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Saxo Bank presents

# OUTRAGEOUS PREDICTIONS

for 2016

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BURKE 2015





## ‘The close of the paradigm’

The irony in this year’s batch of outrageous predictions is that some of them are “outrageous” merely because they run counter to overwhelming market consensus. In fact, many would not look particularly outrageous at all in more “normal” times – if there even is such a thing!

In other words, it has become outrageous to suggest that emerging markets will outperform, that the Russian rouble will be the best-performing currency of 2016, and that the credit market will collapse under the weight of yet more issuance. We have been stuck in a zero-bound, forward-guidance lowering state for so long that there exists a whole generation of traders who have never seen a rate hike from the Federal Reserve. As we close out 2015, it has been nearly 12 years (early 2004) since the US economy was seen as recovering strongly enough to warrant starting a series of hikes - and that series ended in early 2006, nearly ten years ago.

Mind you, I have been trading for over 25 years and I have only seen three Fed rate hike cycles in my entire career: 1994, 1998 and 2004.

We are truly entering a new paradigm for many market participants and the new reality is that the marginal cost of money will rise, and thus so will volatility and uncertainty.

All of this is embedded in this year’s Outrageous Predictions. As always, it’s rewarding to see how our customers pitch in and how this publication creates a stimulating debate. Our hope is that these predictions might both inspire you and unsettle your more complacent assumptions.

More than anything, we encourage you to join the debate – whether you agree or want to push back and argue the other side. It is this process of discussion and thinking outside the box that is at the heart of Saxo’s now quite long history of outrageous predictions.

Let me again and for good order’s sake remind you that this is not Saxo Bank’s official forecast. It is, however, a set of ten independent events which we at the time of writing think could have a material impact on your portfolio should they come to fruition.

2015 was a poor year for us in terms of predicting the outrageous, but as I travelled around the world over the past 12 months it became obvious to me that we are at some sort of an “end of the road” in terms of world markets.

We are at the close of the paradigm that has reigned since the response to the global financial crisis. Quantitative easing and the policy response have failed us, China is transitioning, and geopolitical tensions are as complicated and hot as ever, to name just three key factors.

I hope that this year’s suite of predictions will prepare you for whatever comes our way in 2016, and while we can hardly hope to be right on more than one or two predictions each year, we’d like to think that these “outrageous” calls have at the very least a greater probability of coming true than the near-constantly wrong consensus.

I wish you a happy holiday and a good trading year in 2016!





# EURUSD direction? It's 1.23...

Steen Jakobsen / CIO / Outrageous Predictions 2016



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Many years ago back in 1989 I wrote one of my first research reports and I made the call that USDDDEM should trade all the way down to 1.23. It was an outrageous call and colleagues from back then still remind me when we meet (the dollar to the deutsche mark was trading in the high 1.60s at the time).

Now it's again time to call for 1.23 but this time in EURUSD. In four of the last five Fed rate hike cycles, the US dollar has peaked around the first hike indicating that the direction of the US dollar is inversely correlated to the Fed rate cycle.

A higher EURUSD will not only make the European Central Bank lose face but also catch the consensus out as most investors and traders believe parity between the EUR and USD is only a matter of time.

At a macro level the direction of the US dollar will be the single biggest factor in explaining

net return for all asset classes. The irony here is that if the dollar does not weaken, then the world most likely will be in deep recession as a stronger dollar increases the debt burden for US-dollar funded and dependent emerging markets, lowers profit for bigger US companies, lowers commodity prices through the link of being traded in the dollar and lowers the overall emerging market growth which is more than 50% of world growth today.

In other words the path of least resistance for the world to rebalance and get more growth is a weaker dollar if the expected monetary- and fiscal-policy environment plays out as expected from here.

Europe is running a massive current account surplus and its weaker inflation should, in macroeconomic logic, mean a stronger currency, not a weaker one. The race to the bottom has gone full circle, meaning we are back to a weaker US dollar again as the main policy response for the US and hence global growth.





# Russia's rouble rises 20% by end-2016

John J Hardy / Head of Forex strategy / Outrageous Predictions 2016



By late 2015, the combination of collapsing oil prices and financial sanctions against Russia over the situation in Ukraine saw a rough ride for Russian assets and its currency, the rouble.

But in 2016, oil prices surge again as demand growth in the US and especially China outstrip overly pessimistic estimates, just as US oil production growth is slowing and even reversing on a financial debacle linked to shale oil companies.

This is a boon to Russia's energy dependent economy. Meanwhile, in 2016, the US Federal Reserve allows the US economy to run a little bit hot as the strong USD sees the Fed raising rates at perhaps an inappropriately slow pace. This represents a bonanza for emerging markets

and their currencies, in particular Russia as commodity bears are left out in the cold in 2016.

Meanwhile, Russian assets and its currency get an extra boost as new geopolitical alignment pressures bring Russia and its adversaries to the negotiation table and provide visibility for an exit from the vicious standoff that had left Russian assets under-weighted globally and therefore undervalued over the last year and more.

Flows from international investors and Russian repatriation flows flood back into the Russian economy. By the end of 2016, the Russian rouble, including carry from Russia's high interest rates, rises some 20% versus the US dollar/euro basket in 2016.



# Silicon Valley's unicorns brought back down to earth

Peter Garnry / Head of Equity strategy / Outrageous Predictions 2016



The first half of 2015 had the lowest number of venture capital deals in 25 years as VC firms rushed to plough money into so-called unicorns – startups valued above \$1 billion each. This rush to capture everything that might have blockbuster potential inflated the bubble in unlisted US tech firms.

2016 will smell a little like 2000 in Silicon Valley with more startups delaying monetisation and tangible business models in exchange for adding users and trying to achieve critical mass.

Remember the dotcom gospel of clicks and page views instead of focusing on revenue and profits?

Fidelity's recent writedown of its Snapchat stake by 25% underscores the increasing uncertainty over valuations of VC-backed tech firms. Snapchat, let's not forget, was valued at around 160x on price-to-sales.

As the USD rate cycle gets priced into all asset classes in 2016, yields on alternative investments to VC-backed startups will go up. This, combined with US equity markets going sideways in 2016, will spark nervousness among VC investors who are pushing for IPOs.

But the harsh reality eventually sinks in that public markets just won't buy the VC-backed tech firms at highly inflated prices. The resulting carnage could stop the growth in VC funding and halt housing gains in San Francisco (the most overvalued real estate market in the US).





# Olympics to turbo-charge EM's Brazil-led recovery

Mads Koefoed / Head of Macro strategy / Outrageous Predictions 2016



The poster child for emerging market weakness is Brazil with its recession, collapsing consumer confidence, skyrocketing unemployment and plunging currency. USDBRL has nearly doubled so far this year while confidence is at a decade low and unemployment is at a five-year high.

Oh, and lest we forget; yearly GDP growth has been negative for five straight quarters – and this count could turn double-digit before it is over. A poster child, maybe, but Brazil is hardly alone in struggling to come to terms with the end of the commodity super-cycle, which has morphed into a full-scale oil price meltdown, a weakening China-led global manufacturing cycle and a run-up in dollar-denominated debt. Add uncertainty about the Federal Reserve's first rate hike in almost a decade to the mix and the picture is bleak.

Against this disturbing backdrop we look for the host of the 2016 Olympics to lead EM out

of the current malaise with equities outperforming. Leading indicators are stabilising in China and climbing in India, and recent policy easing furthermore helps the outlook for the former.

Stabilisation, investment spending on the Olympics, and modest reforms will see sentiment rebound in Brazil, and EM exports will be helped by cheaper local currencies. The Federal Reserve's coming rate hike cycle is causing all kinds of commotion in EM, but this ignores that during a typical rate hike cycle, EM equities tend to outperform not only other equities, but also government bonds. The MSCI EM index is trading at a forward P/E of just 12.1 compared to 18.8 for developed market equities – an unreasonable discount. The result: EM equities to have a great year, outperforming bonds and other equities.

The result: EM equities to climb 25% in 2016!



# Democrats retain presidency, retake Congress in 2016 landslide

John J Hardy / Head of Forex strategy / Outrageous Predictions 2016



In 2016, the Republican primaries descend into chaos after the party's voters narrowly manage to nominate another weak, centrist candidate after the long self-destructive process of the nomination process. Donald Trump goes down in flames, taking the Republican Party with him and leaving its voters demoralised with their weak options in the presidential and congressional elections.

In Congress, the Republican Party goes from strength to dramatic weakness as the rifts from its civil war on its future direction play out over the next four years. This leads to a landslide victory for the Democratic Party as the Democrats successfully execute a successful get-out-the-vote campaign.

That campaign gains traction among the US' now largest generation: the younger, more diverse, more liberal, overeducated and underemployed Millennials, who come out to vote in droves in favour of the Democratic ticket as they have been frustrated by the political stalemate and weak job prospects of the last eight years.

In the wake of the election, the fear of a left-leaning new Democratic government free of Republican obstructionism sees risky assets and the USD taking a dive initially. But as 2016 draws to a close, sentiment changes dramatically and asset markets and the greenback rally steeply again on the realisation that a rare political majority in the US can ram through fresh fiscal stimulus that boosts US growth.





# Opec turmoil triggers brief return to \$100/b oil

Ole S Hansen / Head of Commodity strategy / Outrageous Predictions 2016



The oil market remains under pressure as we enter 2016 with oversupply and the imminent increase in exports from Iran adding some additional downside pressure. During the first quarter, Brent crude reaches and breaches the 2009 recession low as US tight oil producers continue to show resilience.

The selling is driven by capitulation from investors in exchange-traded products while hedge funds build a new record short position in the futures market.

Opec's crude oil basket price drops to the lowest since 2009 and the unease among weaker as well as wealthier members of the cartel over the supply-and-rule strategy continues to grow as the economic pain spreads across the 12-member group. The long awaited sign of an accelerated slowdown in non-Opec production finally begins to flicker. Suitably buoyed, Opec catches the market on the hop with a downward adjustment in output. That move

breaks the downward price spiral and price mounts a quick recovery with investors scrambling to re-enter the market to the long side.

With demand growth having remained strong throughout, the focus then turns to the prospect of dwindling future supplies from the scrapping of big multi-billion dollar projects that became unviable in a low-price environment. This combined with the re-introduction of a geopolitical risk premium through the Middle East and other oil-price sensitive zones sees oil spike.

At its peak, the price once again brings \$100/barrel prices onto the horizon, before settling back into a \$50-70/b range. This will require more than an Opec cut, but in an uncertain geopolitical environment, the threat of short-term spikes will remain ever present through 2016.







# Silver breaks golden shackles to rally 33%

Ole S Hansen / Head of Commodity strategy / Outrageous Predictions 2016



# Aggressive Fed sees meltdown in global corporate bonds

Simon Fasdal / Head of Fixed Income trading / Outrageous Predictions 2016



Semi-precious metal silver's price direction is driven by movements in both gold and industrial metals. Its third consecutive annual decline in 2015 was driven by worries about demand (industrials) and tightening US monetary policy (gold).

However, towards the end of 2015, mining companies began responding to falling prices by announcing production cutbacks of key metals such as copper and zinc.

Silver is often mined as a by-product from the extraction of other metals including copper, zinc and gold with primary production only accounting for a third. With copper and zinc both hitting six-year lows at the end of 2015 as the outlook for Chinese demand deteriorated, the only way to support prices was to cut production even more.

During 2016, this will add to production cuts already in place from major producers such as Glencore and BHP Billiton.

While production of silver from these reductions slows economic activity and demand in key markets such as China, both Europe and the US strengthen, helping to boost confidence in silver. The political drive towards reducing carbon dioxide emissions by supporting renewable energy will also add to increased industrial demand for the metal, given its use in solar cells.

As a result of these developments, silver will rally by a third, leaving other metals behind. The outperformance versus gold is particularly noteworthy – the gold-to-silver ratio returns to its 10-year average of 59, representing a 20% outperformance.

When Bridgewater Associates founder Ray Dalio told markets last August that the next big Fed monetary policy move would be to ease and not to tighten, it was a clear message that a tightening path will not be common sense as long as strong secular disinflationary forces are at play. More importantly, he argued that ending the long-term debt cycle with a series of rate hikes would inevitably cause turmoil, because ever-declining interest rates have encouraged endless borrowing and leverage, growing the cycle into a monstrous supercycle. In other words: the bubble is simply too big to burst.

But late in 2016 the Fed will come to believe that there is no way out, and growing evidence of overheating markets – affecting labour, housing, equities and bonds – will propel Fed chief Janet Yellen down a hawkish path with a series of aggressive rate hikes. Although expected for years, this action triggers huge selloffs in all major bond markets as global bond yields start to rise, quickly magnifying the risk premium investors demand on riskier assets, when the risk free rate is not zero anymore. All of this is expected and normal in a rate hike scenario.

But what happens next is so unusual and scary that it's eerily reminiscent of the bond market apocalypse after the Lehman collapse. As the portions of bank and broker balance sheets allotted to bond trading and market making have almost disappeared, one of the vital parts of a functioning market is simply not there. This realisation sinks in too late and the entire buy side – pension funds, bond funds and insurance, as well as risk parity funds with huge leverage – flee into a panic selling one-way street, as highly advanced risk models lurch into a symmetric red alert.

But there's no airbag to shield the market as purchasing power from banks, opposing market interests and trader quotes is absent. The result is devastating: bond markets simply collapse, as trading is halted in some of the major markets, leaving them frozen solid for weeks as we approach the winter of 2016.





# El Niño sparks inflation surge

Peter Garnry / Head of Equity strategy / Outrageous Predictions 2016



According to many climate forecasters, 2015 and 2016 will likely be the hottest two years on record, adding to the growing number of droughts around the world.

The volatile weather we've experienced in recent years has also increased the number of floods and other devastating weather extremes.

On top of this, next year's El Niño will be the strongest on record and will cause moisture deficits in many areas of southeast Asia and droughts in Australia. Global agricultural production will be affected negatively. Lower yields across agricultural commodities will curb supply at a time

when demand is still increasing on the back of global economic expansion.

The outcome will be a 40% surge in the Bloomberg Agriculture Spot Index, adding some much-needed inflationary pressure. The central bankers in the developed world which have been battling with mega deflationary trends caused by negative demographics, lower private consumption and excess labour capacity will welcome this development.

The upshot of all of this is that the tide will start to turn for stagnating wages and the low level of new net investments that have blighted developed economies for far too long.





# Inequality has last laugh on luxury

Christopher Dembik / Economist / Outrageous Predictions 2016



Luxury is the reflection of an unequal society. The conspicuous consumption of luxury goods and services is a way of demonstrating membership of the elite. The elite is ready to pay extra just for the privilege of it and to differentiate themselves from the rest of society. It is what we call the snob effect.

The money spent on luxury cars, jewellery and clothing items could have been used for better infrastructure, education or for poverty alleviation. In that sense, luxury is a net economic loss.

Since the global financial crisis, poverty has increased in Europe because of the economic downturn and austerity measures. The International Labour Organization estimates that 123 million people are at risk of poverty in the EU, which represents a quarter of the European population. This total has risen from 116 million in 2008.

Faced with rising inequality and unemployment of over 10%, Europe is considering the introduction of a basic universal income to ensure that all citizens, regardless of whether they

work, can afford to meet their basic needs.

In Spain, its implementation is supported by the left-wing populist party Podemos. Finland plans a limited geographical experiment in the coming months and Switzerland has scheduled a referendum on the subject for 2016.

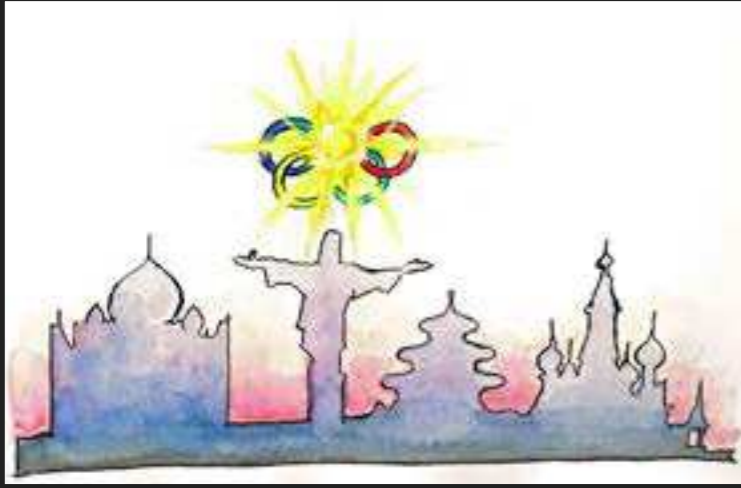
In France, more than 10% of the population is at risk of poverty or social exclusion. In 2016, France will decide to guarantee a basic income to its entire population and will cap the highest wages in order to combat inequality and achieve more inclusive economic growth.

In a more egalitarian society where other values are promoted, demand for luxury goods decrease sharply. Consumer preferences are moving to products of mass consumption and high-tech. As a result of declining European demand and economic slowdown in emerging countries, particularly China, the luxury sector collapses. Sales of the world leader in luxury, LVMH, fall by over 50%.





Illustrations by Chris Burke





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