GLOBAL MACRO DEPARTMENT
UNITED STATES REGIONAL MARKET REPORT

NUS INVESTMENT SOCIETY

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Abstract

The United States of America boasts the largest national economy in the world. Because of its dominance and openness, economic fluctuations in the U.S. have wide-ranging impacts on both the local economy and in financial markets internationally. In spite of its apparent strength, however, the year 2015 saw a rise in volatility in its financial markets, the most striking event being the 'Black Monday and Tuesday' stock market crash on the 24-25th August 2015, the Dow's biggest sell-off in four years. More significantly, on 16th December 2015, the U.S. Federal Reserve raised interest rates for the first time since 2006, amidst an unexpectedly strong jobs report in November and robust GDP growth. In lieu of these key events, investors want to know how to profit from macroeconomic trends in the U.S. economy. Therefore, this section of the market report will attempt to answer that question by providing a technical and macroeconomic analysis of significant market trends in the U.S. economy, describing the possible implications of the interest rate hike on financial markets, as well as providing suggestions as to how sharp-eyed investors may profit future trends.

United States

Economy in Brief

The U.S. has the world's largest and most technologically advanced economy in the world, representing 20% of total global output, which is still larger than that of China. According to the IMF, the U.S. has the sixth highest per capita GDP (PPP), surpassed only by small countries such as Norway and Singapore. It is principally a service economy, with such sectors like real estate, business services and finance representing the largest chunk of GDP. The U.S. also has an important manufacturing base, which represent roughly 15% of GDP. It is also the 2nd leading exporter of goods and services in the world and the number one leading importer. It mainly exports high-value capital goods and manufactured products, including industrial machinery, airplanes, motor vehicles and chemicals.

2015 Technical Summary of the S&P 500 Index

Figure 1: S&P 500 Index of U.S. listed shares

2015 begin with the S&P trading within a narrow range, with an explosion in volatility towards the second half of the year. Following the devaluation of the yuan in late August, the S&P broke sharply downwards of its range and fell by 236 points between August 18 and August 25 (Figure 1). This massive stock-market selloff was collectively known as 'Black Monday and Tuesday'. September continued to reflect extreme volatility in the markets while October, which is historically a bearish month for the S&P, saw instead a massive rally from a low of 1880 to a high of 2114, bringing the S&P back into positive territory for the year. Financial markets continued to range between support at 2020 and resistance at 2100 before the interest rate hike on December 16th. Contrary to popular belief, the market reaction to the news of the interest rate hike was relatively weak. Technical analysis suggests that current price action on the S&P indicates no clear trend, with low to moderate volatility. Our technical forecasts for the coming months is that the S&P will continue to range sideways in early 2016.

Monetary Policy: A Historic Rise in U.S. Interest Rates

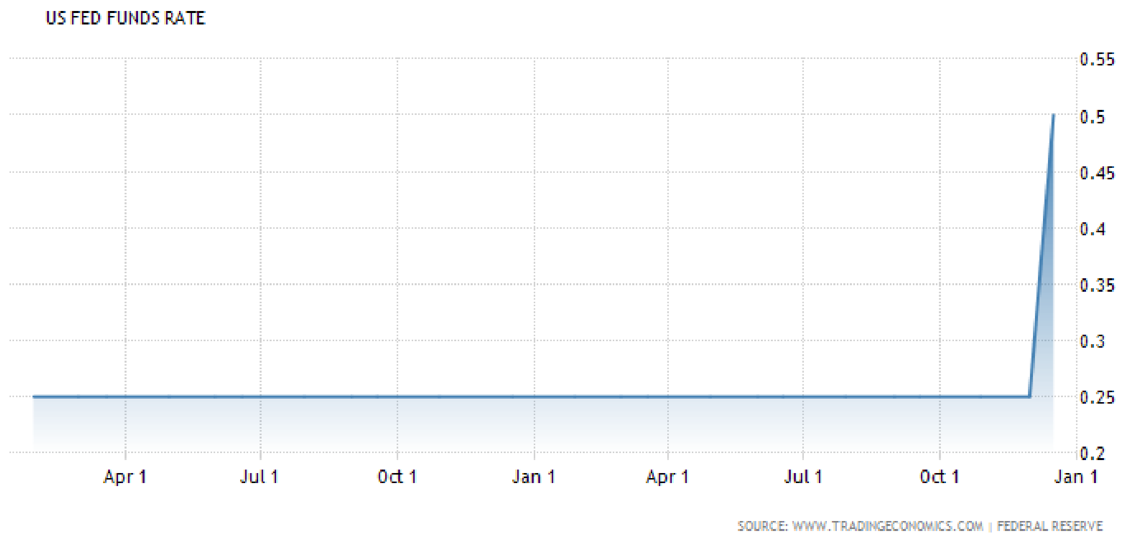

Figure 2: U.S. Interest Rates

On 16th December, the Federal Open Market Committee (FOMC), which is the branch of the U.S. central bank that decides interest rates, decided to raise the Fed Funds Rate by 0.25%, its first hike since the recession. Traditionally, macroeconomic decisions of such tend to have a significant impact on financial markets, but the relatively small magnitude of the rate hike calls that into question. Nevertheless, for the rest of this report, the implications of an interest rate hike will be separated into short-term trends and long-term trends to expect.

Traditionally, in the short term, there are a number of things that investors and traders expect from a rate hike. An increase in interest rates usually implies higher returns on interest-rate products such as bonds. As bonds return higher yields, they also become increasing attractive compared to stocks. More money should be tied up in savings and interest-rate products rather than on stock-market investments. Therefore, there is a tendency for stocks to correct downwards.

However, in this occasion, the interest rate hike is relatively small at 0.25% and the immediate effect of that on financial markets is likely to be equally insignificant. First, an appreciation of 0.25% on the savings rate is unlikely to convince most investors to switch their capital from the stock market to savings or bonds. Second, the Fed only increased short-term rates while the interest rate on longer-term products like 10-year bonds remains stagnant around 2.29%. Finally, interest rates are only increased in response to inflationary pressures. This time round, inflation is at a mild 0.5% (or 2% after stripping food and energy prices) which is exactly where the Fed wants it to be. This leads us to believe that the contractionary effect on the S&P is likely to be small, if there is to be an effect at all.

Monetary Policy: Long Term Implications

In the longer-term, it is far more difficult to predict the direction of the stock market. However, current macroeconomic data leads us to believe that the S&P is due for a mild uptrend, although our outlook on specific sectors is pessimistic.

Historically speaking, as interest rates rise, so does the stock market in the same timeframe. This is due to the fact that a rate hike usually implies robust economic conditions, and robust economic conditions spur higher discretionary spending and corporate earnings growth. As of 20th December 2015, U.S. GDP growth is growing at 2.10%, its jobless rate is stable at 5.00% and inflation is at a reasonable 0.50%. In lieu of positive macroeconomic data, investors bullish on the States might choose to profit from this by going long on the SPDR S&P500 ETF Trust (Standard and Poor's 500 Index). Investors should hold onto this position as the Fed continues to raise interest rates in the near future, but make further evaluations pending future macroeconomic news. Additionally, in an interest rate cycle, financial companies tend to outperform others. If investors choose not to make any bets on the S&P as a whole, they should consider buying into financial stocks.

On the bear side, the U.S. economy is also marred by weak commodity and manufacturing sectors. For example, at the time of writing, soybeans and oil, two of the U.S.' key exports, are on long-term downtrends, and low commodity prices may dampen U.S. businesses more than the Federal Reserve expects. Traditional investing wisdom suggests that we should sell of weakness and buy on strength. Thus, bearish investors might choose to express this sentiment by short-selling the commodity sector through ETFs like USO (United States Oil Fund).

Key Forecasts for the S&P in 2016

Price action on the S&P index is ultimately defined by the relative strength of its individual sectors, some of which, like commodities, are underperforming relative to others. As a whole, the U.S. economy appears to be recovering which should mean corresponding strength in its benchmark index, the S&P, due to investor confidence. This potential for growth is, however, held back by the possibility of a severe energy collapse in the coming months which would imply a considerable downside risk on the S&P. This is exacerbated by macro-risks such as a slowing Chinese economy, a weak Eurozone and a stronger dollar. Our outlook is that S&P growth in 2016 will be relatively weak, moving upwards but reaching a conservative limit of 2200.

U.S. Dollar

Introduction

This section of the publication focuses on one of the most liquid and widely traded currency in the world- the U.S. dollar. For years, the greenback has been hailed as the world's reserve currency by virtue of its pre-eminence in business transactions around the world. It is thus appropriate to have comprehensive examination of the dollar.

Technical examination of the U.S. dollar index

Figure 3: US Dollar Index

The performance of the dollar has been spectacular in the preceding years up till around April this year, where bullish momentum has been largely quelled and transformed into indecision. This is evinced by the trading range was formed around that time (Figure 3).

However, recent speculation regarding the strength of U.S. dollar following fairly strong macroeconomic fundamentals of the dollar has pushed it into a breakout of the range. This breakout, from a technical perspective, seems to be valid and has potential to at least move upwards equivalent to the size of the trading range formed.

This projection is predicated on two things. Firstly, the breakout is strong because there was a large upward move outside of the trading range, and there was a subsequent retest of the upper boundary followed by another bullish move. Secondly, classical range trading methodologies usually prescribed at least a range-sized move outside of the breakout point.

However, this bullish projection from a technical perspective is tempered by the potential technical resistance denoted by the light blue line in the chart.

Notwithstanding the qualification on the bullish position, the technical outlook of the U.S. dollar seems to be inclined towards the bullish side. Time will tell whether there will be continued strength in the dollar. Most importantly the 100 region in the index is noteworthy, and strong momentum upwards of this level could be a good indicator of continued technical strength.

Fundamental examination of the U.S. dollar (Interest rates)

Figure 4: US Fed Funds Rate

Perhaps one of the most fundamental aspects of the currency markets relates to the degree of interest rate a currency offers. Ceteris paribus, a raise in interest rate should give rise to a strengthening in currency. For better or for worse, interest rates have come to play a significant role in the performance of currency pairs.

On December 16th, the Federal Reserve has taken the first step in hiking its interest rates by 25 basis points to 0.5 percent (Figure 4). In furtherance of this move, it was added that they are "reasonably confident that inflation will rise, over the medium term, to its 2 percent objective". This is a move away from a record low of 0.25 percent in December of 2008. Looking at the past history, where interest rates averaged at 5.93 percent through 1971 to 2015, one might be tempted to conclude that there is a wide potential for move interest rates hike and therefore, more bullish momentum in the dollar. This position, while founded, may be a tad premature.

At present, the U.S. economy is characterized by a 0.5 percent inflation and Government Debt to GDP of 103 percent. These numbers are truly worrying and calls into question whether the U.S. economy is strong enough to withstand a rate hike at this point of time. Additionally, while unemployment figures are starting to look better, wages earned by workers have yet to show the same type of strength.

Fed Governors have aptly pointed out that "economic conditions will evolve in a manner that will warrant only gradual increases in the federal funds rate". Given the lacklustre performance of the biggest economies in the world, it may be too soon to conclude that there will be many rate hikes by the U.S. in the future. In fact, major regions in the world such as the ECB and the BOJ are still pursuing very loose monetary policy. In order for expectation of larger rate hikes in the future, economic developments throughout the world and within the U.S. should evince more consistent and convincing strength before a conclusion about more rate hikes in the future can be made.

Potential trade opportunity – EURUSD

Figure 5: EURUSD

<u>Technical analysis of the EURUSD</u>

After a protracted downtrend, EURUSD first showed strong signs of bullish momentum in around the start of December 15 (Figure 5). However, bullish momentum proves to be short lived. Two significant pivot points has formed around the 1.10388 resistance level. Price movement for the month of December has been characterized by range-bound behaviour revolving around the 1.10388 and 1.08081 levels. Additionally, a wedge-like consolidation formation has formed within this range, signifying the potential for breakouts in either direction.

<u>Fundamental analysis of the EURUSD</u>

To properly analyse the fundamental bias of the EURUSD, it is crucial to consider the monetary policies adopted by the ECB and the Fed respectively. Since the Fed's monetary policy has already been mentioned, the ECB's stance will be discussed.

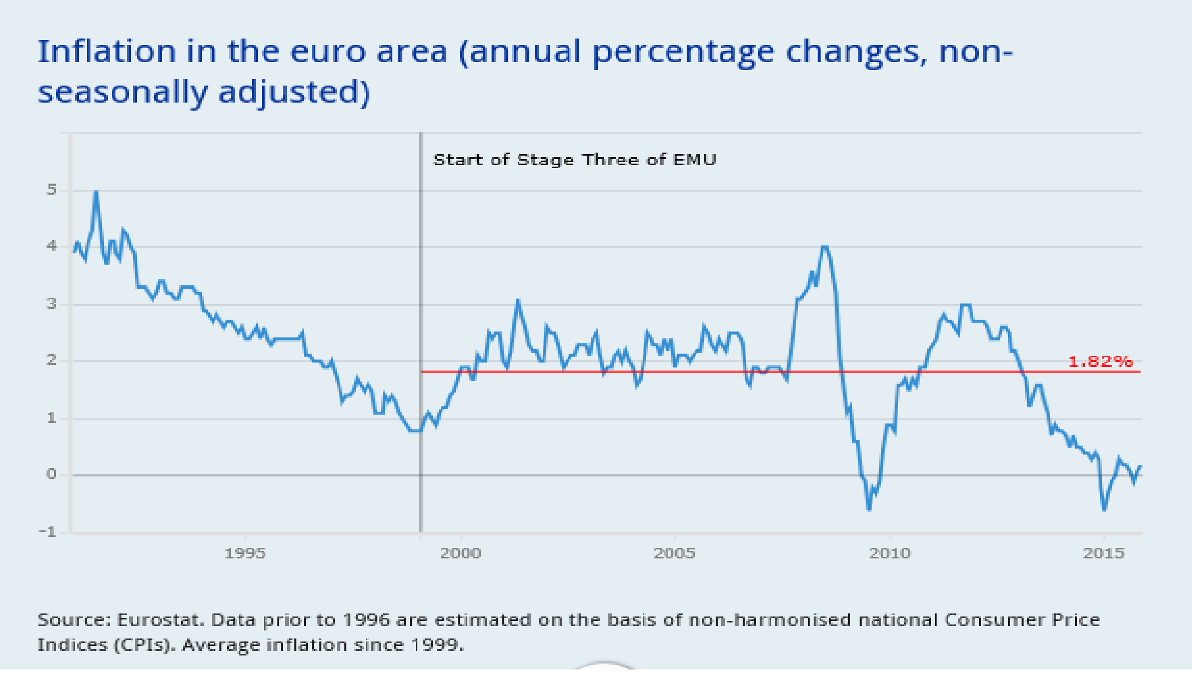

Figure 6: Inflation in Eurozone

With inflation near the zero level and far from the target of 2%, there is much room for inflation to grow. With that in mind, the ECB has stuck to its guns and has been carrying a 1.1 trillion quantitative easing. Given the long term monetary policy outlook and weak growth around the region, there could conceivably be more easing to come. Regardless, the loose monetary policy by the ECB and the hawkish agenda adopted by the Feds gives credence to the view that the EUR/USD has long-term downside potential. Even though recent reports have suggested weaker than expected easing and tamed hikes in interest rates, the fact of the matter is that long term fundamental pressures are still very much favouring a bearish EURUSD view.

Trading plan

With the foregoing in mind, there are a few ways to trade the EURUSD pair. Once could wait for a convincing breakout below the 1.08081 level, and short the retest of that level, placing a stop as high as the 1.10388 level.

Alternatively, a more aggressive method is to short the breakout of the wedge consolidation and placing a stop at the nearest pivot level.

Either way, the trading bias for this to find a convincing bearish signal from a technical perspective that is in accordance with the bearish fundamental view.

Crude Oil

News & Events

Reduction in Oil Prices

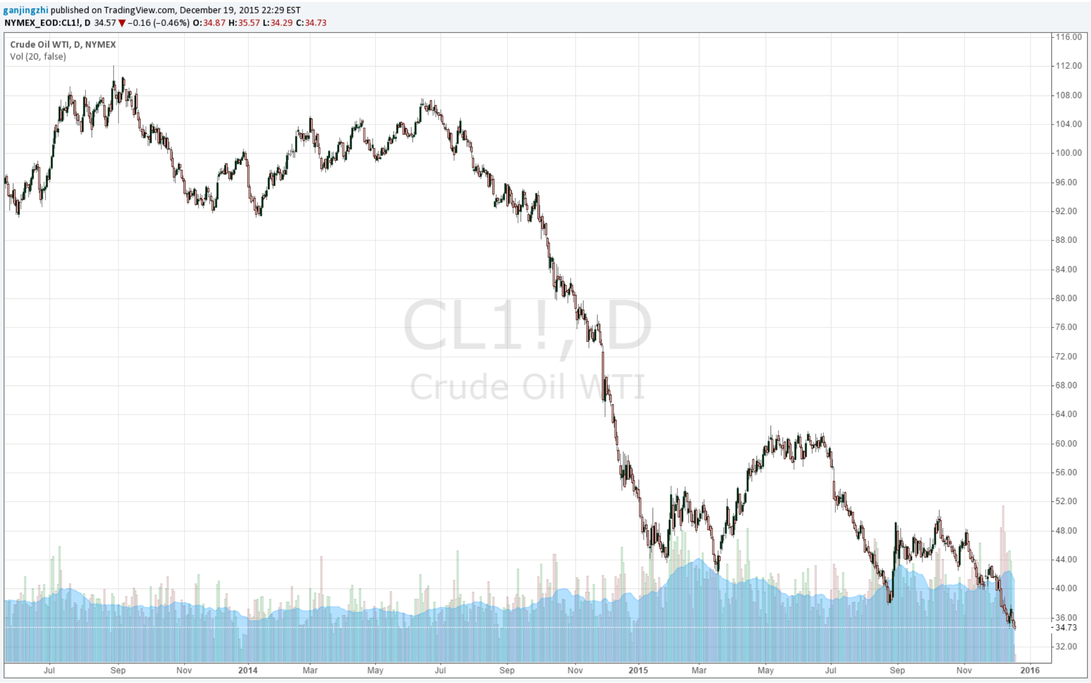

Figure 7: Crude Oil WTI

With reference to Figure 1, crude oil price decreased sharply from almost $108 at June 2014 to near $35 a barrel in December 2015, the lowest level in six years. The price has decrease almost two-third. This sharp and deep drop creates speculations on the possibility of the crude oil price continuing to decline or bound back to more than $100 a barrel as what it did during 2009 to 2011. If the crude oil price rebounds, how long will it take? If not, what is the reason? What should investors do with the trend? To answer all these questions, this article seeks to find out the reason to the plunge of oil price.

The Shale Boom

Due to the development in Hydraulic Fracturing and Horizontal Drilling, the shale oil and shale gas supply greatly increased during the last few years. This is because the drilling efficiency of horizontal drilling is much more than that of traditional vertical drilling. Suppose operators drill into a hydrocarbon bearing formation 100 feet thick, vertical drilling would allow an operator to contact 100 feet of rock, which would limit the potential recovery to oil or gas that would flow into that length of pipe. Horizontal Drilling now allows these same operators to drill and set pipe for a mile or more horizontally through this same rock formation. Operators are now contacting and fracturing 5,200 feet of rock rather than 100 feet, which multiplies expected well recovery rates many times over. This is illustrated by Figure 8. For traditional vertical drilling, production area is the small area of the pipeline down to the production shale. However, with horizontal drilling, the production area increased drastically since the pipeline extends horizontally within the production shale. The result of the shale boom is the supply glut of crude oil. Due to the great increase in drilling efficiency, even if the oil rig counts keep dropping, the total volume of crude oil produced in U.S is stilling increasing. Thanks to shale boom, the United States is now oil producer #1 in the world. The U.S. reached 9.7 million barrels per day in April 2015, crossing also the historical high of 9.6 million barrels per day achieved in 1970.

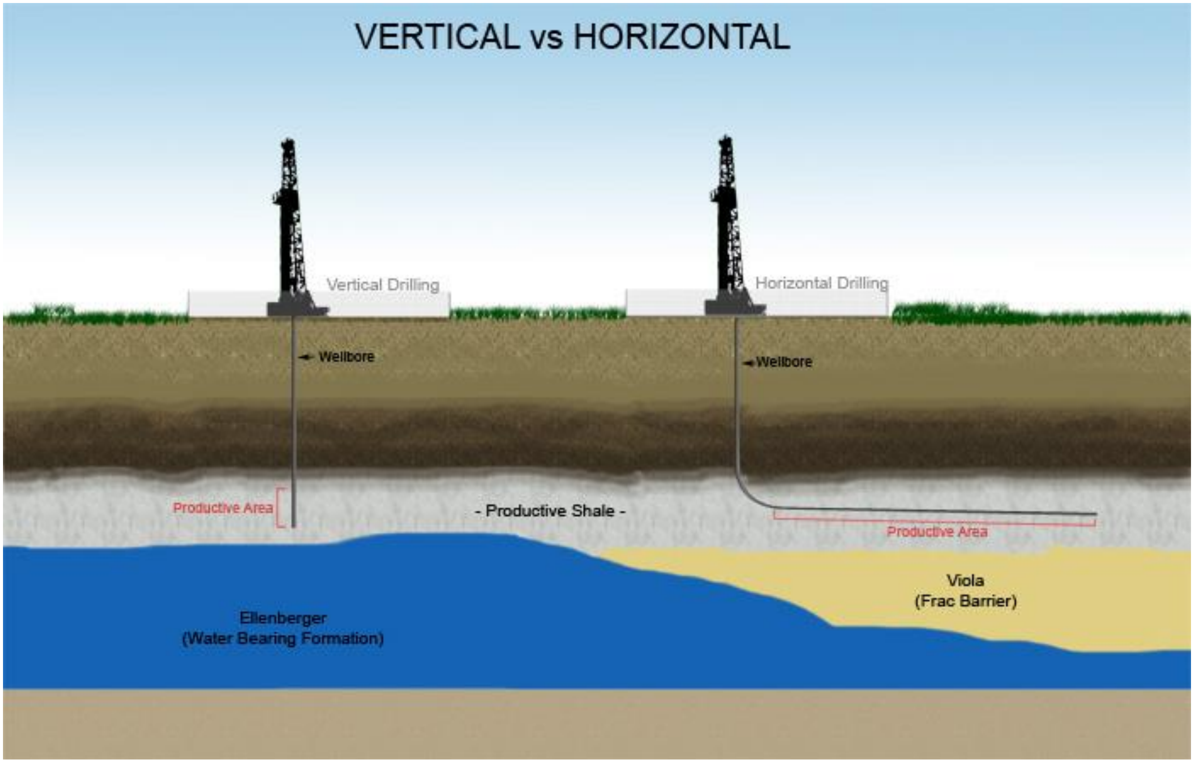

Figure 8: Vertical vs. Horizontal Drilling

The oversupply of crude oil due to shale boom is the main reason that drives down the oil price. Figure 9 shows how the natural gas price goes after there is a boom in shale gas due to horizontal drilling. We can clearly see from the graph that natural gas price dropped to around $2 and rebound back a bit, then dropped to $2 again. Today, natural gas price even dropped to around $1.7. This is what may happen to crude oil as well. Due to the development in technology, oversupply will make crude oil price stay at low area and never go back to the $100 high price.

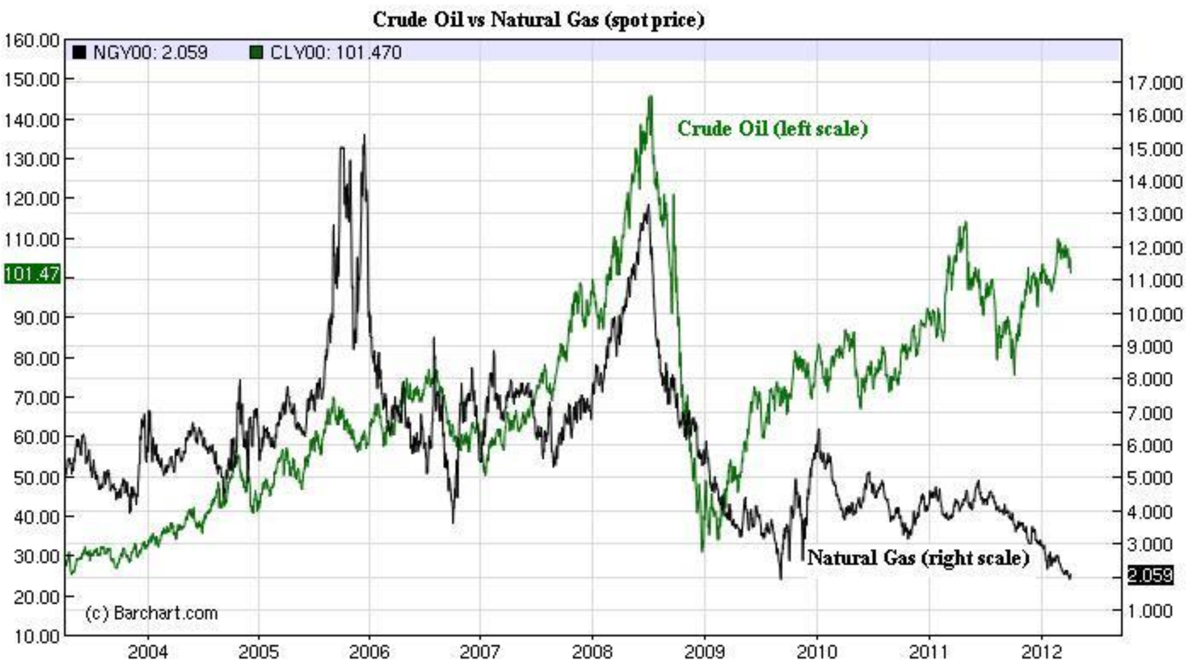

Figure 9: Crude Oil and Natural Gas Prices

OPEC's decision not to cut production

Although crude oil is oversupplied (according to EIA), OPEC still does not want to cut their production to increase the oil price. That's why crude oil price is still in a downtrend due to oversupply. The reason behind this mainly that OPEC does not want to lose market share and they know that crude oil demand will decrease drastically in the future.

Due to the shale oil boom, the production of crude oil in U.S has greatly increased. Despite U.S, Russia is exporting crude oil to the market as well. OPEC knows that if it cuts its production, U.S and Russia will gain more market share since they are increasing production while the cost of shale oil is decreasing due to economy of scale. However, if OPEC does not cut oil production, crude oil prices will drop. Given that shale oil and other oil have higher costs and lower margins, OPEC wants to use price war to defeat its U.S shale oil competitors. That is why OPEC decide to maintain production and keep the crude oil price low. This strategy works because we have a short-term oversupply now, given the slowing down Chinese economy and expectations that Iranian oil will hit global markets, has resulted in big price falls. It's also caused a slowdown in the rate of growth of American crude production, which rose 16 per cent to 8.7 million barrels a day in 2014, but is this year on course to grow just 7 per cent to 9.3 million barrels daily. The slowdown reflects the result of bankruptcy of many small sized U.S shale oil producers. For instance, WBH Energy, one of many tiny shale oil and gas producers in Texas, has filed for bankruptcy protection in January 2015, becoming what may be the first U.S. oil company to do so due to the drop of crude oil price.

One may ask will OPEC itself, or Saudi Arabia suffering from the low price? The answer is yes. Cheap oil has resulted in a 20 per cent of GDP budget deficit for Saudi Arabia. However, Saudi Arabia may know that crude oil demand would decrease drastically in the future. As we know, crude oil is used by the refining and chemical industries to manufacture petroleum products for transportation and industrial uses. Study has shown that 55% of the global demand for petroleum fuels comes from transportation. The remaining 45% of demand comes from industrial and power generation sectors with the latter contributing just around 5%. Most of the growth in demand for these fuels is expected to come from the transportation sector. This is because the global demand from industrial and power sectors is expected to remain largely stable in the long run, as the growth in demand from developing nations is expected to be mostly offset by the decline in developed nations. However, since technology of electric vehicles is developing at fast speed and vehicles are becoming more fuel efficient, the demand of petroleum will decrease drastically in the future. Therefore, if the demand of crude oil will decrease drastically in the future, OPEC may prefer to sell more crude oil to losing market share.

Conclusion

Crude oil price drops mainly due to shale oil boom and OPEC's decision not to cut production. These two reasons cause oil price to stay in low level just like natural gas and will not bound back to high levels. It is possible for oil to go back to $50 but definitely not $80 or even $100.

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