearish**

I am still a big-time emerging-market bear. We’ve had more than five years of a massive bull market in EM and commodities, so one year of a pullback is not enough to get us back into shape. I’d stay short on the MSCI emerging markets ETF, EEM US ($34.00), either outright or through 4-6-month ATM puts targeting the $28-24 zone. Or go outright long the short MSCI emerging markets ProShares ETF, EUM US ($28.50), which is the inverse of the EEM. I would also be outright short or long puts (ATM 4-6 months) on the Korean equities ETF EWY ($52.50), targeting a move to $40 at some point in 2016.

**Headwinds for US treasuries**

As an unconventional play, right after the Fed rate hike you may want to buy 10-year US treasuries. The thesis here is that the US election year, global and US economic slowdowns will throw headwinds into any future Fed hikes. Also, just look at how long it took to get this one Fed hike, and ask yourself if the street is getting ahead of itself by factoring in multiple US hikes.

**Soft commodities could firm**

I still don’t like the asset class, but something’s brewing with coffee ($126.95). I think we could see a move similar to sugar with a 30-60% pop in the New Year given a combination of supply/demand factors, El Nino effects, price action and technical factors, with prices coming off multi-year lows and chances of a commodity relief rally driven by the US rate increase.

Any work in this asset class is more interesting on the soft commodities side. Gold bugs should focus on some of the best-of-breed gold miners which have tanked even more than the underlying asset class. Or, if you really must play the physical, do it through silver which has much better supply/demand dynamics.
Energy’s endgame

by Peter Garnry
Head of Equity Strategy

The three main forces affecting equity markets as we leave 2015 are the stronger US dollar, record low oil prices and a blowout in high yield credit, especially in the energy sector. As dominos fall in the energy sector the main question is whether this credit bubble might start a chain reaction filtering into other parts of the economy and financial markets.
Falling oil prices reaching the 2008 lows have caused carnage in the energy sector and widespread revenue collapse. In addition, energy companies have overinvested in the years 2009-14 with the sector being addicted to cheap USD funding. The investment case was driven by Chinese oil demand rising as far as the eye could see. With lower operating profits and credit rolling into higher USD rates as credit ratings are under pressure, the sector is being hit from all sides.

As we enter the first quarter, global oil production is reaching new highs. The US government is considering lifting its decades-old export ban on oil while Iran has said it will increase oil production aggressively as the country re-enters the global economy after years on the outside because of US-led sanctions. The worst may not be over for oil markets.

The direct consequence of the 70% slump in oil prices from their highs in 2012 is a credit crunch that has pushed the energy sector into its worst creditworthiness since 1995 with the net-debt-to-EBITDA ratio exploding above three, the highest of all sectors. The US high yield energy index reached an OAS of 1,284 basis points as of December 11. If oil prices do not bounce back soon, bankruptcies and asset sales will kick in and shake up the whole industry.

The biggest casualties will be those producers and services companies operating with the highest marginal costs. Oil producers in North America (oil sands in Canada and the US fracking industry), deepwater drillers and producers in the North Sea will all suffer serious damage. It could be a bloodbath and on a country level it would negatively impact Saudi Arabia, Brazil, Venezuela, Canada, Norway, UAE and Russia.

Even though energy and mining companies allowed themselves to be lured into a cheap USD funding trap, the majority of corporates have only marginally expanded their leverage. MSCI World ex Financials leverage is around the average since 1995 with the blowout in energy only having a minor effect. Technology companies, on the other hand, have historically cash-rich balance sheets.

**Asset-light future**

With turmoil in high-yield credit as investors run for the exit in energy and mining, the big question is whether it will cause carnage outside those sectors and amplify the effects of lower oil prices.

Our base-case scenario is that the credit crunch in energy and mining will be an isolated event that will spread to other sectors just as the crash in dotcom stocks was unique to that industry. Back then, while chaos ruled in dotcom, value stocks, such as industrials, chemicals and consumer equities, made large gains.

Energy’s weight in the MSCI World Index has fallen from its peak at 13.4% in June 2008 to 6.6% in November 2015. Materials have the lowest weight since 2000 at 4.4% with mining (one out of five industries in the materials sector) only being 32% of the materials sector (chemicals is the largest industry). Combined, the energy sector and the mining industry have a weight of 8% and thus the impact from another crash of 50% on global equities is miniscule.

The reality is that our society is transforming itself into an asset-light economy with less and less physical assets to generate the same economic output. Manufacturing is only 14% of the US economy and BlackRock’s CIO, Rick Rieder, published a chart on December 11 showing that little over 20% of the 1,500 largest companies in the US have zero or close to zero inventories.

Investors should not worry about debt levels among companies. Debt levels among sovereigns and individuals should instead be the concern. But if our global economy continues to expand at trend growth, the problem will slowly be alleviated.
This Quarter
Q1
Commodities Macro Forex Bonds Asia-Pacific Equities Europe

The medium-term impact from lower oil prices will be positive for household disposable income and thus private consumption and will lift inflation, wages and employment. Lower metals prices will shield companies from a margin squeeze, adding flexibility to increase wages, thereby stimulating the economy further. In a nutshell: the world economy will benefit at the expense of energy and mining.

**THE ENERGY VIRUS**

The real estate boom in the years 2003-07 was amplified by an overleveraged financial system running at around 17 times assets to equity. Since the Lehman Brothers bankruptcy, leverage among financials has gone down constantly driven by regulation and demand from investors who want to avoid a repeat of the financial meltdown in 2008.

The assets-to-equity ratio has declined to 11.3 in November from 17.3 in October 2008, adding the necessary buffer to absorb a future blow to the financial system. As a result, high default rates and non-performing loans in the energy sector will not be enough to impact overall credit channels from banks and will not disrupt other sectors of the economy.

**EQUITY STRATEGY IN 2016**

If equity markets are shielded from energy and mining credit crunch spillover – which is our scenario – then 2016 will likely be a good year for equities as investors face a flattening yield curve in USD yields, negative rates across European government bonds as far out as five-year maturities and in short-term Japanese government bonds.

However, valuations and the strong USD mean we are less bullish on US equities and believe the overall US equity market will underperform Europe and Japan in 2016. The best ways to play US equities is to be overweight financials (especially banks), domestic consumer stocks and biotechnology.

We are bullish on European and Japanese equities driven by monetary policies and increasing fiscal stimulus in 2016. Financials should be avoided in both countries. In Europe, we favour consumer stocks and export-driven companies. In Japan, the best play is through its carmakers and industrials.

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**VALEANT SELLING ABATES AFTER STEEP SLIDE**

Shares in Quebec-based Valeant Pharmaceuticals International fell some 68% this year on worries about its relationships with vendors and distributors, but its large portfolio of patented drugs makes it worth a look.

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**LOWERING STOP ON SEADRILL**

Seadrill, the offshore drilling company incorporated in Bermuda and managed from London, had a rough year because of the oil price plunge. Things don’t look like improving any time soon. And that’s why we shorted the stock.

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Poland’s difficult path

by Christopher Dembik
Economist, Saxo Banque

Poland has enjoyed the reputation of a solid, recession-resistant and well-developed economy for some time now. Unfortunately, it remains highly vulnerable to higher capital costs – particularly insofar as the energy sector is concerned. Our view is that Polish growth is likely to take a hit in 2016.
Higher Country Risk Premium

Poland is a flourishing economy that avoided recession during the global financial crisis and is usually considered the best example of a successful transition from communism to capitalism. Over the last two decades, Poland has emerged as a modern country that has developed high-quality infrastructure and become a major hub for many foreign manufacturers. However, Poland’s economic development is more fragile than most analysts believe.

My take for 2016? Higher capital costs will negatively impact the country’s economic growth, undermine the government’s willingness to go upmarket in the long term, and limit the capacity to reduce dependence on coal.

The exit from the zero lower bound in the US and uncertainty about the speed and magnitude of the Federal Reserve interest rate hikes in 2016 are likely to trigger a global trend of higher average capital costs that will particularly penalise emerging and transitioning economies. The impact could be greater in Poland than in other countries because of the deterioration of the domestic business climate.

During the electoral campaign, the Polish government proposed creating a special tax targeting specific sectors of the economy, mostly financial institutions and retail networks. If this election promise is implemented, it could send the wrong message to investors at the wrong time.

To this worry we must add concerns about the independence of the country’s central bank. By the end of February, lawmakers from the ruling Law and Justice party and the president will nominate eight new policy makers to the central bank’s 10-member board. It will certainly reshape its role and monetary policy as the new government wants a more “active” central bank.

During the crisis, the action and the independence of the central bank were unanimously hailed. It is not certain that the politicisation of the central bank will bring equally good results. This quarter, we must be vigilant regarding these two factors as they could push Poland’s risk premium higher.

The Need for Intensive Capital Investment

Risk premium is a key component in the estimation of the cost of capital, which in turn serves as a benchmark in financial decision-making. If capital costs go up, Poland’s economic development could suffer. Many companies will choose to postpone or cancel investments and will above all shy away from risky projects that are key to moving up market.

Poland’s competitiveness is based on skilled workers earning low wages. This is not a sustainable economic model. The Polish economy is in desperate need of intensive capital investments to move from imitation to innovation, which is a pretty long process.

The country is ranked 46th in the Global Innovation Index 2015, behind most peers in CEE. This disappointing performance particularly reflects the very low innovation efficiency ratio of the economy. In many sectors, Polish companies do not already have the capability to finance risky investments. Higher capital costs will harm innovation and may put an end to Poland’s dream of catching up with the West.

“... of intensive capital investments to move from imitation to innovation”
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