Global FX Strategy

Will the EUR finally drop?

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EURUSD – Killing it softly

The ECB has recently clearly indicated that a deposit rate cut would be used to address the EUR strength. And, no doubt, it is the ECB tool which would hurt the EURUSD the most. The action seems to be close, and our economists have adjusted their forecasts to a 10bp refi- and depo rate cut in June. We have changed our official 3M EURUSD forecast to 1.36 now.

GBP – Inflation report hurts, but not much

With the BoE expected to be one of the first central banks to hike, sterling has truly enjoyed a boost. Short-term the momentum will likely stay.

USDJPY – QE or no QE

Our official forecast is unchanged: USDJPY at 102 in 3M, with downside risks. The stock market will be the trigger, if the downside risks develop.

USDRUB – Geopolitics dominate

The USD/RUB target for the end of the year is RUB 34.5. The rouble may though stay volatile going into the upcoming presidential election in Ukraine.

NOK – Strong buying to turn?

We will see a potential outflow of 32 bn. NOK from redemptions, dividend payments and coupons on government bonds. It is hard to estimate how much of it that will be reinvested in NOK, but a rebound of the drop in EURNOK from 8.34 to 8.12 seems likely.

SEK – Inflation darkness in the Riksbank tunnel

We think that EURSEK will trade around 9 short-term due to a longer period of low inflation in Sweden, but longer term the potential is there for the SEK.

Chart of the month - This time it's different

Source: Nordea Markets and Reuters Ecowin

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FX Overview: ECB in the spotlight

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Appreciation of the EUR has unnerved the ECB and the Central Bank has signalled that it is ready to act as early as June. This is also our economists' call now. We have revised our 3M EURUSD forecast from 1.38 down to 1.36. While a repo rate cut, all things equal, would put EUR under pressure, a real game changer for the EURUSD would still be a sentiment shift in the global markets, resulting in wider credit spreads and higher volatilities. Something we do not envision in the near term.

So far, the numbers from Japan in Q2 have been disappointing – deteriorating business and consumer confidence in light of the VAT tax hike in April. As the currency weakening effects fade, inflation will also come under pressure. But will the BoJ respond with more easing? Maybe – but not yet. It needs to get worse before the bank will act, and "worse" implies a stronger JPY. We leave the 3M forecast for USDJPY unchanged at 102.

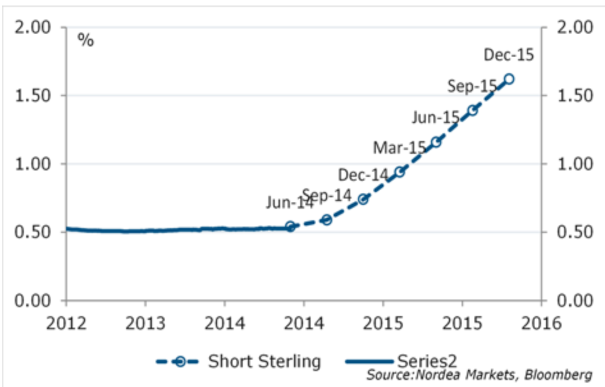
As the UK money market prices a full hike in the first quarter of 2015, and even a small probability for a move before the end of the year, one could of course argue that expectations are high. Especially since BoE sees a gradual and modest rate normalization to start by first half of 2015. Even after this message was repeated in the May BoE inflation report (together with a downside revision of the inflation forecast), money market continues to imply a rather early hike.

Hints of ECB quantitative easing coupled with lower USD yields, lower volatility and the Ukraine effect fading, leave the Emerging Market currencies in the soft spot for now. Even the most severely hit currencies – like the Russian rouble – could get support from global tailwinds as Ukraine headlines fade.

The rouble has been one of the weakest EM and commodity currencies, but the question is whether the rouble has potential to catch up with its peer group when the geopolitical discount disappears? Chances to see the rouble at the levels prevailing at the beginning of 2013 are small given the current internal growth problems in Russia, but as a baseline, we expect the rouble correlation with oil prices to be restored by the end of 2014 with some potential for growth.

Chart 1. Global growth still has tailwind

Chart 2. Money market still price an early hike



EURUSD: killing it softly

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Louder Draghi

The ECB clearly strengthened its rhetoric about the exchange rate at its latest meeting when it noted several times that the exchange rate is a matter of "serious concern".

The ECB has recently clearly indicated that a deposit rate cut would be used to address the EUR strength. And, no doubt, it is the ECB tool which would hurt the EURUSD the most. The action seems to be close, and our economists have adjusted their forecasts to a 10bp refi- and depo rate cut in June. We have changed our official 3M EURUSD forecast to 1.36 now.

We are not the only ones, and that makes things tricky. Now it seems the market participants, even those in doubt, have changed their expectations for ECB to cut rates in June when new staff forecasts are ready. Thus, if Draghi is bluffing about the likely rate action, expect a rebound in EURUSD – potentially a larger one than the post-ECB meeting drop.

Not a game changer

The ECB can tame – but not stop the flow-driven EURUSD move. This time around Draghi cannot use Trichet's former argument - "*a stronger US dollar is in the US' and the world's best interest*" - because the US is struggling with low inflation and weak export growth too. Note, also, the EURUSD has not yet appreciated to levels where the ECB used to talk EURUSD down under Trichet, and the pace of appreciation has been more moderate (*Chart 1*).

In order to bring the EURUSD meaningfully lower, the ECB's words are not enough - we need major concerns about global growth to emerge. It seems sentiment, especially around Emerging Markets, is bearish enough not to allow this to happen in the short term. Thus, a key source of disappointment at this point could be major economies, notably the US. But worsening of data is not our baseline either. So far it seems Q2 will be better both in the US and China. A "muddling through" environment with low volatility should weaken the USD broadly, in support of EURUSD.

Short term, technically the uptrend has been challenged with the EURUSD crossing 1.3730. We recommend re-entering long positions only when/if above this level again, where another run for the 1.40 is likely. The EURUSD crossing the 200D MA at around 1.3640, however, would be a game changer.

Chart 3. This time is different …

Chart 4. Global growth still has tailwind

GBP – Inflation report hurts, but not much

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With the Bank of England expected to be one of the first major central bank to normalize rates, sterling has truly enjoyed a boost versus most peers. With ECB (and even Bundesbank) being on the dovish side, the strong momentum is likely to stay in the near term. In addition, UK growth at close to 3% fits badly with interest rates close to 0.5%.

But as the money market prices a full hike in the first quarter of 2015, and even a small probability for a move before the end of the year, one could of course argue that expectations are high. Especially since BoE sees a gradual and modest rate normalization to start by first half of 2015. Even after this message was repeated in the May BoE inflation report (together with a downside revision of the inflation forecast), money market continues to imply a rather early hike. In other words, there is a divergence between Carney's forward guidance and the market pricing; the question is for how long it can last. As of now not much has been able to trigger a lasting correction. This divergence is most likely to continue as long as the positive momentum, or positive surprises, in the UK data continues. Record low correlation between GBPUSD and EURUSD indicates that market focus is on diverging fundamentals between UK/BoE and Euro zone /ECB.

The 2015 elections could be another reason for the central bank to wait with a hike until early 2015, as the economic consequences of the hike will not be known when voters enter the polls. Also, as the UK's biggest trading partner, ECB, is ready to ease, UK will have problem with sterling already at highs versus the USD.

So all in all, the money market is too optimistic compared to BoE rate path. BoE is unwilling to adjust rate path to market pricing. But does that mean the pound will weaken? Not necessarily right now. What we need is a trigger, such as UK economic data under delivering or a major correction in risky assets. Hence yesterday's weak UK earnings growth was likely more interesting than the repetition of the central bank stance in the inflation report.

Chart 5. Money market still price an early hike

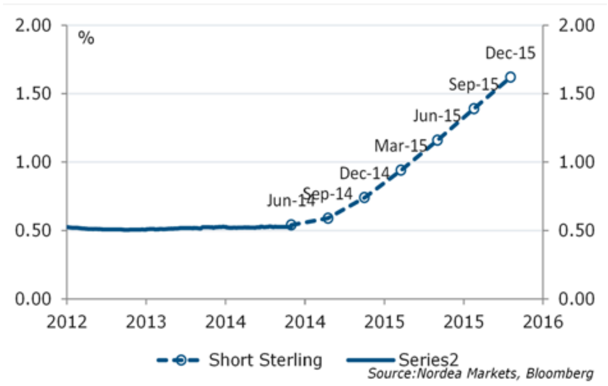

Chart 6 EURUSD vs GBPUSD correlation at record lows

JPY: QE or no QE

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BoJ won't budge

Our official forecast is unchanged: USDJPY at 102 in 3M, with downside risks. Our baseline remains that the Bank of Japan will not engage in more quantitative easing, in contrast to the common hope among market participants now. For example, close to 50% of the surveyed economists (8 May) still expect the BoJ to engage in more easing by July.

The BoJ seem complacent so far, sounding positive, maybe too positive, on both growth and inflation, in light of the most recent survey indicators for Q2. Inflation, which the BoJ projects now to hit 2% in 2015, has come up – but probably mostly due to weakening JPY effects. We will likely see those fade in H2 (*Chart 1*).

However, the BoJ is uncomfortable with the side effects of quantitative easing. Firstly, the real wage growth has become more negative, hitting consumer confidence lately (e.g. willingness to buy durable goods at the lowest level since 2008!). The VAT tax hike in April does not help either. Secondly, the trade balance keeps worsening – despite the weaker JPY – suggesting that imports are more challenging to substitute (no surprise being energy dependent).

All else equal, failing Abenomics should suggest a weaker stock market and a lower USDJPY currency cross. It must get worse before it gets better! That is, we first need to see a trigger for the BoJ to act – and that trigger will likely be associated with the worsening risk sentiment and a stronger JPY.

Key drivers

Technically the USDJPY and the EURJPY have moved within a range for a while, and a breakout requires a push from one of the major drivers – either the stock market (Nikkei 225) or USD yields (UST 10Y) (positive correlation with both). In the very short term, the USDJPY faces support around 101.5, which has held several times. If it fails – we will see a double-digit USDJPY in no time.

The JPY short positions remain historically high; the highest among G10 currencies. And the correlation between USDJPY, EURJPY and stock market since Lehman has been consistently strongest among G10 currencies – meaning, when we see a stock market correction, the JPY will be the first currency to go down. The question is not IF but WHEN.

Chart 7. Inflation to fade?

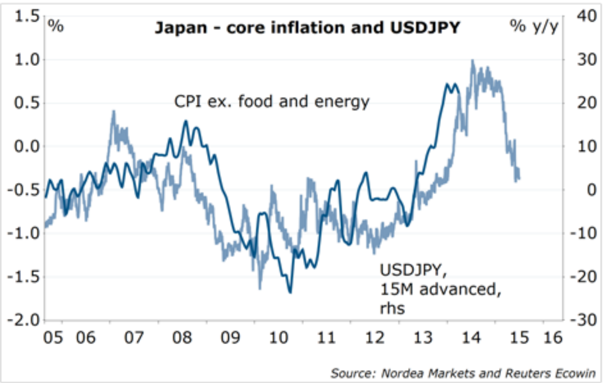
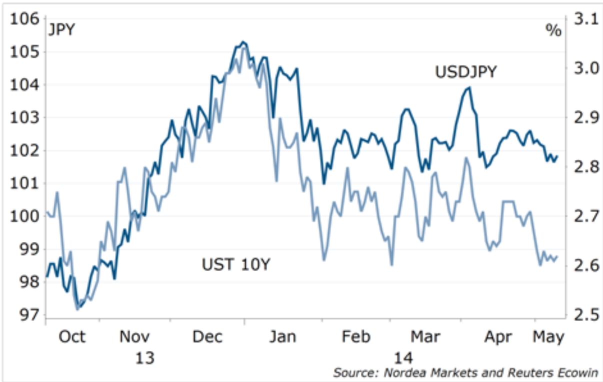


Chart 8. USD rates – a drag



RUB: Geopolitics dominate

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The rouble has been under pressure given huge capital outflows caused by the intensified geopolitical risks surrounding Ukraine and threats of severe economic sanctions against Russia. Since the beginning of 2014 the rouble has been one of the weakest EM and commodity currencies, but the question is whether the rouble has potential to catch up with its peer group when the geopolitical discount disappears?

The major problem is increased capital outflows, which in Q1 2014 rose to an unimaginable USD 51bn (compared with USD 62.7bn in 2013). Basically this ugly figure was the major explanation of the rouble weakness at the beginning of 2014 when the currency completely lost its fundamental historic correlation with the oil markets. Sanctions imposed by the EU and the US have not become a big threat to the Russian economy as they do not have a direct negative impact on the economy and the rouble. However, what indeed became a driver of the outflows and put pressure on the Russian economy and the rouble was the threat of tougher economic sanctions against key sectors. The threat is causing significant capital outflows from rouble-denominated assets. The Bank of Russia has done its best to cap the pace of RUB depreciation via intervention and hikes.

The efforts of the Bank of Russia are of course not in vain, and the regulator will continue to support the rouble by way of high rates at least till the beginning of H2 2014, taking into account increased inflationary pressures. This April inflation in Russia reached 7.3% y/y; the highest level since May 2013. Moreover, fewer market participants will dare speculate against the rouble as the Bank of Russia significantly decreased the sensitivity of the operational band borders of the currency basket by increasing the volume of cumulative intervention – currently the band borders are as follows: RUB 36.40-RUB 43.40. However, the Bank of Russia is not the force that will bring the rouble back on track and restore its historic correlation with the commodity market. Exporters, the major market participants, will play a major role when the geopolitical pressures ease. The geopolitical discount is still in the market (~3-5%) but will likely narrow down in coming months. Chances to see the rouble at the levels prevailing at the beginning of 2013 are small given the current internal growth problems in Russia, but as a baseline, we expect the rouble correlation with oil prices to be restored by the end of 2014 with some potential for growth. The USD/RUB target for the end of the year is RUB 34.5. Near term, the rouble may stay volatile without an evident vector as the coming presidential election in Ukraine (to be held on 25 May) will keep tension in the region.

Chart 9. CBR made currency basket band less flexible

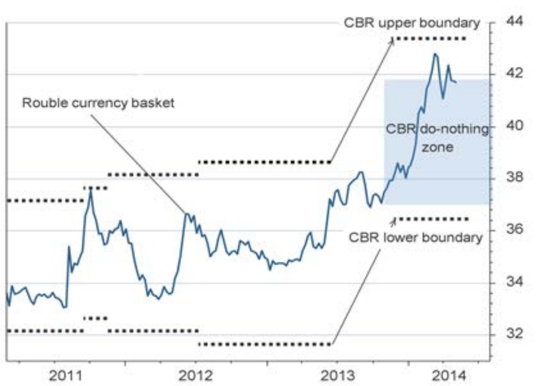
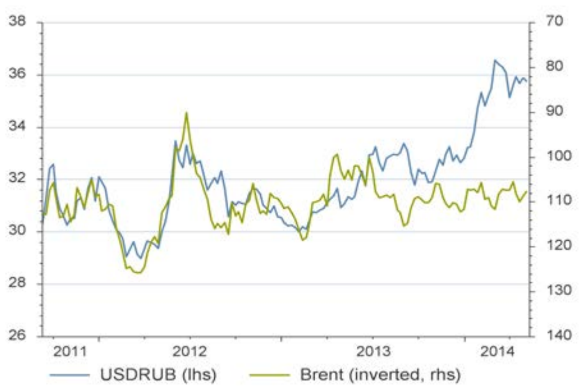


Chart 10 RUB lost fundamental correlation with oil prices



Scandi Corner

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EURNOK: Strong NOK-buying to turn?

Surprise in the real estate markets supports NOK

Surprisingly good news from the macro picture of Norway is the obvious motivation for the NOK-buying we have seen lately. Perhaps the most important turnaround is in the real estate market which by, especially foreigners, was seen as the biggest risk last year. The thinking was probably that falling real estate prices has been able to destroy quite some economies the last couple of years so here goes Norway down the same drain. Right now this scenario does not look too likely, even if it might be premature to conclude.

The elevated Nibor has most likely also contributed to the stronger NOK. With a rate cut from ECB this differential could go further and push EURNOK even further down.

We will likely see negative flows in May

However, in the last half of May we are likely to see NOK-negative flows from several sources. We will see redemptions in EURNOK-bonds of NOK 13bn, dividend payments to foreign owners of large Norwegian corporates of NOK 12bn and NOK 7bn in coupons from Norwegian government bonds to foreign owners. As always it is hard to estimate how much of it that will be reinvested in NOK. A rebound of the drop from 8.34 to 8.12 seems quite likely.

Chart 11. Foreign investors re-entering NOK position

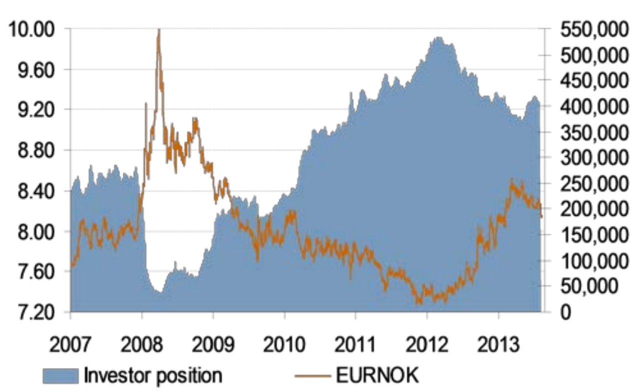
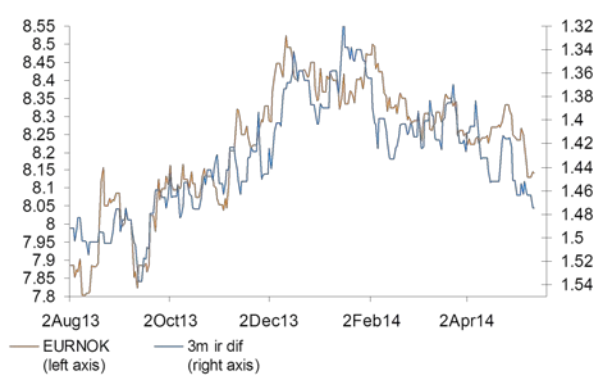


Chart 12. Macro picture, but also elevated Nibor



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EURSEK: Inflation darkness in the Riksbank tunnel

It would seem that the asymmetrical monetary response to overly low inflation and subpar growth between the Riksbank and the ECB is over. The ECB now has an easing bias going into the June meeting and it gave the EURSEK a gentle push downwards toward 9 as rate spreads widened. Our 3m forecast is that the EURSEK will trade around 9 due to a longer period of low inflation and the Riksbank having shifted its policy response towards low inflation alone. The downward pressure on shorter maturities will continue as the 3m Stibor drifts downwards going into the July meeting. The de-anchoring of our inflation forecast compared to the Riksbanks forecast does suggest that the July meeting could potentially see an inflation revision and hence it is rational to expect a slight bias towards a further cut in September. That would mean leaving the EURSEK above or marginally below 9 throughout the summer.

The de-anchoring of our inflation forecast does suggest that the July meeting could potentially see an inflation revision

We don´t expect a significant weakening of the SEK because a sustained supportive growth outlook will keep the upside in EURSEK contained as it implies a risk premium to the counter cyclical monetary policy currently conducted by the Riksbank.

It certainly takes two to tango and Draghi's pre-warning of softening monetary policy in June could weigh on the euro. The counter intuitive take (which post crises, has become a rational one) is that the EUR will remain strong because a slight improvement in growth, together with an easing central bank bias, supports risky assets. EUR exposure might turn out to be the sweet spot. On the other hand: If one considers Draghi's rhetoric i.e. that "the strengthening of the exchange rate in the context of low inflation is a cause for serious concern" one could easily entertain the notion of the conventional toolbox being empty.

We would consider a new short term range of 8,95 - 9,10 in EURSEK for the next month or two

We would consider a new short term range of 8.95 – 9.10 in EURSEK for the next month or two. For unhedged cash investors, the weakening of the SEK has left SGBs much more attractive to DBRs (see chart 8.). But we would also, perhaps a little too early, like to highlight the September election as a possible SEK negative event. The process of forming a government could take time in a situation with a hung parliament.

Chart 13. Elections in September – a SEK risk

	Red	Blue
Majority	• The combination of S, V and MP is a historically constellation that has worked • *SEK neutral*	• *SEK neutral/positive*
No majority	• *SEK negative*	• The Alliance doesn´t gain majority but with active/passive support from SD the form government • *SEK negative*

Chart 14. Sweden/Germany adjusted for FX movement