MORNING NEWSLETTER

February 2018

Summary

1. Currency war reopened ?
2. US – The return of the twin deficit ?
3. Eurozone – Rate markets start to price the end of negative rates
4. Japan – Kuroda claims victory on deflation (almost)
5. Oil prices at a 3-year high

6. Commodities – Gold and US real rates: the negative correlation has broken
7. Forex – Higher US 10 Year Treasury yield and a weaker US dollar vs. the Japanese yen
8. South Africa – The South African rand surged on the back of increased investor confidence
9. Volmaggedon
10. Cryptopocalypse



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01

Currency war reopened ?

US officials have unexpectedly brought attention back to foreign exchange movements at the latest World Economic Forum in Davos. US Treasury Secretary Steven Mnuchin's comment ("Obviously a weaker dollar is good for us as it relates to trade and opportunities") ignited a sudden depreciation of the Greenback, down to its lowest level since mid-2015. Subsequent attempts to counterbalance the message were not enough to put the genie back into the bottle.

Whether this declaration was clumsiness or intentional is open for speculation. What can be taken for granted is that: a) Donald Trump had repeatedly complained about the unfairness of global trade terms for the US during his campaign; b) his election triggered a sharp dollar appreciation, later deflated by the lack of progress on tax reform; c) the dollar resumed an upward trend as soon as the prospect of a tax reform became real again at the end of 2017. Regardless of the conclusion one might derive from this chronology, the unusual comments made in January look like a breach of the so-called Shanghai agreement of February 2016, when G20 leaders were said to have agreed to stabilise currency markets after a strong two-year US dollar appreciation.

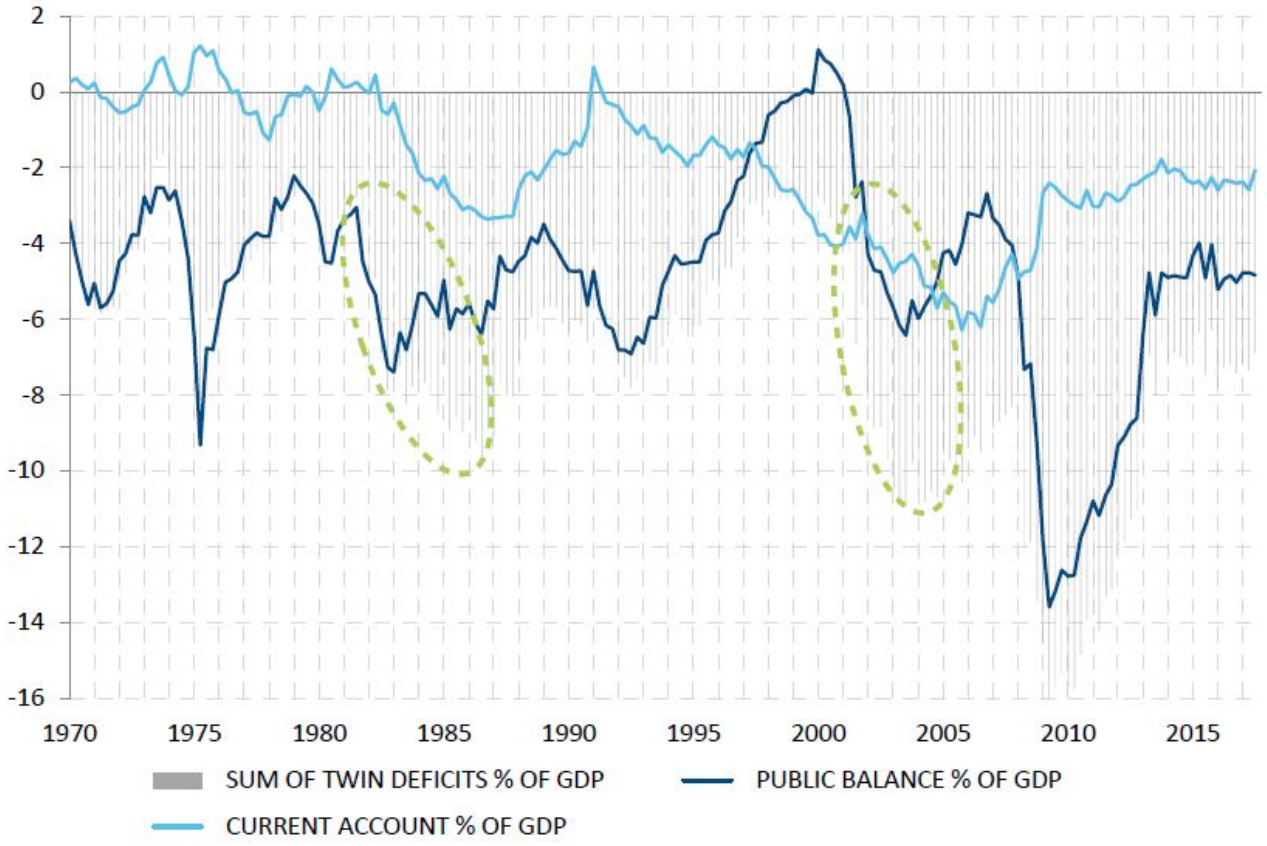
The US dollar down to a 30-month low after Davos

Source : Bloomberg, SYZ Asset Management. Data as at : 2 February 2018



The comeback of the US twin deficit ?

Sources : Factset, BEA, US Treasury, SYZ Asset Management. Data as at : 29 December 2017



02

US – The return of the twin deficit ?

The US economy has had two episodes of “twin-deficit concerns”, during the 1980s and in the 2000s. Each time, tax cuts unmatched by public spending reductions led to a deterioration of the public finance balance and, in parallel, to a widening in the current account deficit as the stimulus to domestic final demand (consumption + investment) led to larger trade deficits financed by foreign savings. On each occasion, the sum of these twin deficits neared 10% of the US GDP after a few years.

The recent tax reform voted by the US Congress has some similarities with those two episodes: unfounded tax cuts expected to trigger an increase in final domestic demand, that would ultimately have to be financed by foreign savings via a current account deficit widening.

However, both in the 1980s and in the 2000s, fiscal support was provided right after an economic recession and was meant to accelerate the economic recovery. Today, the US economy is in the 9th year of its expansion cycle, and at full employment. Whether this difference will make for a different outcome this time remains to be seen. But one shouldn't be surprised to hear of the of US twin deficit in the coming months.

03

Eurozone – Rate markets start to price the end of negative rates

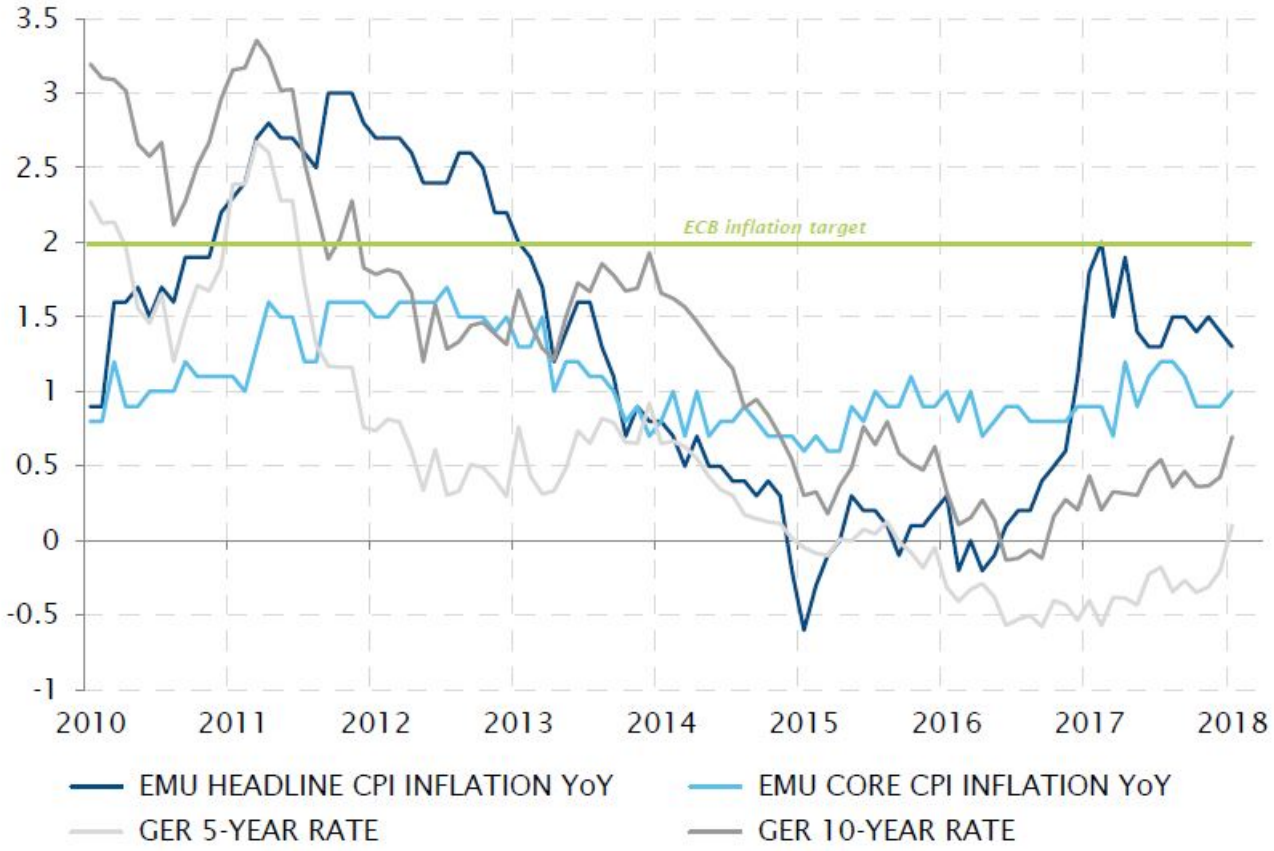
As seemingly ever-better growth indicators continue to accumulate in the Eurozone, the debate around inflation has become topical on this side of the Atlantic too. Granted, inflation remains quite far from the ECB's targeted level ("below 2%, close to 2%"). In January, headline HCPI inflation even declined to 1.3%, while "core" inflation (excluding energy and food prices) ticked up to a modest 1.0%. The ECB doesn't expect inflation to reach its target before 2020.

However, as deflation concerns have now dissipated and inflation rates now seem set on an upward, if mild, trajectory going forward, all eyes turn toward the ECB. The extraordinary monetary policy support implemented at the height of deflationary pressures is increasingly out of sync with the current economic backdrop.

At least that is the perception of financial markets, that are increasingly pricing an end of the asset purchase program and ultimately rising short term rates. Upward pressure is not only visible on long-term interest rates: the yield of German five-year government bonds has just turned positive for the first time since 2015, a sign that investors do not expect negative short-term rates to be maintained forever.

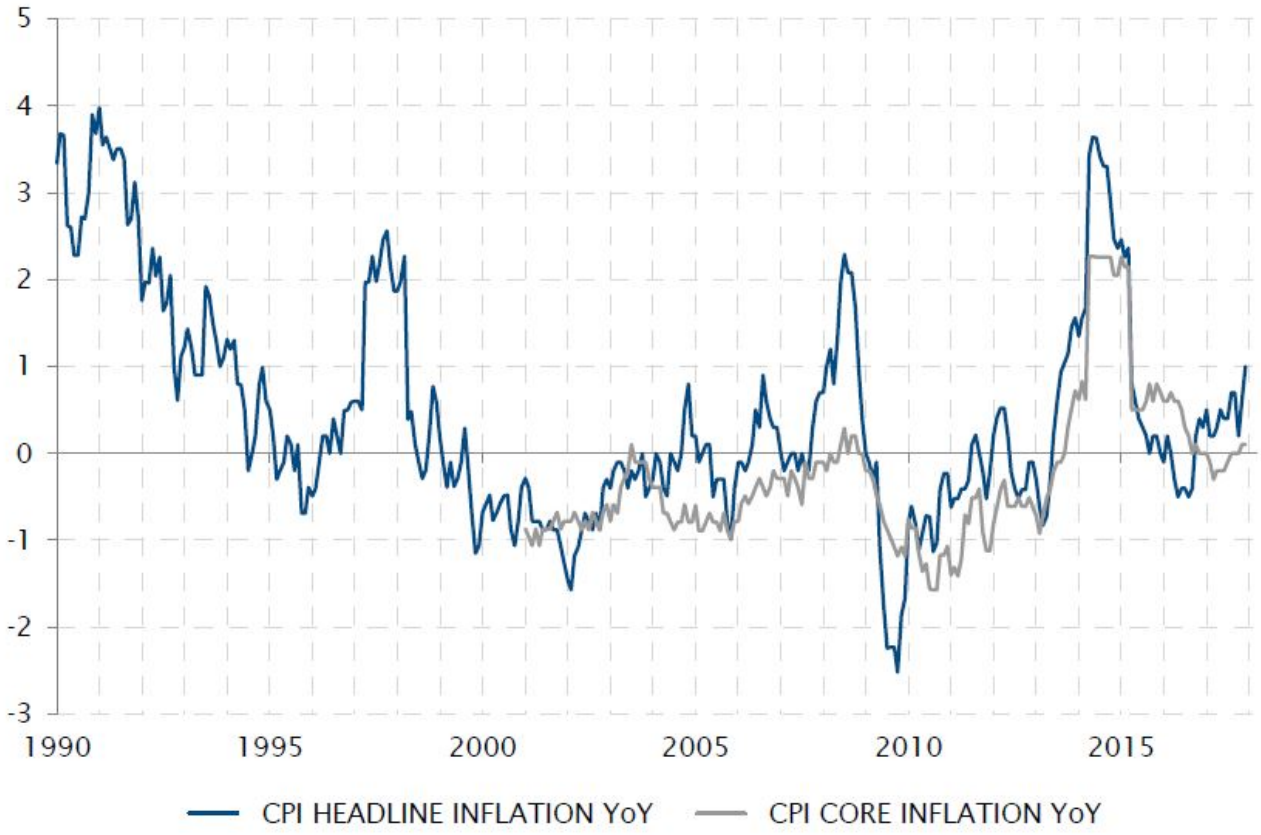
Inflation may not have picked up yet, but interest rates will

Sources : Bloomberg, SYZ Asset Management. Data as at : 31 January 2018



Headline inflation at 1% in Japan, “ finally close to target ”

Sources : Factset, SYZ Asset Management. Data as at : 31 January 2018



04

Japan – Kuroda claims victory on deflation (almost)

Inflation really is topical at the beginning of 2018: it is even showing up in Japan! Yes, the very economy that has been plagued with a 20-year long deflation. Headline inflation rose to 1% in December, a level reached only in three episodes over the past two decades, twice because of VAT rate increases and once because of a short-lived oil price bubble. No such obvious cause this time, even if favourable base effects on energy prices may play a role.

The improving economic backdrop in Japan certainly supports a gradual improvement in the inflation picture, despite still strong structural headwinds. This was in any case enough for the Bank of Japan's Governor to almost claim victory in the reflation operation launched in 2013: in Davos, Mr Kuroda said that inflation was finally close to the target of around 2%.

This could be seen as a clear signal that the BoJ is happy to take advantage of the current improving picture to consider withdrawing some of its policies, with negative externalities for the Japanese financial system. It could also be seen in the light of the ending term of Mr Kuroda at the helm of the BoJ in April: better to claim success if one wants to be reappointed! Or it could simply mean that, for city-dwellers such as Mr Kuroda or Mr Mnuchin, the altitude of Davos loosens their lips possibly more than they would like.

Oil prices at a 3-year high

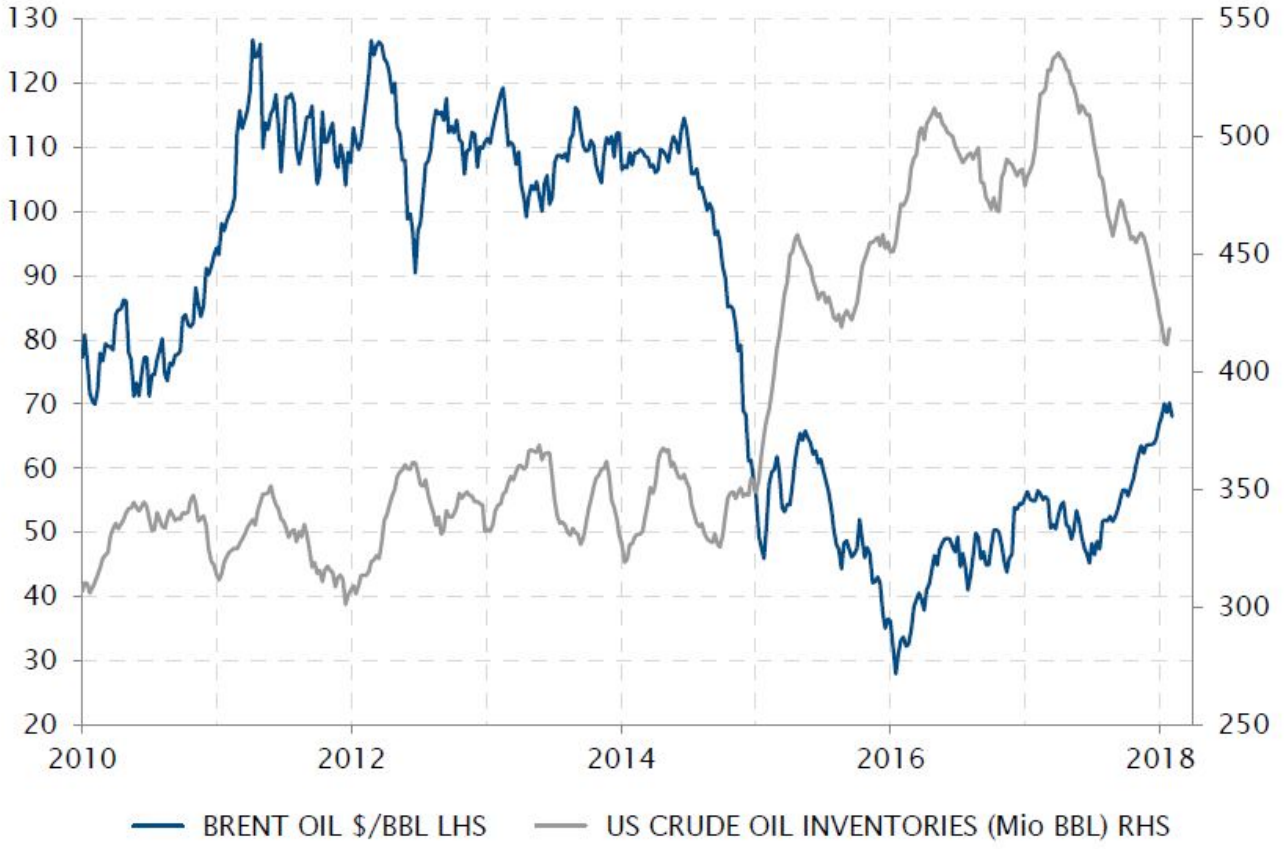
Crude oil prices extended their rise in January with a seventh consecutive monthly increase, up 50% from last June and at their highest level in three years. US dollar weakness certainly has had a role in supporting prices over the period. The strength and acceleration of the global economy has also supported the demand side of the equation.

But supply-side factors have also driven this rise in prices. The growth in the world oil supply has slowed down after the surge recorded in 2014-2015, after OPEC eventually agreed on a supply cut and low prices shut some US shale producers out of business.

As a result and quite noticeably, oil prices have been rising in 2017 even as inventories have been drawn down. US inventories, that had almost doubled from 2015 to early 2017, have declined over the remainder of the year. This is maybe the best indicator that the large imbalance between supply and demand at the root of the oil price collapse in 2014-15 has now been resolved. If true, oil prices should become less prone to big price shifts in the future.

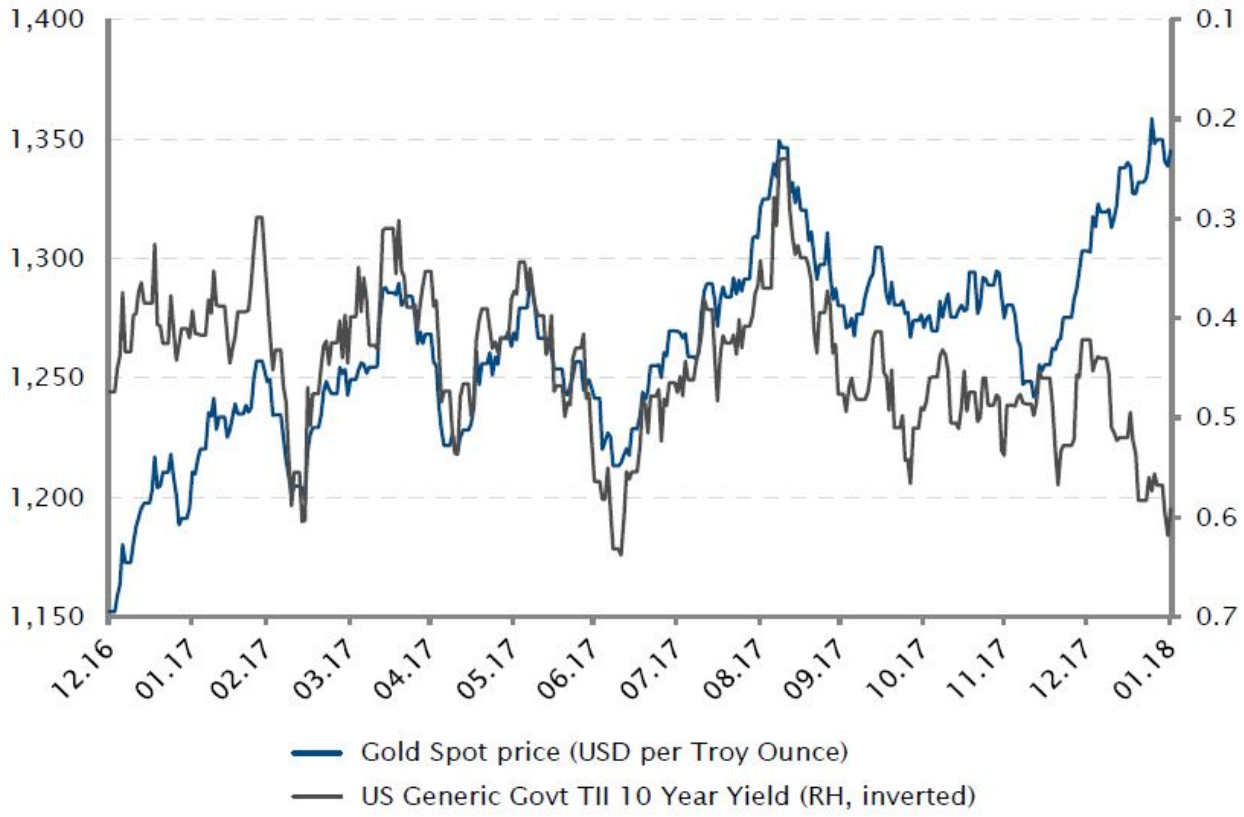
Oil prices at a 3-year high despite inventory decline

Sources : Factset, SYZ Asset Management. Data as at : 2 February 2018



Gold price and US 10 Year TIIPS yield evolution

Sources : Bloomberg, SYZ Asset Management. Data as at : 13 February 2018



06

Commodities – Gold and US real rates: the negative correlation has broken

Besides geopolitical risks, the two main drivers of the gold price are the US dollar and US long-term real rates, which have an historically inverse relationship with the precious metal.

Over the period 2013-2015, the stronger US dollar coupled with a higher real interest rate environment penalised gold prices, which collapsed by -37%. Since 2017, the price of bullion (up +17%) is supported by a softer US dollar despite a slight increase in US real rates. Recently, the rapid and strong depreciation of the US dollar has clearly overtaken the relatively subdued increase in US real rates.

Going forward, the evolution of gold prices is likely to remain torn between the two forces - a lower US dollar or higher US long-term real rates. If you believe US real rates will rise meaningfully, you should stay away from gold, but if you believe in the continuation of a weaker US dollar and a muted increase in US real rates, gold could shine again.

07

Forex – Higher US 10 Year Treasury yield and a weaker US dollar vs. the Japanese yen

Historically, there is a positive correlation between rising interest rates in the United States and a stronger US dollar.
However, for a few months now, the USD/JPY exchange rate has stopped tracking US bond yields, which are on an upward trend since the Federal Reserve initiated its less accommodative stance coupled with several rate hikes.

Despite the recent sell off of US government bonds (yields trending higher), which should normally increase the attractiveness of those US assets yielding more and also contribute to a firmer US dollar, the Japanese yen is now strengthening instead of the US dollar.

In January, the JPY was up +3.2% vs. the USD while the 10Y Treasury yield went up 30bps to reach 2.7% by the end of the month, a level not seen since April 2014.

The BoJ left its policy unchanged, while in parallel noting an improvement in inflation expectations contributing to the JPY rally.

Finally, the BoJ is in a more difficult position - the JPY is going against the direction of the central bank’s accommodative monetary policy, while it should be among the last of the developed central banks to start to normalise its monetary policy.

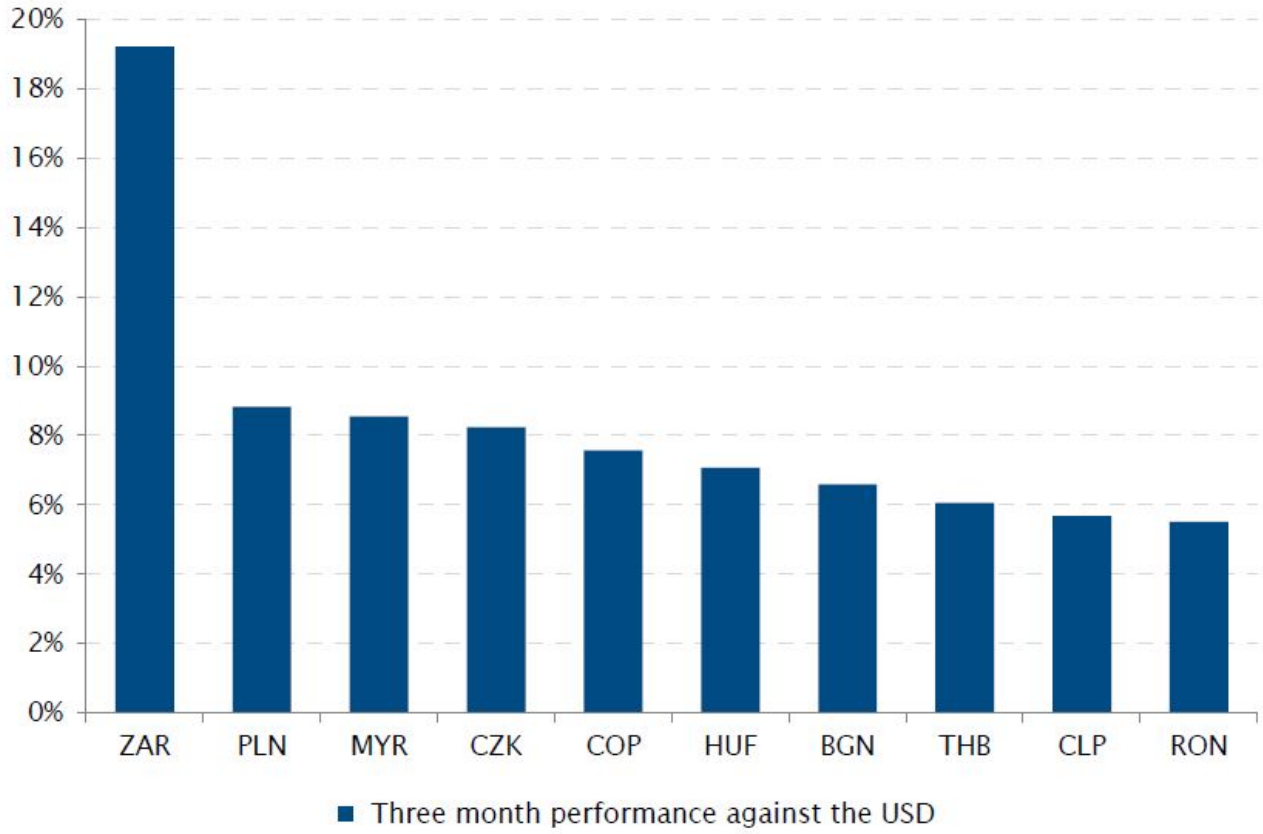
US 10Y Treasury Yield and USD/JPY FX Spot Rate evolution

Sources : Bloomberg, SYZ Asset Management. Data as at : 13 February 2018



ZAR : best performing currency among emerging markets over three months

Sources : Bloomberg, SYZ Asset Management. Data as at : 31 January 2018



08

South Africa – The South African rand surged on the back of increased investor confidence

Since Cyril Ramaphosa was elected as the new ANC leader in December, becoming the natural successor of President Zuma, investors' sentiment on South Africa has turned positive and the South African rand has experienced a sharp appreciation.

In January, the rand gained +4%, reaching 12 per US dollar for the first time in more than two years. Over the past three months, the rand has been among the best performing emerging market currencies, appreciating by +19%. Such a performance has been mainly driven by the expectation of a political transition (probably with Zuma's resignation) and some potential reforms, coupled with the overall risk-on sentiment in the markets and finally the weaker US dollar environment.

In addition, in the last year, the South African economy has recovered from negative growth and high inflation. The country is no longer in recession, even if growth is still weak, and inflation rates receded as headline CPI is now within the central bank's target range. Meanwhile, investors are expecting that the country will avoid another credit rating downgrade in March.

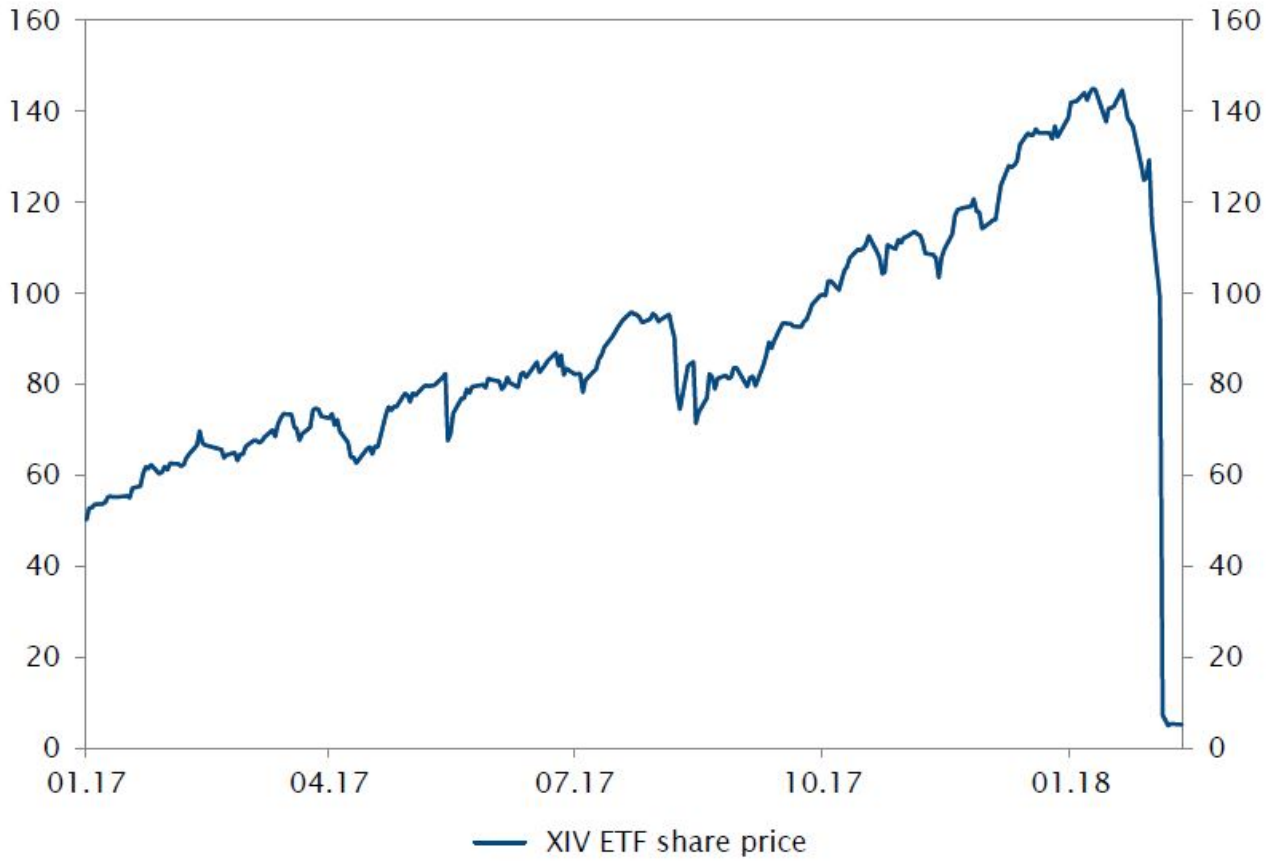
Volmaggedon

The surge in volatility in early February took the market by surprise. The move was the biggest ever, 20 volatility points from Friday close to Monday close (although VIX spot traded higher during the night) and killed a number of strategies, including the infamous XIV.

The ETF XIV was designed to replicate the inverse of the VIX via the futures market. However, the ETF entered into a death spiral most likely because investors started to redeem it after a bad week in equities, triggering the ETF to re-adjust its exposure by more VIX futures, sending volatility higher and creating a vicious circle. Although the potential damage of this unwind has been well documented recently, a number of investors continued to sell volatility despite knowing that the trade had a very negative asymmetry.

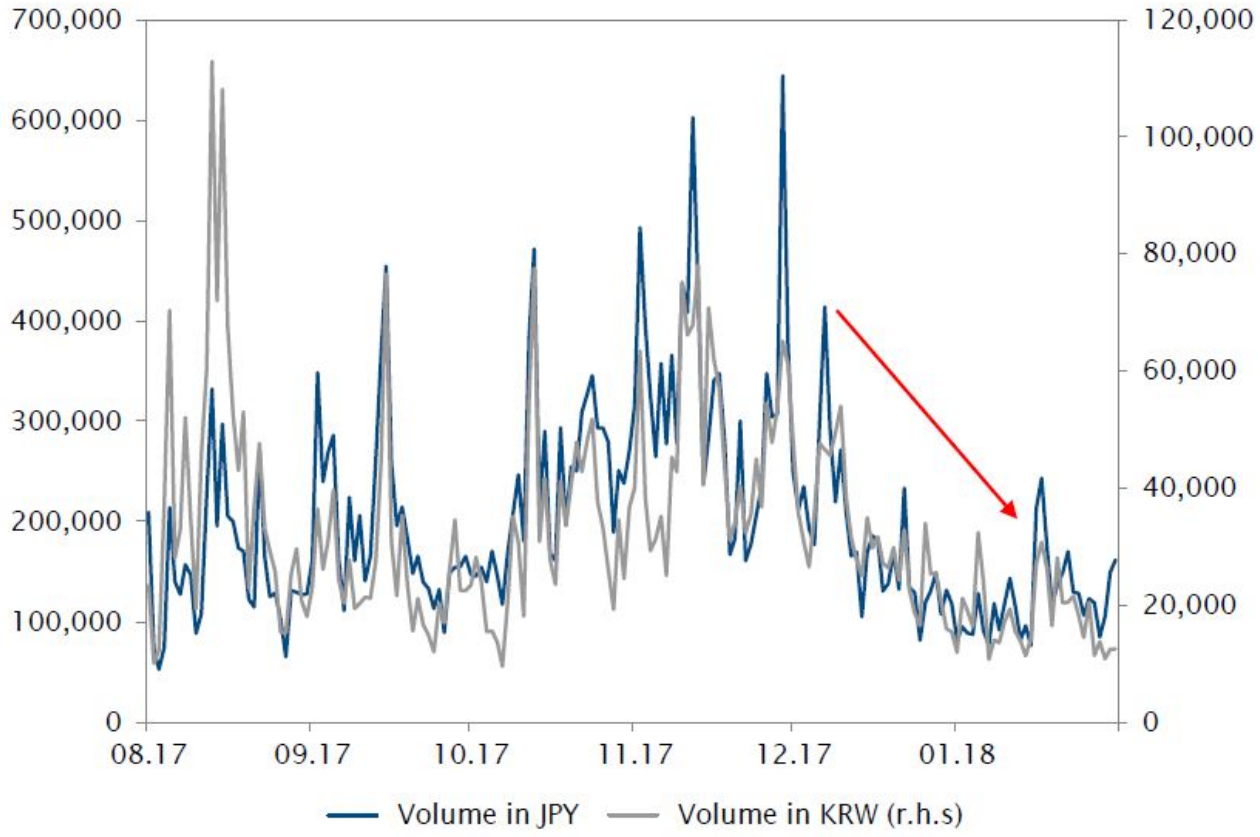
The end of the short volatility ETF

Sources : Bloomberg, SYZ Asset Management. Data as at : 13 February 2018



Daily Bitcoin volume by currency

Sources : Cryptocompare, SYZ Asset Management. Data as at : 31 January 2018



10

Cryptopocalypse

Investors in cryptocurrency discovered in January that their asset class was also subject to gravity as most cryptocurrencies crashed during the month. Bitcoin fell more than 60% from its top, Ethereum suffered a 50% loss, while Ripple took a dive and plunged more than 75% from its early January high.

A number of theories emerged trying to explain why the asset class suffered so much. Among them, the fear around potential regulations in Asia, especially in Japan and South Korea, seems to be a good explanation. More than simple regulation, Korea talked about banning the trading of cryptocurrencies and shutting down exchanges, which most likely contributed to the selloff. The heist of the Japanese platform Coincheck was certainly another negative factor for investors, as the platform lost the equivalent of $400M in a cyber-attack. Finally, China indicated that crypto coin mining could be prohibited due to its intense use of power. The reality check for investors has

been difficult!

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