TD Securities

2016 Global Outlook

Rates, FX and Commodities Research

10 November 2015 | **TD Securities**

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2016 Global Outlook

Don't fight the Fed, ignore it. Position for moves premised on a Fed which will tighten in the coming months and look for stops that can ride the volatility of precisely how it is delivered. We think the bar has been met for a December hike and 100bps of tightening by September 2016, furthering 5s30s flattening in the US, driving convergence in NZ-US-GE 10s, and divergence in US-GE 5s and CA-US 30yr breakevens. We do not expect Fed tightening will be USD-positive much beyond the initial knee-jerk and look for its strength to peter out early in 2016. That implies only somewhat more pressure on EMs and commodities and, in fact, less downside than seems discounted in EM assets at this point. This presents opportunities which will likely grow larger through the year as each passing month of 2016 will mean falling risks of an imminent EM or Chinese crisis.

Core Views

	Bias	Asset Allocation	
G10 Rates	Policy divergence to create opportunities in front-end; long-end rates to remain pinned.	Underweight 2-5yr Treasuries against EU, NZ.	
Risk Assets	Moderate growth and low inflation keeps us cautiously optimistic, though upside should be limited with Fed hikes and risk of USD strength.	Neutral equities	
Foreign Exchange	USD on last up-leg but pressure for EUR to persist on divergent policy. USDJPY may have already peaked while GBP poised for gains vs. commodity FX.	**LONG**	**SHORT**
		USD/CAD/JPY	EUR
		GBP	EUR/NZD/CAD
		CAD/SEK	NZD
EM	2016 will be transitional as external risks weigh in H1 but ease into H2, allowing local factors to drive relative performance.	Long BRL Short TRY; Long MXN Short CAD; MXN TIIE 2s5s Flattener.	
Commodities	Oversupply to keep oil moderating, until balanced mkt takes over H2 2016. Silver/gold to perk up later in H2 2016. Base metals dependent on China to do better in 2016.	Long Au/Ag then reverse at target; Short WTI for now but reverse at target; Long Zn-Al spread.	
Volatility	Realized vol to remain high due to regulation and increasing cost of balance sheet.	High vol within a range.	

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The TD View

		Macro Outlook	Trading Bias: Rates	Trading Bias: FX	Key Risks
G10	US	After faltering due to inventory correction and global headwinds, growth should re-accelerate to an above-trend pace.	A faster Fed hiking cycle should flatten 5s30s. Global factors and a low terminal rate should keep 10s relatively pinned.	The USD bull rally is nearly mature. Very selective USD long versus G10 in 2016 with JPY poised for position-driven rebound.	A sharp deterioration in financial conditions would dent confidence, stall private sector spending, and delay Fed hikes.
G10	Canada	Recovery from negative terms of trade shock with rising growth offsets. Muted domestic demand and more imported inflation.	Canadian rates will rise in sympathy with the US. Look for steeper 2s5s and 2s10s, while 10s30s flatten.	Remain long USDCAD, target 1.40. Get long GBPCAD. Relative outperformance versus its commodity peers.	Further commodity price washout impacting investment or a significant downturn in US growth represents key downside risks.
G10	Europe	Growth is around trend but central banks are divergent: ECB and Norges Bank easing, Riksbank on hold, and BoE tightening.	More ECB QE/depo cuts. 10yr UST-bund spread to tighten from 190bps lvl, rec 5yr EURUSD basis as ECB excess liquidity rises.	EURUSD to challenge parity and bearish EUR vs. GBP, CAD and JPY for early 2016. Bullish GBP vs. commodities. Short NZDSEK.	Inflation may fail to pick up and inflation expectations drift lower. Downside EM risks remain acute across all of Europe.
G10	Asia-Pac	The RBA and RBNZ easing bias is consistent with respective central banks' lower growth and inflation forecasts.	Our bias for AUD rates is to keep duration short, for the curve to steepen, and for swap spreads to narrow.	AUD and NZD to lose ground vs the USD. Disposed to sell rallies, US$0.72 for AUD and US$0.68 for NZD.	China remains the risk for both commodity producers. Weak house prices raise odds of rate cuts.
EM	Latam	Brazil's recession, CPI and political risks improving. Mexico gaining steady traction while CPI remains tame.	In Brazil biased to receive as we expect rates to have peaked. In Mexico, TIIE 2s5s flattening as Banxico hikes with Fed.	BRL carry trade attractive, but risks suggest short TRYBRL. Short CADMXN on widening short-term rate differentials.	Political risks and downgrades are major risks for Brazil. Fed hikes faster than we expect. Faltering risk appetite.
EM	EMEA	CE3 growth still solid while CPI rises slowly. High political risks in Turkey and Russia. S. Africa growth still sluggish.	Steeper curves in Poland and Hungary; higher rates in Turkey; Russia CBR easing more; too many hikes priced in S. Africa.	We prefer EMFX vs EUR in H1 2016, then look for appreciation vs USD. Biased for much weaker TRY and ZAR.	Fed rate hikes faster than expected. Politics, particularly in Russia, Turkey and less so Poland. ECB policy missteps. China.
EM	Asia	Monetary easing to help growth in India and Indonesia, while politics and low oil prices remain a major drag for Malaysia.	The bias is for lower rates and a steeper curve in India and Indonesia. Malaysia rates higher in 2016 on BNM tightening.	INR to remain low vol currency; IDR to pick up in H2 2016; MYR weaker vs USD on political noise and low oil prices.	Fed tightening faster than expected. Corporate leverage, but not in India. China slowdown and political risks.
COMMODITY	Energy	Oversupply to continue moderating oil prices in coming quarter, but non-OPEC production cuts to lift prices in H2 2016.	Short bias for now, long WTI later into 2016.		Non-OPEC production declines are much more modest than expected and Iran produce more and earlier.
COMMODITY	Precious metal	Nearing Fed hike keeping prices subdued into 2016, with rising inflation and waning USD serving as an upside catalyst later.	Long gold/silver ratio now, reversing once target reached.		Stronger US data and unexpected inflation prompts Fed to be more aggressive in removing monetary accommodation in 2016.
COMMODITY	Other metals	Stabilizing China economy, supply cuts along with muted USD rally should help base metals to show some upside.	Long Zinc - short Aluminum spread.		China stimulus is ineffective and demand growth does not materialize as expected, prompting metals to correct further.

Central Bank Monitor

Inflation: Deviation from target* (% points) — axis -4, -2, 0, 2, 4, 6, 8, 10; Below Target | Above Target. 12m Fcast (bps∆ from spot) — axis -150, 0, 150, 300.

		Inflation: Y/Y%	As of	Next Print	Last Mtg: Date	Last Mtg: Change	Current %	Next Mtg: Date	Next Mtg: TD	12m Fcast: Mkt	12m Fcast: TD
G10	UK	-0.1	Sep	17 Nov	5 Nov	+0bp	0.50	10 Dec	+0	+0	+50
G10	NZ	0.4	Sep	20 Jan	29 Oct	+0bp	2.75	10 Dec	+0	-24	-25
G10	Japan	0.0	Sep	26 Nov	7 Oct	+0bp	0.10	19 Nov	+0	+0	+0
G10	US	0.0	Sep	17 Nov	28 Oct	+0bp	0.25	16 Dec	-25	+26	+100
G10	Sweden	0.1	Sep	12 Nov	28 Oct	+0bp	-0.35	15 Dec	+0	-30	+0
G10	EZ	0.0	Oct	17 Dec	22 Oct	+0bp	0.05	19 Dec	-20	-6	-20
G10	Canada	1.0	Sep	20 Nov	21 Oct	+0bp	0.50	2 Dec	+0	+8	+0
G10	Australia	1.8	Oct	29 Nov	3 Nov	+0bp	2.00	30 Nov	+0	-8	+0
G10	Norway	2.5	Oct	10 Nov	5 Nov	+0bp	0.75	19 Dec	-25	-4	-50
Emerging Markets	China	1.3	Oct								
Emerging Markets	Poland	-0.8	Oct	13 Nov	4 Nov	+0bp	1.50	2 Dec	+0	-37	-50
Emerging Markets	Hungary	0.1	Oct	10 Nov	20 Oct	+0bp	1.35	17 Nov	+0	+5	+0
Emerging Markets	Mexico	2.5	Oct	9 Dec	29 Oct	+0bp	3.00	17 Dec	+25	+131	+100
Emerging Markets	S Africa	4.6	Sep	18 Nov	23 Sep	+0bp	6.00	19 Nov	+0	+109	+75
Emerging Markets	Malaysia	2.6	Sep	19 Nov	5 Nov	+0bp	3.25	n/a	+0	+11	+75
Emerging Markets	India	4.4	Sep	12 Nov	20 Nov	-50bp	6.75	29 Jan	+0	n.a.	-25
Emerging Markets	Indonesia	6.3	Oct	30 Nov	15 Oct	+0bp	7.50	17 Nov	+0	n.a.	-25
Emerging Markets	Turkey	7.6	Oct	3 Dec	21 Oct	+0bp	7.50	24 Nov	+0	n.a.	+250
Emerging Markets	Brazil	9.9	Oct	9 Dec	21 Oct	+0bp	14.25	25 Nov	+0	+192	-50
Emerging Markets	Russia	15.6	Oct	4 Dec	30 Oct	+0bp	11.00	24 Dec	-50	n.a.	-150

Current ⟶ Forecast for 2016

View From the Top

Inflation, the Boogeyman, the Tooth Fairy and Other Things That Still Won't Exist in 2016

Don't fight the Fed, ignore it. Position for moves premised on a Fed which will tighten in the coming months and look for stops that can ride the volatility of precisely how it is delivered. We think the bar has been met for a December hike and 100bps of tightening by September 2016. We do not expect Fed tightening will be USD-positive and look for its strength to peter out early in 2016. That implies only somewhat more pressure on EMs and commodities and, in fact, less downside than seems discounted in EM assets at this point. This presents opportunities which will likely grow larger through the year as each passing month of 2016 will mean falling risks of an imminent EM or Chinese crisis.

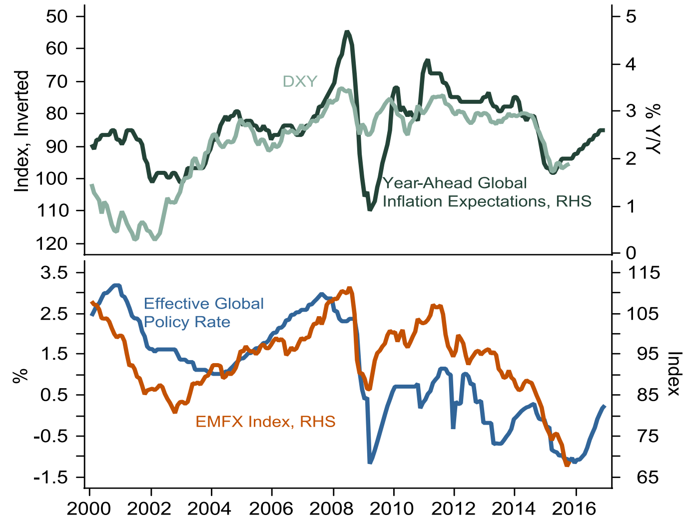
We see no reason to question that 2016 will be a world of moderate growth and low inflation. We find it hard to generate broad upside risks to inflation, and Fed tightening will be yet another reason to think inflation more likely disappoints than surprises higher. It is easier to generate upside risks to growth, though, as the downside drags from terms of trade shocks wane and upside benefits may yet prove stronger than expected. But we also see apprehension as the largest immediate issue holding back markets. That can, does, and is having a real effect on economies and markets by limiting investment and liquidity, but it is also an environment that can reverse more quickly.

The 2016 cycle is based on removing emergency rates and limiting the potential for future financial imbalances—it has less to do with inflation. This means the hurdle to raise rates to 1.25% is lower than the hurdle will be to get to 2.25%, when the Fed will want to see some active risk of above-trend growth and above-target inflation to justify the next leg. Even if Fed tightening is unnecessary this soon, fallout from premature Fed tightening would be a story for 2017, not 2016, so we do not see scope to try and find trades there.

In fact, fear of the Fed is misplaced. 100bps of tightening would typically shave 10bps off US inflation and 30bps off output growth within the first year. The ex-post impact on the dollar is generally negligible to the extent that it has been anticipated by the market. This is hardly the makings of a market rout and end of days scenario—even if the Fed is comfortable killing Christmas.

So the Fed simply isn't that important. Central banks moderate growth and liquidity, but it is still the macro environment that determines market direction. This leaves monetary policy to determine what level asset prices can realistically reach within that trend. So as the modalities of Fed tightening and further divergence in global monetary policy pass through new regulatory constraints and shifting global investor preferences in 2016, this will present numerous tactical opportunities across US and global rates. But it is hard to say there will be a big overall trend across rates markets—middling macro makes for middling volatility.

Turning Inflation and Policy Typically USD-Negative and EMFX-Positive



Source: JPM, Consensus Economics, TD Securities
* Effective global policy rate is average G3+China rate plus ex-ante expected QE benchmarking $250bn equivalent to 25bps. Forecasts from TD Securities.

In EM, fear may be reasonable, but we also think the risks may already be reasonably priced. If there is large downside to growth in 2016, it is much more likely be because of an EM collapse, not the Fed. But as that is only a risk to what is looking like an environment that can be more pro-risk, we prefer to hedge that downside risk by being long an AUDJPY put and maintaining WTI shorts for now, where excess supply is an additional factor which will weigh on any rally.

For this story, the biggest question will be the direction of the dollar. Typically, a reflationary environment is USD-negative and EMFX positive. Typically, a tightening global monetary policy cycle is EMFX-positive. And typically, the dollar tends to peak shortly after the Fed begins to raise rates. All of this provides reasonable support to our assumption for a top in the dollar.

But three complications point to a risk that USD strength might linger. The Fed is likely to get further ahead of global central banks than in previous cycles, so rate differentials might be more USD-positive than usual. Global CPI will move higher, but this reflation will still leave inflation running at some of its lowest, non-recessionary levels. And the need for EM credit adjustment suggests that risk appetite may be less than usual. If the dollar does not turn lower, and especially if the dollar strengthens materially, that would pose a significant complication to the 2016 outlook. While most G10 policymakers might think they would prefer a strong dollar trend that gives their own currencies relief, significant dollar strength would still weigh on EMs, and delay the ability of EM credit adjustment to lessen and risk to rally.

Richard Kelly

Summary of Trade Recommendations

Global Rates

● **Sell 5yr US against Germany:** Policy divergence between a faster-than-priced in pace of Fed hikes and an easing ECB (depo cut and QE extension). We enter at 179bp, targeting 200bp and with a stop at 160bp.
● **Own 30yr CAD inflation breakevens against US:** Canadian core CPI has been running above US core CPI all year and a stronger USD should put upward pressure on Canadian inflation relative to the US. We enter at -29bp, targeting -5bp and with a stop at -40bp.

United States

● **5s30s flatteners:** We believe that the Fed will signal subsequent hikes after liftoff and the market should price in 3-4 hikes in the first year of the hiking cycle. Meanwhile reinvestments are likely to continue during all of 2016 and the backdrop of a lower terminal FF rate and low global bond yields keep the long end more pinned. We enter at 137bp, targeting 105bp and our stop is 150bp.
● **Long TIPS breakevens:** We expect headline inflation to turn due to base effects and stabilization in energy prices. Core inflation to remain high due to owners' equivalent rent. Breakevens look cheap relative to fundamentals. We look to enter at 150bp, targeting 185bp and our stop is 135bp.

Canada

● **10s30s flatteners:** Higher policy rates in the US will cause 10s to underperform in Canada. Entry levels look less compelling for 2s10s steepening trades. We target a move to 52bps.
● **Buy 30yr breakevens (D44s vs D45s)** with a target of 184 bps. Oil prices are likely to trend marginally higher next year, which should push headline inflation to above 2.0%. Easy monetary policy also argues for higher breakevens on the margin.

Europe

● **Buy 10yr UST, Sell 10yr bund**: We expect the spread to move higher to around 180/190bps on an ECB announcement effect and on expectations of earlier Fed hikes. We would then expect the spread to tighten as the market fully absorbs the impact of ECB easing, as investors sell bunds and buy USTs in search for higher yields. Enter 180bps, target 120bps, stop loss at 210bps.
● **Receive 5yr EURUSD basis**: We look to receive at current levels of -43bps as ECB excess liquidity rises on a QE extension, cheapening EUR funding. We expect the basis to temporarily test the -50bps floor implied by the Fed-ECB FX swap lines and would target a -60/-65bps level, stop loss -25bps.

Australia / New Zealand

● **Non-AAA rated AUD semis to outperform ACGBs:** The supply of semi government bonds could shrink materially should asset sales by the AAA-rated states materialise. This should leave non-AAA semis as beneficaries with ongoing ACGB supply to drive relative outperformance. Enter: 53.5bps, target: 40bps, stop: 60bps.
● **NZ-US 10yr spread compression:** NZGBs are attractive, trading at 115bps above USTs, above our forecasts for the spread to range between 90-100bps over 2016. The first catalyst for spread narrowing should be a Fed hike as early as next month followed by the RBNZ rate cut risk. Enter 125bps, target 85bps, stop 145bps.

Emerging Markets

● **Short TRYBRL:** Brazilian problems are well known and highly discounted, while the market continues to exhibit complacency against Turkish political and macro risks. Enter at 1.32 with target at 1.10. Stop at 1.40. The trade has carry of +29bps/month.
● **Short CADMXN:** Canada and Mexico are similarly reliant of a US economic pickup; however, monetary policies in Mexico and Canada are set to diverge on Banxico matching every Fed hike with tightening of its own. Enter at 12.65 with target at 11.85. Stop at 12.90. The trade has carry of +21bps/month.
● **MXN TIIE 2s5s flatteners:** We think the Mexico curve is too steep, particularly in relation to US 2s5s and the level of Mexico's rates. Enter at 114bps with target at 85bps. Stop at 125bps. The trade has a negative carry/roll of -2.1bps/month.

Commodities

● **Maintain long XAU/XAG ratio bias, then reverse:** Precious metals should remain under pressure into technical support lows heading into the December FOMC meeting, where rates will be hiked for the first time, and then 3 more times in 2016. However, a continued stance on easy monetary policy and gaining inflation expectations should help to lift precious metals once again—silver more than gold. Enter: 77.5x; Target: 69.0x; Stop: 80.0x.
● **Long Zinc - Short Aluminum spread:** A bounce in China, continued growth in the US, and a stabilized Europe after renewed ECB easing measures will lift most base metal boats, but the continued overproduction and export of aluminum by China will overhang prices versus the zinc market tightness, which has seen some additional supply capitulation in a market already woefully undersupplied. Enter: $144/t; Target: $700/t; Stop: flat.
● **Maintain short bias then get long WTI at target price:** Global oversupply of oil will persist well beyond the first half of 2016, before a non-OPEC supply response and inventory drawdowns can offset the return of Iranian oil—remain biased short WTI until price hits our target, where we suggest building longs. Enter: $42.50/bbl; Target: $60.00/bb; Stop: $32.50/bbl.

Foreign Exchange

● **Short EUR vs. FX basket (into early 2016):** The combination of ECB QE-infinity and Fed hike in December will see EURUSD challenge parity. Short EURJPY as BOJ has no appetite to pursue further unorthodox policy (enter 132.40, target 119, stop 137). Wait for a bounce to implement EURGBP (enter 0.75, target 0.66, stop 0.78) and EURCAD shorts (entry 1.46, target 1.35 stop 1.50).
● **Long GBP vs. CAD & NZD:** Policy divergence will still exist between the UK and commodity regions and posit. Long GBPCAD - enter 1.96, target 2.15, stop 1.90. Long GBPNZD - enter 2.30, target 2.80, stop 2.10.
● **Short NZD vs. SEK & CAD:** RBNZ easing in 2016 is nontrivial as housing slows, ToT shock intensifies and El Nino undermine economy. Riksbank is doubling down on a policy error. Enter 5.80, target 5.08, stop 5.98.NZDCAD entry 0.8650, target 0.8000, stop 0.8850.
● **Long AUDJPY put option:** Implement crash protection. Spot / vol ref 87.00 / 21.7%, expiry 30-Apr-16, strike 64.00, cost 0.107% of AUD.

* Note: All levels as of November 9, 2015.

Global Macro Themes for the New Year

- The dominant growth theme in 2016 will be the lagged positive terms of trade shock for commodity consuming developed market economies. This sets the stage for relative outperformance in the US, UK, and the Eurozone.
- 2016 will also see an upturn in inflation, but ongoing global slack will limit the magnitude while inertia in core inflation will limit the degree of policy tightening.

Recovery from the Great Recession continues to be frustratingly slow. From its origin as a balance sheet recession, the headwind to growth from the deleveraging cycle has shifted from the household sector in the United States to Eurozone sovereigns and is now restraining many emerging market economies. The recovery narrative was further complicated in 2015 by two large shocks that had significant effects on countries' wealth and terms of trade: an adverse global demand shock caused by diminished emerging market demand and a positive global supply shock caused by a supply glut of many commodities that severely undercut prices. The drag on commodity producing economies happened rapidly while the stimulus to commodity consumers takes time to boost domestic demand. Our expectation for a strengthening in global growth hinges on the realization of this latter development in 2016.

Tracing the Terms of Trade Shock Through 2016

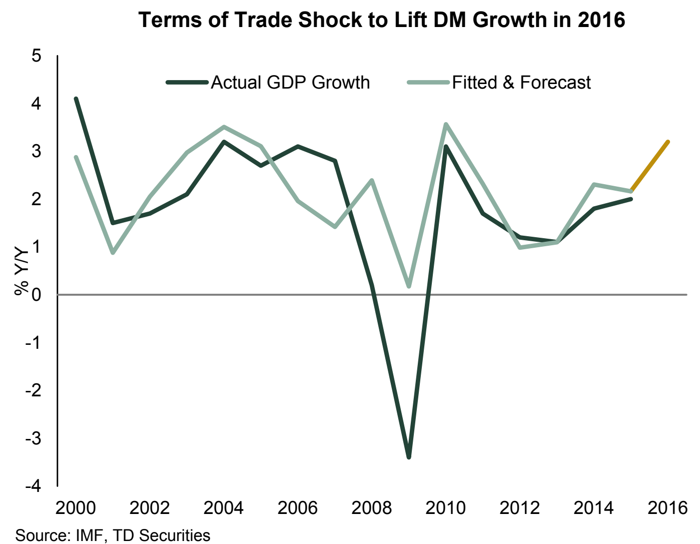
Modeling the terms of trade impact of a large drop in commodity prices on growth in emerging market (EM) and developed market (DM) economies explains much of the 2015 disappointment and provides some confidence in expecting a rebound in the year to come. While this division does not uniformly capture the distinction between commodity producers and consumers, it does nevertheless provide an initial screen to gauge the relative performance across regions. The impact of the negative terms of trade shock on EM growth shows up immediately—as we saw in 2015—while the positive terms of trade shock to DM growth takes a year to be realized—as we expect in 2016.

A contemporaneous relationship between EM and DM growth exacerbated the drag on DM growth this year and we anticipate that ongoing structural drags in EM growth (at least over the first half of 2016) will continue to act as a headwind to DM growth. The typical one to two quarter lag from tightened financial conditions in EM economies to DM growth will exacerbate this challenge.

Of course the performance across DM economies will not be uniform, and the second element of our screen is how far a given economy is along the road to deleveraging. From this perspective, the United States is expected to lead the pack early in 2016. Economy-wide leverage as a percentage of GDP has fallen nearly 40 percentage points from its 2009 peak. The composition has also evolved favorably, as leverage in the private sector—where a distended balance sheet is a far greater impediment to growth—has steadily declined while government debt levels remain elevated.

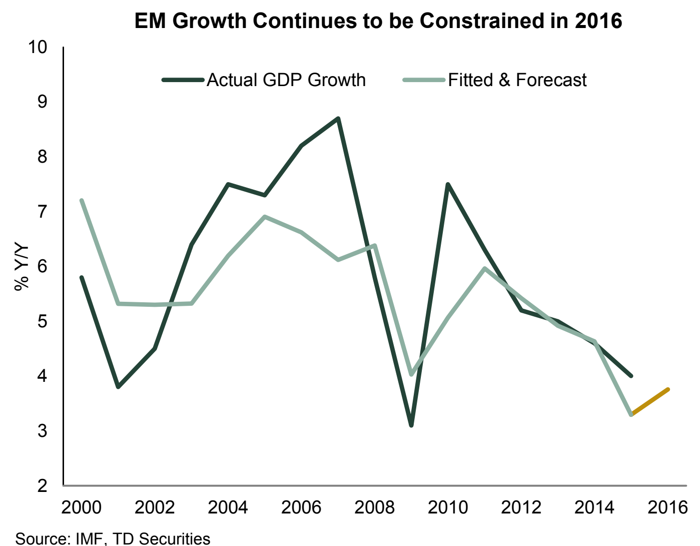
The relative maturation of the recovery in the US economy will give the impression of a relatively more rapid acceleration in growth across the Eurozone in 2016. In oil-importing Europe, growth in the major economies should remain on track next year at or above potential output growth. The UK is currently undergoing an internal rotation of demand, with external-facing sectors struggling against a strong currency, but the domestic economy is growing at a healthy clip with household income and spending providing key support. In the Eurozone, past and further expected easing by the ECB is leading to easier bank lending conditions and consequently activity there has remained above

Terms of Trade Shock to Lift DM Growth in 2016

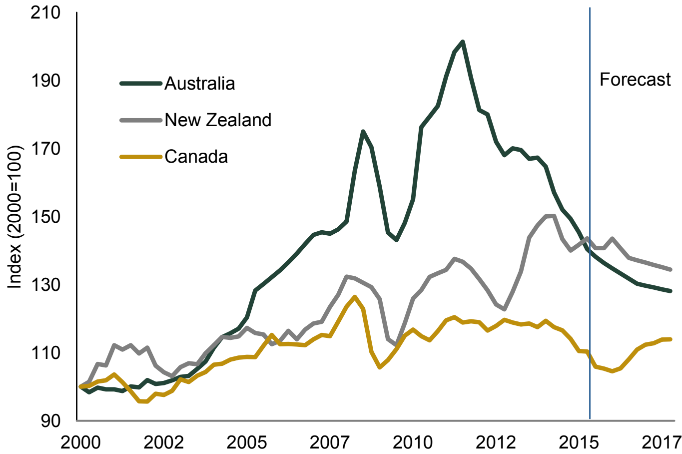


Source: IMF, TD Securities

EM Growth Continues to be Constrained in 2016



Source: IMF, TD Securities



Source: ABS, StatsNZ, Statistics Canada, TD Securities

potential output growth for 2015 and is expected to continue doing so into 2016. The relative performance between the US and the Eurozone, and in particular the relative stability in the US labor market compared with a broadening recovery in the Eurozone labor market, will allow the 10yr UST-bund spread to tighten after the ECB eases (see page 12).

Commodity producing economies such as Australia, Canada, and New Zealand are expected to feel the downdraft of the terms of trade shock for some time. Assisted by a higher USD, currency weakness will help drive a more prolonged reallocation of resources away from commodities and towards non-commodity exports and services. With a larger manufacturing base that is leveraged to the relative strength of the United States, Canada is better positioned to benefit from this rotation and we are forecasting an outperformance in CAD relative to AUD and NZD (see page 20).

The Turn in Global Inflation and What Lies Beneath

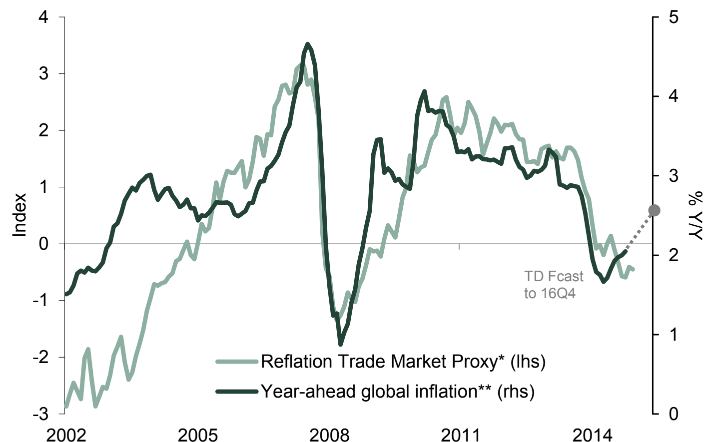
While 2016 is expected to see some improvement in global growth, the outlook for inflation will be much more complicated. As the base effects of the decline in oil prices in late-2014 and early-2015 drop out of year-ago calculations, it is a foregone conclusion that global headline inflation will rise. While the impulse will grow stronger over the course of the year, the prevailing rate at the end of 2016 is nevertheless forecast to be at a non-crisis low. The outlook for core inflation remains even more muted and disparate across economies depending on the degree of slack and forecasted moves in the exchange rate.

For developed market economies such as the United States and the United Kingdom that are set to experience above-trend growth, an anticipated appreciation in the exchange rate accompanying expectations for tighter monetary policy will curtail imported prices and ultimately core inflation. The growth outlook for the Eurozone is expected to be reasonably upbeat, but by virtue of a tremendous amount of slack and the impact of additional currency weakness, core inflation is expected to remain benign. This will mean that any market expectations that the ECB will reverse course and hike in response to stronger growth will inevitably be disappointed.

The opposite dynamic is expected in economies with a relatively subdued outlook for growth. In addition to a slower absorption of slack, the lagged and future inflationary impact of forecasted currency weakness will place additional pressure on imported prices and underlying inflation. This outcome is expected in commodity producing countries such as Australia, Canada, and New Zealand. The risk becomes more acute as headline inflation accelerates as the base effect from lower commodity prices fade. The differential expected in 2016 inflation underpins our recommendation to buy breakeven inflation in Canada versus the United States (see page 10).

Central Bank Regime Shift in 2016 as the First Wave of Hikes Takes Hold

The overarching bias for central banks in recent years has been continued accommodation given a balance of risks that remained tilted to the downside. Wary of the difficulties of combatting prolonged disinflation or outright deflation, dovish central banks were more proactive in providing stimulus while hawkish central banks still had an incentive to remain behind the curve under the guise of risk management. This was an easy strategy to employ in 2015 as slowing growth and falling inflation provided both the justification and the cover to remain accommodative. As we look to 2016, a somewhat brighter outlook for global growth will help to



*First principal component of select market indicators. **US, EZ, UK, Japan, China, and India.
Source: TD Securities, Haver, Consensus Economics

alleviate the need for most central banks to provide additional stimulus on growth fears alone. However, a wide spectrum of inflation outcomes will result in a variety of policy responses and tactical trading opportunities.

The timing of the first rate hike from the Federal Reserve provides tactical trading opportunities, but it is ultimately the pace of tightening to follow that will determine the thematic trend in the year ahead. While the firming in global growth and a continued recovery in the United States will allow the Fed to hike in December and then tighten a further 75bps by the end of 2016, the inertia in core inflation will prevent sequential hikes. Instead, the Fed funds rate is expected to be increased by 25bps at every other FOMC meeting. While this is faster than what the market currently has priced, the forecast does reflect a reaction function that is very responsive to any deterioration in domestic and global financial conditions—including a further appreciation in the USD—that would threaten the wider economic recovery.

On the heels of the first Fed hike, the focus will quickly shift to who will be next to follow suit. In North America, there will be a clear divergence with Mexico expected to be next in line. By contrast, the Bank of Canada is expected to spend all of 2016 on the sidelines. While the close economic ties to the United States could argue that the Bank should follow the Fed higher, the divergent impact of the terms of trade shock argues for a longer period of accommodation in Canada. Allowing the currency to aid in the reallocation away from the resource sector is also consistent with this assessment (our forecast is for USDCAD to reach 1.40 early in 2016 and we have recommended being short CADMXN). Governor Poloz has remarked that tighter Fed policy is negative for financial conditions in Canada and the Bank has shown less willingness to respond to domestic developments—above-target core inflation and elevated household imbalances—that would otherwise demand a tighter policy stance. As a result, we expect Canadian rates to outperform versus Treasuries and still see a small risk for additional accommodation in 2016 with a large drop in commodity prices or a significant and sustained slowing in the US economy acting as the catalyst.

Across the Atlantic, the story for the Bank of England is similar to the Fed. The domestic economy in the UK is performing well but inflation still remains somewhat weak on account of lower consumer energy prices and pass-through from lower import prices. Furthermore, the UK remains highly exposed to foreign economies, and with trade openness double that of the US, will be particularly sensitive on this front to any adverse developments in the euro area. Rising domestic cost pressures and a gradual reduction in the relatively small degree of spare capacity left in the UK economy should put enough pressure on inflation in the medium term, and allow the Bank of England to start a gradual pace of rate tightening in May 2016.

The divergence within this region is captured by what will remain a very accommodative European Central Bank. The ECB expects inflation to remain especially weak in 2016, and has signalled that it will make further downward revisions in its December forecast. With such a high degree of slack remaining in the economy, the ECB sees risks of over-stimulating growth and inflation as minimal, and will remain in an easing position through 2016. They have explicitly stated that all tools are on the table for their December policy meeting, where we expect a 20bp cut to the depo rate (in December) in conjunction with the omission of the end date of QE (in effect, launching QE-infinity). That may very well see them need to tweak the buying rules in order to increase the liquid universe of assets they buy, but this simply biases the ECB to surprise markets even more than expected and have a larger effect in 2016. This should keep growth prospects healthy in the euro area, with little risk of inflation picking up above target in 2016.

In Scandinavia, monetary policy prospects may be correlated in the near term but for very different reasons. Sweden's Riksbank remains in a position to staunchly maintain a low (and only gradually appreciating) currency, and will be tempted to follow the ECB in order to do this, even if this means inflation and output overshoot. We expect no further easing by the Riksbank, but action could arrive hot on the heels of the ECB in December, should EURSEK move significantly. The Norges Bank should also ease further—once in December and once more in Q1 2016. The terms of trade decline caused by lower oil prices is still working through the economy, and a two-pronged fiscal and monetary stimulus program will be necessary to prevent Norway from slipping into recession. While the government is loath to dip too far into its wealth fund, we think that Norges Bank will be equally reluctant to dip into negative interest rate territory; two more rate cuts would take the key policy rate to 0.25%.

Across the Pacific, the Reserve Bank of Australia at 2.00% recently added an explicit easing bias to its toolbox, joining the Reserve Bank of New Zealand. Both central banks are in a comfortable position to ease further in 2016 if necessary, although both appear reluctant to deliver given strong credit growth and house prices. Of the two banks, we see a greater likelihood of a policy response by the RNBZ given the risk of a more prolonged terms of trade shock that may not be fully compensated for by a depreciating exchange rate.

David Tulk, James Rossiter, Annette Beacher, Millan Mulraine

Regional Risks

Canada

● A significant and sustained drop in commodity prices is a clear downside risk to 2016 growth. The primary channel will again be through business investment. If prices fall below their production breakevens, then the shock would spread to other parts of the domestic economy and place additional pressure on fiscal and monetary policy to respond. While the former is willing, the latter has little room to maneuver.

● A downturn in US growth would imperil the nascent recovery in non-energy exports and leave the growth outlook without a positive offset to the ongoing terms of trade shock.

Asia-Pacific

● Concerns about a China-led slowdown remain, but there are silver linings. While manufacturing and construction are in decline, keeping commodity prices under pressure, there are opportunities elsewhere. Non-core-commodity exports jump in Australia and New Zealand, and with even lower currencies in the cards for 2016, expect more of this rotation.

● Financial market contagion remains the major tail risk, as Chinese debt restructuring, the experimental CNY fixing regime and the opening up of capital markets rarely go smoothly.

● A risk for the RBA/RBNZ is that the Fed doesn't hike by March, boosting the currencies and potentially forcing both to act on their easing biases.

● Alternatively, hot housing markets could prompt hikes by year-end.

United States

● The US economic recovery is expected to regain its footing in 2016, as the combination of diminished global headwinds and a favorable domestic fundamental backdrop provides the platform for the recovery to shift back to an above-trend 2.5% or better pace. Despite this relatively constructive growth outlook, the risks to this view are tilted slightly to the downside as further missteps in China or the absence of the long-awaited rotation in the driver for growth from fatigued US consumers—who continue to carry the heavy load of the recovery—to business investment activity could add further strains for the recovery.

● A disorderly global financial market response to the expected liftoff in rates in December could also present an obstacle to the ongoing economic recovery. The response of the dollar will be particularly key to assessing the extent of the fallout. However, even if the Fed delivers on the current expectation for a December hike, the subsequent path of tightening should be sufficiently shallow to mitigate the risks of a disruptive feedback loop from financial markets to the real economy.

Europe

● Risks are that Eurozone disinflation persists, and no matter how much the ECB eases, price pressures remain weak on such large spare capacity. Downside risks to the EM recovery pose significant risks for Eurozone (in particular German) growth.

● Weaker foreign demand risks (in both EMs and the Eurozone) are important to the very open UK economy. If productivity continues to disappoint, domestic cost pressures may build more quickly than anticipated, but conversely, inflation expectations could fall with the BoE forecasting sub-1% inflation in 2016.

● Risks lay only to the downside for Norway, where the non-energy economy has yet to show the full impact of lower oil prices. Conversely, Sweden risks over-heating as policy remains overly aggressive to keep SEK weak.

EMs

● The two major external risks affecting EMs are Fed tightening and the prospects for China growth and FX policy.

● Volatility in EM asset prices should start falling once the first couple of Fed rate hikes are out of the way, but before then we could have a bumpy ride.

● Poor growth prospects are likely to continue to plague a sizeable portion of the EM asset class. The biggest growth pick-ups will be in Russia and Brazil, but these are two economies recovering from deep recessions. The best growth stories remain in Asia and we continue to like India and Indonesia.

● Political risks continue to be a major issue in a number of EM countries, particularly in Russia, Turkey, Brazil, and Malaysia.

Global Rates

Policy Divergence in a Recoupling World

- Long end rates have displayed a significant amount of co-movement since 2008, driven by global disinflationary trends.
- We recommend positioning for policy divergence by selling 5yr Treasuries against Germany and owning 30yr Canadian RRB breakevens against TIPS breakevens.

We believe that the overwhelming theme in the global rates complex next year will continue to be one of policy divergence. We forecast the Fed and the BoE to begin hiking rates, while the ECB and BoJ will continue with established easing programs. We expect the BoC and the RBA to remain on hold all year. For the first time since 2008 there will be much divergence in monetary policy globally, which should be reflected in asset markets. Country-specific trades are discussed in detail in their respective sections.

However, it is not easy to play policy divergence via long end cross-country spreads due to very high correlations among global developed bond markets. This could very well be a function of movements in currencies, which then act as the equilibrating mechanism for growth and inflation. We therefore recommend playing the divergence in the front end of the curve and in inflation breakevens.

10yr rates show significant co-movement globally

We run a principal component analysis (PCA) across G10 10yr yields on a rolling 5yr window to capture the trend in the co-movement between these rates. A common "global factor" (or PC1) appears to explain as much as 90% of the co-movement in developed market bond yields. Interestingly, the extent of co-movement has steadily increased since 2008 (Figure 1).

What drives this co-movement? We use a shorter window of correlation to see what macro variables correlate with the global factor. We find that it is highly (inversely) correlated to inflation—as inflation declines, the explanatory power of PC1 rises (Figure 2). This is consistent with much of the academic literature on the subject. The causality could well be that low inflation globally results in QE, which creates the reach for yield across markets.

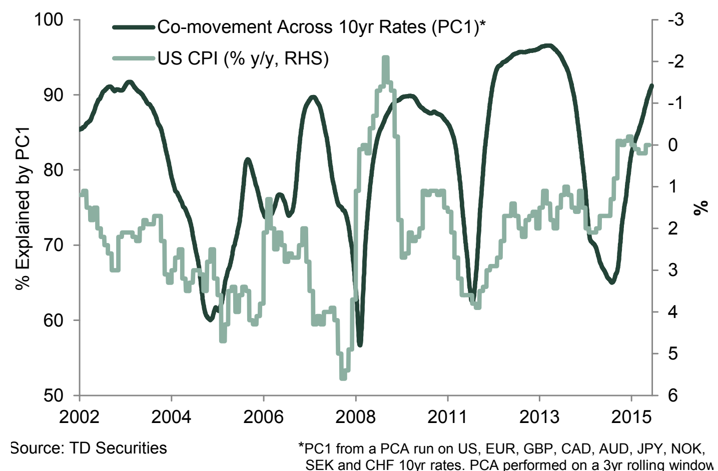
It is also intuitive that the extent to which this global factor drives each country's 10yr yields individually (which is captured by the PC1 coefficients) is positive (Figure 3). This suggests that a shock to PC1 moves all the rates in the same direction—making PC1 a "level" factor. This makes it less straightforward to trade policy divergence at the long end. We do find that bond correlations tend to decline going into QE announcements but then increase once QE is underway as there is a reach for yield. Thus trading 10yr cross country spreads heading into QE requires precise timing.

Figure 1: Co-movement* Across 10yr Rates Has Risen Post-Crisis

Source: TD Securities

*PC1 from a PCA run on US, EUR, GBP, CAD, AUD, JPY, NOK, SEK and CHF 10y rates. PCA performed on a 5yr rolling window to capture trend

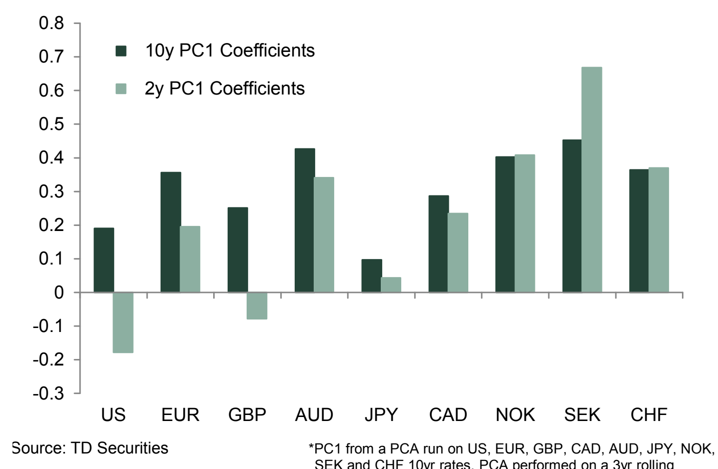
Figure 2: Co-movement* Across 10yr Rates vs. US CPI



Source: TD Securities

*PC1 from a PCA run on US, EUR, GBP, CAD, AUD, JPY, NOK, SEK and CHF 10yr rates. PCA performed on a 3yr rolling window

Figure 3: Sensitivity to Global Factor (PC1* Coefficients) - 2yr and 10yr Yields



Source: TD Securities

*PC1 from a PCA run on US, EUR, GBP, CAD, AUD, JPY, NOK, SEK and CHF 10yr rates. PCA performed on a 3yr rolling

Trade divergence in the front end

When we perform the same PCA analysis on 2yr and 5yr yields, we find that while the general co-movement in yields has also risen post-crisis, the rise has been far more volatile. This is intuitive as front end yields capture the monetary policy divergence between regions and exhibit less of a "reach for yield" effect. In addition, we find that the coefficient to the global factor is not consistent across markets. A shock to PC1 moves US and UK 2yr yields in one direction, and the other G10 yields in the opposite direction. For 5yr rates, a shock to PC1 moves US yields in an opposite direction to the rest of the G10—making PC1 on 2yr and 5yr yields more of a "slope" factor.

Given our expectations of divergent monetary policies between the Fed and the ECB, we recommend selling 5yr US against Europe. We choose the 5yr over the 2yr, as the carry/roll is less punitive and current levels look more attractive. The 5s also carry negatively but we believe that the risk/reward is still compelling.

A history lesson: There has been another historical period of divergence between the Fed and the ECB. In 2004, the Fed began to hike but the ECB began hiking only a year later. We ran a PCA on both curves jointly from June 2002 to June 2005. We find that from 2002-2004 (synchronised monetary policies of easing and then hold), the global factor (PC1) impacted both the US and European rates in the same direction. But as the Fed began hiking, a shock to PC1 impacted US rates positively but European rates negatively. In addition, the extent to which PC1 drove each rate was greatest for front end US rates and negative for European rates—reflecting a hiking Fed and ECB on hold. This was consistent with the much greater widening of 2yr and 5yr differentials than at the 10yr point (Figure 4).

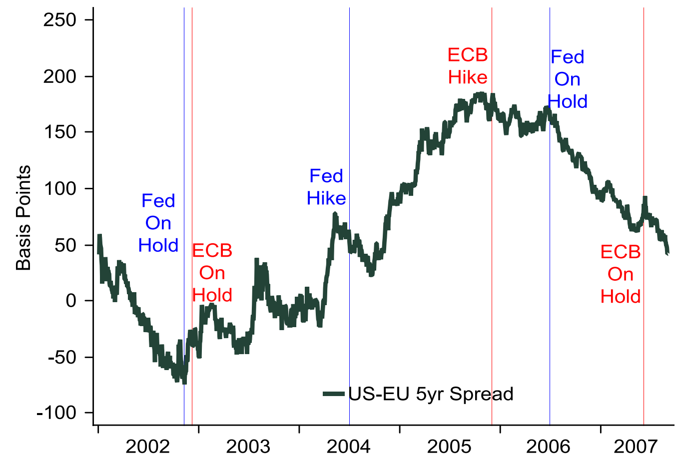
Thus, we conclude that as the Fed hikes and the ECB eases further, the volatility of the 0-5yr US yields (and therefore the sensitivity to PC1) should not only jump, but also be considerably higher than for European yields. This further explains why a 5yr US/EU trade should be profitable and outweigh its negative carry. In addition, we expect an ECB depo cut in coming months, which would further depress front end European yield vol. For clients expressing the trade in swaps—we expect the spread to move to 160bp from 140bp currently.

Trade Recommendation: Sell $200mn Treasury 5yr vs. German 5yr. Current: 179bps, Target: 200bps, Stop loss:160bps. 3m Carry/Roll: -10bps.

An inflation divergence view

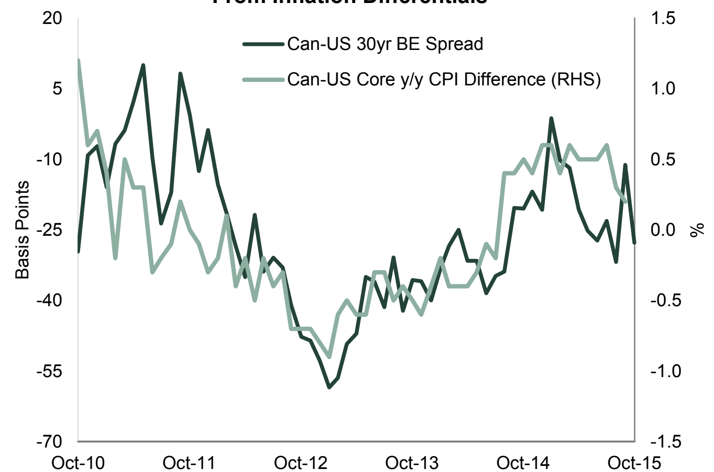
While we look for inflation breakevens (BEs) to generally widen across G10, we believe that Canadian RRBs have the most room to outperform. Y/Y core CPI in Canada has been running above 2% for more than a year, in sharp contrast to the US. The spread between 30yr BEs in US and Canada had tracked this differential reasonably well between 2011-2014, but the drop in oil prices in 2014 created a significant wedge between this relationship (Figure 5). If oil prices stabilize or head higher from here, we would expect Canadian BEs to outperform. Further, the continued strength in USD should put upward pressure on Canadian CPI, while depressing import prices and hence CPI in the US. These trends should persist once the Fed begins to raise rates. Over the medium term, the easier BoC monetary policy stance should argue for greater inflation risk premium in Canada. Thus we argue for owning 30yr Canadian BEs against US TIPS BEs.

Figure 4: Policy Divergence Reflected in US-EU Spread



Source: Macrobond, TD Securities

Figure 5: Canada-US Breakevens Have Diverged From Inflation Differentials



Source: Bloomberg, TD Securities

Trade Recommendation: Own 25mn 30yr CAD breakevens (CAN 1.5% 12/44s vs CAN 3.5% 12/45s) and sell 30yr US breakevens (TII 0.75% 2/45s vs T 2.875% 8/45s).Current: -29bps, Target: -5bps, Stop loss:-40bps. 3m Carry/Roll: 2bp

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US Rates

Start Your Engines, Fasten Your Seatbelts

- We recommend positioning for a Fed hiking cycle that is faster than currently priced in via EDH6-H7 steepeners and 5s30s flatteners. Long end rates should remain contained amid muted productivity, demographics and low global bond yields. TIPS BEs are cheap on a fundamental basis, but given near term negative carry, we wait for a dip to buy.
- We expect a choppy market in 2016, with significant realized volatility as investors grapple with a hiking Fed amid regulatory pressures that constrain dealer risk appetite. Final NSFR rules and money fund reform will dominate the front end. Pressure on dealer balance sheets should keep swap spreads at the tighter end of the spectrum and the correlation between on-balance sheet and off-balance sheet assets should continue to decline.

It is never easy to write a year-ahead outlook, but as we put pen to paper this year, it seems especially challenging. After seven years of being at the zero lower bound, we forecast the Fed to finally raise rates in December and proceed with subsequent hikes throughout 2016. Much of the market's attention next year will be spent on deciphering the Fed's next steps and the ramifications of rate hikes globally across assets.

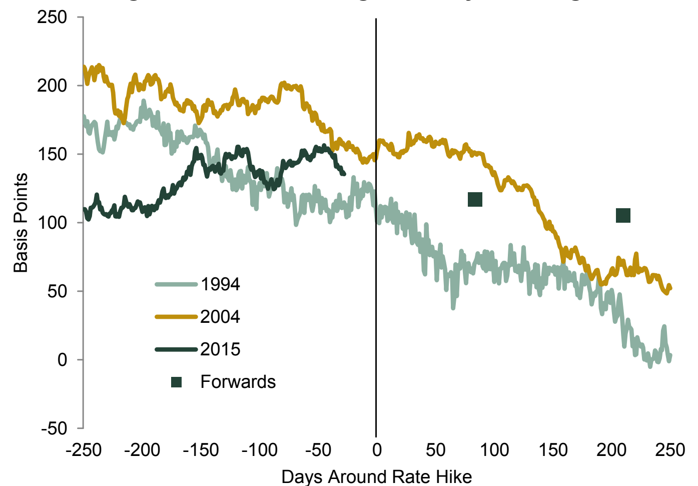
However memories of 2014 and 2015 are still fresh as the market began to truly appreciate the vulnerability of the US recovery and the impact of global forces. The overriding theme since the crisis has been one of sub-par growth, which creates the risk of being derailed due to global growth weakness or tighter financial conditions. The Fed is finally able to hike due to cumulative progress in the labor market, but longer-term questions remain about potential growth and ability to reach the inflation target.

What does "gradual" mean?

Despite the market's obsession with the timing of liftoff, we believe that the pace of hikes and the fate of portfolio reinvestments are more important for the level of rates and curve. Even though the Fed has been suggesting a gradual pace, the definition of "gradual" may be becoming misinterpreted by the market. The Eurodollar curve is pricing in less than 3 hikes in the first year following liftoff, while the median dot plot signals about 4.

We believe that the market is essentially pricing a bi-modal distribution of 2 scenarios: 1) "no hike" or just "one-and-done" and 2) a more normal hiking cycle. If the Fed hikes in December and suggests more hikes in the future, the probability of the "no-hike" or "one-and-done" scenario should decline and the distribution should shift towards higher front end rates. This should steepen EDH6-H7 and flatten the 5s30s curve.

Figure 1: The Flattening Has Only Just Begun



Source: Bloomberg, TD Securities * Assumes Dec 2015 hike for current cycle.

Historically the curve has flattened going into the first hike and continued to flatten as the hiking cycle progressed. While forwards are arguably flatter than spot levels, they are not as flat as historicals would have suggested (Figure 1). There are arguably many differences between the upcoming hiking cycle and the last two cycles in terms of the global backdrop, the inflation outlook and Fed transparency, which is why we expect a slower pace of hikes. However, we do not expect the Fed to wait too long before delivering a second hike. Monetary policy affects the economy with a lag and a single hike has almost no impact on the economy, thus we believe that the Fed will want to hike a few times before being able to assess the impact of higher rates.

We also believe that the Fed will continue reinvestments throughout 2016, until the funds rate has risen to a "more reasonable level of 1-2%" as suggested by Dudley and the September FOMC minutes. This should prevent a re-pricing higher of term premia as the stock of assets held by the Fed stays unchanged all year.

We therefore see the 5s30s curve flattening heading into and out of liftoff, and recommend initiating the trade at current levels.

Trade Recommendation: 5s30s flatteners ($50mn of 30s). Enter: 137bp, Target: 110bp, Stop: 140bp, 3m Carry/Roll: 8bp.

Outlook for duration: not as bearish

We have so far argued for higher front end rates as the Fed should hike more quickly than what is priced in. However, we forecast the 10yr to reach only 2.5% by the end of 2016. This is a few basis points lower than forwards, but much lower than consensus of 2.85%. Our forecast is driven by two main factors:

- **Lower terminal funds rate:** There is growing acceptance in the academic world of a lower potential growth rate in the US

which results in a low real terminal funds rate. This could be due to cyclical reasons (a function of the financial crisis itself) or structural reasons (such as productivity), but the fact that many estimates of the natural real rate have not risen despite the recovery in the labor market tilts the balance more towards structural factors.

Demographics do make a structural case for a decline in the potential growth rate with a declining share of working-age population, which is projected to fall further as the population ages. A factor that may have compounded the problem since the crisis is the decline in the labor force participation within this cohort (Figure 2). It is difficult to find a sufficiently convincing explanation for the decline in participation among this working-age group, but the fact that it has not risen despite significant overall job gains hints at more structural reasons such as skill mismatch or hysteresis. We estimate that the market is currently pricing in a terminal Fed funds rate of about 2%, which appears reasonable to us for now.

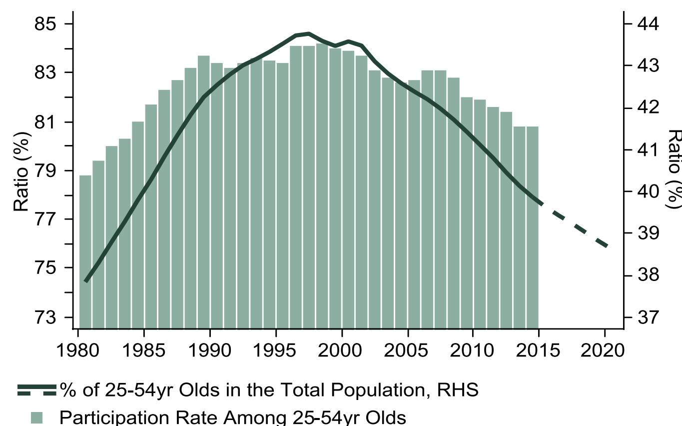
- **Lower global bond yields:** As the Global Rates section argues, there is significant and rising correlation across global bond markets. Easing by many global central banks is likely to keep bond yields low globally, which can bring about cross-over buying to higher yielding Treasuries and keep a lid on long end rates.

As we have previously discussed, there has been a rotation from price inelastic to price elastic buyers of Treasuries over the course of 2015 and we expect this trend to persist into 2016. A Fed that is in hiking mode may very well increase risk premia and volatility, and make a case for Treasuries as a hedge within a broader portfolio. Further, Treasuries can see inflows from foreign private investors. Thus we expect cross-asset correlations to remain high over the course of the coming year.

Furthermore, we expect cross-asset correlations to be supported by the Fed's more pronounced focus on financial conditions than during previous rate hiking cycles. Dudley stressed this in a June speech, noting that "*if financial conditions tighten sharply, then we are more likely to proceed more slowly*." This can help prevent a "taper tantrum" like reaction to the hike as the Fed appears responsive and sensitive to market gyrations.

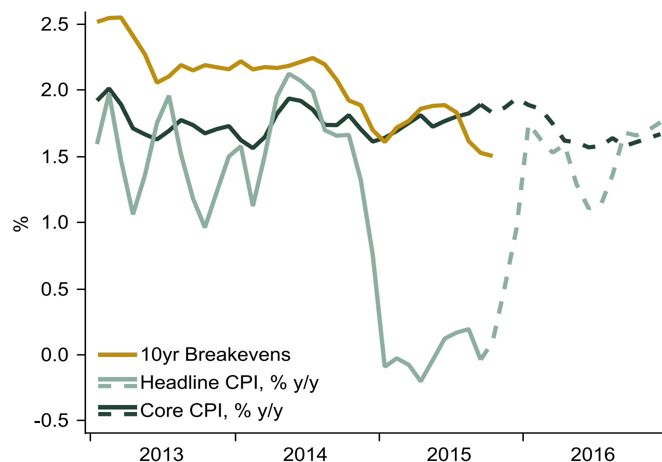
On the supply front, we expect similar levels to 2015, in notional and duration terms. We expect the FY2016 deficit to be marginally higher at $450bn, though Treasury will likely cut coupon auction sizes in favor of bills to respond to money fund reform. While the higher deficit should result in a modest pickup in issuance, more bill issuance should keep additional duration pressure relatively low. We expect corporate supply to decline next year due to the significant amount of pre-funding that

Figure 2: Declining Share of Working Age Population Compounded by Lower Labor Force Participation



Source: Macrobond, TD Securities

Figure 3: Inflation Rebound Will Begin Aiding BEs Soon



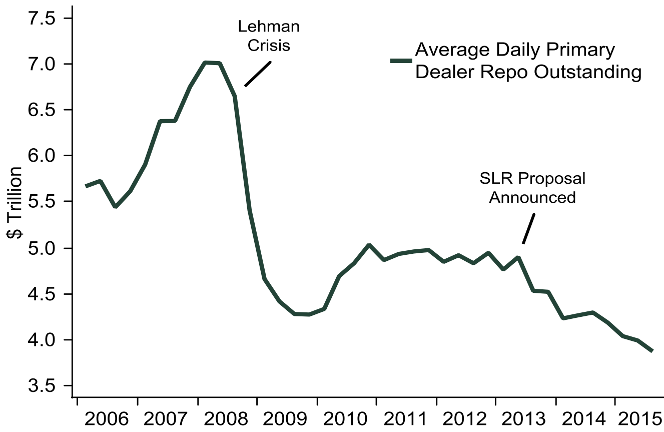
Source: Macrobond, TD Securities

occurred in the lead-up to the Fed hiking cycle. Corporate issuance at $1.5tn in 2015 stands just a hair below record YTD levels. We do expect USD-denominated SSA supply in 2016 to continue rising as it remains advantageous for European issuers to fund in USD and swap proceeds into EUR. The story for GSE supply is likely to remain unchanged, with FNMA and FHLMC net issuance continuing to fall (in line with mandated shrinkage) and FHLBs and FFCB unable to fully offset the decline.

A turn in sentiment for TIPS breakevens

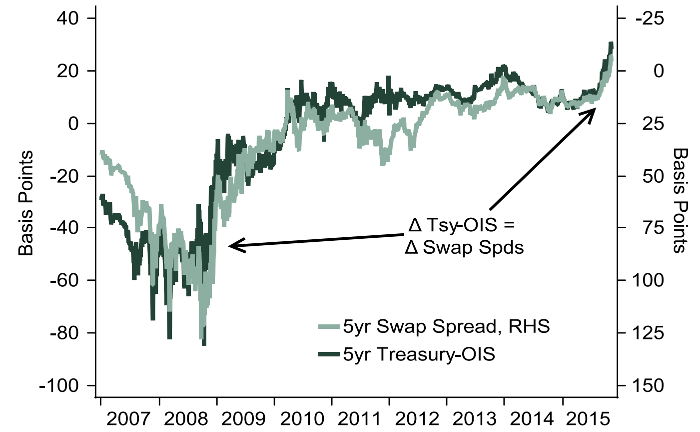
TIPS had a difficult year, with continued decline in CPI and impending Fed hikes. However, most of the decline in CPI was driven by energy and food. Our commodity strategists expect oil prices to begin stabilizing over the coming months before proceeding higher by end-2016, suggesting that the drag from these categories should dissipate even beyond the base effects. One key factor that has continued to support both headline and core CPI has been very strong Owners' Equivalent Rent (OER),

Figure 4: Significant Decline in Repo Balances Following SLR Announcement



Source: SIFMA, TD Securities * Includes repo and reverse repo.

Figure 5: Treasuries Cheapening Against Swaps and OIS a Function of Balance Sheet Constraints



Source: Macrobond, TD Securities

due to a particularly low housing vacancy rate. Our analysis points to a roughly 12m lag between the vacancy rate and OER, suggesting the likelihood of further upward pressure on CPI in 2016 alongside dissipating drag from food and energy.

We therefore believe that TIPS look cheap on a fundamental basis, even though Fed hikes could keep upside capped. With y/y headline inflation set to begin turning higher in January (Figure 3), TIPS should begin to look more attractive as carry should turn positive in March. Despite our constructive outlook on TIPS, we wait for a dip (150bp on 10s) before going long since breakevens have risen recently, near-term carry remains negative and balance sheet pressures could intensify into year-end.

Trade Recommendation: Long $100mn 10yr TIPS breakevens. Enter: 150bp, Target: 185bp, Stop: 135bp

Balance sheet pressures: the new normal

We believe that the market displayed clear signals of constrained balance sheets throughout the year. We had previously highlighted that despite rates staying largely range-bound, there were many more 1σ and 3σ days in 2015 for Treasuries, which may be a sign of lower liquidity conditions. Treasury futures persistently traded rich to their underlying cash deliverables, implying an arbitrage opportunity, assuming access to balance sheet. Treasuries cheapened to Libor despite the absence of a catalyst.

We believe that these market movements can be explained by a rising cost of balance sheet due to the Supplementary Leverage Ratio (SLR) and upcoming Net Stable Funding Ratio rules (finalized rules due in 2016). The repo market is most inexorably linked to the cost of balance sheet and therefore faces the brunt of new regulations. Interestingly, the it has adjusted to this new reality through price (wider bid-ask spreads) as well as quantity.

Figure 4 highlights that repo balances have shrunk by 20% since Q2 2013, when SLR was announced. Note that the SLR rules are binding for most US and European banks and disproportionality hit repo and Treasuries, which previously benefited from zero risk weighting. We believe this higher and variable cost of balance sheet implies that the correlation between on balance sheet assets (such as Treasuries, MBS or corporates) and off balance sheet assets (swaps or OIS) should be lower going forward. This is consistent with the fact that Treasuries cheapened not just to Libor but also to OIS in recent weeks. This is similar to the post-Lehman environment, when balance sheet was also dear (Figure 5). We believe that swap spreads will remain extremely tight.

Risks to our outlook: symmetric

As always, there are many risks to our baseline outlook of a flatter curve led by higher front end rates but a largely unchanged 10yr. Note that these risks within the backdrop of less liquid market conditions can create the potential of significant realized volatility. The biggest downside risk to our outlook is further weakening in global growth, which can spill over into US growth and inflation. The other risk is continued strength in the USD or weakness in risky assets, which tightens financial conditions and hurts growth. This could slow the hiking path.

The biggest risk towards higher rates would be significant outflows from bond mutual funds as the Fed begins to raise rates. This could create selling pressures across fixed income and Treasuries can often bear the brunt of the selling due to better relative liquidity. The other risk of a selloff would be upward pressure on global bond yields similar to May-June 2015, when the rise in bund yields sparked a commensurate selloff in Treasuries.

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Canada Rates

Slow on the Uptick

- Policy divergence will be the most important theme, as the BoC stays on hold amid Fed hikes. Higher US rates will feed into Canada, but the impact will be greatest in the belly of the curve as BoC policy anchors the front-end.
- 2s10s should steepen materially, but the tactical backdrop for 2s10s is poor right now. For the moment, 10s30s flatteners look like a better way to position for higher US rates. We also see significant upside in RRBs, as 30yr real yields are at their highs for 2015 with breakevens near post-crisis lows.

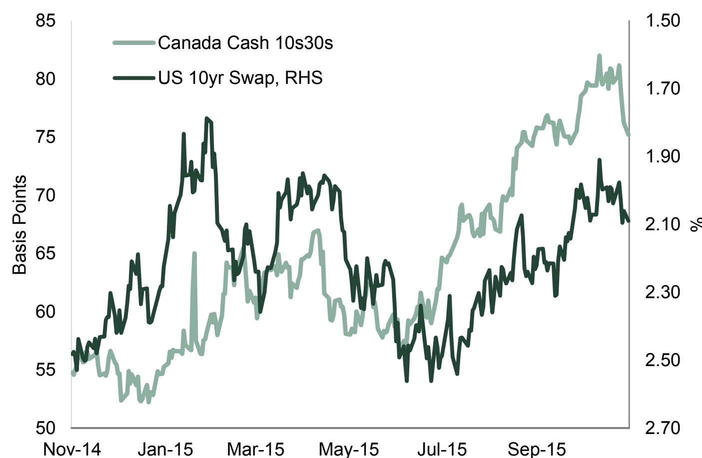
2015 was one of the more interesting years in recent memory for Canadian fixed income, with the Bank of Canada cutting policy rates twice in response to the collapse in oil prices. By easing, the BoC was effectively catching up with dominant trend in the rest of the G10; over the last 3-4 years the Fed, ECB, BoJ, and RBA have all added varying degrees of monetary stimulus. The Bank of Canada just looks like the last central bank to join the easing parade—so in that sense the story for the Canadian rates space was convergence. This was most apparent in the front-end of the curve, where Canadian 2s went from trading 40bps wide of Treasuries to 20bps through. By the start of the new year, the metronome will swing back to divergence, as there is virtually no scope for the BoC to lift policy rates in H1 2016, and even in the second half of the year hikes feel premature.

The move to normalize monetary policy in the US will be the driving factor in Canadian rates, and the 2011-13 period when the Fed was adding more stimulus while the BoC remained on the sidelines should provide us with some guidance for the upcoming year. The most obvious implication is that correlations between Canadian and US rates will weaken in the front-end of the curve. The OIS curve has moved to incorporate a slight tightening bias in sympathy with the Fed (the implied rate for July 2016 is 54bps), but there is only the faintest hope of actually seeing tightening in Canada by mid-2016. If anything, the risks around the BoC skew towards lower rates as we are still in the early phase of the export recovery and oil prices will remain depressed through H1 2016, which makes Canadian 2s very attractive now that they offer modest positive carry. In the very near-term we may see further upward pressure on front-end rates, but we would revisit outright long positions in 2s and BAXs ahead of the December 2nd Fixed Announcement Date.

10s Will Lag Early in the Year

While cross market correlations will weaken and GoC bonds will tighten versus Treasuries across the curve, the direction in yields will still be higher. 10s tend to be most sensitive to movements in the Treasury market, and we expect 2s to be well supported near current levels. Consequently, we look for the curve to bear-

Figure 1: 10s30s Tend to Flatten as the General Level of Rates Rises



Source: Bloomberg, TD Securities

steepen through the latter half of December and into January. This is the opposite of 2011-13, when Fed easing pushed yields lower in the belly and long-end in Canada but BoC forward guidance blunted the impact on 2s.

We like 130bps as a target on 2s10s, but we do not think it is the best way of expressing 10yr underperformance. 10s30s flatteners also tend to perform when yields rise, and they tend to be far less volatile. The daily standard deviation on 2s10s was roughly 3bps in 2015 compared with 1.1bps for 10s30s; there is slightly more upside to 2s10s (25bps from current levels versus 20bps for 10s30s), but not enough to justify the added volatility.

> **Trade Recommendation:** 10s30s Flattener (Buy $4.2M CAN 2.75% Dec 2048s vs $11.1M CAN 2.25% June 2025s).
> **Enter:** 72bps.
> **Target:** 52bps.
> **Stop:** 82bps.
> **Carry/Roll:** -4.5bps/quarter.

Taking a longer-term view, entry levels are also more attractive for 10s30s flatteners—even following the 10bps flattening since the October 28th FOMC meeting. 70bps is still an abnormally steep level for 10s30s in the post-crisis period, whereas 2s10s are essentially in the middle of their longer-term range (2s10s have traded between 60bps and 160bps over the last 5 years). We also take comfort from the fact that long bonds should outperform in the US. We like 52bps as a target, selling benchmark 10s (because they are richer than J24s or J26s) versus the incoming 30yr which sits at the wide end of its range versus D45s. At 90bps, 2s10s probably become the more attractive trade, but at 100bps we would only enter steepeners on a tactical basis. Note that 5s30s are also likely to flatten (and 2s5s to steepen), but the excellent rolldown in the 5yr segment of the

curve and closer linkages between policy rates and 5s make the 10yr segment a much better candidate for shorts.

A possible change in issuance patterns next year is a wild card, as 10s and 30s are the two parts of the curve where adding an auction would be easiest given current patterns. Refinancing needs for FY2016-17 should be roughly $215B ($129B in T-bills and $86B in bonds), so a $10B deficit should imply a modest increase in bond issuance—but it should be noted the government could easily soak up the entire deficit using the T-bill program as the T-bills stock was above $150B as recently as FY2014-15. Canadian residents (including institutional investors) hold roughly two-thirds of Government of Canada bonds, so the market should be able to weather any change in flows from foreign investors.

With Rising Rates, Swap Spreads Should Narrow

Other parts of the Canadian markets are also likely to see the dominant trends form the financial repression era go into reverse once the Fed begins to hike. We have already seen swap spreads narrow materially this year, but higher bond yields should drive further narrowing at the margin—especially if EM reserve accumulation has in fact peaked. We are also biased to see Provincial spreads narrow in a rising rate environment, though the spreads seen during the great moderation/pre-crisis period are unlikely to return any time soon.

Trade Recommendation: Buy 30yr Breakevens (Buy $6.5M CAN 1.5% Dec 2044s vs. $4.1M CAN 3.5% Dec 2045s).
Enter: 153bps.
Target: 184bps.
Stop: 139bps.
Forecasted Carry/Roll: -1.6bps/3mths; +1.7 bps/6mths.

Breakevens Have Fallen Too Far

Sticking with the long-end of the curve, the most glaring dislocation in the Canadian rates space is in RRBs. Simply put, breakevens look unsustainably low here. The low level of headline inflation in 2015 was primarily due to declining energy prices—but if oil prices haven't yet found a bottom, we expect that they are close. Moreover, core inflation has been running above 2.0% in Canada for quite some time; part of the buoyancy in core prices is linked to the pass-through from currency depreciation, but it also reflects an economy with decent (albeit unspectacular) wage growth and above-trend growth prospects in the near-term. We expect headline inflation to reach 2.4% y/y once the base effects from the oil shock have fully worked their way through the data.

This isn't the best time to own RRBs from a seasonal perspective: there will be $700M in new supply on December 3rd, and CPI inflation tends not to accelerate until February—but not only are

Figure 2: Canada 30yr Breakevens: Inflation Compensation Has Been Trending Lower, But Recent Weakness is Overdone

Source: Bloomberg, TD Securities

breakevens close to their post-crisis lows (and lower than they were at any time prior to 2008), but the compression in breakevens has come against a back drop of relatively high real yields.

We recognize that the RRB market is not for the faint of heart, and that part of the underperformance can be linked to persistent liquidity factors. Still, relatively easy monetary policy from the BoC and further expected weakening in the CAD (we look for USDCAD to reach 1.40 in Q1 2016) should both support RRBs on the margin, and seasonals in CPI will turn positive in February. We would target at move to 184bps (the pre-oil crash low), and would not be surprised to see 30yr breakevens approach 2.00% by the end of 2016.

Andrew Kelvin

Figure 3: Elasticity of Canadian Rates to Changes in US Rates

	United States				
Canada	2s	5s	10s	30s	*Average*
2s	0.48	0.31	0.29	0.27	0.34
3s	0.60	0.41	0.39	0.37	0.44
5s	0.85	0.63	0.62	0.60	0.68
7s	0.89	0.67	0.67	0.67	0.73
10s	0.91	0.72	0.74	0.76	0.78
30s	0.78	0.64	0.68	0.71	0.70

Source: TD Securities, Bloomberg Swaps, October 2014-15

Australia/New Zealand Rates

We Can Cut, But We Don't Really Want To

- The RBA and RBNZ both have an easing bias but remain reluctant cutters. Treasuries to drive ACGB and NZGB yields higher in H1, but policy divergence could emerge in H2.
- For Australia, we recommend investors position for non-AAA rated semis to outperform ACGBs, while we expect NZGB 10s to outperform Treasuries.

TD forecasts the RBA to keep rates on hold at 2% for all of 2016. However, as we have seen in the past few weeks, the market is likely to test our resolve and price in cuts at some point, drawing support from the RBA's decision to adopt a contingent easing bias. We see risks that the market trims RBA easing expectations approaching the new year, thanks to the Fed wanting to normalize rates and evidence that China Q3 stimulus (in the wake of the equity meltdown) is finally beginning to bear fruit. We also forecast a firm Australian Q3 GDP outcome that should reinforce the RBA's "glass half full" outlook. All in, we see the market trimming RBA easing first before possibly entertaining RBA cuts early next year. The bias is therefore is to keep duration short, for the curve to steepen, and for swap spreads to narrow. Our most recent views can be seen here.

Our strongest conviction trade in Australia is for longer dated AA-rated semis to outperform bonds. We think these issues will perform for the following reasons:

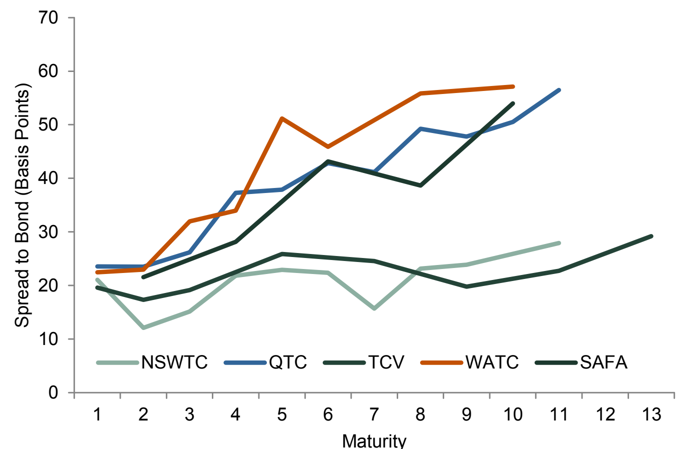
1) **Semi government authorities net funding needs are declining:** The NSWTC 2015/16 borrowing program is A$7.3B, but these forecasts do not factor in potential proceeds from the NSW State Government's proposal to privatize 49% of its electricity assets. If successful, NSWTC's term funding requirement could all but disappear. Similarly TCV announced privatizing the Port of Melbourne leaving TCV's funding requirement for 2015/16 in net surplus. These sales should see fiscal positions improve while a net reduction in issuance should support spread narrowing. These announcements have now arguably been well-flagged, so spread compression is unlikely to be material for NSWTC and TCV, but the culmination of the above asset sales should drive spreads in more for QTC, WATC and SAFA as the available supply of semis shrinks. Non-AAA names to outperform and are currently trading cheap vs peers.

2) **Swap spread are narrowing:** Recently we outlined why we believed Australian swap spreads were more likely to narrow than widen. These views remain. Fundamentally, the RBA's easing bias should see the bills outperform the 3s, driving spreads in at the short end while a selloff in the outright should also encourage swap spread narrowing. Against a backdrop of narrowing US swap spreads, any widening in Australia should be limited given 1) paying swaps is negative carry, 2) ongoing AUD SSA issuance and 3) slowing loan growth as housing normalizes. Additionally, our forecast for a steeper bond curve should be supportive of narrower long end swap spreads over a period where we forecast the RBA to be on hold. Limited AUD upside as per our FX forecasts should also keep long end swap paying interest at bay.

3) **Balance sheet buying capped:** Australian Depository Institutions appear to have hit a ceiling on Australian government and semi government securities held at 48.5%. The only way for these ADIs to add semi holdings is if the supply of securities on issue increases so as to not breach the 48.5% limit. Given that Australian government bond supply is set to increase but semi supply is set to decrease (in itself supportive of semis over ACGBs), the logical way that balance sheets can add yield to their portfolio is by switching out of short and mid curve semis to long dated semis. Perhaps this is why recent long end semi issuance was so well bid.

4) **Credit/China fears to recede:** Our conversations with clients in the past few weeks reveal less concern with liquidity and even less so with credit. Our view that concerns over China have been overplayed and expectations for China activity to pick up should support the AA-rated commodity-based states. In this regard, QTCs and WATC's bonds are attractive vs comparables on issue (Figure 1).

Figure 1: WATC & QTC Offer the Most Value to Bond



Source: Bloomberg, TD Securities

NZ: at greater risk of policy divergence vs the Fed

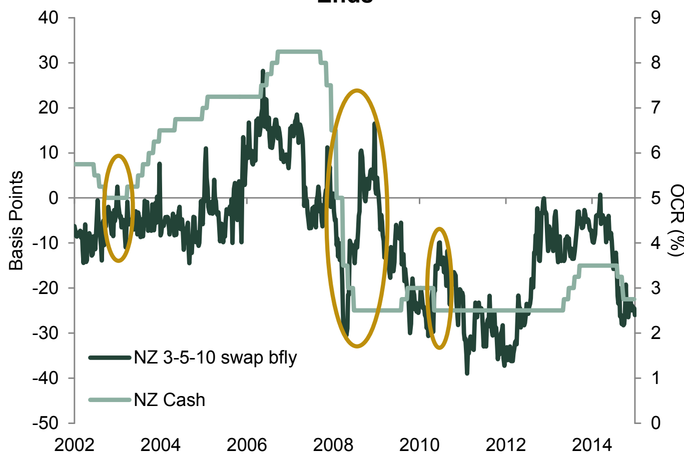
Like the RBA, we expect the RBNZ to keep rates on hold over 2016. With both Banks sharing a reluctance to cut rates further,

Trade Recommendation: Buy WATC 07/25 to bond.
Buy A$25M WATC 07/25s to sell A$27M ACGB 04/25s
Enter: 53.5bps; **Target:** 40bps; **Stop:** 62bps; **3m Carry/Roll:** -2bp.

this should mean volatility in AU-NZ spreads should be less than usual (until of course the market senses a divergence in monetary policy). What both Banks are leaning on are their currencies doing the heavy lifting to assist in the transition away from the mining sectors for Australia and for the RBNZ to meet its inflation target. If our fundamental forecasts are correct for the NZ terms of trade to deteriorate (lagging the Australian ToT deterioration that began in 2011), the risk is that a weak NZD may not be enough to support the NZ economy. As a result, we assign a higher probability to the RBNZ needing to cut than the RBA in 2016. Once again, this appears to be an H2 2016 development, particularly if the ToT decline occurs in conjunction with a slowdown in NZ housing (negative for GDP). So for H1 2016, we see NZGB yields edging higher, directionally led by Treasuries, but for divergence in H2 potentially opening up opportunities.

Heading into the new year we expect weakness in the 5yr segment of the NZ curve. Historically, 5s have underperformed in the month or two before the RBNZ's last easing as can be seen in the 3s5s10s swap butterfly (Figure 2).

Figure 2: NZ 5yrs Underperform as Easing Cycle Ends



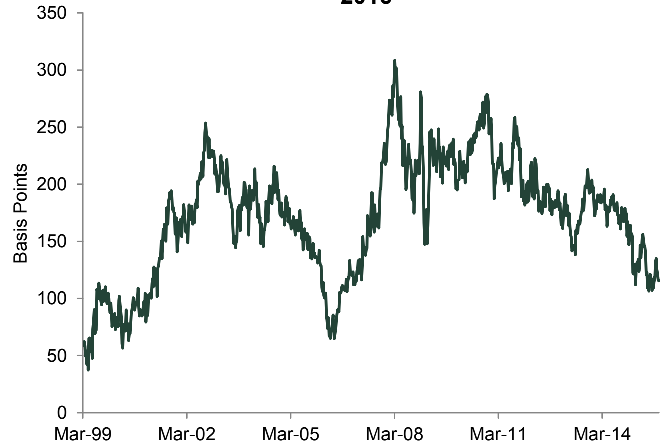
Source: Bloomberg, TD Securities

The risk to the initial move up in NZ yields is that weakness in NZ materializes earlier than we forecast. As we detailed earlier, we assign a higher probability to the RBNZ cutting in 2016 than the RBA, and given our call for the Fed to raise rates to 1% by September 2016, it supports NZGB outperformance over Treasuries over the year.

Trade Recommendation: NZ-US 10yr spread compression. Buy NZ$25m 04/27s to sell US$19m T 2% 08/25s
Enter: 125bps; **Target:** 85bps; **Stop:** 145bps; **Carry/Roll:** -5bp/quarter

Based on our global forecasts, we expect the NZ-US 10yr spread to trade below 100bps in the first half of next year. So given the spot spread at 115bps, buying NZGB 10s to sell Treasury 10s

Figure 3: NZ-US 10yr to Trade Below 100 Over 2016

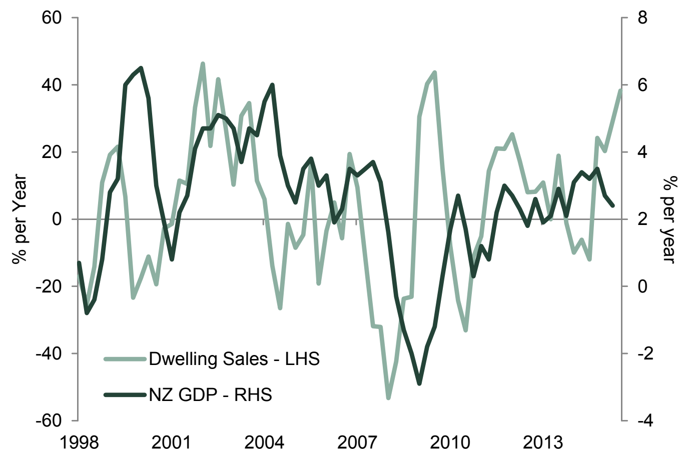


Source: Bloomberg, TD Securities

makes sense. The first catalyst for this spread to narrow would be the Fed hiking rates in December. That should drive this spread closer to 100bp (Figure 3).

The NZ-US 10yr spread got to as low as 70bps in June 2006 when the Fed was hiking rates and the RBNZ kept rates on hold, what we expect to unfold over 2016. With the NZ-US cash differential reaching 2% then and given that TD forecasts the NZ-US cash differential to narrow to 1.5% by September 2016, then a spread as low as 2006 levels is conceivable. And if the risks around NZ housing do materialize (home sales peaking, Figure 4), lifting the odds of the RBNZ cutting, this strengthens the case for the 10yr spread to trade well below our forecasts.

Figure 4: A Turn in Housing Lifts the Risks of Sub-trend NZ Growth



Source: Bloomberg, TD Securities

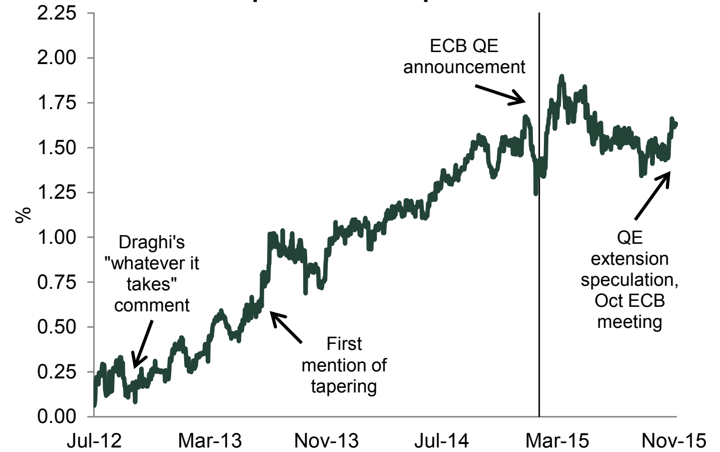
Prashant Newnaha

Europe Rates

Déjà vu: More QE and a Lower 'Lower Bound'

- We expect 2016 to be marked by the effects of more ECB QE and a further cut to the deposit rate. While short rates, swap spreads and periphery are pricing in some easing already, we believe that the periphery has more room to tighten. We expect the 10yr UST/bund spread to compress and recommend waiting to enter around 180bps (current level: 168bps, target: 120bps, stop loss: 210bps).
- We continue to expect EURUSD basis to widen. We flagged this in September and continue to expect the 5yr to test the -50bps floor implied by the Fed-ECB FX swap lines, temporarily breaking through. We recommend receiving the 5yr basis at -43bps, target:-60 to -65bps, stop loss: -25bps.

Figure 1: 10yr US-EU Spreads: Expect Bond Spreads to Compress



Source: Bloomberg, TD Securities

Positioning for US-EU compression

We expect 2016 to be marked by repercussions of further ECB QE and more deposit rate cuts, which we expect to be announced at the December 2015 meeting. At his October press conference, Draghi essentially pre-announced further QE by stating that that the degree of monetary policy accommodation would be reviewed at the December meeting. In addition, he paved the way for further cuts to the deposit rate; and in a recent interview stated "*The lower bound of the interest rate on deposits is a technical constraint and…may be changed in line with circumstances. The main test of a central bank's credibility is...the ability to achieve its objectives; it has nothing to do with the instruments.*" Given this, despite the ECB stating previously that the lower bound had been reached, it would appear that further cuts are on the table. The market is pricing in around 10bps of cuts by December, we expect a 20bps cut in December and the risk of a further 20bp cut in 2016, pushing yields lower across the curve and further dampening front end rate volatility.

Thus, we expect continued rate divergence with the US, and favor positioning for this on the 5yr sector, rather than the 2yr, where the carry/roll is less punitive (see page 9). Positioning for policy divergence on the 10yr is less straightforward since co-movement in 10yr bond yields has increased. In addition, the factor (PC1) that drives the co-movement impacts all G7 10yr yields in the same direction, which is not the case for front end yields. QE further complicates matters as it tends to lower 10yr global bond correlations initially. Consequently we choose not to express a EU-US divergence trade on the 10yr currently.

However, our findings do suggest that once the news of further ECB QE is absorbed by markets, global bond correlations tend to rise again. Investors tend to move out of the QE asset (i.e., bunds) and into higher yielding bonds (such as Treasuries). This move would be further amplified if the ECB decides to drop the capital key and instead adopts another weighting approach such as the total outstanding stock of sovereign securities. The ECB has already shown flexibility with its QE plan by raising the issue cap to 33% from 25% at its September meeting, making the likelihood of the capital key being altered a possibility.

Given this, we recommend entering a 10yr UST-bund spread tightener once further easing is fully priced in. Note that we do expect the spread to widen from current levels of 168bps on a ECB QE extension and likely Fed hikes. However, we expect the rise to be capped at around 180-190bps. We recommend waiting for a 180bp entry level, targeting a compression to 120bps.

Trade Recommendation: Buy UST $100m 10yr, Sell 10yr bund.
Current: 168bps, **Enter:** 180bps, **Target:** 120bps, **Stop:** 210bps, **Carry/Roll:** -1.5bp/quarter

More periphery compression, duration is a risk

Additionally, while the market is also pricing in more ECB QE and a (small) deposit cut, indicated by a lower 1y1y and 2y2y Eonia forwards (note that 1y1y Eonia is below the deposit rate), narrower periphery spreads and wider swap spreads since the June 2015 selloff in bunds (Figure 2), we believe that the periphery has more room to go. Italian spreads to bunds are only

Figure 2: Market Pricing in More QE and Rate Cut

	1y1y Eonia (%)	2y2y Eonia (%)	10yr EUR swap spreads (bp)	10yr SP-GE bond spread (bp)	10yr IT-GE bond spread (bp)
31-Nov-14	-0.08	0.07	27.4	107	103
22-Jan-15	-0.10	0.13	30.9	96	80
03-Jun-15	-0.04	0.36	31.3	125	110
Today	**-0.24**	**0.09**	**32.0**	**126**	**86**

Source: Bloomberg, TD Securities

back to ECB QE levels and not really pricing in much more QE. Spanish spreads to bunds have room for even more compression, which could be furthered post-elections in December. Even though bund yields declined significantly after ECB QE was announced, we believe that the QE extension is likely to be met with a more conventional response: higher bund yields driven by inflation expectations. We note that after bund yields nearly reached zero after ECB QE, yields jumped by almost 100bp in the following 2 months. While some of it was arguably overblown by fears of ECB tapering, there was a reassessment of the price insensitive demand for core European government bonds. In 2016, despite extended QE we see 10yr bund yields rising to 1.5% by year-end driven by a stronger economic outlook, a strengthening EUR and rising inflation expectations. This should support our call for a tighter US-bund spread by year-end.

More QE to increase pressure on cross-currency basis swaps

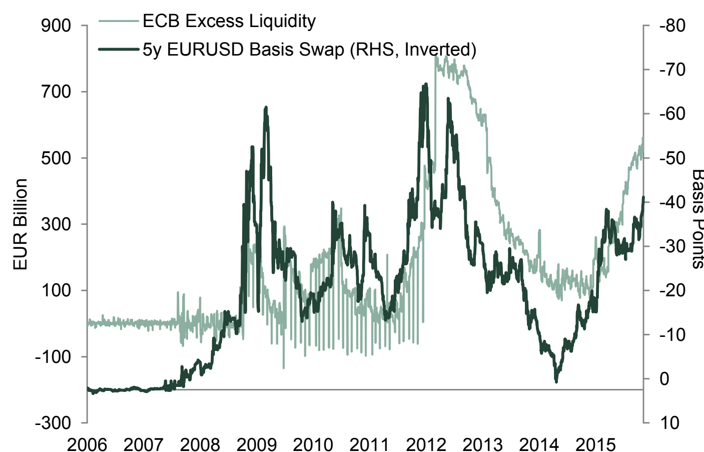
Given our view of an extension to QE, excess liquidity in the euro area should continue to rise, resulting in widening (more negative) cross-currency EURUSD basis spreads. Figure 3 shows that basis swaps are highly correlated with the level of excess liquidity in the euro area. Fixed rate/full allotment tender operations were first introduced in October 2008. Excess liquidity reached a peak in March 2012, following the allotment of two 3yr LTROs. In line with this rise in excess liquidity, the EURUSD basis widened as the cost of funding in EUR fell. Since early-2013, banks have had the option of repaying the 3yr LTROs on a weekly basis, which, in turn, led to a sharp decline in the level of excess liquidity and consequently a dramatic re-tightening of the EURUSD basis.

The introduction of ECB QE in 2015 has once again caused a sharp rise in excess liquidity, leading to a substantial decline in EUR yields and credit spreads, and as such, an increase in EUR bond issuance activity from foreign investors. This in turn has led to a sharp fall in EUR funding, causing the EURUSD basis to re-widen. Widening in itself will increase the incentive to issue in USD, swap into EUR and pay back through the basis, thereby slowing the pace of widening; however, we think the basis has further room to go (which we called for in September when it was at -35bps). While we saw some respite in late-September as the market priced out a Fed hike, spreads have since re-widened on much higher Fed hike risks and expectations of more ECB QE.

Trade Recommendation: Receive 5yr EURUSD basis
Enter: -43bps, **Target:** -60/-65bps **Stop loss:** -25bps

Given our expectations of more ECB QE and Fed liftoff in December, we expect the basis to widen further. We continue to expect the 5yr EURUSD basis to temporarily test the -50bps floor implied by the Fed-ECB FX swap lines, possibly reaching -60/-65bps. We note that despite the Fed reducing the rate on the lines from OIS+100bps to OIS+50bps in November 2011, the basis widened to -62bps, through the implied floor.

Figure 3: ECB Excess Liquidity vs EURUSD 5y Xccy Basis Swap



Source: Bloomberg, TD Securities

ECB spillovers

Currently there is a tit-for-tat mentality in monetary policy across Europe. The more aggressive the ECB is on rate cuts, the greater the chance the Riksbank and Norges Bank will respond. However, we see low risk/reward playing this in Sweden, as we see little scope for more easing (5-10bps) or more QE from the Riksbank if the ECB meets our expectations. Indeed, the greater the optimism on European growth and the effect of ECB QE, the higher the incentive to position for a steeper curve in Sweden, in our view, with the caveat that disappointment is now increasingly more likely to be met with FX intervention rather than more QE.

We have also liked using Sonia forwards to position for higher rates in the UK as an ECB policy traction trade, and suggested playing this via steepening of the L H6/L H7 spread when it hit a low of 33bps at the end of October. The spread has since steepened 19bps, so we no longer see entry levels compelling from here.

Pessimists, meanwhile, are likely to find Norway the best vehicle to express that sentiment. 5yr Norway swap rates continue to trade ~22bps above their Jan low despite 50bps cuts in the deposit rate since then. If rates continue to drift much higher, and risks of an oil price shock rise in sync with any rising risks of further Norges bank cuts, we see opportunities to receive rates, and to position for the spread to Sweden 5yr swap to tighten.

Renuka Fernandez

Foreign Exchange

Approaching Peak Divergence in FX Markets

- Theme of growth/policy divergence, a key driver of FX markets in 2015, should transition towards convergence in 2016. This implies a tale of two halves for the USD vs. G10 as the longstanding bull rally is on its last up-leg.
- Bearish the EUR into early 2016 vs. GBP, JPY, CAD and will likely challenge parity vs. the USD. Peak in USDJPY may have already been observed. We are bearish commodity currencies, especially vs. GBP. Short NZDSEK and implement crash protection with AUDJPY put option.

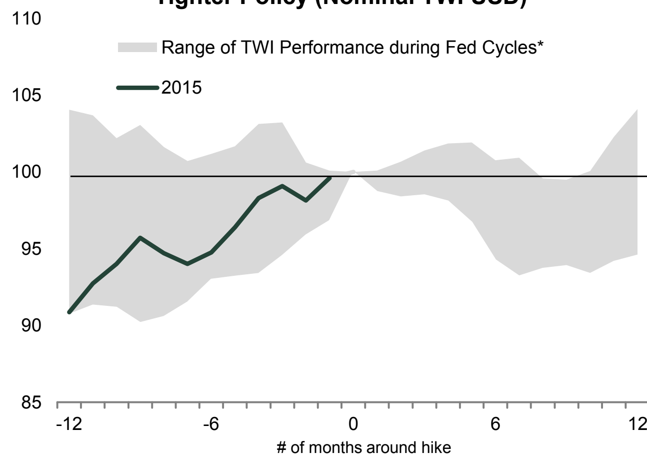
With the US dollar TWI on track for its third consecutive annual gain, a major question for markets is whether this remarkable bull run will extend to a fourth in 2016. To gauge this potential, we observe that the USD has benefitted greatly in recent years from two major macro themes intersecting with markets and economies: *divergence* and *deflation*. Of these, divergence has been the one most readily embraced by the FX markets. With still -resilient US growth setting up the Fed to be first out of the gate with rate hikes, capital has flowed into the USD. As other central banks have eased amid struggling domestic economies, capital has flowed out of these currencies. To date, the divergence story has been simple and straightforward.

Interestingly, divergent forces look likely to take on an added dimension in the final weeks of 2015. Indeed, widespread expectations for a December 'bazooka' from the ECB combined with the likelihood that Fed liftoff will also come that same month mean that divergence appears as potent and as obvious a FX market driver as it ever was. Ironically, however, we think this latest intensification of divergence may come to herald its turning point as a dominant theme in FX markets. Instead, we think 'Peak Divergence' may arrive in the early part of next year, suggesting a more complex backdrop for FX than what we have seen lately. By the time 2016 draws to a close, we think the market's conversation may instead be centred more on convergence and—possibly—reflation as key currency themes.

To be clear, both the Fed and ECB will remain on opposing policy paths for the foreseeable future. This may well keep other asset classes, such as rates, focused intently on the immediate differences in monetary policies. The key distinction for FX, however, is that these various trajectories look close to being fully priced into current trends in our view. If history is any guide, we expect markets to quickly shift gears to assessing the aftermath once the Fed and ECB both (finally) deliver on their promises.

From there, the key determinant will be the relative macro outlooks for the major economies. We see the US economy continuing its steady growth as Europe also gathers momentum.

The Dollar Tends to Lose Its Sizzle Once the Fed Embarks on Tighter Policy (Nominal TWI USD)



Source: Federal Reserve, TD Securities
*Major tightening cycles since 1985. Most recent data point used for November.

At the same time, China should begin to stabilize and help foster a broader EM recovery. Importantly, we see 2016 growth in most major economies at, or slightly above, potential. This scenario lets the Fed normalise carefully while other major central banks revert to a more neutral footing at a minimum. The alternative, of course, is the world slips into a global recession. While we downplay these risks, they are non-zero. In this environment, the Fed reverses course and eases further as policymakers elsewhere also redouble their stimulus efforts. Either way, we do not think the current malaise is likely to be sustained throughout 2016. It appears we have used up nearly all the 'middle ground' remaining and expect more clarity in the months ahead.

Either way, this suggests economic and financial conditions may be quite different at the end of next year than at its start. Accordingly, this has us looking for a similar transition in currencies. If we are correct that the main drivers rotate in coming months to a renewed focus on *convergence* and (nascent) hopes of *reflation,* then the two main pillars of support for USD rally look increasingly vulnerable. Current conditions leave us more confident in the convergence component than reflation, but experience teaches us that a year is a very long time in FX.

This suggests the USD may reach an important peak next year, but this process may have already started. If USDJPY fails to sustain new highs amid a more neutral BoJ, then we may have reached a key milestone in the dollar's peaking process. We note though, that it is a *process* rather than a singularity. The USD must still find its peak against EM, commodity, and European currencies independently, each in turn. Here, local conditions and policies will determine both timing and sequencing.

The USD's uptrend has further to run, but it now looks increasingly mature. The first Fed rate hike tends to coincide more closely with the end of a strong USD than its beginning. In

practical terms, this implies that 2016 could be a year of two phases for the USD. We fully expect the USD to start the year on a solid footing, but we are not as ambitious over longer horizons. We favour core USD longs into H1, but also like strategic opportunities in certain cross rates. The GBP should do well ahead of the BoE's first hike in Q2, but while the ECB will strive to keep the EUR weak in H1, we expect it to have a better second half. We think the JPY could surprise with a solid position-driven rebound. The commodity currencies are likely to remain soft but we see greater performance diversity there. Of these we remain cautious vs. CAD but see scope for gains against NZD.

Short EUR versus USD, JPY and CAD

With the ECB on course to launch additional QE, the balance of risk is clearly skewed towards EUR downside over the next several weeks in our view. The EUR remains a key funding currency, but investors should be aware of seasonal year-end repatriation flows. These are typically supportive of the common currency, but expectations of ECB easing provide an important offset. This leaves EURUSD likely to re-test the March lows at 1.0458, with some additional downside potential, but only temporarily. We think that once both the ECB and Fed deliver, the appeal of remaining short EURUSD may rapidly diminish. We would look to institute a trailing stop quickly to protect any accumulated profits. Also interesting, we think, is pursuing EUR downside on the crosses. The JPY and CAD look particularly appealing to us. We would look for a climb back to 1.45/1.46 before getting short EURCAD (target 1.40). For EURJPY we think 126.10 is an achievable initial target for a move lower.

Bullish GBP vs. EUR and commodity currencies

While they remain patient, the Bank of England should not be too far behind the Fed in normalizing interest rates. In itself, this reduces the market's singular focus on USD strength. We expect this to occur in May next year, sooner than where the market has it priced (Q3), but our view is more consistent with how we expect growth and inflation dynamics to unfold in the region. From a macro perspective, the economy boasts firming labor productivity and real wages which will support UK domestic demand. Should the Fed normalize rates as soon as December, that could put pressure on rates markets and pull forward BoE expectations even further. Meanwhile the risks of additional easing from the commodity producers remains nontrivial for these economies that are in the process of a growth rebalancing act. As such, we think long GBP positions versus the commodity crosses is attractive on a risk/reward basis. Policy divergence is also expected to weigh on EURGBP, but the BOE normalizing policy is a necessary condition to meet our mid-year target of 0.67 by mid-year. We prefer to sell a bounce above 0.75, however, as an ideal entry point. Brexit concerns would undermine GBP performance but we think this is more of a topic for late 2016/early 2017.

Top FX Trades for 2016

		Enter	Target	Stop
Short EUR	**vs USD**	1.0750	0.98	1.11
	vs. JPY	132.40	119	137
	vs. GBP	0.75	0.66	0.78
	vs. CAD	1.46	1.35	1.50
Long GBP	**vs. NZD**	2.30	2.80	2.10
	vs. CAD	1.96	2.15	1.90
Short NZDSEK		5.80	5.08	5.98
Short NZDCAD		0.8650	0.8000	0.8850
	Spot / Vol Ref	**Expiry**	**Strike**	**Cost**
Long AUDJPY put	87.00 / 21.7%	30-Apr-16	64.00	0.107% of AUD

Bearish NZDSEK

This trade epitomizes the transitional phase of our divergence/ convergence theme. We expect the RBNZ to cut to 2.50%, but risk of additional easing cannot be ruled out in 2016 with El Niño projected to be one of the worst in history. This could leave New Zealand's agriculture-intensive economy reeling, intensify the commodity/terms of trade shock and risk undermining an overinflated housing market. On the other hand, the Riksbank has become an activist central bank but there is only so much it can do to mitigate currency strength. Against a backdrop of firming domestic demand/inflation expectations and the ECB's expansive dovishness, we think the Riksbank will be compelled to accept more currency appreciation than it would prefer. If our upbeat outlook for growth to converge next year is correct, then this will be positive for SEK as this highly cyclical currency remains considerably leveraged to global growth expectations.

Bearish AUDJPY via Options

This position serves primarily as a hedge against our more rosy risk outlook overall (especially in a risk-off event emanating from EM), as AUDJPY tends to sell off sharply in periods of systemic risk aversion. That said, it also has a broader appeal. While a stabilization in China should be positive for high beta currencies like the AUD, a multi-year growth rebalancing towards services and eventual inclusion into the SDR basket should keep AUD performance biased to the downside especially with a chance of a cut by the RBA (which will depend on how fast the housing market corrects). If we are correct in assuming that the end of the USD rally is nigh, then we may have already seen the peak in USDJPY. Pension reallocation is largely complete and the BoJ has also signaled little appetite to renew unorthodox policy measures. JPY weakness is a positive for exports, but corporates have used this for balance sheet repair while seeing little follow-through on wages, which is problematic for domestic demand.

Ned Rumpeltin, Mazen Issa

Emerging Markets

It's Always Darkest Just Before Dawn

So far in 2015, emerging markets have experienced one of their worst years in at least a decade, and definitely the worst—on par with 2014—since the Credit Crunch and the Great Recession.

Some statistics may give a better sense of this debacle. Our global EMFX index shows year-to-date performance of -11% to the dollar, same as in 2014 but better than 2008, when the index contracted by more than 13%. Regional performance has been positively correlated, as usually is the case, but the selloff was driven by Latin America this year (-16% YTD and worst performance since 2001) while in 2014 it was EMEA (-18% and also worst since 2001). Both in 2014 and 2015, AxJ currencies outperformed other regions and the global index, confirming our Asia overweight call. Nonetheless, 2015 has been the worst year for Asian currencies since 2001.

EM stocks have behaved similarly, with the MSCI index recording a contraction for a third year in a row. Surprisingly, in the three years through 2015, EM stocks and FX have recorded the longest streak of negative performance since the early 2000s, while rates have remained resilient after the 2013 Taper Tantrum.

So what to expect next year? Will 2016 be the year of the rebound or rather feature an extension of the adverse trend?

We think 2016 will remain transitional, with chances to see better EM performance in the second half, while H1 2016 may still exhibit high volatility as markets receive and fully digest Fed tightening. So investors should still expect a bumpy ride.

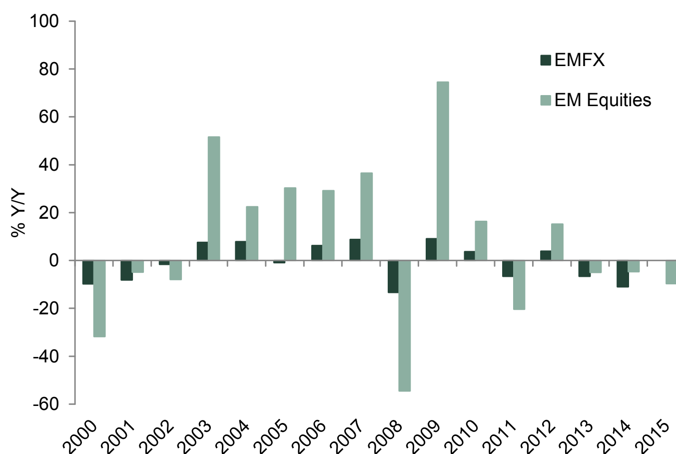
In order to assess the 2016 outlook, we focus on four main factors—Fed tightening, assessment of China risks, EM growth vs inflation dynamics, and EM-specific political risks.

External risks remain in the driver's seat for now, but likely to ease in H2 2016

Fed and China remain the most important factors in determining the performance of EM assets. Historical correlations show that monetary tightening in the US is generally negative for EM bonds, stocks and currencies, while different EM asset classes exhibit positive correlations in selloff scenarios. Empirical evidence, however, shows that uncertainty ahead of the first move rapidly dissipates after the Fed takes its first steps.

We expect this process to be well ingrained by end-H1 2016. We now expect an earlier Fed hike in December, which means the EM reaction could be more negative than with a March liftoff as tightening would happen at a time that markets are less liquid. But as markets see the first several hikes, possibly receive some clarity on the pace, and with a tightening cycle already priced in, there should not be much left in the way of lower volatility.

EM FX vs Equity Annual Performance



Source: Bloomberg, TD Securities

The biggest obstacle, however, is a further deterioration of China fundamentals or the perception of risks thereof. In 2015, worries about the real economy have been exacerbated by the fact that the government is still strongly focused on growth targets, which primes the market to be worried more about the deceleration than it should be. But deceleration is natural, needed, and a by-product of the ongoing efforts to transition the growth model and reform the financial sector. Moreover, China's economy at around $10.8tn in 2015 will be double its 2009 size, and though the pace of growth has slowed from 11.7% to 6.9% over this period, its contribution to global growth has remained nearly unchanged.

However, the financial risks are more important, and one should neither neglect nor overstate them. Bad loans are a burden on banks, while the Chinese equity and rates markets are not mature. At least to some extent dysfunctional, which exposes the limitations of policymakers in transitioning to proper functioning markets. As a consequence, capital allocation is either impeded or inefficient, dysfunctions are carried forward, but a real opening to market rules will have to wait longer.

Given these financial risks, the likelihood of a worst-case scenario is small, with the government still in control of the situation as local markets are not deregulated enough yet. FX and capital flow risks are slightly more concrete, but if a capital account crisis ever flared, policymakers would likely impose additional restrictions on capital flows to support the yuan until they rode it out of trouble.

We can possibly conclude that Chinese authorities have learned their lesson and will not commit another policy error on CNY like the poorly-executed August devaluation. This should help restore confidence that tail risks remain as such, help volatility recede and EM assets find better grounds for performance in 2016.

Surging EM political risks require more differentiation

That EMs were stuck in a low-growth cycle has been a theme for 2015. Large economies such as Brazil and Russia will be contracting this year and possibly next. Growth in South Africa and Turkey slowed down this year, and will at best show only a modest pick-up next year, while most of Asia is failing to gain traction. India is a relative bright spot, but together with Indonesia and Malaysia, will continue expanding below potential.

The international context continues to penalize some of the most export-oriented EMs, a situation that should find a bottom and eventually start reversing in 2016. But while for some the economic turnaround may happen next year, others will continue to see their potential output decline as policymakers have lost their opportunity to introduce reforms and make higher growth rates sustainable in the future. This points at risks that the likes of Brazil, Turkey and Russia may fall in the 'middle-income trap,' as historically happened to the vast majority of EMs.

However, the market has been discounting these risks in a differentiated manner with EMFX showing correlation levels approaching the late-2007 lows. Declining correlations mean more attention to local factors, but by no means does it assure that local risks are correctly priced by the market. The recent rise in political risks has in fact created opportunities to trade the market mispricing. We think Turkey is one of these cases, where the market has remained very complacent for too long, but as political risks fail to wane, we see an opportunity to trade Turkey against Brazil, where risks have been widely discounted and possibly even beyond reasonable.

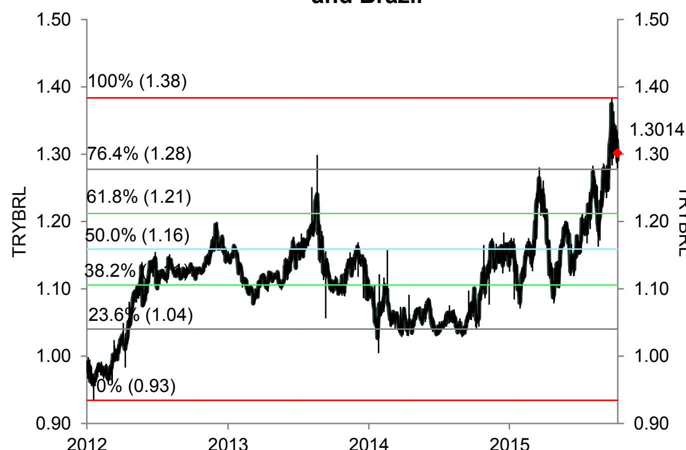
Other countries that may be negatively affected by the combination of political risks and subdued commodity prices are Russia and Malaysia. In the former, we want to see sanctions lifted before returning to a more constructive view, while in the latter, the government remains at risk given the allegations against PM Najib. South Africa's economic performance is also lackluster as politics has failed to transition to a different growth model, from a cheap-labor, high-commodity price one.

Finally, we continue to like quality in terms of low political risks or high proclivity to reforms and good fundamentals. In this group, we include India, Mexico, Indonesia (though the market remains skeptical on the government capability to deliver on reforms), and CEE economies, such as Hungary and Poland (but the new government will need to be settled in before the market restores confidence on risks of populism).

Short TRYBRL on relative risk mispricing

In 2015, Brazil capitulated to market pressure under a broad set of macroeconomic imbalances. Political risks have also played

Short TRYBRL on Market Mis-pricing of Risks in Turkey and Brazil



Source: Bloomberg, TD Securities

out poorly, with President Dilma Rousseff at risk of impeachment, fiscal consolidation under threat and, eventually, a full downgrade to junk more likely than not in 2016. The market, however, has priced in a great deal of these risks and even if a downgrade remains a likely scenario, 5yr CDS already trade in line with a split 'BB/BB–' rating, which is two notches below current levels taking the average rating from the three major agencies. In a nutshell, the market may not be pricing in a worst-case scenario yet, but Brazil assets do discount a lot of the possible negative outcomes.

Trade Recommendation: Short TRYBRL
Enter: 1.32
Target: 1.10
Stop: 1.40
Carry: +29bps/month

On the contrary, the market has been unreasonably complacent with Turkey, where political risks won't fade after the election. The AKP has singlehandedly won a parliamentary majority in November, but even before a new government is born, the AKP's rhetoric turned particularly aggressive. Polarization in the country is set to rise, reflecting the ongoing feuds between those who oppose the political establishment and their supporters. With politics focused on regaining full control of power, there won't be much space for the reforms needed to overhaul the economy.

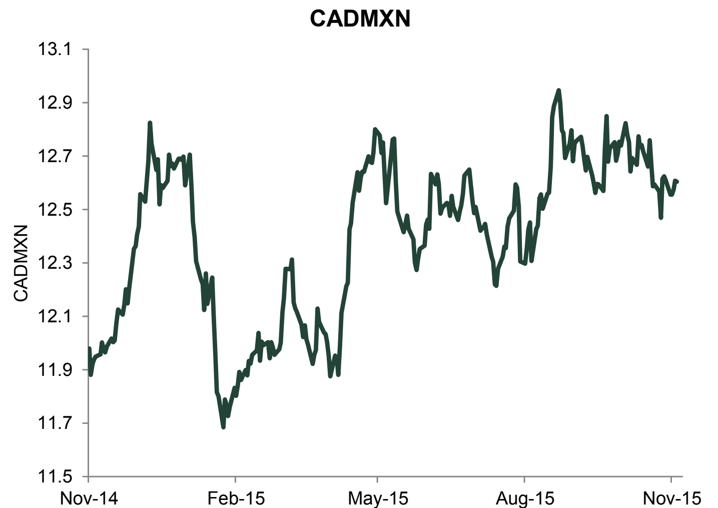
We recommend trading divergence in Brazil vs Turkey risks in 2016 with a short TRYBRL position, targeting 1.10, stop loss at 1.40 (risk-reward 2.8:1 and +29bps/month of positive carry).

Short CADMXN on diverging rate expectations

We recommend short CADMXN positions principally because we expect that Banxico and BoC monetary policy are set to diverge. This year and next, we think that Banxico will slavishly follow the Fed, exactly matching any US rate hike. Governor Carstens has

on a number of occasions said that Banxico will not automatically follow the Fed, but we think that when push comes to shove, that is precisely what they will do, particularly in response to the first Fed hike. Therefore, we expect Banxico to hike its Overnight Rate by a total of 100bps between now and the end of 2016, the same as the Fed. On the other hand, we expect the BoC to keep rates on hold well into 2017 with risks in the near-term skewed to the downside. The widening short-term rate differentials should help push CADMXN lower.

Trade Recommendation: Short CADMXN
Enter: 12.65
Target: 11.85
Stop: 12.90
Carry: +21bps/month



Source: Bloomberg, TD Securities

Mexico and Canada have a lot in common. Their economies are both strongly linked with that of the US and their currencies are both, more or less, regarded as commodity currencies. Next year we expect a pick-up in growth in both Mexico and Canada. In Canada, the pick-up will be mainly because the natural resources sector will no longer be providing such a drag on growth. In Mexico, we expect that the reform program will finally start showing clear signs of feeding through to the growth numbers.

Although next year we are generally positive on the outlook for EMFX, we think that outright USDMXN positions are too risky as there could be significant volatility, particularly around any Fed rate hikes even if they are matched by Banxico hikes. Short CADMXN positions instead have historically shown lower volatility than for USDMXN positions.

We recommend short CADMXN (current spot 12.65), targeting 11.85 with a stop at 12.90 over a period of 12m (risk-reward 3.2:1 and +21bps/month of positive carry).

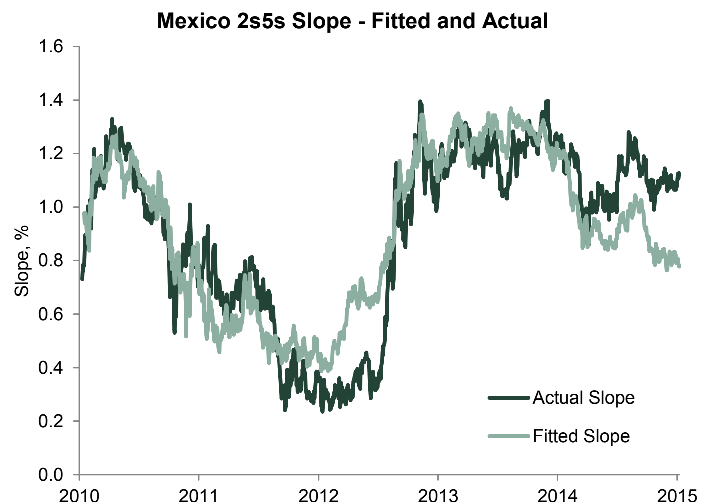
Mexico curve still too steep—Look for flatteners

Whether looking at the short-end or the longer-end, we think that the Mexico curve is too steep, particularly relative to the US curve. The TIIE curve is pricing in about 128bps in rate hikes by the end of 2016. This is more than the 100bps we are expecting or the 78bps currently priced into the US curve.

Trade Recommendation: MXN TIIE 2s5s flatteners
Enter: 114 bps
Target: 85 bps
Stop: 125 bps
Carry/Roll: -2.1bps/month

Looking further out along the TIIE curve, our regression model shows that the 2s5s slope is too steep. Historically the main drivers of the 2s5s TIIE slope have been the US 2s5s slope and the overall level of Mexican rates, higher rates tending to be associated with flatter curves. The chart shows that, based on a historical regression, the 2s5s slope, currently at around 114bps, is about 33bps too steep. Also in the 2s5s sector, the TIIE curve is the steepest of all the major EM curves.

There are a number of trades that can be structured around these observations. A trade which directly takes advantage of our view that too much is priced into the short-end of the TIIE curve is to receive 1y/1y forward TIIE rates at 4.89% (the 1y TIIE rate is 3.90%). However, although we think that this trade will ultimately prove profitable, we are loath to recommend a long rates trade in an environment where we expect rates to move higher.



Source: Bloomberg, TD Securities

So we recommend a 2s5s TIIE flattener, with an entry level of 114bps, a target of 85bps and a stop loss of 125bps (risk-reward 2.6:1 and a negative carry and rolldown of -2.1bps/month).

Cristian Maggio, Paul Fage

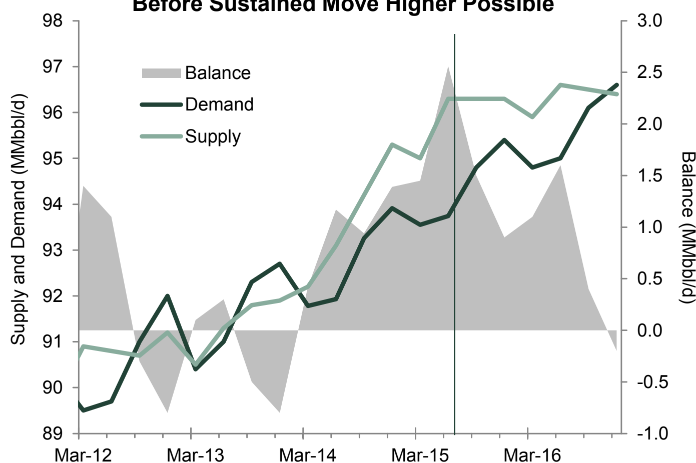
Commodities

Commodity Bear May Still Get Grumpier Before its Ready to Cuddle

Following a year of weakness and the risk of an additional correction in the latter part of the year, the commodity complex including crude oil, base metals and precious metals will likely continue to be under considerable selling pressure through early-2016. The energy complex still looks at risk of dropping even lower due to OPEC's aggressive over-quota sales, a steadfast US production profile, and pending new supplies from Iran in the aftermath of its nuclear weapons deal with the P5+1 group, which are all expected to create large surpluses well into the second half of 2016. Meanwhile, the industrial metals are vulnerable to an additional correction due to disappointing Chinese growth, outsized inventories and investors who are ready to go short. If the negativity emanating from industrial metals and the energy complex weren't enough, gold too is expected to trend lower as the rising probability that the Fed pulls the trigger on higher rates in December lifts the USD and increases carry costs. The strengthening dollar in the early part of 2016 along with higher US policy rates will also go a long way in pressuring oil and base metals, as it lowers production costs and makes commodity purchases more expensive outside the US.

But the negative trend is unlikely to prevail for the entire year. The promise of supply declines on the part of miners and oil producers, the need to rebuild inventories, and stabilizing demand from China should all start to help tighten physical fundamentals and provide relief to oil, zinc and nickel. The period following a prolonged trough should also see an increase in investor interest, as the first-to-tighten Fed will only lift rates modestly and other central banks such as the PBoC and the ECB will have finished adding new stimulus and the USD starts to wane. It is wise to remember that the cure for low commodity prices is low prices—as they force money losing operations to cut output.

Fundamentals Point to More Bad Oil Price News Before Sustained Move Higher Possible



Note: comprised of crude oil, condensates, NGLs and non-conventional-sourced
Source: Bloomberg, IEA, TD Securities

Crude oil, zinc and nickel all continued to perform poorly in early-November, as it became increasingly clear that OPEC will not cut production and on the expectation that recent China stimulus will take time to work its way through the economy. But these commodities should perform significantly better as Chinese green shoots mature into more robust demand while supply cuts tighten markets. Unfortunately, projected demand increases and supply cuts will do little to help lift aluminum and copper. Meanwhile, after dropping in response to tighter Fed policy, gold should perform better as real rates drop—the Fed will take a guarded approach to monetary policy tightening and inflation is expected to return back to target.

Trade Recommendation: Maintain current short bias until price corrects back to support in order to get long WTI.
Enter: $42.50/bbl.
Target: $60.00/bbl.
Stop: $32.50/bbl.

Crude oil will likely move lower in the latter part of 2015 and early-2016, as excess barrels will find it hard to find a home amid a struggling demand environment. While seasonal factors that see petroleum inventory builds morph into draws have the potential to trigger some short covering over the next couple weeks, the North American crude benchmark is unlikely to break through the 100 day MA (rolling contract) just above $49/bbl. The poor global supply/demand fundamental will likely reverse any rally that may materialize in the near term. WTI is likely to test the lows posted back in October.

Despite the very large declines in US drilling activity (-64% from the peak), US crude production has fallen only 5.1% and continues to remain strong in the face of low spot prices. Conversely, since many producers are very well hedged, additional large US production declines are unlikely to materialize until late next year. At the same time, global production remains very firm as OPEC continues to produce some 2.2 million bbls above its stated quota and Iran will increase its contribution to the global market as it is once again allowed free access in the aftermath of the P5+1 nuclear agreement. This all suggests that the global oil market place will see some 1.3 million bbls pumped into storage tanks each and every day over the next nine months or so.

However starting in Q3 2016, the global market is projected to start posting deficits as non-OPEC producers cut output by some 1.2 million bbls/d from the Q3 2015 high. This inflection in deficits and the fact that neither OPEC nor western world oil firms have invested in new capacity suggests that global crude market will tighten up in the latter part of 2016.

Trade Recommendation: Stay long XAU/XAG ratio, but take profit and go short at target level.
Enter: 77.5x.
Target: 69.0x.
Stop: 80.0x.

While the precious metals market is likely to strengthen somewhat in the second half of 2016, the complex will likely have a bout of considerable weakness into the next quarter or so as the Fed readies to pull the trigger on higher rates. Higher US policy rates suggest that the USD and short term yields will all move higher, which increases the USD cost of carry. Any additional QE action on the part of the ECB is another reason why gold and silver may be under pressure in the latter part of 2015 and early-2016 due to the strengthening USD impact this would no doubt have.

Considering silver's traditionally higher volatility and a historic weakness during periods when investors are sour on gold, silver underperforms. This should also be augmented by weak EM industrial activity in the near term. Conversely, recovering precious metals markets suggest that gold will recover less robustly relative to silver.

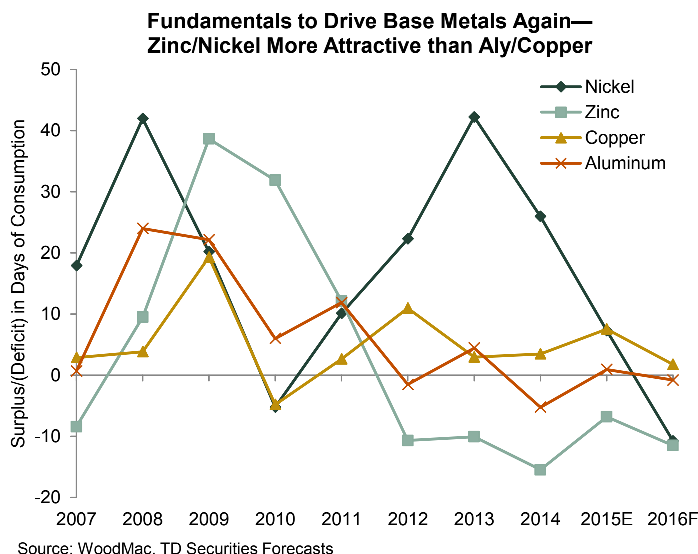
As the Fed tightens, we see silver continuing to underperform (maintain our long XAU/XAG ratio) gold, but as inflation starts taking its trajectory back to target and markets confirm the US central bank will be very measured in how it removes monetary accommodation, the precious sentiment should improve as real yield increases fade. Once the market prices in the first few Fed hikes and sees no new increases, both metals should rebound from cyclical low territory. Any renewed investor interest in gold and silver should help the white metal first, especially since industrial demand is likely to have improved by then as well.

Trade Recommendation: Long zinc—Short aluminum spread.
Enter: $142/t.
Target: $700/t.
Stop: flat.

The base metals story will be predicated on how well China can rebound. After methodically cutting benchmark lending rates/ required reserve ratios, slashing sales taxes on small car sales, lowering down payment requirements on home purchases, devaluing their currency by as much as 4% at one point to the USD, and enacting targeted infrastructure spending stimulus announcements among other factors, the year ahead should provide decent demand growth for commodities, at least in absolute terms.

Base metals will benefit from growing demand, with the US continuing to expand and Europe stabilizing once again, as renewed QE measures provide a lift. TD expects global growth to increase from 3.1% in 2015 to 3.4% in 2016. Emerging markets will be a sore spot though, keeping our upside expectations tempered for now, as well as the transitioning Chinese economy away from materials-intensive infrastructure growth to consumer spending-led growth. The broad themes we will continue to watch in China are unsold home inventory drawdowns, the seemingly good sign that starts and construction activity are picking up in the country, after the price gains and sales activity we have already seen, along with the above noted stimulative measures feeding through. Auto sales should also pick up further as consumers become wealthier, and infrastructure spending is also likely to expand in order to shore up local government finances.

Fundamentals to Drive Base Metals Again—Zinc/Nickel More Attractive than Aly/Copper



Source: WoodMac, TD Securities Forecasts

While the view on demand is one of more optimism than what resulted in 2015, the supply side factors will help to tell the relative story between the base metals. In particular, we prefer to express our relatively more bullish view on the zinc market versus the aluminum market, on a pickup in demand. Despite the recently announced cutbacks in both metals, the zinc market will see strong drawdowns of refined and concentrate stockpiles to historically low levels. On the other hand, aluminum still has plenty of above-ground stockpiles to use up, exchange visible stocks shifting off to opaque non-exchange reported stockpiles, and the market will likely still need to contend with Chinese aluminum overproduction and exports to the rest of the world. Government support of the sector in order to keep employment stable will keep Chinese smelters producing despite the fact that prices are insufficient to cover total costs.

Bart Melek, Mike Dragosits

Forecasts

			G10 Rates Forecasts								
			Spot	2016				2017			
			Nov 10, 2015	Q1 F	Q2 F	Q3 F	Q4 F	Q1 F	Q2 F	Q3 F	Q4 F
DOLLAR BLOC	United States	Fed Funds Rate	0.25	0.75	1.00	1.25	1.25	1.50	1.75	1.75	1.75
		3m	0.13	0.50	0.75	1.00	1.00	1.25	1.50	1.50	1.50
		2y	0.87	1.25	1.50	1.75	1.75	1.85	2.10	2.10	2.10
		5y	1.72	2.00	2.10	2.25	2.25	2.35	2.45	2.45	2.45
		10y	2.33	2.45	2.50	2.50	2.50	2.55	2.65	2.75	2.80
		30y	3.10	3.15	3.20	3.20	3.20	3.20	3.25	3.30	3.35
	Canada	Overnight Rate	0.50	0.50	0.50	0.50	0.50	0.50	0.50	1.00	1.25
		3m	0.44	0.45	0.45	0.45	0.50	0.55	0.80	1.15	1.20
		2y	0.66	0.65	0.75	0.80	0.90	1.05	1.20	1.50	1.75
		5y	1.02	1.20	1.30	1.45	1.55	1.65	1.80	2.00	2.25
		10y	1.72	1.90	2.00	2.10	2.15	2.25	2.35	2.50	2.65
		30y	2.41	2.45	2.50	2.60	2.65	2.75	2.85	3.00	3.15
	Australia	Cash Target Rate	2.00	2.00	2.00	2.00	2.00	2.25	2.50	2.75	3.00
		3m	2.22	2.15	2.15	2.20	2.45	2.55	2.70	2.95	3.20
		3y	2.06	2.10	2.15	2.30	2.35	2.65	2.80	3.05	3.30
		5y	2.32	2.35	2.45	2.60	2.80	3.05	3.30	3.50	3.70
		10y	2.89	2.90	3.00	3.15	3.25	3.40	3.60	3.80	4.00
	New Zealand	Cash Target Rate	2.75	2.50	2.50	2.50	2.50	2.75	3.00	3.25	3.50
		3m	2.90	2.60	2.60	2.70	2.65	2.90	3.20	3.45	3.70
		2y	2.68	2.45	2.60	2.65	2.75	3.10	3.30	3.55	3.75
		3y	2.78	2.75	2.85	2.95	3.15	3.45	3.70	3.90	4.00
		10y	3.24	3.40	3.45	3.60	3.70	3.90	4.05	4.15	4.25
EUROPE	Germany	ECB Refi Rate	0.05	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15
		3m	-0.37	-0.30	-0.30	-0.30	-0.30	-0.30	-0.30	-0.20	-0.10
		2y	-0.35	-0.30	-0.15	-0.10	-0.05	0.05	0.20	0.25	0.35
		5y	-0.07	0.10	0.30	0.45	0.60	0.75	0.95	1.20	1.30
		10y	0.63	1.00	1.25	1.35	1.50	1.55	1.65	1.80	1.90
		30y	1.52	1.60	1.70	1.85	2.00	2.10	2.15	2.30	2.35
	UK	Bank Rate	0.50	0.50	0.75	1.00	1.00	1.25	1.50	1.75	1.75
		3m	0.50	0.65	0.90	1.05	1.10	1.35	1.60	1.85	1.85
		2y	0.71	1.05	1.30	1.55	1.60	1.80	2.00	2.20	2.20
		5y	1.38	1.85	2.10	2.30	2.35	2.50	2.70	2.85	2.85
		10y	2.03	2.20	2.30	2.40	2.50	2.60	2.75	2.90	3.00
		30y	2.69	3.25	3.30	3.40	3.50	3.55	3.65	3.75	3.80
	Norway	Deposit Rate	0.75	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
		3m	0.66	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20
		2y	0.64	0.45	0.55	0.60	0.75	0.85	1.05	1.15	1.25
		4y	0.81	0.80	0.85	0.90	1.10	1.20	1.50	1.70	1.90
		10y	1.57	1.45	1.55	1.65	1.80	1.90	2.00	2.15	2.30

Forecasts

G10 FX Forecasts	Spot	2016				2017			
	Nov 10, 2015	Q1 F	Q2 F	Q3 F	Q4 F	Q1 F	Q2 F	Q3 F	Q4 F
USD/JPY	123.3	125	123	120	118	118	120	122	122
EUR/USD	1.07	1.03	1.06	1.10	1.12	1.15	1.15	1.20	1.20
GBP/USD	1.51	1.49	1.58	1.62	1.65	1.64	1.64	1.67	1.67
USD/CHF	1.01	1.04	1.01	0.97	0.96	0.92	0.94	0.92	0.92
USD/CAD	1.33	1.40	1.37	1.35	1.33	1.28	1.25	1.20	1.20
AUD/USD	0.70	0.67	0.67	0.69	0.70	0.72	0.74	0.76	0.76
NZD/USD	0.65	0.61	0.59	0.57	0.56	0.58	0.58	0.60	0.61
EUR/NOK	9.28	9.25	9.20	9.15	9.10	9.05	9.00	9.00	9.00
EUR/SEK	9.31	9.05	8.80	8.65	8.50	8.50	8.50	8.50	8.50
DXY	99.4	102.5	99.4	96.2	94.5	92.5	92.6	89.8	89.8

Emerging Market Forecasts		Spot	2016				2017			
		Nov 10, 2015	Q1 F	Q2 F	Q3 F	Q4 F	Q1 F	Q2 F	Q3 F	Q4 F
Central Bank Rates	Brazil	14.25	14.25	14.25	14.25	13.75	13.50	13.00	12.50	12.00
	Mexico	3.00	3.50	3.75	4.00	4.00	4.25	4.50	4.50	4.50
	India	6.75	6.50	6.50	6.50	6.50	6.75	6.75	7.00	7.00
	Indonesia	7.50	7.25	7.25	7.25	7.25	7.25	7.25	7.25	7.25
	Malaysia	3.25	3.50	3.75	4.00	4.00	4.25	4.50	4.75	5.00
	Poland	1.50	1.00	1.00	1.00	1.00	1.25	1.50	1.50	1.75
	Hungary	1.35	1.35	1.35	1.35	1.60	1.85	2.10	2.10	2.35
	Russia	11.00	10.25	10.00	9.75	9.50	9.50	9.50	9.00	9.00
	Turkey	7.50	8.50	10.00	10.00	10.00	10.00	10.00	10.50	11.00
	South Africa	6.00	6.50	6.50	6.75	6.75	6.75	6.75	6.75	6.75
EM vs USD	USD/BRL	3.80	4.03	3.98	3.85	3.75	3.70	3.70	3.63	3.60
	USD/MXN	16.81	17.07	16.65	16.55	16.35	16.44	16.48	16.43	16.40
	USD/CNY	6.36	6.40	6.40	6.45	6.45	6.50	6.50	6.50	6.50
	USD/INR	66.31	65.70	65.40	65.00	65.20	65.20	65.30	65.30	65.50
	USD/IDR	13619	13800	13600	13500	13400	13400	13450	13450	13450
	USD/MYR	4.38	4.50	4.50	4.45	4.40	4.40	4.30	4.30	4.25
	USD/PLN	3.97	4.23	4.01	3.86	3.77	3.65	3.61	3.46	3.40
	USD/HUF	292	305	292	280	272	263	263	250	245
	USD/RUB	64.49	66.70	64.00	63.00	61.00	60.50	60.00	60.00	59.00
	USD/TRY	2.92	3.20	3.30	3.35	3.40	3.50	3.50	3.50	3.60
	USD/ZAR	14.34	15.00	15.30	15.75	16.00	16.00	16.00	15.90	15.90
EM vs EUR	EUR/BRL	4.06	4.15	4.22	4.24	4.20	4.26	4.26	4.36	4.32
	EUR/MXN	17.98	17.58	17.65	18.21	18.31	18.91	18.95	19.72	19.68
	EUR/INR	71.19	67.67	69.32	71.50	73.02	74.98	75.10	78.36	78.60
	EUR/IDR	14638	14214	14416	14850	15008	15410	15468	16140	16140
	EUR/MYR	4.71	4.64	4.77	4.90	4.93	5.06	4.95	5.16	5.10
	EUR/PLN	4.25	4.35	4.25	4.25	4.22	4.20	4.15	4.15	4.08
	EUR/HUF	313	314	310	308	305	302	302	300	294
	EUR/RUB	68.96	68.70	67.84	69.30	68.32	69.58	69.00	72.00	70.80
	EUR/TRY	3.12	3.30	3.50	3.69	3.81	4.03	4.03	4.20	4.32
	EUR/ZAR	15.34	15.45	16.22	17.33	17.92	18.40	18.40	19.08	19.08

Forecasts

		Commodities Forecasts								
		Spot	2016				2017			
		Nov 10, 2015	Q1 A	Q2 A	Q3 A	Q4 F	Q1 F	Q2 F	Q3 F	Q4 F
Precious metals	Gold *	1089	1075	1100	1150	1200	1200	1175	1125	1075
	Silver *	14.39	14.00	14.75	15.75	16.50	16.55	16.25	14.90	14.75
	Platinum *	907	1025	1150	1200	1250	1250	1300	1300	1300
	Palladium *	599	700	750	800	850	850	850	900	900
Other metals	Copper **	2.26	2.28	2.30	2.25	2.25	2.20	2.25	2.50	2.50
	Zinc **	0.74	0.88	0.96	1.04	1.10	1.15	1.15	1.20	1.20
	Lead **	0.75	0.84	0.92	0.97	1.02	1.05	1.05	1.10	1.10
	Nickel **	4.33	5.25	5.75	6.00	6.25	6.75	7.25	8.00	8.00
	Aluminum **	0.68	0.72	0.74	0.74	0.78	0.78	0.80	0.84	0.84
	Molybdenum +	4.70	5.25	5.50	6.50	7.50	8.00	8.00	9.00	9.00
	Iron Ore *+	47	55	60	62	62	70	70	75	75
Energy	Nymex Crude Oil +-	44	44	46	54	62	64	64	66	66
	Brent Crude Oil +-	48	47	50	59	68	70	70	72	72
	Heating Oil -+	1.49	1.45	1.50	1.70	1.95	2.05	2.00	2.05	2.15
	Gasoline -+	1.37	1.40	1.55	1.65	1.70	1.90	2.05	2.05	1.95
	Natural Gas --	2.31	3.00	2.75	3.25	3.00	3.25	3.10	3.60	3.80
	AECO Natural Gas --	1.87	2.30	2.15	2.55	2.40	2.55	2.50	2.90	3.20
	Newcastle Thermal Coal-	62	55	58	65	75	80	80	85	85

Commodity forecasts are period averages

**London PM Fix $/oz.*

+ Molybdenum equivalent to moly oxide, FOB USA

+- $/bbl

-- $/mmbtu

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