

# Quarterly Update

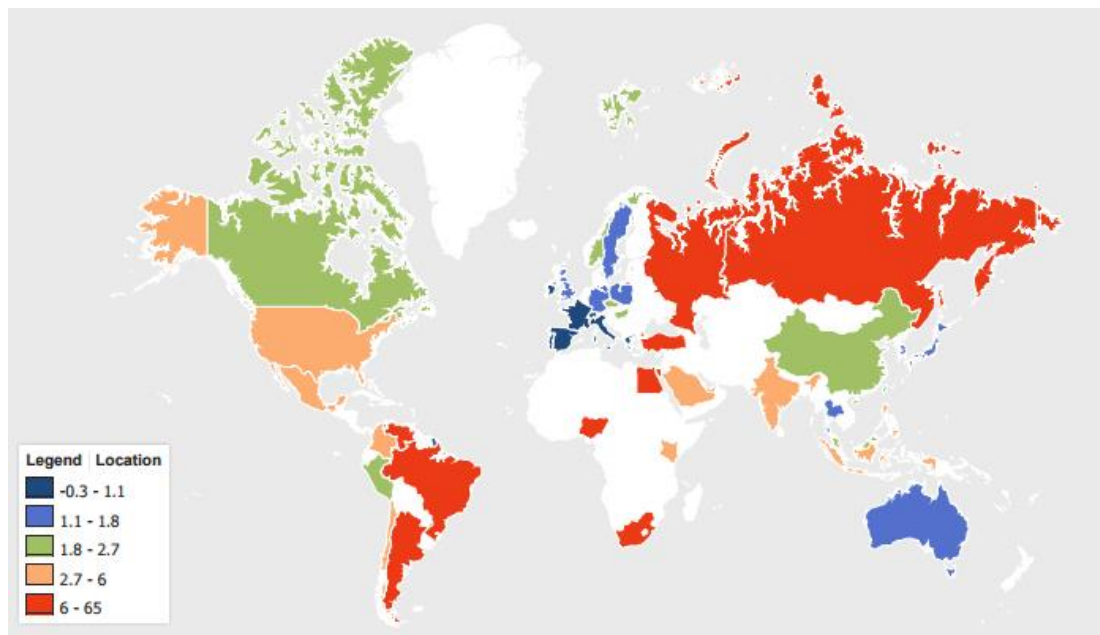
ETF Securities Research and Roubini Global Economics

## Volatile Rates: A Sign of Normalization or Danger?

Government bond markets were rocked by the April-May sell-off of German bunds, which resumed in early June. This reflected a healthy realignment of yields to economic reality and market conditions. Looking forward, volatility should remain suppressed by quantitative easing (QE), but bouts of panic are likely.

- The European Central Bank (ECB) began QE as announced, but the conditions associated with the program were somewhat stronger than expected. This resulted in a continuation of the momentum trade until mid-April, when a reversal began, sparking a rapid jump in G4 yields, with the largest bout of volatility seen in long-term bunds. However, much higher rates would be inconsistent with the weak global growth and very gradual Federal Reserve policy-rate hikes that we expect.
- Short-term yields, which are more reflective of monetary policy expectations, were little changed. Thus, the government-bond roller coaster that buzzed through the U.S. in Q1 put in a repeat performance, with Europe experiencing the largest dive. None of these sell-offs, however, were large compared with those seen in 2013 with the “taper tantrum” and many previous episodes.
- Equity markets, meanwhile, have shown resilience, but have also been a bit choppy. This is mainly caused by the tight link between the euro and 10y bund yields, which both have a strong impact on European equities. After sharp spikes in volatility in late 2014 and early 2015, developed-market equities have mostly rebounded and many emerging-market equities have also rebounded from earlier sell-offs.

## Heatmap: Roubini’s End-2016 Inflation Forecasts (%)



Source: Roubini Global Economics

## Key Macro Theme: Volatility

Early in the year, the bull market in global bond markets was unstoppable, as oil fell and central banks cut policy rates or added to unconventional easing. But, in Q2, sharp sell-offs reversed many of those gains.

### Market Rather Than Macro Drivers

Until recently, the fall in global yields had persisted fairly steadily since last fall, coinciding with the more downbeat growth outlook the IMF presented at its annual meeting.

In January, the U.S. 10y yield had fallen by 100 basis points as 10y UK and bund yields declined by 130 basis points from a year earlier. That reversed early this year for the U.S., the UK and Japan as growth prospects began to improve.

Bunds were an exception, continuing to decline even as the eurozone's GDP growth prospects gained further and the high hopes for the U.S. and Japan reversed, spilling over into the other G4 bond markets in March.

### Higher Yields Reflect QE's Success

Bund-yield suppression was likely due in part to the start of the ECB's QE, as it was: 1) larger than many expected; 2) linked to the Bank's capital key (rather than to driving down yields in the eurozone's weakest economies), thus making Germany the largest beneficiary; and 3) designed to allow the ECB to buy bonds across the entire yield curve.

With Germany running a fiscal surplus that would cut bunds outstanding by some €8 billion, yet holding just over 25% of the ECB's capital, there was an additional €10 billion in relatively price-insensitive demand for bunds.

In Greece, meanwhile, the rising risk of a Syriza-led government began pushing up Greek credit-default swaps in December and creating safe-haven demand for bunds. These factors led to large long bunds and short euro trades.

The April bunds sell-off, and spill-over to the rest of the G4, was, we believe, a healthy realignment to economic reality and market conditions, and could be seen as a sign of QE's success, as it in part reflects higher inflation expectations. However, it was a painful blow to holders of bunds, with the 10y yield rising by 70 basis points.

### Sell-Off's Causes Are Hard to Pin Down

Events that may have shifted prospective demand for bunds in April include optimism about negotiations toward a new Greek adjustment program, and comments on April 21 by German Finance Minister Wolfgang Schäuble on regulatory constraints.

However, as is common in frothy, overbought and illiquid markets, there were no economic surprises to justify the speed and magnitude of the bund-yield spike. We expect German yields to remain compressed, but the start of policy-normalization cycles in the U.S. and UK should support a slight

increase in long-term yields in those countries. Japanese government bond (JGB) yields will continue to be compressed by extra doses of easing in Japan. We lay out our expectations for G4 rates in detail on page 6.

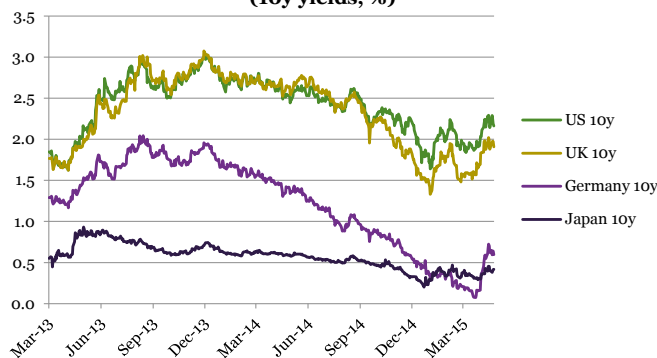
### Low Volatility With Bouts of Panic

Looking forward, a tug-of-war between reflationary efforts, disinflationary fundamentals in an environment of crowded trades and decreased market-making means bond markets, while still a "risk-free" benchmark, will be anything but stable.

Central banks in the U.S. and UK need to strike a balance between currency strength and disinflationary forces, and better growth and employment that auger inflation. An end to "zero interest rate policy" (ZIRP) is not only priced into forwards, but volatility is no longer at the suppressed, pre-"taper tantrum" levels, and thus the beginning of rate hikes, while undoubtedly important, should not be destabilizing.

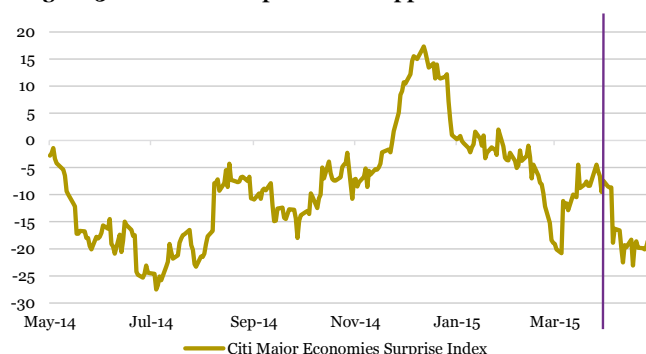
However, further down the line, it's far from clear what the G4 central banks will do (if anything) to adjust the size of their balance sheets. The Bank of Japan's and ECB's work is not yet done, but they have yet to signal what actions will come next.

**Figure 2: Bunds Were at Heart of April-May G4 Bond Sell-Off (10y yields, %)**



Source: Bloomberg, Roubini Global Economics

**Figure 3: Economic Surprises Run Opposite to Yield Moves**



Source: Bloomberg, Roubini Global Economics. Note: Purple line shows April 20 bund trough.

## Risks Around Our View on Rates

There are significant upside and downside risks around our rates expectations.

### German Bunds

Bund yields will continue to be subject to forces pushing them in both directions. The presence of a large, price-insensitive buyer in the market (the ECB), the still-low inflation, “safe-haven” moves stemming from geopolitical events (including the possibility of “Grexit”—Greece leaving the eurozone) and the absence of new net issuance of German bunds all exert downward pressure on yields.

So, too, would the occurrence of some kind of “accident” in the Greek negotiations, which might force Greece to introduce prolonged bank closures and then capital controls, making it harder to achieve a deal on the next (third) bailout program.

Or indeed renewed weakness in the eurozone economy, originating either in the core or in the periphery (perhaps due to excessive austerity). Or concerns about the financial stability of institutions (such as insurance companies) that are most affected by low long-term yields.

Meanwhile, the prospect of a reflationary move, the effects of higher Treasury yields due to the Fed’s coming hiking cycle, the perceived partial mutualization of eurozone debt via the ECB’s QE and the prospect of more rapid policy “normalization” all exert upward pressure on the 10y bund yield.

And there are other factors that could push it toward the upper end of the 0-1% range in which we see it trading (on average) for the next few years, such as higher realized and expected inflation (for example, as a result of higher oil prices), a stronger-than-anticipated recovery due to the lower euro and rates or a more hawkish-than-expected Fed.

### U.S. Treasuries

In the U.S., Treasury yields have been pushed higher by the rise in oil prices and the rise in bund yields. The upside risk to Treasury yields is a further significant rise in either oil or bund yields. That would mostly be a reflection of market dynamics rather than a fundamental change to the U.S. outlook. The downside risk to our Treasury yield call arises from the domestic outlook. Given most estimates of GDP growth are still too optimistic, market realization that the U.S. will miss those estimates could push the yield below our 2.5% forecast.

### UK Gilts

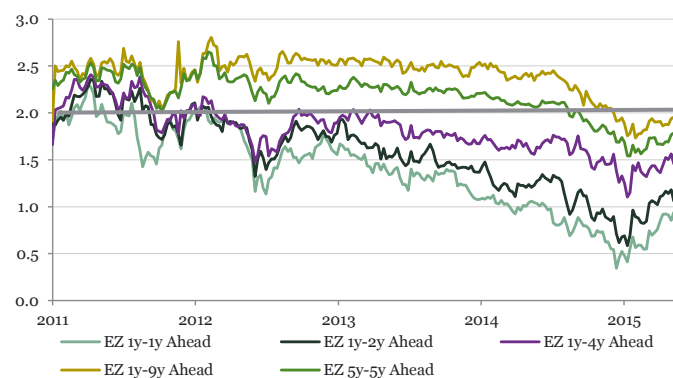
We think UK gilts will continue to follow U.S. Treasuries along a lower trend line as the Bank of England will likely wait for the Fed to make the first move. At the same time, if the uncertainty around the UK’s forthcoming EU “in/out” referendum were to weigh on business investment more than we anticipate, UK growth could slow further, which would support a new

widening of the long-dated U.S. Treasury-UK gilt yield spread. And if wage growth were to pick up more significantly than we anticipate, supporting an increase in unit labor costs, the Bank of England might want to step up its policy-rate normalization, which would tend to lead to a closing of the spread.

## Japanese Government Bonds

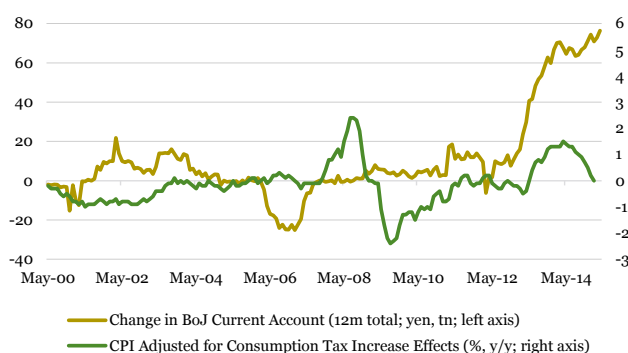
Japanese yields will likely remain dependent on Bank of Japan action and inflation developments. If inflation disappoints again, forcing the Bank to significantly step up its easing program, the 10y JGB yield might fall back toward 0.2%. Conversely, if inflation surprises to the upside, the 10y yield might rise above 0.5% by year-end.

Figure 4: Eurozone Inflation Expectations Look Healthier



Source: Bloomberg, Roubini Global Economics

Figure 5: Japan's QE Has Failed to Shore Up Inflation



Source: Haver, Roubini Global Economics

## What to Watch

- **Fed ‘lift-off’ and future path.** A delayed hike (2016) and a lower rate path would drive Treasury yields down.
- **ECB’s QE ‘taper.’** The end date for QE is September 2016, but the Bank could do more, keeping bond yields lower for longer.
- **Bank of Japan needs to cement inflation expectations.** If inflation disappoints, the JGB yield could fall.
- **Greek tragedy:** The ongoing negotiations risk a “Graccident” or even a “Grexit.”

## Revisiting Our Key Themes

With half the year gone, we take a look at how the key themes we introduced earlier in 2015 have progressed.

### Monetary Policy Divergence

The theme of monetary-policy divergence—a countdown to tightening in the U.S. and UK alongside continued easing by the ECB and the Bank of Japan—still holds, although the tightening in financial conditions via the rapid appreciation of the dollar and pound has reduced the imminent need for rate increases in those countries.

The ECB's QE will continue as planned. Initial signs of reflation have already prompted the first calls for tapering, but Mario Draghi and the Governing Council will resist them.

The Bank of Japan is waiting to assess how Q2 wage increases impact inflation before undertaking further easing; we still expect its easing program to be topped up in the fall, with forward guidance enhanced as well. This will help weaken the yen significantly.

Meanwhile, the U.S. Fed remains cautious about starting its rate-normalization program, awaiting sufficiently robust data to warrant “reasonable confidence” that inflation will return to target in the medium term.

Similarly, the Bank of England has reiterated that a rate hike is more likely than a rate cut, as wage growth is expected to accelerate into year-end, when favourable base effects should help inflation return to less abnormal levels.

A risk scenario is that the second half of the year might be characterized by the risk of reduced divergence in G4 monetary policies, if not a convergence, as both the Fed and the Bank of England could postpone their hiking plans.

### 2. Europe's Challenging Year

The Greek saga has provoked turbulence, as we expected, but the government will likely reach an eventual deal with the so-called “institutions” (Greece's official-sector creditors), preventing “Grexit.”

Perhaps emboldened by Syriza's rise to power in Greece, populist and anti-system parties elsewhere in Europe continue to find their way into government or make strides in that direction.

The results of Spain's regional elections show how fragmented that country's political system has become. Uncertainty over the outcome of Catalonia's election (September) and the national elections (December or early 2016) will likely weigh on domestic investment.

In France, meanwhile, the Front National has also gained meaningful electoral support.

All in all, we expect these developments to remain a drag on growth, especially investment; however, the chance of an acute shock looks relatively low given that downside risks, although still extant, have eased due to improving financial conditions, lower oil prices and monetary policy easing.

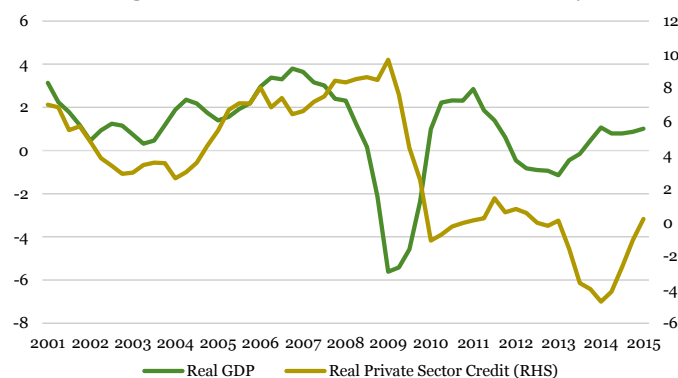
### 3. Asia's Sheepish Recovery

The divergence in economic performance that marked Asia's 2014 has not diminished so far this year, with China, ASEAN and most of the rest of Asia slowing sequentially (Japan, India and Australia are notable exceptions). However, most Asian central banks were able to cut interest rates.

We expect that pattern to reverse in the remainder of the year as Chinese stimulus kicks in to protect the authorities' bottom-line growth target, but Japan's reflation efforts fall short.

Inflation will also tick up in the region as the oil-price base effect falls out, biasing monetary policy toward tightening. Indonesia stands out as vulnerable to such an increase in inflation.

Figure 6: The Eurozone's Credit-Less Recovery



Source: Haver

## Surveying the Major Economies

### United States

The U.S. economy once again stumbled early in the year. But unlike last year, the Q1 weakness does not set the stage for a strong rebound in Q2, although H2 looks better.

Consumer spending, which has been disappointing year-to-date, will begin to show some vigor in response to job gains and improved real incomes, lifting H2 growth.

Core inflation is running well below the Federal Reserve's 2.0% target and is not expected to reach that marker until well into 2016, restrained by pass-through from the strong dollar, weak oil prices and anemic wage gains.

We continue to see the September FOMC meeting as the most likely time for the first Fed rate hike, but recognize a rising risk that this move will be pushed back to a later date, and a falling non-accelerating inflation rate of employment (or NAIRU) may lead to a slower pace of hikes.

### Eurozone

The eurozone is benefiting from a cyclical rebound as a result of lower interest rates, a weaker euro, low oil prices and greater fiscal forbearance from the EU authorities. Turning this into a structural recovery will be difficult.

Germany and Spain remain the eurozone's main growth engines. Although Italy and France are entering a cyclical upswing, their growth rates will still fall short of their already low pre-crisis levels this and next year.

Inflation will remain subdued due to the lagged effects of the past euro appreciation, lower oil prices and abundant spare capacity.

The political environment across the entire EU remains challenging, and upcoming elections could generate headwinds for the region if anti-system parties gain further support.

### Emerging Europe

Thanks to the eurozone's recovery, growth has surprised on the upside in most of Emerging Europe. Moreover, Central and Eastern Europe (CEE) is moving slowly out of deflation.

The stable ruble, lower rates and less restrictive fiscal policy have tempered Russia's recession to 2-3%. Inflation will fall to single digits by end-2015. We don't expect changes to the sanctions situation, but Ukraine should manage to strike a deal with its creditors late in Q3, perhaps following a debt moratorium.

Political uncertainty will keep Turkish growth low and inflation rising in 2015, with the central bank guiding the effective interest rate up. Turkey remains the country in Emerging Europe most exposed to the Fed's rate hikes given its rising inflation.

CEE growth will remain stable in H2, helped by eurozone demand. Inflation will return slowly to positive territory in

Poland and Hungary. The latter's central bank has a bit further to cut, and local currencies will remain stable against the euro.

### Asia/Pacific

In Japan, Abenomics has so far failed to achieve its goal of reinvigorating growth and snuffing out deflation, with the Bank of Japan undershooting the 2% inflation target it set at the outset of its easing program in April 2013.

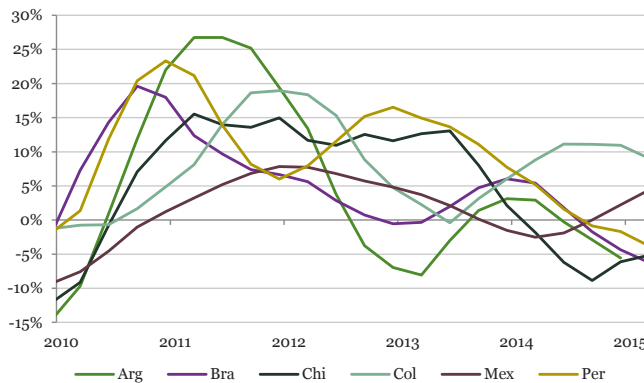
In South Korea, fiscal stimulus and recovering domestic sentiment should help push Korea's growth rate higher in the remainder of 2015 without further monetary easing. Elsewhere, strong recoveries in India and Thailand should offset moderation in Malaysia and Indonesia.

### Latin America

Most LatAm countries are tightening fiscal policy, having struggled to save during the commodity and credit boom. Even Mexico, a rare reformer, risks below-potential growth this year. Brazil, meanwhile, is in recession.

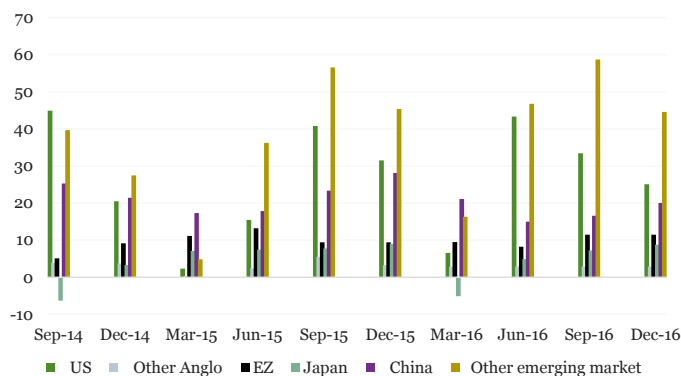
With net exports and investment falling/decelerating, growth will largely depend on private consumption. Despite disappointing growth, we see LatAm's main policy rates rising in the next 12 months as central banks act to anchor inflation expectations (with Fed rate hikes exerting pressure on financing).

Figure 7: Investment a Drag in LatAm (y/y, 4-qtr mvng avg)



Source: Roubini Global Economics

Figure 8: Contributions to Global GDP Growth (% , 2005 USD)



Source: Haver, Roubini Global Economics

## Asset-Class Implications: Fixed Income

### United States Rates

Although a number of upside risks (including higher oil prices and faster wage growth) suggest long-dated Treasury yields will eventually rise, we think they will remain low for longer than in a typical recovery, and expect the 10y yield to end 2015 at 2.5% and only slightly higher in 2016.

### Europe Rates

In line with this view on the U.S., we expect UK gilt yields to rise, with the 10y yield reaching 2.1% by year-end and the curve flattening further, unless the Bank of England joins the tacit global “currency war” and postpones its own rate hikes to 2016.

German bund yields will remain compressed (below 1%) for some years due to a combination of flight to safety, the ECB’s aggressive easing and the lack of a credible plan to reflate the eurozone. We expect the 10y yield to remain well below 1% this year. At the shorter end, bund yields will likely fall further into negative territory, thus widening the 5y U.S. Treasury-bund spread to over 200 basis points by year-end.

In the Nordics, the 10y Swedish government bond-bund spread should narrow toward zero. And in Switzerland, short-term rates will become even more negative this year, dragging down the longer end.

The easing we expect in CEE (including Russia) looks well priced into local curves, particularly in Hungary, where there are some signs of reflation. Turkish local and external debt do not price in the tail risk of another round of elections, which would exacerbate outflows. Turkey has accelerating inflation and a widening current account deficit.

### Asia/Pacific Rates

Long-dated JGBs, which recently sold-off when the Government Pension Investment Fund finally started to move from government bonds into riskier assets, will remain compressed on the back of the Bank of Japan’s redoubled easing, which we expect later this year.

We believe the short end of the Aussie curve is too steep, as stronger growth will lead the Reserve Bank of Australia to cut rates by less than the market expects.

We like paying 5y interest rate swaps in South Korea and Hong Kong and receiving U.S. 5y swaps since there is no economic basis for Korean or Hong Kong rates to trade lower than U.S. rates five years from now.

### Latin America Rates

We expect only moderate further upward pressure on government bond yields as the U.S. Fed embarks on its gradual rate hikes. Although the short ends of some yield curves need to rise, as is the case with Mexico’s, most curves are already

steep and the curves should flatten as markets reassess the pace of Banxico tightening.

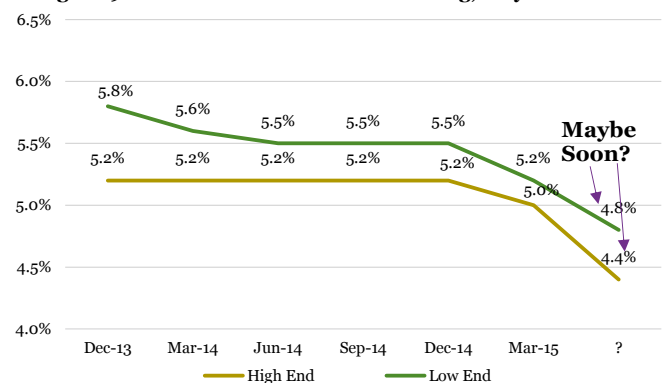
Meanwhile, the market’s expectation of 100 bps of additional hikes in Brazil looks excessive to us, while fiscal adjustment should support the longer end of the yield curve, leading to further inversion.

### Credit

In credit, U.S. high-yield spreads seemingly offer a relatively large risk premium (406 basis points). This may reflect irrational pessimism, as conditions remain benign outside of energy-related sectors. Investment-grade and European spreads, in contrast, are tight and have been little affected by turbulence in emerging markets, the dollar and global rates.

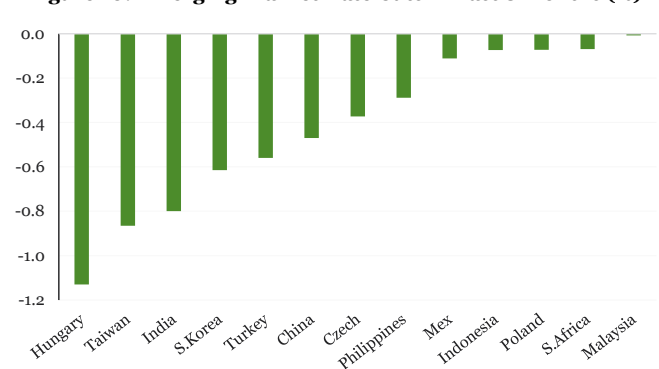
We are anticipating defaults to rise in exploration and production companies, but it is unclear how severe these will be. We expect 10-20% of these firms to go bust, but the recovery in oil prices comes alongside mounting downside risk, in our view, and recovery values are as important as the number of defaults in determining the fair value of spreads.

**Figure 9: Fed Estimate of NAIUR Is Falling, May Fall More**



Source: FOMC, Roubini Global Economics

**Figure 10: Emerging-Market Rate Cuts in Past 8 Months (%)**



Source: Roubini Global Economics

## Asset-Class Implications: Equities

### Global Equity and Developed Markets

Despite improving on the back of reduced concerns (for now) about the slump in oil prices and monetary policy divergence, market sentiment remains vulnerable to the outlook for Fed policy in the near term, increasing the potential for pullbacks.

U.S. equity remains between a rock and a hard place as strong data raise rate risk, while weaker data risk undermining the trend recovery narrative. But as we move past the Federal Reserve's first rate hike, rates and stock prices will re-establish their normal (positively correlated) relationship, with both driven higher by better growth.

As long as higher rates come alongside stronger growth, a compression of equity risk premium should offset the effect of higher rates on discounted cash flows.

The ECB's QE and the cyclical upswing in eurozone data have helped boost eurozone equity. Similar factors have allowed Japan's stock market to enjoy a sustained surge as well, with the additional Bank of Japan stimulus we anticipate in the fall set to offer further support.

Volatility has fallen to lower levels, with the VIX index retreating below 14 after several spikes above 20 as investors have become more confident that the oil-price shock was primarily supply driven.

We expect renewed pressure on equities going into Q4 as concerns about the Fed's rate path, the Greek saga and geopolitical tensions re-emerge, exposing stocks' lack of valuation cushion (especially in the U.S. and the UK).

Earnings uncertainty will likely rise as dwindling slack in the U.S. economy exerts greater pressure on margins. Revenue growth expectations will have to improve markedly to provide an offset.

Ultimately, high valuations keep us cautious on global equity, seeing little upside potential in the U.S. and UK markets at present.

The risk-reward balance for the broader market still looks unattractive over a 12-month horizon, but some opportunities can be found at the country and sector levels. We continue to favor U.S. domestic cyclicals and Japanese global cyclicals.

### Emerging Markets

It has been a tough start to the year: Growth momentum has slowed in most emerging-market regions and is only modestly positive heading into H2. In aggregate, GDP growth in emerging markets will drop to 4.2% in 2015 from 4.7% in 2014, but should rebound slightly in 2016.

That said, there are several headwinds to growth and asset

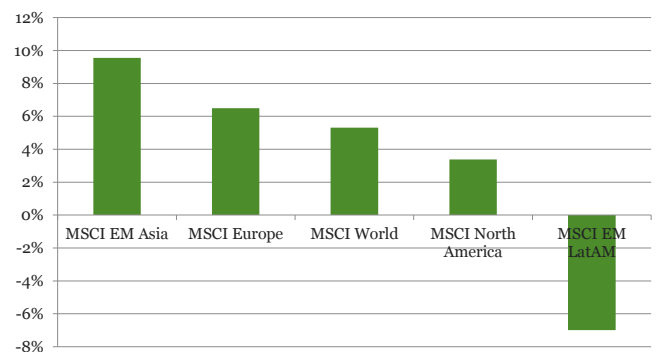
performance that could make it another bumpy 12 months for equities, such as the relatively weak commodity prices, the coming U.S. rate hikes (which will tighten emerging-market financial conditions) and the caution of the global consumer, which has dampened local investment.

Nonetheless, the relatively modest moves of emerging-market curves in the recent G4 rate sell-off highlight some resilience and underscore our view that country selection matters when it comes to emerging-market equity.

We prefer emerging markets with attractive equity risk premium. The catalysts we look for include economies that stand to benefit from better sequential U.S. growth (such as Mexico), fiscal stimulus (South Korea) and easing domestic financial conditions (Russia).

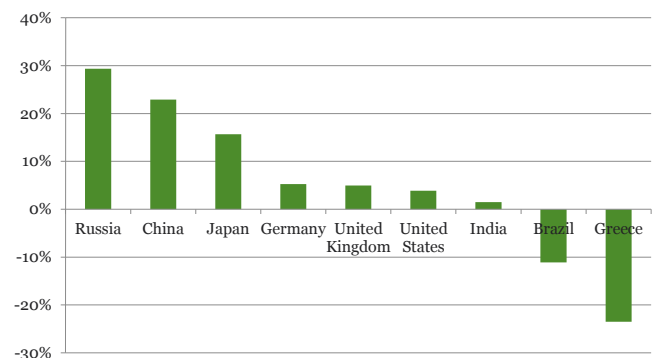
Uncertainty around reform implementation and unattractive valuations keep us cautious on other emerging markets.

**Figure 11: Total Returns by Region Year-to-Date (USD terms)**



Source: Bloomberg

**Figure 12: Total Returns by Country Year-to-Date (USD terms)**



Source: Bloomberg

## Asset-Class Implications: Commodities

Sentiment rather than fundamentals has been driving many commodity prices and we believe that once fundamentals regain power we could in some instances see a significant repricing.

### Industrial Metals

Although fundamental conditions appear to be tightening for a range of industrial metals, other factors are keeping gains in check. A broadly stronger US Dollar and concern over Chinese demand are having a restraining affect, but we expect the influence of these factors to fade over the second half of 2015. We expect that the stronger US Dollar will continue, but its impact is likely to become more limited on industrial metals prices because it reflects the pick-up in economic activity, helping underpin demand. While individual industrial metals will continue to trade in line with their own fundamentals, we believe that an upside surprise in Chinese and the stimulatory European monetary should be beneficial for the industrial metal complex.

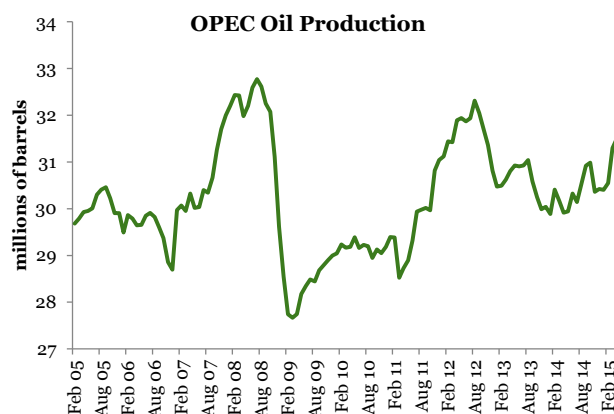
### Gold

While gold has been trading in a relatively tight range between US\$1160/oz and US\$1225/oz in Q2 2015, we think the metal will trade higher by Q4 2015 as global policy easing will largely remain in place and the slow speed of US rate increases will take some by surprise. Physical demand is likely to continue to grow though the course of this year.

Greece's precarious financial situation could drive haven demand for gold higher as the country continues to flirt with the prospect of default. The upcoming referendum in Greece could be a pivotal point in the saga. With capital controls in place and bank holidays enforced, demand for alternative monetary assets like gold could turn favourable.

### Oil

The constant struggle for market share will see oil prices initially decline as OPEC in particular will continue to produce more than the market requires. However, the tightening supply from high cost producers outside of the US will eventually see prices recover. We believe that the market has reacted a little too early to the prospect of tightening. With prices where they are today, the incentive for high cost producers to pare back has diminished. Approximately US\$100bn of CAPEX cuts have announced in the industry. We believe weaker prices are required for those cuts to be followed through. We believe that it will be the high cost producers outside of the US shale industry that will bear the brunt of the fight for market share. The nimble US shale oil industry has a lot of potential to ramp up production quickly when prices recover while conventional oil producers have very long lead times and therefore won't be able to take advantage of higher prices when they emerge.

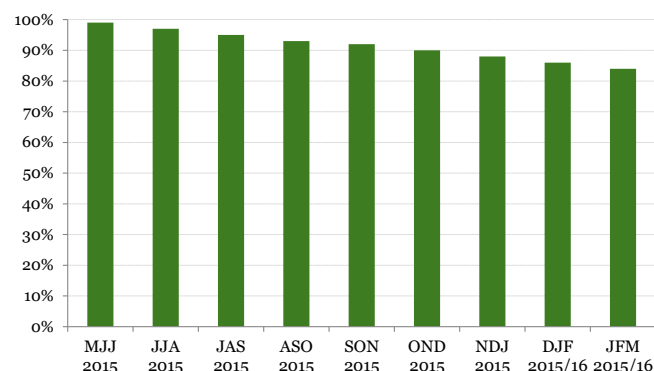


Source: ETF Securities, Bloomberg

### Agriculture

We are currently in an El Niño weather event that has intensified to a moderate strength. For some crops, an El Niño could boost production, while for others it could damage production.

**El Niño Likely to Last into 2016**  
(Probabilistic Based ENSO Forecasts)



Source: International Research Institute for Climate and Society (Columbia University), ETF Securities

Should the El Niño intensify further, we expect better growing conditions for coffee (a reduction in frost damage in South America) and soy (better growing conditions in US), which will weigh on price. Elsewhere, primarily drier, hotter weather in key growing areas will spoil conditions for wheat, corn cocoa and sugar cane, acting as a catalyst for price gains.

Price Projection	Baseline	El Niño Intensified	Overall
Arabica Coffee	↔	↓	↓
Sugar	↔	↑	↑
Cocoa	↑	↑	↑
Wheat	↓	↑	↑
Soybean	↓	↓	↓
Corn	↓	↑	↑



## Asset-Class Implications: Foreign Exchange

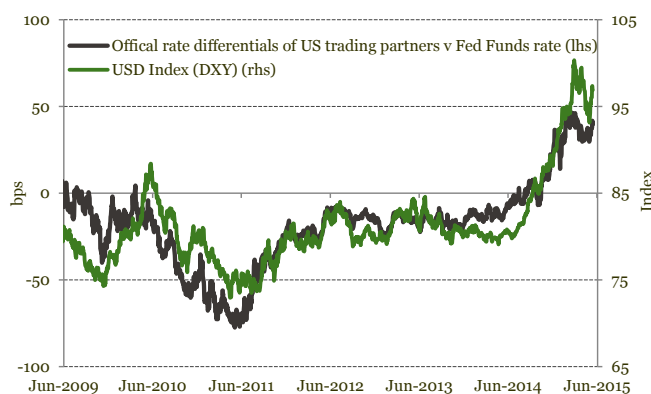
Volatility has been a pervasive force in G10 currency markets in recent months, a product of the ongoing Greek saga and the focus on the potential of tighter monetary policy in the US. While sentiment has been a key driver of policy moves recently, we expect underlying growth and policy fundamentals to become more a focus for investors in the quarter ahead.

Central bank policy will reassert its prominence as a currency performance determinant and the expected divergence of monetary policy, as the recovery paths of major economies differ, is expected to continue over the coming quarter. Policy rates will remain low or negative to support economies and this will predictably exert continued downward pressure on exchange rates. Currency wars continue to be a feature of monetary policy and those countries that are significantly exposed to the global trade environment continue to talk down the value of the local currency. Such rhetoric tends to be most effective when backed up by actual policy commitment. As a result, we have seen relatively poor performance from commodity currencies and expect this to continue in the near term.

Central Bank	Official Rate
Swiss National Bank	-0.75
Riksbank	-0.10
European Central Bank	0.05
Bank of Japan	0.10
US Federal Reserve	0.11
Bank of England	0.50
Bank of Canada	0.75
Norges Bank	1.25
Reserve Bank of Australia	2.25
Reserve Bank of New Zealand	3.25

While choppy trading is likely to remain a feature of currency markets in 2015, we remain bullish on the US Dollar in the medium term, expecting tighter policy by end-Q3. We feel that any weakness is a good opportunity to establish long positions.

### Rate Hike to Boost the Dollar



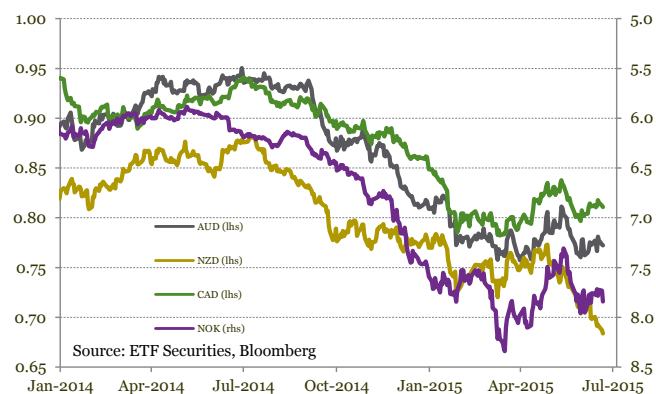
The Euro and Yen likely to be the underperformers. Both central banks (ECB and BOJ) have committed to aggressive Q(Q)E programs and the flood of liquidity is likely to keep these currencies under pressure against the USD as any policy tightening of is not expected ahead of 2016 at the earliest.

The gradual pace of economic improvement of the Japanese economy appears in line with the expectations for the Bank of Japan. The central bank continues to add to the monetary base via its Quantitative and Qualitative Easing (QQE) policy a steady rate, and is expected to do so until the inflation target is achieved. Inflation is currently hovering around the 0% level (2% with the consumption tax effect). We expect that against the Euro, JPY will continue to exhibit its long held relationship with money supply and is likely to continue to trade a range, albeit with downside risks as the European Central Bank is also pursuing aggressive monetary stimulus.

Volatility has historically been an adverse influence on the value of the British Pound. The pound has remained strong as the ECB has pursued its QE policy to offset deflationary forces. The fresh strength in GBP has come at a time when expectations have begun once again to price in rate hikes by the Bank of England. We expect the recent strength in GBP against the USD to reverse somewhat as rate hike expectations in the US again take hold. Against the Euro the outlook is more favourable and we expect further gains in the medium term.

Commodity currencies are likely to struggle in the near-term pressured by the dual weight of soft commodity sentiment and supportive central bank policy. Commodity currencies have seen a divergence with the antipodean pair of the AUD and NZD experiencing lacklustre growth, while the recent oil demand rebound has boosted oil prices and in turn buoyed the CAD and NOK. We expect this recent buoyancy to fade, as oil production remains elevated and oil prices soften in the near term, with performance across these currencies converging.

### Commodity currencies diverging



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