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HOTFOREX GLOBAL TRENDS 2015



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Dear Reader,

I would like to take this opportunity to personally thank you for your interest in HotForex and my analysis, and to invite you to read the HotForex Global Trends 2015 Report, which is an outlook for the rest of the year. I will explore the trends that have led the world's economies to where they currently are in terms of inflation, interest rate expectations, job market developments and central bank policies.

As you will see as you read through this report, much of the future economic and forex market dynamics revolve around central bank activity and, more specifically, around the actions of the US Fed and European Central Bank. USD is valued against a basket of currencies, which is used to create the US Dollar Index DXY. As the euro is the heaviest weighted component in this index, trading activity and trends in EURUSD will impact how many other currencies and assets (USDCAD, Crude Oil and Gold) are traded.

Until recently, the US dollar has been rising on the back of diverging central bank policies while weakness in other economies and robust recovery in the United States has contributed to the dollar strength. Since March however, there has been a new element of uncertainty as Fed Chair Janet Yellen suggested that the US economy might not be that strong after all. And more specifically, it is the dollar strength that is starting to hurt economic growth by slowing exports.

Just as market participants thought they knew the script for the future market moves and could even guess what the Fed might say next, Yellen hinted that the Fed is going to get dovish again. At the March meeting the word patience was dropped, but at the same time the Fed was quickly adopting other forms of language that hinted that it would stay on the sidelines unless there were reasons in the data to put the hawk's costume on again.

This means that the plot for the rest of the 2015 is not that simple anymore. Now that the Fed might change its feathers as the data changes, there is no real guidance on its future actions and we have to take our cues from the data as it is released.

There is also another newly added flavour to the story. This flavour comes from green shoots that have been evident in IFO and ZEW indices and positive PMI readings in the Euro Area. While the Euro Area still struggles with many of the challenges that have plagued it over the recent years, there is some hope that the euro weakness is turning into economic strength in the Euro Area. When this is combined with the fact that the US jobs market is capable of disappointing analyst consensus with approximately 50% deviation to the downside, unless the March Non-Farm Payrolls gain of only 126k is a statistical outlier, it is more challenging to make a case that USD will keep on rising for the rest of the year. This could well be the case as EURUSD fell so mightily before the ECB program even started their program and really begs the question, 'How much of the QE is already priced in?'

I hope that this report is the first step to you becoming a regular reader of my daily analysis at analysis.hotforex.com



Best Regards,
Janne Muta
Chief Market Analyst

April 2015

HotForex Global Trends 2015

Background Overview

As we came into this year, improving labour markets and extraordinarily accommodative monetary policies had been supporting economic activity in the UK and USA, while countries such as Japan, and the Euro Area struggled. Last year, the Euro Area and Japan were to blame for more than half of the downward revisions to global growth in 2014, while the conflict between Russia and Ukraine acted as another deterrent for global growth. Now that the price of oil and EURUSD have been at historic lows, the Q1 data coming from the eurozone is starting to look better. At the same time US data is going through a soft spot.

The labour market in the US in 2014 improved when measured in terms of the number of jobs created, but the wage growth that ultimately drives consumption was weak. This has global significance as roughly 70% of the US economy relies on consumer spending. Being the largest economy in the world, US consumer spending impacts other economies, especially Asian countries such as China, which rely heavily on US exports.

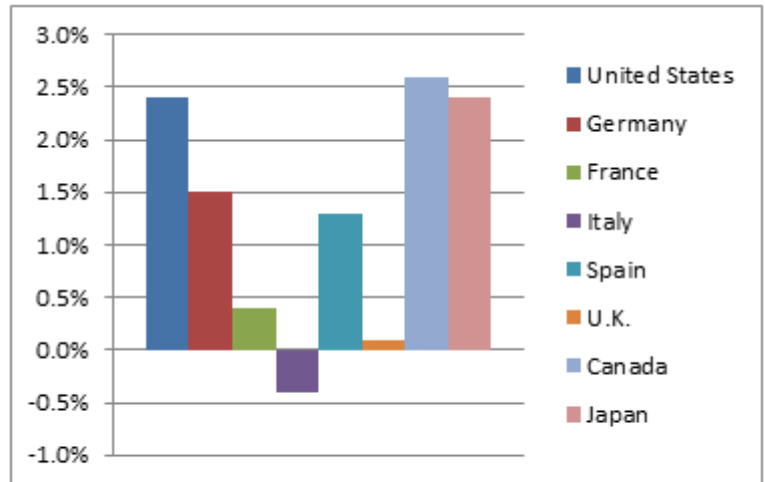


Figure 1: Global Real GDP Growth in 2014,
Source: HotForex.com/ActionEconomics.com

These trends are expected to continue throughout 2015 as the challenges in the Euro Area and Japan are significant and cannot be resolved easily, while US economic recovery has been relatively steady. However, there is some softness in US data as a strong dollar is seen impacting the rate of export growth and, at the time of writing, the IMF has cut its outlook for US growth due to recent dollar strength. All in all, domestic demand has been weak in several countries despite the respective governments' efforts to boost demand by bringing interest rates lower.

United States	2.7%
Euro Area	0.9%
Germany	1.1%
France	0.7%
Italy	0.3%
Spain	1.7%
Japan	1.0%
U.K.	0.5%
Canada	2.4%

Figure 2: Global GDP Growth Estimates 2015, Source: HotForex.com/ActionEconomics.com

In Q1 2015, economic activity in the Euro Area has been supported by lower oil prices, further aggressively accommodative monetary policy, fiscal policies and the lower price of the euro. However, some of the benefits will be offset by weaker investment prospects and the weaker growth in emerging economies impacting exports. Annual Euro Area growth is expected to be 0.9% when adjusted for inflation. Some positive development in the Euro Area has been seen in economic confidence surveys and Purchasing Manager Indices. While the ECB president, Mario Draghi, has attributed this to the newly started QE program, it is more likely that the development is coincidental with the program. The ECB easing program is still too young to have had a significant impact on the Euro Area economies.

The weaker currency will eventually lead to higher import prices and will contribute to an upturn in inflation. I expect Euro Area inflation to stay low (between the current -0.1% and 0.5%) for the remainder of this year. In general, low energy prices will have a positive impact on global GDP growth figures even though it looks like oil has bottomed and is likely to move higher in the coming months.

In April 2015 the International Monetary Fund estimated that low oil prices will increase global GDP growth by 0.5% over the rest of the year, but suggested that the price of oil could rise more quickly than expected. Should the price of oil stay low, the countries that are net importers of oil would benefit, while the contribution from oil exporting countries (Saudi Arabia, Russia, the United Arab Emirates, Canada and Norway) would be smaller than in 2014. In addi-

tion to soft energy prices, low commodity prices have been supporting growth, especially in emerging economies. Countries like India would be major beneficiaries if the price of oil were to stay relatively low. As the growth trend in China is on a downward slope and India's growth is accelerating, it has been estimated that India's growth will overtake China in the next two years. India imports 80% of the oil it consumes and low energy prices contribute to this substantially. The downward growth trend in China means that in real terms GDP is expected to grow (only) by 6.5% this year. It's likely that global GDP will grow by 3.1% in 2015 with the USA being the best performing high income country, while the negative trends in Japan and the Euro Area will persist and hinder growth.

Extraordinary Measures by the Central Banks

With the exception of the United States, all major economies have been trying to devalue their currencies in relation to competitors'. The aim of this so called 'race to the bottom contest' has been to devalue one's own currency and therefore support the economy by making exported goods cheaper than the competitors' goods. To achieve this, central banks have used every monetary trick in the book, while some have come up with a couple of new ones too. While the Bank of Japan and the European Central Bank are using quantitative easing programs to stimulate the economies, the Swiss National Bank and Danish Central Bank have cut the interest rates into negative territory. The Danish Central Bank has even stopped issuing government bonds to keep the currency from appreciating against the euro. These are unconventional measures and move beyond what was once thought to be the limit to what the central banks could do. Now, instead of paying rates below inflation on their sovereign debt issues, these central banks are actually charging for the privilege of parking investor money with them. This has created a low rates environment that is unlikely to change any time soon as many economies struggle. However these policies are limited in effectiveness as all competitors are trying to achieve the same results by the same means. If one country devalues its currency, the result is that their goods are cheaper in relation to the others, but when all participants manipulate their currencies, no one reaps the intended benefit. Now that the US Fed and the US economy are showing signs of getting weary of the strong dollar, the current balance of things will change. If the Fed wants to start pushing the US dollar lower, all they have to do is to continue with the dovish line Fed Chair Yellen introduced in March. Over time this will take some of the advantage away from the other side of the Atlantic and European exports will once again become more expensive.

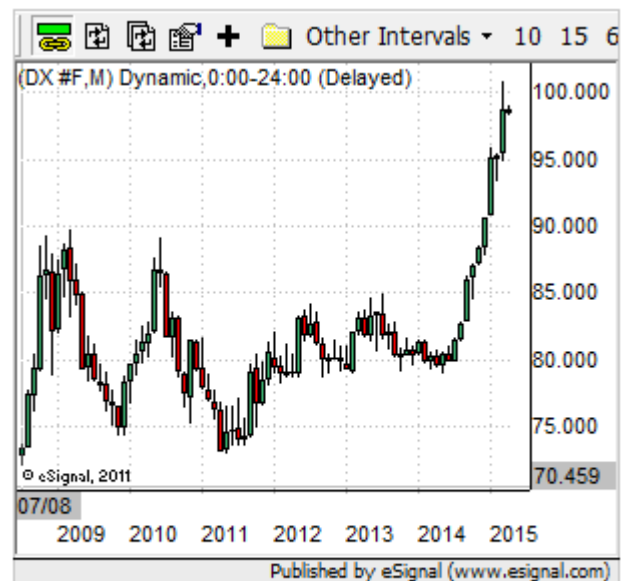


Figure 3: US Dollar Index Monthly,
Source: HotForex.com/esignal.com

Low Interest Rates and Low Rates of Inflation

Low interest rates are a result of the monetary experiment by the central banks over recent years as they attempt to fight against deflation. Inflation figures have been low throughout the major economies and the recent slump in prices has brought inflation even lower. Credit growth has been accelerated by lowering interest rates with a hope that it will increase lending and therefore economic activity and prevent economies from slipping into a deflationary spiral.

This would be a challenging environment for the central banks as they can, to certain extent, manipulate inflation expectations by loosening monetary policy. However they have no weapons in their arsenal to manipulate deflationary trends. A prolonged deflation would be challenging for economies as well. In a deflationary environment, prices trend lower as people become accustomed to the fact that by waiting a little longer, goods and services can be obtained for less. This means that there is less incentive to increase consumption, which in turn takes away the incentive to invest. All of this combined will result in fewer jobs and less tax revenue.

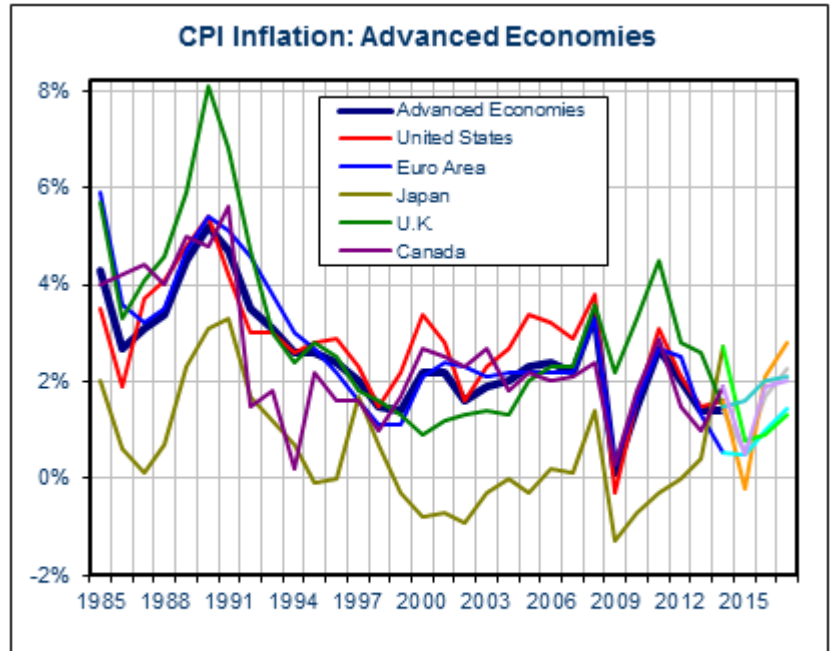


Figure 4: CPI Inflation, Advanced Economies
Source: HotForex.com/ActionEconomics.com

USA

According to the Federal Reserve, inflation has declined further below the Federal Open Market Committee's (FOMC) longer-run objective, largely reflecting declines in energy prices. The surveys indicate that longer-term inflation expectations have remained stable and the Fed expects inflation to remain near its recent low level in the near term, but to rise gradually towards the 2% target over the medium term. The FOMC expects inflation to rise gradually towards 2% over the medium term (over the next two to three years) as the labour market improves further and the transitory effects of lower energy prices and other factors dissipate.

Canada

The Bank of Canada does not usually surprise the markets when it comes to interest rate decisions and normally signals changes well in advance. However, in January 2014, the bank did just that. It dropped the target for the overnight rate from 1% to just 0.75%. Stephen Poloz, the central bank's governor, said that the bank was moving quickly to counteract the negative economic impact of lower oil prices on Canada. The country is the world's fifth largest crude oil producer and lower oil prices mean lower oil revenues. The risk is that the lower cost of financing might encourage consumers to borrow even more heavily and push house prices even higher. Canada's housing market is already over-valued by 30% and lower rates can lead to even higher valuations. Canada's CPI grew at a 1.2% y/y pace in March, following the 1.0% growth rate in January while the BoC's core CPI index rose 0.6% in March after an identical gain of 0.6% in January.

Euro Area

In January 2015 the ECB announced its Quantitative Easing program of buying up to 60 billion euros of securities per month totalling more than 1 trillion euros by the time it has finished. This is an attempt to create inflation in the Euro Area and to encourage consumers to spend, and businesses to invest. This however is not something that the ECB can force and some economists are sceptical about the outcome. However, lower oil prices and a stabilizing job market have encouraged consumers to spend. This was evidenced by the year-on-year Retail Sales jump to 3.7% in January.

The QE announcement was anticipated by the markets in the latter half of 2014 and bond yields were pushed lower by market participants buying bonds in advance. As a result, the European Sovereign bond yields are at extraordinarily low levels and the 10 year French, Italian and Spanish bonds yield less than the US government bonds. This is very unconventional as the yield should be in line with the default risk. Now the pricing of the government debt suggests that it is more likely that the US government will default on its debt than Italy, France or Spain. In other words, it would be safer to lend money to struggling Italy than the United States of America, even though it is experiencing a relatively solid recovery.

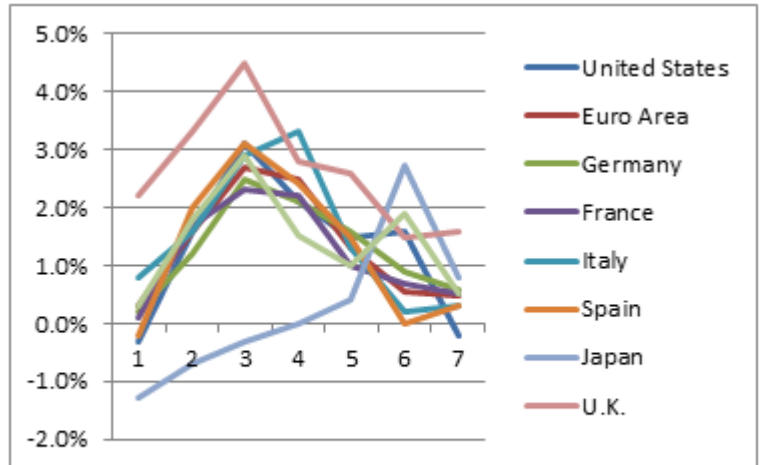


Figure 5: Consumer Price Inflation 2009 to 2015
Source: HotForex.com/ActionEconomics.com

The current Euro Area headline inflation is negative at -0.1% (March) while the Core CPI is at 0.6% but has been trending lower since 2012. Whether we follow the headline figure or the Core CPI, reading the message is clear; Europe is too close to deflationary levels and the ECB bond buying program is needed to boost inflation.

Switzerland

In an effort to prevent the Swiss Franc from appreciating against other currencies, the Swiss National Bank (SNB) lowered interest rates to -0.75. The SNB was forced to remove the 1.20 EURCHF floor as the ECB was about to start the massive Quantitative Easing Program. The move caused extreme volatility in CHF pairs and created a tougher environment for Swiss corporations that survive on exports to the Euro Area. Inflation has been very low with CPI ranging below zero since the beginning of 2012 while the recent rise in the value of the Swiss Franc has increased the deflationary pressures in the economy. The latest (February) year-on-year CPI change was -0.8% and the Swiss National Bank expects the 2015 CPI at -1.1%.

UK

Interest rates have been at a record low at 0.50% and the Bank of England monetary policy committee members have been reluctant to hike the rates as they have been expecting the Euro Area problems to impact the UK growth negatively. However, the United Kingdom's economy has been improving relatively well even though the eurozone, an important trading partner, has been struggling. The year-on-year Core CPI has been falling since May 2011 and is currently at 1.4%.

China

China cut interest rates in November for the first time in more than two years and then again in February to 5.35%. Interest rates in China are at a relatively high level when compared to the other major economies. This however is natural as the economic growth in China is over nine times the average growth in the Euro Area and over two and a

half times the US economic growth. The government is steering the economy towards domestic consumption and away from export and public investment. This has been slowing economic growth.

The central bank supports growth by reducing financing costs to companies and tries to encourage more borrowing as the price of money comes down. Additionally, in September, the Chinese Government provided nearly \$131 billion in medium-term loans to banks on the condition that they lower borrowing costs for small businesses. Recently the People's Bank of China cut down-payment requirements for buyers of second homes and the Ministry of Finance introduced tax exemptions for those that have owned a home for at least two years. This was done to support the slowing housing market. The February 2015 year-on-year change in the Consumer Price Index (CPI) was 1.6% after a meagre 0.9% in January. The CPI figure has been trending lower since May 2014 and reflects the longer term trend of the Chinese economy cooling down.

Australia

The Q4 year-on-year CPI slowed to 1.7% from 2.3% (the 2008 high for CPI was at 5%). Core CPI measures also slowed, as the trimmed mean was +2.2% y/y from 2.4%. The Reserve Bank of Australia kept rates on hold at 2.25 at the April meeting. However, the RBA maintained a dovish guidance, saying that "further easing of policy may be appropriate over the period ahead, in order to foster sustainable growth in demand and inflation consistent with target". The Chinese economy slowing down, a weaker than expected Japanese economy and a continued decline in commodity prices have slowed the Australian economy and have resulted in a downward sloping trend in Gross Domestic Product since 2012. The decline started roughly a year after the peak in copper prices and economic activity has been trending down with the price of copper and the Australian dollar. The latest year-on-year GDP growth figure is 2.5%, a way off from the peak of 4.3% in 2012. It is likely that we will see another rate cut in the coming months as the Australian dollar remains above its fundamental value.

Japan

The Japanese storyline is not much different from most of the other economies. The interest rates are low (the target rate is at 0.10%) while the 2 year Japanese Government bonds have a negative yield of -0.01% with the 5 year bond yields are slightly higher at 0.07% at the time of writing. The ten year bonds provide investors with only 0.33% yearly income. In January, consumer prices, excluding fresh food, rose 2.2% from a year earlier. The figure was less than expected and when the sales tax increase is stripped off, the actual inflation number was as low as 0.2%. The latest release for February showed inflation stayed flat. This increases pressure on the Bank of Japan to ease monetary policy further.

Weak Global Trade

The weak world trade we are now experiencing has its origins in a period between 2000 and 2008 when Asian economies grew fast and eroded the Euro Area competitiveness substantially. Asian economies benefitted from having very flexible labour laws and vast quantities of low cost labour, whereas in Europe the ignored structural reforms in the labour markets accompanied by an aging population severely hindered the ability of European nations to compete against new competitors from the East.

As the Asian economies had vast supplies of cheap labour, they attracted direct investment from the USA and Europe, but the Euro Area itself lacked the ability to respond to the changing environment. The single currency, the euro, was partly to blame as the introduction of the euro probably could not have been timed more unfortunately. Had countries like Spain, Italy and France had their own freely floating currencies at the time of new Asian economies rising to challenge them, the currency markets would have adjusted to the change and the low currency rates would have helped the export-driven economies that were losing jobs to Asian countries.

With the single currency eliminating the traditional way of currency market driven adjustments and the European Central Bank in charge of monetary policy, the only option European nations had was to resort to borrowing money. Because of the single currency and an assumption that the European Central Bank would be backing the member countries, European nations were able to borrow money at rates that were simply too low compared to the risks these mature economies had. Pricing of risk in European sovereign bonds was distorted and the European governments were allowed to borrow money practically at the rate available for Germany. This led to overleveraging in the public sector and investment projects and resources were wasted on building bridges to nowhere. It would have been demanding to manage the European economies burdened by bureaucracy, aging populations and inflexible labour markets in the best of times, but during a period of unforeseen increase in competition from Asian countries and the US-bred credit bubble, the single currency ensured it was impossible to respond to these challenges. The politically motivated, wrongly timed and badly designed euro project came at a major cost to European economies and will be crippling them for many years to come.

In the globalized world, problems in a major economic area such as the eurozone will have effects on other economies. The Euro Area is one of the major importers of Chinese goods and an important trading partner for the United Kingdom. Therefore the impact of this currency experiment was felt and is still being felt across the globe.

Even though the underlying problems still exist there has been some positive development in the first quarter of this year. Eurozone industrial production improved (y/y) to 1.2% in January, up from 0.6% in December and the PMI numbers have nudged higher with March Manufacturing PMI at 52.2. Additionally the economic sentiment indicators, Ifo and ZEW in Germany, have picked up from the previous month.

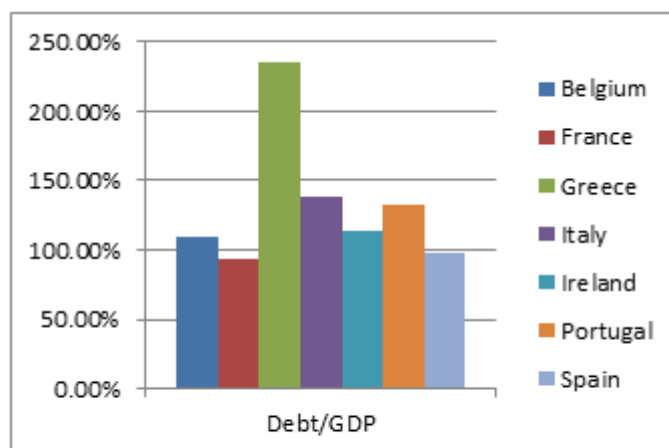


Figure 6: Debt to GDP as Percentage in Europe
Source: HotForex.com/Nationaldebtclocks

Economic and Geopolitical Risks

Impact of low oil prices in emerging markets

The biggest negative impact of low oil prices will be felt in the oil producing countries that have planned their budgets based on high oil prices. Now that the price of oil is low and the fiscal buffers that have weakened some of the public services may have to be cut off or made available against a payment. This could lead to demonstrations and social unrest. In addition, corporations and banks that have borrowed heavily in financial markets could face financial stress, which in turn could lead to markets reassessing these assets in other emerging markets as well. Also, countries that have euro denominated export revenues but the corporate borrowings and liabilities in US dollar would be more exposed to the risks coming from strong currency fluctuations derived from central bank policies. With oil possibly bottoming these risks are now reduced.

Slow growth in the Euro Area

According to the World Bank, a prolonged period of slow economic growth, often called 'a *stagnation*', could lead to continued high savings rates and demand for safe assets. This would mean further low domestic demand in the Euro Area and present risks to the economies closely related to it (the United Kingdom and Switzerland). Low growth could also lead to higher financing costs for the private sector as lenders would ask for a higher risk premium due to degrading business conditions in Europe.

Unintended consequences of unconventional central bank policies

The Danish Central Bank has been pegging its currency, the Danish Krone, to the euro quite successfully over the last few years. This year however, the central bank has already spent over 30 billion EUR in defending the currency peg. This is almost 10 per cent of the country's Gross Domestic Product. The reason for this operation is that the most Danish pension funds are invested in euro assets and would face insolvency if the currency peg were to be removed and the Danish Krone appreciated against the euro. The assets are denominated in weakening euro while the liabilities are obviously in Denmark and in a currency that would appreciate against euro without the manipulation by the central bank. One of the extraordinary measures the Danish Central Bank has taken to tackle the situation is that they have stopped issuing government bonds.

From currency war to protectionism

The United States has so far taken the impact of the surging dollar in its stride, but there are growing calls for a change in policy. Both Republicans and Democrats in Congress have been voicing their support for legislation that introduces binding currency rules for trade deals and imposes punitive import taxes on those countries that the US sees as "currency manipulators". This is aimed at China, Japan and, potentially, Germany, but even the Scandinavian countries might get black listed by the US. This is a rather strong form of protectionism and would be damaging to global trade and growth.

Geopolitical risks

Geopolitical risks have once again taken centre stage in Europe, as it has been claimed by several parties that Russia has been supplying heavy weapons to the separatists in Eastern Ukraine. The Ukrainian conflict has dominated European news ever since the annexation of the Crimean peninsula by Russia and the tragic event of Eastern Ukrainian rebels shooting down a passenger aircraft, killing almost 300 civilians. It has been claimed that the missile technology that made this possible was provided by Russian military. Thus far the claims have not been verified due to lack of conclusive evidence. However, just recently according to BBC forensic analysis of a metal fragment found at the crash site of flight MH17 indicated it was from the warhead of a Russian-made BUK. Russia denied any involvement in the matter. It has also denied the claims of Russia providing weapons to the separatists that fight against Ukrainian government forces.

Russia has been blamed for destabilizing Europe via its support for the rebel forces, but I don't think enough emphasis has been placed on Western involvement and motives in the area. Perhaps it is not unreasonable to conclude that the conflict in Ukraine is likely related not only to Russian politics, but also to the battle over control of energy and more specifically natural gas supplies to Europe. European nations, of which many belong to NATO, find it disturbing that they have a considerable dependency on Russian-supplied natural gas.

Increased uncertainty and sanctions issued by European nations as well as Russia mean that the global GDP growth is likely to be less than it otherwise would have been. Furthermore, there is always a risk of an escalation in the crisis which could lead to a lower level of investments, especially in Eastern European economies.

From Grexit to Pigsxit

Greece

At the time of writing, money is pouring out of Greece as the concerns over its willingness to commit to the required reforms are growing. The country is running out of both time and money as European lenders have blocked further financial aid and the IMF is not giving into Greece's demands for a delay in payments. This raises a question of capital controls and increases the likelihood that the country will default internally and use its pension funds to fund the government. According to some sources, this is already taking place. Another alternative is an external default which would cause serious harm to the already troubled relationships between the country and the European lenders. As the other Euro periphery sovereign bond yields have started to widen, it is likely that there will be a last minute deal that ensures Greece will stay funded and in the eurozone. Another reason to expect a last minute deal is that European leaders will not want Greece to fall in the hands of Mr. Putin and Russia. There is no reason to assume that European leaders would hand out a strategically important country to Russia. Greece staying in the currency union is clearly the best and most likely outcome for the eurozone as a whole. However, the risk of an exit still exists and therefore some space should be committed to studying the consequences.

Greece leaving the single currency would mean the country defaulting on its debts and suffering from a financial crisis as banks would no longer have access to funding from the ECB. Greece would need to introduce its own currency, the Drachma, again and impose capital controls in order to stop the currency outflows from the country. This would lead to a period of financial crisis and recession in the country. Inflation would be high as the newly introduced currency would decline in value against the other currencies. Public services such as health care would be in crisis due to decreased government funding and this would lead to lack of medical supplies and medicine. Greece is self-sufficient in terms of agricultural products and this would save the Greeks from a worse kind of humanitarian crisis. However, an economy that is highly indebted and consists mainly of service industries would be vulnerable in the short run and could be expected to recover only after it attracted tourists again by being the cheapest holiday destination in Europe. Greek debt is currently almost 168% of Gross Domestic Product and the yearly interest payments alone are over 24 billion euros, approx. 13% of the GDP. It is clear that Greece will never be able to achieve such growth that the debt will be reduced by any meaningful measure. Instead, an exit from the single currency and a default on loans would mean that Greece is some 328 billion euros better off and would once again attract tourists to its beautiful archipelago.

It is unlikely that Greece's economy will be transformed into a German-style, disciplined and productive economy or that the required structural reforms would be executed in the near future. The current government was chosen by people who are tired and frustrated by the austerity demands. It has a mandate from the Greek people to bring about a change. However, it seems likely that Greece will stay in the eurozone as long as there is hope of getting further financing. Once that hope is gone, the country will exit the single currency as there will be no longer be any strong incentives to remain in the union. Due to geopolitical tensions in Europe, it might well be in the interest of the rest of the European Union to keep financing Greece in order to prevent it from sliding into an alliance with Russia. Should the country exit the Euro Area, those investing in government bonds could conclude that other euro periphery countries could also exit the single currency and start reducing their investments in Italian, Spanish and Portuguese bonds, causing the yields to move higher. This would obviously make borrowing more expensive for these governments and further hinder growth prospects in the Euro Area.

Italy

In the seventies, the Italian economy grew in leaps and bounds and even surpassed the GDP growth of some of the current economic leaders in the Euro Area. Inflation stayed high, but the weak lira helped the economy over and over again. Since about the time of the introduction of euro, the Italian economy has hardly grown at all and the single currency has made things worse as the currency market has not been there to help the economy to adjust. As Asian economies entered the picture in the early 2000s and were more competitive in producing lower specification consumer goods, Italy was one of the losers among the Euro Area economies. The problems in the Italian economy

have their roots in ignored structural reforms and government debt. The debt to GDP ratio is high (139.02%) and as GDP shrinks, the ratio would keep on ticking higher even if the debt burden didn't grow at all.

If Italy were to exit the eurozone, the politically difficult structural issues could be dealt with later while the debt burden would be eased with higher inflation caused by weak currency.

An old saying goes that people are ready to change only when they begin to fear the current state of things not changing, more than the change itself. This is certainly true about politicians. Once they realize that the easier way out is to exit the euro and to inflate some of the Italian sovereign debt burden, gaining export related jobs in the process, the option becomes attractive.

Should Greece set an example first, the process becomes a lot easier to accept and undertake. After all, the main reason Germany is motivated to hold the ailing currency union together is the fact that troubled economies such as Italy keep the euro from appreciating against major trade partners. This translates directly into better employment numbers in Germany.

Spain

It has been claimed that the main cause of economic crisis in Spain was the enormous housing bubble. The reason however for the housing bubble to balloon to such proportions was low lending rates caused by the introduction of the euro. Both public and private borrowing increased as the price of money came down. Cheap money pouring into the private sector created a boom in the property sector. This translated into GDP growth, encouraging the government to increase its spending and the markets were happy to finance the spending spree at artificially low rates.

Between the introduction of the single currency in 1998 and the collapse of the Lehman Brothers in 2008, the yield for 10 year government bonds ranged from three to six per cent while between 1992 and 1997, the yield ranged from six to twelve per cent. This meant that Spain was able to borrow money too cheaply relative to the risks of the government defaulting on its debt.

The housing market ballooning meant higher GDP growth, but the growth rate was not sustainable as it was based on external resources flowing into the country and inflating the market, not on solid growth in manufacturing and other economic activity. From 1996 to the third quarter of 2008 the Spanish government debt to GDP ratio actually declined even though the debt kept piling on. This was a result of an unhealthy rise in real estate markets that doubled in value during the same period. Since the property bubble collapsed, unemployment has been among the highest in Europe (currently at 23.7%) and the debt to GDP ratio is higher than it has ever been. Currently the ratio stands at 97.29%.

Spain is recovering and created more than 430 000 jobs in 2014. This implies that the immediate risk of Spain leaving the eurozone is low. However, even though an exit from the eurozone looks unlikely at the moment, the so called *contagion risk* remains. Should Greece exit the single currency, default on its loans and gain an unfair advantage over the other eurozone countries, the calls from Spanish politicians for similar advantages could increase. This in turn would be likely to cause investors to sell their Spanish government debt holdings and push the yields higher.

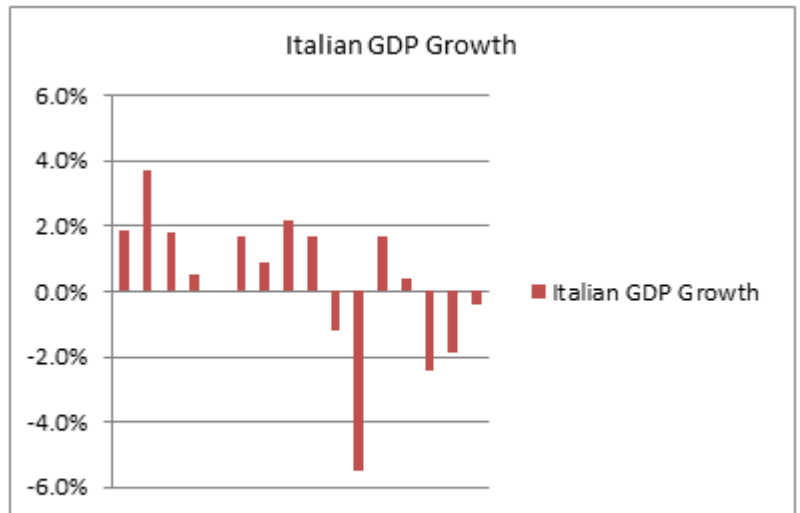


Figure 7: Italian GDP growth 1999 – 2014
Source: HotForex.com/ActionEconomics.com

Portugal

In 2009 Portugal started to slide into a debt crisis when it raised its budget deficit forecast to 8% from the previous 5.9%. This was not well-received by the rating agencies and a month later Standard & Poors lowered Portugal's outlook to negative after Moody's and Fitch had already done so in the previous months. In 2010 further cuts in ratings led the Portuguese government to increase taxes and reduce the salaries of politicians and public sector employees. As the credit spreads widened and the price of borrowing became unbearably high for the country, the government finally asked for a financial bailout from the European Union in 2011. By the end of 2011 the Portuguese debt as a percentage of GDP had risen to over 124% and currently stands at 131.88%, one of the highest figures in the Euro Area.

What happened in 2011 may look like something pretty far in the rear mirror, but the fact remains that just over 6 months ago in August 2014, one of the biggest banks in Portugal, Banco Espirito Santo (BES), was split into two banks. One of them kept the healthy operations while the other bank is a bad bank and holds the toxic assets. It is clear that the problems have not disappeared and there are still issues that need to be resolved. One of the burdens that the country could do without is the extensive debt burden.

At the moment Portugal uses 4% of its GDP just to service the existing debt. As the unemployment rate is over 13% and the GDP growth below one percentage point (0.7%) the politicians might find it difficult to justify a Euro membership should other countries, such as Greece, exit the single currency and inflate default and a significant portion of their debt. The probability of Portugal leaving the euro in 2015 is low, but should there be a Greek exit it would be likely that the investors in the government bond market will start offloading Euro periphery sovereign bonds from their portfolios. This would significantly increase the price that Portugal pays for the money it borrows.

Markets Outlook



Figure 8: US Dollar Index (DXY), Monthly
Source: eSignal

USD

Even though the majority of the central banks have been lowering interest rates and trying to devalue their currencies, it has been the ECB QE program and the fall of the euro that has had the biggest impact on the dollar index as it has the biggest weighting (approx. 60%) in the US dollar index. At the time of writing, the dollar index has risen over 25% from the low of 2014 to the March 2015 high. The US dollar has been rising on the back of the diverging central bank policies on both sides of the Atlantic. At first the driver was the expectation that the Federal Reserve would raise interest rates and the European Central Bank ECB start its quantitative easing program. Now that the ECB stimulus program has actually started the future moves in DXY and EURUSD depend on market's perception of when the Fed might start the rate hike cycle. The Fed itself has advertised that it is now data dependent and will take its cues from the economic data as it unfolds

Until recently the US economy has improved with the annualized quarterly GDP growth, up from the 2014 low of -2.10 to the latest (Q4) figure of 2.2%, and the unemployment rate has come down to 5.5%. Now, however, there has been some softness in US data and it has been argued that it would be difficult for the Fed to raise the rates with the US dollar already being at such elevated levels. Further moves higher would cut even more into large American corporations' revenues from abroad.

US economic growth is mainly driven by private consumption (almost 70% of GDP) and exports contribute only approximately 13% to the GDP. Now that expensive USD has driven the price of oil lower, the energy cost has come down and supports the US economy. Low oil prices are like a tax cut to the US consumers and they are expected to increase the economic activity over the coming quarters in 2015. However, it looks like the price of oil has now bottomed and in its latest statement, the Federal Open Market Committee (FOMC) hinted that the Fed is starting to focus on the negative impacts of the rising dollar. In the March meeting, Fed Chair, Janet Yellen, downgraded the Fed's assessment of the US economy which is attributed partly to the slowing export growth. The Fed also seemed less confident that pressures on inflation are transitory. According to Chair Yellen, the Fed will start hiking rates when it sees further improvement in the labour market and is reasonably confident that inflation will move back to the Fed's 2% objective.

Until very recently, the US labour market has been healing and adding in excess of 200k jobs per month since October 2014. The March payroll number, however, was drastically lower than expected (126k instead of 245k new jobs), but this could be related to seasonal changes coinciding with a very severe winter. Therefore the number could be an outlier in a string of strong employment numbers. We need more data points to confirm a trend change, but one thing is certain, this disappointing figure will make it more difficult to argue for an early start in the rate hikes. Therefore it seems likely that the Fed will not start rate hikes before the September meeting and might even push the first rate hike until Q1 2016.

Technically the width of the huge bottoming formation in the USD suggests that the dollar index should rise to the 108 – 109 region, which coincides with the monthly highs in September 2002. Should the 109 target be reached, the DXY would then be relatively close to the upper end of the range between the 2001 high and the 2008 low. This would mean that the dollar would be less attractive in relation to other currencies as the upside might be getting limited.

What might turn the DXY trend lower? The short and simple answer would be the US macro data and the inactivity of the US Fed. Some 25% of S&P 500 companies' profits come from abroad and the strong dollar could therefore increase probabilities of a stock market correction. As the Fed has pointed out that they are data dependent, it makes sense to argue that the dovishness will prevail and the USD should come under pressure. Additionally, should the US stock market lose momentum and start correcting lower, the Federal Reserve might start to worry about the wealth effect and delay the rate hikes further. This would mean that the US dollar would move further south. At the time of writing, the euro, the heaviest component in dollar index, has found some support and crude oil looks like it has bottomed. This has sent the USDCAD lower and added serious questions of whether the DXY can get past the recent highs.

A rising trendline in EURUSD drawn from the 1985 low to the low in the year 2000 has an extension right at the current levels and has, together with Yellen's dovish statement, caused EURUSD to first bounce higher and then move sideways. Due to the euro's weighting in DXY, this obviously pushed the DXY lower and until the rising trendline in the EURUSD is broken, it is likely that the DXY will move sideways or correct lower. The first line of defence would be the region close to the January 2015 high at 95, which is the nearest likely support level. This level has already proven to be a valid support as the massive down move caused by Yellen's comments was halted at 94.76. This kind of volatility is only possible when the market is one sided, almost everyone is long on the dollar and short euro. This suggests to me that the market needs to move sideways or correct lower.

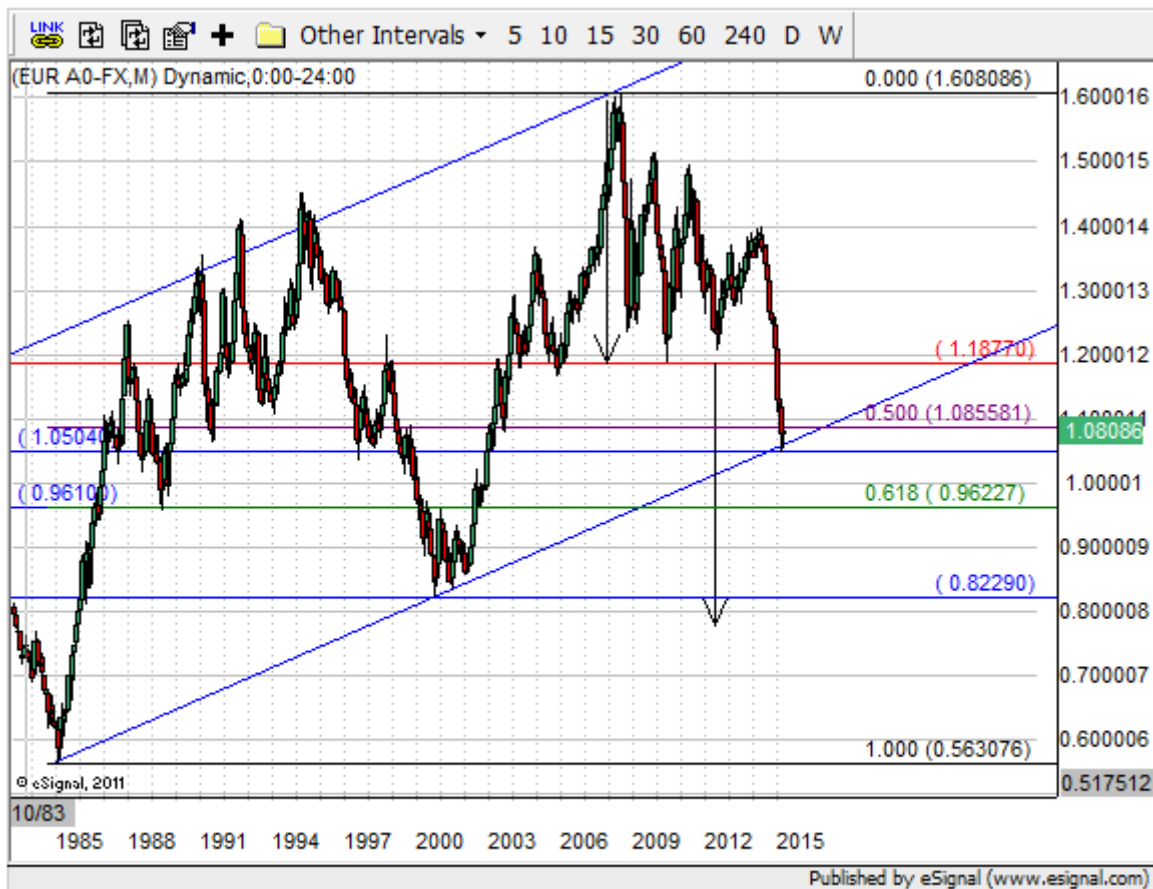


Figure 9: EURUSD, Monthly
Source: eSignal

EURUSD

First the expectations of Quantitative Easing from the European Central Bank and then the actual announcement of the program drove EURUSD substantially lower but the economic, political and geopolitical challenges have contributed to the fall. China, an important trading partner, is slowing down, the continuity of Greek membership in the eurozone is nowhere near guaranteed and a possible Grexit could over time lead to a Pigsxit or varying degrees of one. If Greece leaves the Euro Area, contagion fears will rise and market participants might start selling their holdings in other Euro periphery government bonds. However, currently the main driving forces behind the EURUSD weakness have been the ECB's massive QE program and the Fed rate hike expectations. According to Fed Chair Yellen's comments, the latter will depend on the data and this has brought the macro data pickup in the eurozone and softness of the data in the US into markets' focus. Even though there has been some disappointing data in the US, the economy is growing and the Fed is still expected to raise rates later this year or Q1 2016. At the time Manufacturing PMI data showed that in March, German manufacturing expanded at the fastest pace in a year. Also, the lower price of energy together with the cheap euro are expected to support economic activity in the eurozone through a likely increase in domestic demand and increase in exports over the rest of 2015.

The above EURUSD chart has been created by merging the EURUSD data with the German Mark data from the period before the euro existed as a currency. The huge topping formation above 1.1870 and a break below it suggests that technically EURUSD still has substantial downside potential and a major resistance at the 1.1870 region. A projection from the width of the topping formation points to levels well below the 0.8440 low, but before the pair can move that far there are several support levels to deal with. The historical levels at 1.0504 coincide with a rising trend line while the 50% Fibonacci level (drawn from 1985 low to 2008 high) is in the proximity at 1.0855. The latest low is only some 50 pips below the historical support at 1.0504. Together with the rising trendline support this level is there-

fore already proven to be an important support. Additionally the 100% Fibonacci extension level measured from the topping formation is not that far either at 1.0794. This combination of technical factors has already stalled the down move in EURUSD and might even cause the pair move higher as the market has been so one sided lately. The next technically important support level is at the 0.9610 region and coincides with the 61.8% Fibonacci level. A projection made based on the width of the topping formation points roughly to the year 2000 low at 0.8229 with 161.8% Fibonacci level coinciding perfectly with the level. The nearest resistance level is at 1.1098 and should EURUSD manage to close above it, the next significant resistance is in the region of 1.17 to 1.19.



Figure 10: USDJPY, Monthly
Source: eSignal

USDJPY

The reason for the weakness in the Japanese Yen has obviously been the central bank's monetary policy. Prime Minister Mr Abe has introduced three stimulus programs with the first one starting almost two years ago when 10.3 trillion JPY was injected into the economy. Then another program started in April 2014 sized at 5.5 trillion JPY, while the last one (3.5 trillion JPY) started in December 2014. As a result the debt to GDP is now approaching 245%. Combined with the rate hike expectations from the US Fed, this has at the time of writing driven the USDJPY up by over 50% since the 2012 low. However, 2014 growth was still a disappointment and the Japanese government hopes that the latest package will increase real GDP by 0.7% in 2015 – 2016. The IMF revised its growth forecast for Japan down to 0.6% with stagnation being a risk for the Japanese economy. Japan needs more private demand and higher growth potential in the medium term. Being a net importer of oil, the country should get some help from lower oil prices. USDJPY has moved close to the 2007 highs at 124.15 and then consolidated at just below 120. This consolidation coincides with 61.8% Fibonacci retracement level (measured from the 1998 high to 2011 low).

The currency pair is therefore now approaching levels where it might be getting challenging to buy the pair on a valuation basis. In other words, a substantial part of the QE and interest rate expectations are probably already priced in and the pair becomes vulnerable to corrective moves. USD is still a stronger economy and I expect it to outperform in the long run. However, unless Prime Minister Abe and the Bank of Japan announce further quantitative easing programs, it is not likely that this market would see such explosive moves to the upside that we have seen over the last two years. The current and past stimulus programs have not produced the intended results of inflation and self-sustained growth. Therefore it is likely that the BoJ will try to expand its efforts in this front and introduce further easing down the line. Technically, major resistance levels are at 124.15 and 135.16 while the first significant support level is in the proximity of the 38.2% Fibonacci level and December 2014 high at 103 to 105.



Figure 11: GBPUSD, Monthly
Source: eSignal

GBPUSD

The UK economy has been improving even though the eurozone, an important trading partner, has been struggling. Obviously the oil producing sector has suffered in the UK due to lower oil prices, but at the same time the lower cost of energy has supported wider growth in the UK. The United Kingdom has seen strong job market growth with the unemployment rate down to 5.6% from 6.3% a year ago. Job vacancies are at a record high and both productivity and real wages are growing. This creates pressure to raise rates moderately, but I don't expect this to happen before Q1 2016. The BoE governor, Carney, warned in March that even though domestic demand is picking up together with wages, it is possible that we will have a protracted and persistent period of low inflation globally. He argues that sterling strength against the euro could mean lower prices in the UK for some time. There has been some worry that the improvement in the UK economy is mainly housing market and construction related. However, the March manufacturing PMI survey was the third survey in a row that showed improvement, suggesting that the economy's recovery is on a wider footing.

Over the last few years GBPUSD has been ranging between support approximately at 1.50 and a resistance below 1.70 area with the latest peak being an exception and taking the pair up to the 1.72 area. When the US dollar index started rallying last summer, the rally in GBPUSD turned to a downtrend that has taken the pair to the general region of historical support (2013 lows). This level coincides with a 61.8% Fibonacci retracement level. The pair is now hovering in proximity of this support and even though the elections in the UK represent a risk to market participants, I believe that the downside is now limited to the range between 1.4800 and 1.4200. If the US data continues to be soft and the Fed maintains a dovish tune, I expect this market to bottom out over the year 2015 and the aforementioned range could well be the area where the bottoming formation will take place.



Figure 12: AUDUSD, Monthly
Source: eSignal

AUDUSD

According to the Reserve Bank of Australia, growth is continuing at a below-trend pace, with domestic demand growth quite weak overall. As a result, the unemployment rate has gradually moved higher over the past year. The bank says that the economy is likely to be operating with a degree of spare capacity for some time yet. With growth in labour costs subdued, it appears likely that inflation will remain consistent with the target over the next one to two years, even with a lower exchange rate. Credit is recording moderate growth overall, with stronger growth in lending to investors in housing assets.

The AUDUSD pair has been moving lower with the price of copper since 2011. In February the pair reached a level where supply and demand were balanced enough to create a Doji like candle with a narrow body and close only slightly above the open. This was very likely encouraged by the fact that the price of Copper rose higher throughout the month. The Reserve Bank of Australia decided to keep the rates on hold at 2.25%, but is signalling that they will

cut the rates later this year. According to the RBA, it was appropriate to hold the cash rate steady for the time being, while recognising that further easing over the period ahead may be appropriate to foster sustainable growth in demand while maintaining inflation consistent with the target.

The nearest resistance level is relatively close at 0.8067 and should dampen enthusiasm to buy AUDUSD. Should the price rally that far. The 161.8% Fibonacci extension level is at the same region while the 261.8% extension coincides with a swing low from February 2009. The price of Copper has been relatively strong since the beginning of February this year, but it is still in a downtrend. As AUDUSD has a high correlation with the price of Copper, it is safe to assume that the recent loss of downward momentum has a connection to the strength in Copper prices. Should China intensify its efforts to boost the economy by introducing new economic stimulus and the Fed's dovishness drive the USD lower, the price of Copper could bottom out and support the AUDUSD at higher levels. However, at the time of writing the divergence between the Fed and RBA rates policies is still rather clear and should pressure the pair towards the 0.7269 support. I expect the AUDUSD to bottom out in the range between or above the 0.72 level.



Figure 13: USDCAD, Monthly
Source: eSignal

USDCAD

GDP growth in Canada has been ranging between the low of -0.50 in 2011 to the high of 5.6 in 2010. Therefore, the current figure of 2.4% is close to the average growth over the last few years. However, the impact of lower oil prices has not yet come through to the Canadian economy and is expected to slow down the GDP growth over the coming quarters. The Bank of Canada cut the interest rates in January in an effort to subdue the impact from the oil price slump as it sees the negative impact of the oil price shock appearing in the first half of this year.

USDCAD and Crude Oil have a high inverse correlation due to energy exports being so important to the Canadian economy. Even though the impact of energy price fluctuations seeps through the Canadian economy with a delay, the currency markets discount (anticipate) the future impact and react pretty much in line with the changes in the price of oil. The Crude Oil market has been consolidating lately and looks like it is bottoming. This has caused USDCAD to move lower from the highs.

The pair was trading just below a year 2009 high and has now reacted lower from 50% Fibonacci level. This means that the previous consolidation will now be a resistance. I look for a move to 1.15 to 1.17 level over the coming weeks and believe the pair is capped for the rest of the year. With the US recovering relatively strongly and the Canadian economy suffering from the consequence of oil price collapse, the focus is on whether the softening in the US macro data will be temporary or develop into a trend. This will drive the markets' expectations on the Fed policy. Another focal point will be the price of oil. Now that crude oil is bottoming out it is likely that USDCAD will keep on reflecting this change of trend. This leaves us with two not so easy predictions, the actions of the Fed and the price of oil and will emphasize the need for price action based analysis.



Figure 14: Crude Oil, Monthly
Source: eSignal

The Price of Oil in Turmoil

The price of oil collapsed with the strengthening dollar and has recently reached levels that were last seen in the later stages of the financial crisis in 2008. This suggests to me that the current levels are deeply oversold both fundamentally and technically. The world economy is in a better shape than it was in the last quarter of 2008 when the US Crude Oil futures dropped to \$33.35. Therefore, it makes sense to expect the price of oil to be relatively close to the levels it could find a bottom. In fact the latest price action suggests that the market is in fact bottoming.

The economies globally are now much more stable than in 2008 when oil was hammered down due fears that the global financial system would be in danger and would not recover for many years. Keeping this in mind the turnaround in the price of oil could happen more quickly this time around. In fact, at the time of writing there are definite signs of this. Also, we do have a world economy that has been slowing down and technological advances that allow oil to be extracted from new sources. All this together with the Saudis decision not to defend the price of oil, but market share, is bound to pressure the price of oil in the near future. However, the world we currently live in is a very different one to the bleak picture of the future painted against the backdrop of financial crisis that threatened to break up the global financial system in 2009.

Shale oil production is very capital intensive and with lower oil prices, the financing deals for new exploration and drilling are harder to get. This and the lower incentive to invest should decrease the number of new entries into the business substantially. The global economy is still predicted to grow above 3% this year. Therefore the combination of low oil prices and projected global growth has started to weigh in as different market participants have been hedging their future energy costs.

Over the last 30 years it has taken, on average, two to three months for oil to bottom out after a major downside move. Now the market has been moving sideways for three months and is breaking higher. If the current monthly candle closes above 52.50 price has very likely bottomed and we should expect higher prices over the rest of 2015. However, the study of historical prices also reveals that the price of oil is likely to stay subdued after a major move lower. This together with major technical resistance in proximity of 75 dollars suggests that the 'new normal' for Crude Oil prices will be below this level with the low end of the range at somewhere close to \$50.

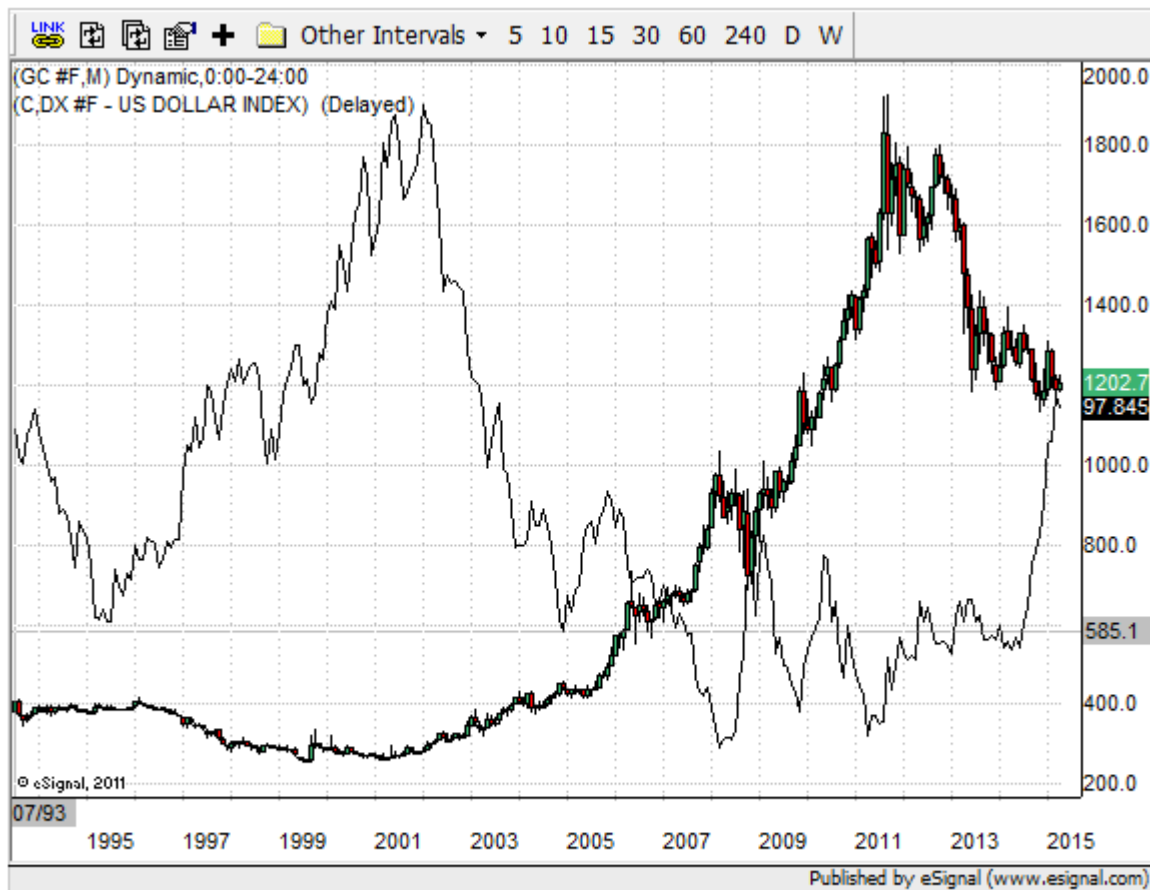


Figure 15: Gold and US Dollar Index, Monthly
Source: eSignal

Gold

According to the World Gold Council, the demand for bars and coins was less than the record in 2013, but still the demand for physical Gold remained relatively strong. Central banks were also active in buying the yellow metal and their purchases were close to a 50 year high. This was the fifth consecutive year that the central banks were net purchasers of gold. At the same time, gold supply stayed flat with 0% change as mining production increased to a record high and recycling decreased to a seven year low. The outflows from ETF (Exchange Traded Funds) were far lower than in 2013 when price dropped massively. The World Gold Council says that as the price of Gold is now lower, it is likely that mining production will level off over the years 2015 and 2016. This will eventually help to scale down the supply side and support the price of Gold.

The policies of the US Federal Reserve have an even greater impact on the price Gold when measured in the USD. The dollar price of gold is sensitive to appreciation in the USD and historically US Gold Futures have not been performing well during periods of a strongly rising dollar. Since November 2014 however, Gold has been relatively

strong. The price has moved sideways even though the US Dollar index has been rising substantially. In fact, Gold has been relatively throughout the US Dollar Index rally. Since the end of May 2014 to the end of the Q1 2015 Gold declined only 5.4% while the US Dollar Index climbed almost 23% over the same period.

In November 2014 the price of Gold rallied even though the Swiss had voted against the idea of Swiss National Bank increasing Gold reserves over the next five years. This would have increased yearly global demand by 7%. When a market rallies in the face of negative news, the implication is that there is significant institutional demand for Gold.

The price of Gold moved significantly higher from the levels it traded at the time, but have since returned to the same support. This happened after a big positive surprise in US employment numbers caused the price to move lower from a key support level and the markets took that as an indication that the Fed will indeed start the rate hike cycle this year. Since then we have however seen a negative surprise in the US employment numbers and softening in the US macro data. This has moved the Fed rate hike expectations by at least 3 to 6 months further into the future.

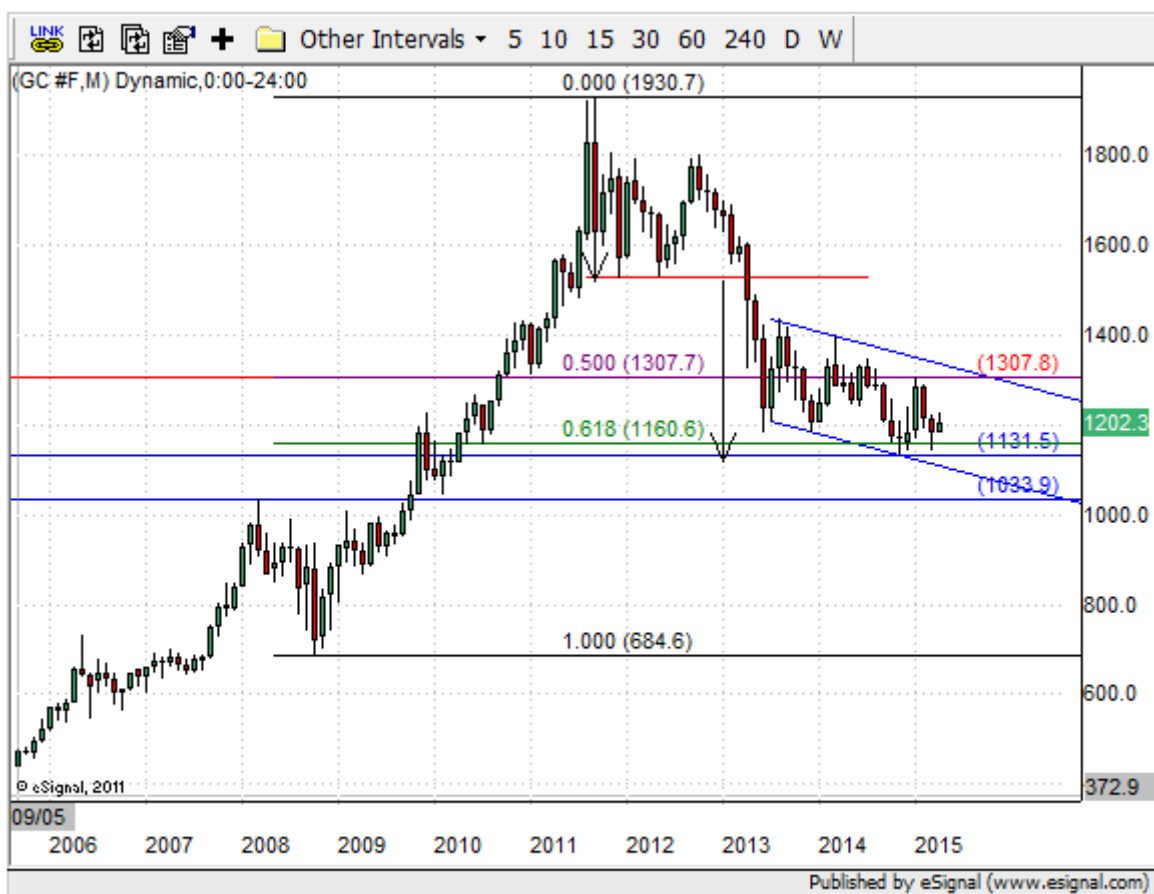


Figure 16: Gold, Monthly
Source: eSignal

At the time of writing, Gold is trading relatively close to a support level created by a monthly pivot candle from 2010. It has reacted higher from the support at the lower end of the bearish long term channel low. This level coincides with a projection from the 2011 to 2012 market top and even though they are not drawn in the picture the lower Bollinger Bands (20) have also been supporting the price. The lower high in the monthly chart at 1307 and move to the lows have deteriorated the technical picture slightly but the fact that price rallied again from the proximity of 1130 support suggests that market participants are still interested in buying Gold at that level. Gold needs to create a higher pivot low in proximity of 1131.50 support to further validate the positive indications by the November rally (after the Swiss vote).

Gold is technically at key levels in the longer term picture and needs to find buyers here to maintain the status of being relatively strong in the face of rising US Dollar Index (DXY). From historical study of the price of Gold and the DXY, it can be concluded that as it is clear that the Fed will raise interest rates, the performance of Gold should be subdued. However, as we can see from the chart (Figure #15), DXY skyrocketing doesn't mean the price of Gold will collapse. Should the current support fail, the next important support level is the 2008 high at the 1030 area while 50% Fibonacci retracement level and bearish channel high close to 1307 are likely to resist moves higher. However, now that it seems the Fed is reluctant to hurry up with the rate hikes and is getting more dovish, it is more likely that the support at 1131.50 will hold.



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