FINANCIAL MARKETS TODAY

North American edition

Friday 5 January 2018

INSIDE TODAY'S EDITION:

- **NEWS & RUMOURS**

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- **FOREX MARKET STRATEGY**

The USD has regained some lost ground today (gaining particularly vs the JPY) ahead of the US employment report, which can prompt further gains.

- **BOND MARKET STRATEGY**

Treasuries found downward pressure across the curve on Thursday, pushing to session lows in the wake of stronger the expected ADP employment data for December.

- **INFLATION STAYS TOO LOW**

The Eurozone's preliminary CPI (HICP) inflation rate for December dipped to 1.4% y/y from 1.5% in November, matching expectations. With inflation, particularly core, running persistently well below the ECB's target, this argues against earlier-than-planned policy tightening

- **US PREVIEWS: EMPLOYMENT REPORT & MORE ON TAP**

In addition to the December Labor Department employment situation report at 08:30EST (13:30GMT) – for which we expect non-farm payrolls will increase +180k – the US trade balance, non-manufacturing ISM and factory orders will be released.

- **FX TECH FOCUS: USD/JPY & USD/CAD**

-- USD/JPY: Price action holding in the upper half of the 108.00 and 114.35 range

-- USD/CAD: Sharp sell down through 1.2660/1.2600 towards key swing low at 1.2460

DAILY ECONOMIC DIARY

DD/MM	GMT	R*	CTRY	DATA RELEASE	FOR	ACTUAL	IDEA	MEDIAN	LAST
05/01	**13:30**	**5**	**US**	**NONFARM PAYROLLS**	**DEC**		**180**	**190**	**228K**
05/01	13:30	1	US	PRIVATE PAYROLLS	DEC		175	185	221K
05/01	13:30	3	US	MANUF. PAYROLLS	DEC		15	20	31K
05/01	**13:30**	**5**	**US**	**UNEMPLOY RATE**	**DEC**		**4.1**	**4.1**	**4.1%**
05/01	**13:30**	**1**	**US**	**AVG HRLY EARNING**	**DEC**		**0.2**	**0.3**	**0.2%**
05/01	13:30	1	US	AVG WEEKLY HOURS	DEC		34.5	34.5	34.5
05/01	13:30	4	US	TRADE BALANCE	NOV		-48.0	-48.1	-$48.7B
05/01	13:30	2	CA	INT'L MERCH TRADE	NOV		-1.20	-1.25	-C$1.47B
05/01	**13:30**	**4**	**CA**	**NET EMPLOY**	**DEC**		**-5.0**	**-2.5**	**79.5K**
05/01	13:30	4	CA	UNEMPLOY RATE	DEC		6.0	6.0	5.9%
05/01	**15:00**	**3**	**US**	**ISM NON-MANF.**	**DEC**		**57.0**	**57.6**	**57.4**
05/01	15:00	4	US	FACTORY ORDERS	NOV		1.0	1.4	-0.1%
05/01	15:00	1	CA	IVEY PMI	DEC		58.0	N/A	63.8

*R=Market Significance rating, on scale 0-5   Source: Reuters/Bloomberg

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DD/MM GMT CTRY EVENT
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05/01       UK BOE MPC'S HALDANE SPEAKS
05/01 15:15 US PHILADELPHIA FED PRESIDENT HARKER SPEAKS
05/01 17:30 US CLEVELAND FED PRESIDENT MESTER SPEAKS
06/01       UK BOE MPC'S HALDANE SPEAKS
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NEWS & RUMOURS

The Eurozone's preliminary HICP inflation rate for December dipped to 1.4% y/y from 1.5% in November, matching expectations - and returning the rate to that two months prior. The ex-energy-and-unprocessed food rate remained steady at 1.1%, while the narrow-core (excluding alcohol/tobacco as well) stayed at 0.9% y/y. IDEA: Although risks to this release were seen on the upside, little market reaction is seen. With inflation, particularly core, running persistently well below the ECB's target, this argues against earlier-than-planned policy tightening, which is in principle euro-negative.

Markit's Eurozone Retail PMI for Dec rose to 53.0 -- a 6-month high -- from 52.4.

French December consumer confidence rises to 105, vs market expectations for 103 and vs an upwardly revised 103 in November (prev. 102). Meanwhile French preliminary HICP seen at 1.3% y/y in December vs an expected unchanged 1.2% seen in November.

German retail sales rose by 2.3% m/m, 4.4% y/y in November, vs market expectations for 1.0% and 2.5% respectively. The data provided EUR/USD with a base ahead of 1.2050 earlier with the pair seen eyeing another run at the 3-year high of 1.2092 traded on 8 Sept ahead of 1.2100/10 (1, 2 Jan 2015 high).

UK unit labour costs decelerated to 1.3% y/y in Q3 from 1.7%, which is the lowest since Q2-2015. [IDEA: This points to lower inflationary pressures from wages in future.] Published simultaneously by the ONS, output per worker (i.e. labour productivity) was up 0.9% y/y, vs 0.8% for the previous quarter.

UK BRC Shop Price Index for December declined -0.6% y/y, fall at fastest rate since March, down further from prior -0.1% seen in November. Meanwhile, the GBP/USD traded flat at 1.3556 by 02:00GMT.

On the short-term chart EUR/USD is neutral whilst trading between 1.2045 and 1.2075 with support seen initially at 1.2035/45 (50 & 100-hour ma) ahead of 1.1995/05 (Mon, Tues, Wed's and yesterday's low) and 1.1970/80 (200-hour ma), and resistance at 1.2085/95 (8 Sept and yesterday's 3-year high) ahead of 1.2100/10 (1, 2 Jan 2015 high) and 1.2160/70 931 Dec 2014 high).

The USD and JPY remain under pressure heading into the weekend with the former seen weighed by low inflation concerns and political developments and the latter by a rise in market risk appetite that has seen the DJIA move above 25K and the Nikkei gain a further 0.9% today following on from yesterday's 3.25% rise. The USD is also seen weighed by the lack of upward reaction to yesterday's better than expected ADP employment report ahead of today's non-farm payrolls where market expectations are for a gain of 190K in December down from 228K added in November. Elsewhere EUR/USD continues well supported by recent data releases, coupled with expectations that the ECB will steadily reduce its stimulus programme during 2018 leading to higher interest rates.

China's central bank did not conduct open market operations for tenth day, saying that banking liquidity is at a relatively high level, offsetting teh impact of required reserves payments.

Nikkei 225 closed up 0.89% at 23,714.53.

Japan Finance Minister Aso said that the sales tax needs to be raised for fiscal consolidation. However, if the economy is not strong enough, the hike cannot proceed further.

Japan Nikkei December Services PMI fell to 51.1, down from 51.2 seen in November. On the other hand, the composite PMI remained flat at 52.2 in December. Anything above 50-mark indicates growth. Meanwhile, the USD/JPY traded nearly flat at 112.81 by 02:30GMT.

Japan's December monetary base rose 11.2% y/y, down from prior 13.2% y/y.

Australia recorded a trade deficit of -AUD628mln in November, worse than the market expectations of an AUD800mln surplus, revised down from October's narrow AUD105mln surplus to AUD302mln deficit. Exports were largely unchanged on a seasonally adjusted basis, while imports rose 1%. Following this release, the AUD/USD fell 0.20% to 0.7849 by 02:20GMT.

-- Recap from yesterday's North American session --

St Louis Fed President Bullard said that the link between the jobs market and inflation might have disappeared, as the Phillips Curve has become flatter since central banks started targeting inflation. [IDEA: Indeed, to what extent the declining unemployment rate triggers faster wage growth will be key for policy this year. The next indication will come with today's average earnings figures. Note: Bullard's position is relatively dovish; he doesn't vote on the FOMC this year.] Bullard adds that adopting a Taylor rule would help steer expectations.

Bullard said in Q&A that the Fed wouldn't need to react to the supply-side effects of the tax bill. Said the US economy looks good but the yield curve should be debated; its current slope is OK but the Fed should avoid inverting the curve.

The ADP employment estimate came in at 250k for December, versus the revised 185k increase seen in November (prev. 190k), above market expectations for a +190k result. IDEA: despite the stronger result seen here, we anticipate a milder 180k increase in December non-farm payrolls on Friday, coupled with a 4.1% headline unemployment rate.

US Initial jobless claims for the week ending 30 December increased +3k to 250k, versus the revised 247k reading seen in the week prior (prev. 245k), above expectations for a 240k result. The 4-week average was reported at 241.8k, up from the revised 238.3k reading seen in the week prior (prev. 237.8k). Meanwhile, continuing claims for week ending 23 December decreased to 1.914mln, versus the 1.951mln reading seen prior.

The final Markit US Service PMI measure decreased to 53.7 for December (preliminary: 52.4), versus the 54.5 result seen for November. Meanwhile, the final Markit US Composite PMI measure decreased to 54.1 in December, versus the 54.5 reading seen for November.

According to Challenger, Gray & Christmas, planned US job cuts decreased -7.6% to 32,423 in December, versus November (down from 35,038). Compared to December 2016, the number of planned cuts decreased -3.6% (down from 33,627). IDEA: the Challenger survey represents planned intentions, which do not always materialize in actual cuts.

The Bloomberg US consumer comfort index decreased to 51.8 for the week ending 31 December, versus the 52.4 reading seen the week prior. IDEA: despite the weaker readings seen in recent weeks, the series continues to hold relatively steady compared to other sentiment measures.

According to the US DOE, crude inventories decreased -7.4mln bbls (vs a draw of -4.6mln bbls seen prior) for the week ending 29 December. This came alongside an increase in gasoline inventories of +4.8mln bbls (vs a build of +0.6mln bbls seen prior) and an increase in distillate inventories of +8.9mln bbls (vs a build of +1.1mln bbls seen prior).

The Canada producer prices report revealed an overall increase in IPPI of +1.4% m/m for November, versus the revised +1.1% m/m increase seen in October (prev. +1.0% m/m. Meanwhile, the RMPI measure increased +5.5% m/m in November, versus the +3.8% m/m reading seen in October.

According to the release, the RMPI measure increase was primarily due to higher prices for crude energy products.

JP Morgan's Global Composite PMI for Dec rose to 54.4 from an upwardly-revised 54.1. This is the highest since March 2015. IDEA: As such, it chimes with the synchronised upswing that currently characterises the global economy.

The Dow Jones Industrial Average climbed (and closed) over 25,000 for the first time.

FOREX MARKET STRATEGY

The USD has regained some lost ground today (gaining particularly vs the JPY) ahead of today's US employment report, with the **DXY** reclaiming the 92.00 mark -- within this week's range of approximately 91.80-92.25. Generally, though, the price action for the greenback remains poor, despite the FOMC's hawkish-tinged minutes and better-than-expected US data this week (in particular yesterday's strong ADP – which bodes well for Friday's NFP). We (in the minority) expect negative dollar sentiment to be overwhelmed by more aggressive-than-expected US interest rate increases this year. A strong employment report (with a particular eye on average earnings) should see the **DXY** bounce back towards 92.50. Otherwise, the index would face support at 91.50 and 91.00. In any case, post-payrolls direction will be informative. Note that the US non-manufacturing ISM also comes out later; while less market-sensitive, it is an important indicator for the overall economy.

EUR/USD should meanwhile trade between the 1.2000 mark that it has touched in recent days, and 1.2090, which it has also tested and approximately represents its 2017 high. Today, the preliminary Eurozone inflation rate for December dipped to 1.4% y/y as expected – without much market impact or policy implications.

USD/JPY has diverged by climbing above 113.00 for the first time in since 27 Dec. as the pair is underpinned by higher US yields, particularly at the short end, as well as higher risk appetite detracting from the yen. This pair could go on up to 113.50-113.75, with the latter representing its December swing high. **EUR/JPY** (136.50) is clearly extending last week's break above the 135.00 mark and could be heading towards 140.00 during the course of this year.

GBP/USD remains in the middle of this week's range of roughly 1.3500-1.3600, while **EUR/GBP** hovers around 0.8900. We reiterate that we expect sterling outperformance (on a trade-weighted basis) this year.

With the CHF also depressed by market risk appetite (as well as unchanged SNB policy), **EUR/CHF** is pushing up towards last week's highs of about 1.1775 and seems on track to continue climbing steadily back towards the old 1.2000 level.

As oil prices retrenched a bit, **USD/CAD** has rebounded over the 1.2500 mark that it dipped below yesterday. It faces support around 1.2450 and resistance at 1.2550. Note that Canada releases its own employment report on Friday too. **AUD/USD**, dented by a poor Australian trade release, has dipped below 0.7850, but should stay above 0.7800 and can still climb to its October highs of nearly 0.7900 multi-day.

BOND MARKET STRATEGY

US: Treasuries found downward pressure across the curve on Thursday, pushing to session lows in the wake of stronger the expected ADP employment data for December (increasing 250k in December, up from 190k in November). The 10yr yield ended the day just up slightly to 2.45%, though, while the 2yr climbed to a new 9-yr high of 1.95%. Despite the lackluster correlation between the ADP estimate and non-farm payrolls, further improvement on this front

at least suggest further improvement in employment conditions overall. All of this plays provides further support for additional policy tightening in the quarters ahead. As mentioned previously, continued support for higher rates clearly keeps the Treasuries on their collective heels, though there remain plenty of potential potholes with respect to data that could limit the Fed's desire to deliver another 75bps in 2018 (i.e.- further weakening in inflation). Markets now await a greater flow of data to finish off the week on Friday, highlighted by employment situation, trade balance, ISM non-manufacturing and factory orders releases.

EUROPE: Bunds, like Treasuries, appear to be on course for higher yields, with the US 10yr heading towards 2.50% while its German counterpart faces 0.50% (its approximate highs for September-October, having come within 3bps of that level so far this week). These levels could be tested on Friday assuming a strong US employment report. In any case, progressive interest rate hikes from the Fed (next in March), along with higher US inflation prospects, will continue to put upward pressure on short-end Treasuries (with the 2yr heading towards 2%), with inevitable spill-over to the longer end and global bond markets. Coming out earlier on Friday will be the preliminary Eurozone inflation rate for December, which is expected to have dipped to 1.4% y/y. In any case, monetary policy implications are minimal at this stage, with the ECB not set to make its next decision (on QE) until mid-year.

EUROZONE: INFLATION STAYS TOO LOW

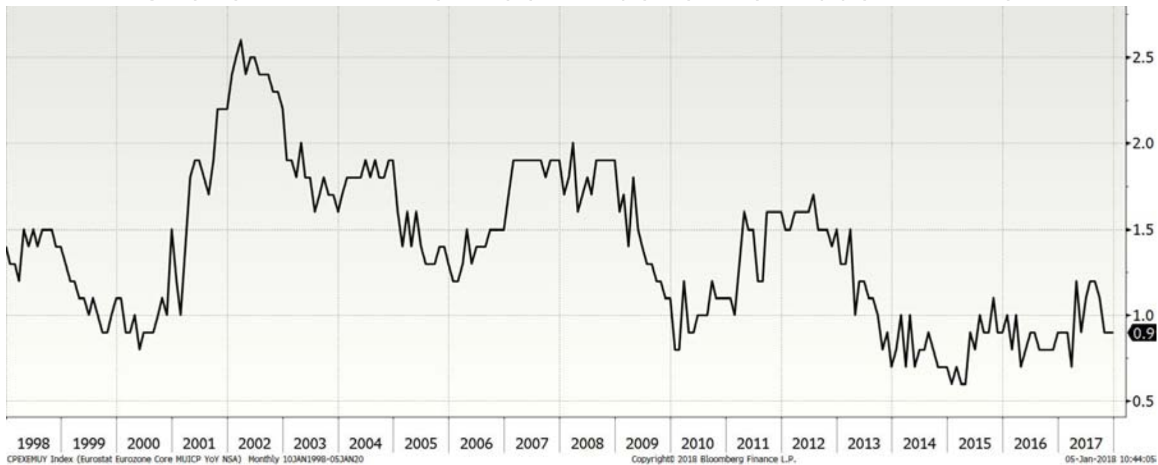
The data: The Eurozone's preliminary CPI (HICP) inflation rate for December dipped to 1.4% y/y from 1.5% in November, matching expectations – and returning the rate to that two months prior. The ex-energy-and-unprocessed food rate remained steady at 1.1% y/y, while the narrow-core (excluding also alcohol/tobacco) stayed at 0.9% y/y.

Analysis: As an indication of the underlying inflation trend, it is best to strip out volatile energy prices. The narrow-core rate has shown a slight upward trend since it bottomed at 0.6% y/y in early 2015, but remains below the 1.2% rate that it hit in mid-2017. It hasn't been at the central bank's target of just-below 2% since the financial crisis in late 2008. Although inflation is likely to grind higher over the coming years as the global economic upswing continues and price pressures build internationally as well as in the Eurozone, the process is likely to be a slow one. That's particularly because wage growth remains subdued – Eurozone labour costs rose only 1.6% y/y in Q3 (down from 1.8% in Q2) and have been running below 2% for four years. That's despite a steady decline in the Eurozone unemployment rate. A tightening labour market should eventually put upward pressure on wage demands, but judging by the experience in the US and UK, which are well ahead of the economic cycle, the lag could be long. And there are doubts about whether the unemployment-wage relationship has diminished (i.e. a "flatter Phillips Curve" in economics jargon).

Implications*:* With inflation, particularly core, running persistently well below the ECB's target, this argues against earlier-than-expected monetary policy tightening. So while the robust Eurozone economy will mean the ECB maintains a tightening bias, the central bank is unlikely to surprise in a hawkish direction. Recall that its bond purchases have already been cut in half starting this month and are set to carry on at EUR30bn/month through September. We expect the programme to then be wound down by end-year (as a few ECB officials have already hinted at since Christmas) and for rates to start going up in spring 2019. But until CPI data start to pick up, delays in such moves cannot be ruled out.

Markets: Although risks for this CPI release were seen on the upside based on the German figure having declined less than expected last week, little market reaction was seen. In principle, lower inflation is euro-negative.

EUROZONE EX-ENERGY-FOOD-ALCOHOL-TOBACCO INFLATION



US PREVIEWS: EMPLOYMENT REPORT & MORE ON TAP

Employment Situation: The December Labor Department employment situation report will be released today at 08:30EST (13:30GMT). Overall, we expect non-farm payrolls will increase +180k in December (market expectations are for a +190k increase), versus the +228k reading seen in November. This should come alongside no change in the unemployment rate of 4.1% (market expectations are for a 4.1% result). **Greater focus will likely be paid to average hourly earnings,** which we expect will increase +0.2% m/m, alongside no change in weekly hours of 34.5. On balance, despite the volatility seen in recent months, we anticipate continued improvement taking hold in the coming months as conditions gradually improve. Given the greater focus on what the Fed is likely to do next, we anticipate the December employment report will be sufficiently strong enough to justify additional moves higher (reaffirming long-established market expectations).

December non-farm payrolls look to continue along an expansionary course, something that could be improved by revisions to the November estimate (possibly also for October), further undoing some of the weakness related to hurricane activity in recent months. On balance, we expect solid improvement in services to accommodate further gains. As conditions improve, we expect to see some further downward pressure in the unemployment rate, possibly offset by people re-entering the workforce (making it more sticky), though we anticipate broader improvement in the quarters ahead.

Trade Balance: The November Commerce Department trade balance report will be released today at 08:30EST (13:30GMT). We anticipate the trade deficit will show overall widening to around -$48.0bln in November versus -$48.7bln reading seen in October. Weaker global demand (dampening exports) will likely be outpaced weaker performance from imports in November, leading to an overall decrease in the US trade deficit. Moving forward, fear of potential weakness in growth for key trading partners should weigh on foreign demand. Meanwhile, improved demand out of the US will likely continue to bolster imports measures.

The export component of the November ISM manufacturing survey decreased to 56.0 (from 56.5). Meanwhile, the imports measure increased to 54.5 (from 54.0). Overall, the mixed support in the readings seen in manufacturing exports reported by the ISM in recent months is congruent with performance seen elsewhere. Looking at the ISM non-manufacturing release, the export component decreased to 57.0 in November (from 60.0). Meanwhile, imports increased at 52.5 in November (from 52.0). On balance, we put greater emphasis on the manufacturing survey as the exchange of goods represents about 77 percent of US trade

activity, versus 33 percent represented as trade in services, placing forecast risks to the downside. All things considered we anticipate some downward in the US trade deficit, leading to a shortfall of around -$48.0bln.

ISM Non-Manufacturing: The December Institute for Supply Management non-manufacturing report will be released on Friday, 5 January at 10:00EST (15:00GMT). We expect the headline measure will show modest downward pressure in December to around 57.0, versus the 57.4 reading that occurred in November. As seen previously, weak inflation adjusted consumption levels decreased the real purchasing power of individuals to the extent that markets observed clear signs of slowing in relatively stable areas of the economy, particularly the service sector. Anticipating some pullback from the mixed reading seen in recent months, we expect a modest decrease will be on display in the December release, yielding a 57.0 result.

Looking back at the November release, business activity decreased in November to 61.4 (from 62.2). Meanwhile, prices paid decreased to 60.7 in November, from 62.7 in October. Overall, downward pressure was seen from new orders (58.7, from 62.8), employment (55.3, from 57.5), inventory sentiment to 56.0 (from 61.0) and exports to 57.0 (from 60.0) and supplier deliveries to 54.0 (from 58.0), partially offset by an increase seen in imports to 52.5 (from 52.0). Alongside the weaker headline result, most underlying components show dampened support for gains moving forward, though remaining broadly supportive of our view of gradually improved growth in the quarters ahead.

Factory Orders: The November Commerce Department factory orders report will be released at 10:00EST (15:00GMT). Mirroring the results seen in durable goods orders data, factory orders should reflect near-term improvement for the industrial sector, supporting our call for a +1.0% m/m increase for November, with some risks to the upside.

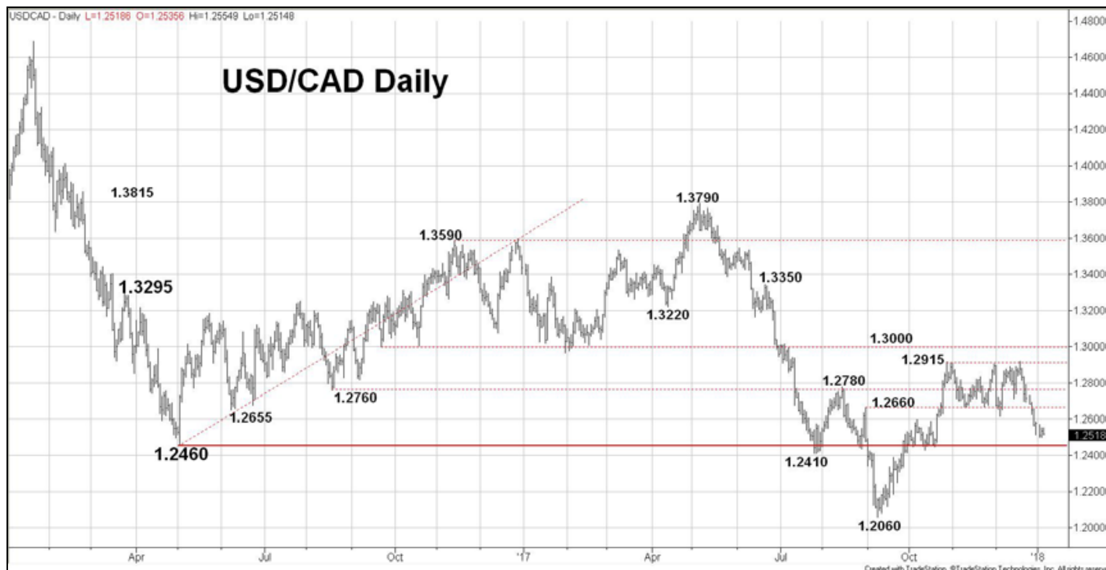
Looking back at the October numbers, alongside the weaker headline reading, mixed pressure has been seen across a number of series thus far in 4Q17, something we expect will gradually improve in the months to come. Despite the overall decrease seen in orders, shipments increased +0.6% m/m in October, versus the +1.1% m/m reading seen in September. Meanwhile, inventories increased +0.2% m/m, following the +0.6% m/m reading seen in September, leading to no change in the inventory/shipments ratio of 1.37 months.

The -4.2% m/m reading seen in transportation equipment orders provided some downward momentum for the overall measure, alongside mixed readings seen elsewhere. Moving forward, the ongoing concern remains the status of inventory levels amid improvement in consumer demand. However, we do not expect to see any consistent improvement in manufacturing until the auto sector completely rights the ship and the inventory correction spurs activity, something that appears to be increasingly underway.

FX TECH FOCUS: USD/JPY & USD/CAD

USD/JPY [Bullish congestion +20%] Price action is holding in the upper half of the well established sideways range between 108.00 and 114.35. This has been in place for most of last year and showing no signs yet of breaking out. The weak attempt to trade back to the 114.35 high into the end of last year was quickly neutralized and seeing the start of the year with the price action showing little activity in either direction. Watch pivotal support at 111.00 on further draw down, below which would see a drift back towards the 110.00 and 108.00 area. Really need to see a break out from the range for a more sustained to develop.

USD/CAD [Bearish turn -30%] The failure to clear the 1.2915 resist top in Dec has led to a sharp sell down through initial supports at 1.2660/1.2600 and focus now on a test of key swing low at 1.2460. Any break clear below this area, including the brief low of 1.2410 in Jul, will turn the bias towards a renewed bearish push towards the major swing low in Oct at 1.2060. Intermediate support at 1.2200. Pivotal resist now at 1.2660 and above would limit the bearish appetite with further levels then at 1.2760 through to the now major topside level at 1.2915.



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