Global FX Strategy

Geopolitics, liquidity in drivers' seat

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EURUSD: Geopolitics & liquidity outlook drivers

The EUR has been under pressure over the summer due to e.g. the ECB's upcoming TLTRO operations and the geopolitical instability in the eastern Ukraine. Expect the EUR to remain under pressure for now.

GBP: Swervin' Carney

While dovish in August, the Bank of England is still on a diverging path compared to the ECB. The main factor deciding the timing of any BOE rate hikes will be wage growth. EURGBP still have got potential to fall later on.

EM FX: Risks on the horizon

EM currencies have generally weakened over the past month with summer liquidity explaining part of the weakness. We are cautious on EM FX.

SEK: Political thriller may justify a risk premium

We fear that the immediate outcome and the period after the election in September could evolve into a political thriller which would justify a political risk premium being factored into the SEK.

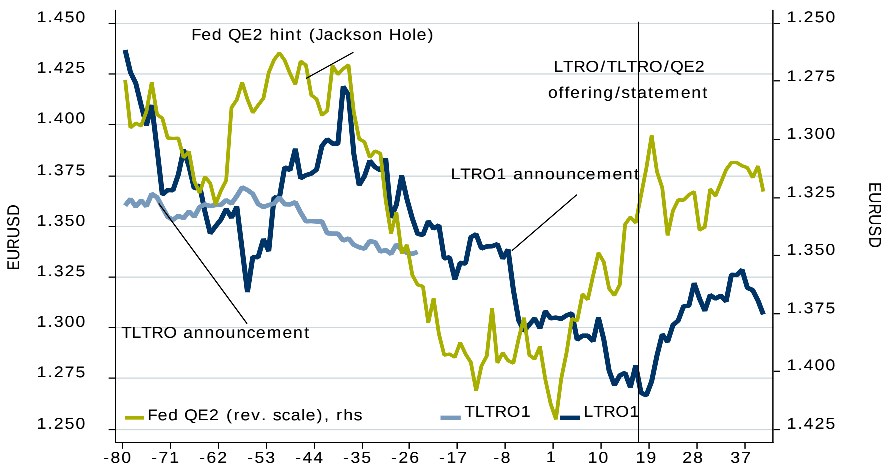
NOK: Norges Bank to lead the way again

Strong data over the summer has shut the door for a cut from Norges Bank. Instead, Norges Bank will hike its inflation forecast at the upcoming September policy meeting, helping pave the way for further NOK strength.

DKK: Wider repo spread works

Two independent rate hikes and a substantial intervention of more than DKK 20bn has helped stabilize the EURDKK just below central parity.

EUR under pressure until TLTRO dust settles



Sources: Nordea Markets and Macrobond

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The EUR has been under pressure over the summer for a plethora of reasons, including the potential for a boost to Eurosystem liquidity from the ECB's upcoming TLTRO operation while the Fed is (eventually) turning off its liquidity spigot. As the TLTRO dust starts to settle, the market should be able to more or less fully price in the coming EUR liquidity expansion, possibly comprising more than EUR600bn.

More important for global markets during the autumn will be the Fed's communication concerning the eventual switch from a Quantitative Easing (QE) regime to a Quantitative Tightening (QT) regime. After six years of QE the market may be faced with six years of QT – what does this mean for the notions of cheap credit and easy money? How and when the Federal Reserve either lets liquidity drop organically (via coupon payments and maturing bonds on its earlier QE purchases – this would be primarily a 2016 phenomenon) or via sterilizing liquidity with reverse repo operations, will be crucial for markets.

In Europe, greater geopolitical risks are currently acting as a dampener on activity, with Germany's Ifo index rolling over and exports to Russia and Ukraine dropping. Investments are under pressure as companies opt to wait and see. These developments are weighing on the EUR. A sharp drop in geopolitical uncertainty (Ukraine/Russia) would pave the way for a rebound in European activity and for a short-term bounce in EURUSD, while further escalation would be negative for the cross. In our updated forecasts we have assumed tensions will remain fairly unchanged.

After warning markets they were too dovish in June, the Bank of England changed direction once more in its August Inflation Report. Wage growth will remain in focus – where is it? While there are few near-term triggers for a stronger GBP, EURGBP should still have potential to fall later on as the BOE and the ECB are on diverging paths.

EM currencies have generally weakened over the past month. Summer liquidity may explain part of the weakness and certainly exacerbated the reaction to the event risks that have materialised. Numerous risks weigh on the horizon and we are generally cautious on EM FX for the remainder of the year.

EURUSD: liquidity & geopolitics weigh

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EUR to remain under pressure

The EUR has been under pressure over the summer for a plethora of reasons, including the potential for a boost to Eurosystem liquidity from the ECB's upcoming TLTRO operations in September and December. This is quite in line with the normal pattern: ahead of the first of the 3y LTROs in 2011, the EUR remained under pressure until a few days after the operation was settled *(Chart 1).* As the dust starts to settle in September, the market should be able to more or less fully price in the coming liquidity expansion, possibly comprising more than EUR600bn.

As for the Fed, it is still expected to announce the end of its QE3 program in October, eventually replacing it with a Quantitative Tightening (QT) program, either when its bond holdings starts to mature (primarily 2016), or earlier through sterilizing liquidity via reverse repo operations (RRPs).

Fed exit communication will be crucial

The Fed's communication pertaining to its exit path will be crucial: should the Fed start to sterilize its reserves earlier than expected (not our main scenario) via RRPs, the liquidity outlook would cause further USD strength, while if it were to signal a clear intent to keep the amount of reserves unchanged – most near-term USD strength may be priced in for now.

Gradual and hawkish Fed re-pricing to weigh

The central bank perspective nonetheless suggests a further drop in the cross later on - both from a relative liquidity and a relative interest rate perspective. The spot fixing spread (Euribor – Libor 3m USD) suggests the cross is currently close to fair value around 1.34. We nevertheless change our EURUSD forecast to 1.32 in the three months horizon (from 1.36), primarily based on a gradual and hawkish re-pricing of USD rates while EUR rates remain range-bound. The outlook for rates suggests cross will trade lower in 2015 and 2016 *(Chart 2).*

Chief upside risk stemming from positioning

The chief risk to this bearish outlook stems from positioning - the EUR is a popular short. One possible and positive trigger would be a dovish speech by Fed chief Yellen at Jackson Hole August 21-23 – will she be inspired by the soft BOE? Another positive trigger would be a drop in geopolitical uncertainty (Ukraine/Russia) which would pave the way for a rebound in European activity.

Chart 1. EUR under pressure until TLTRO dust settles

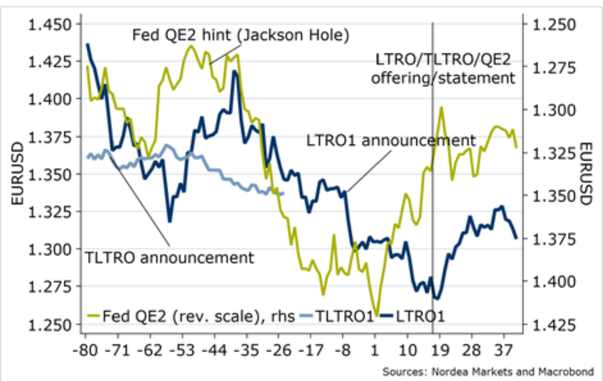
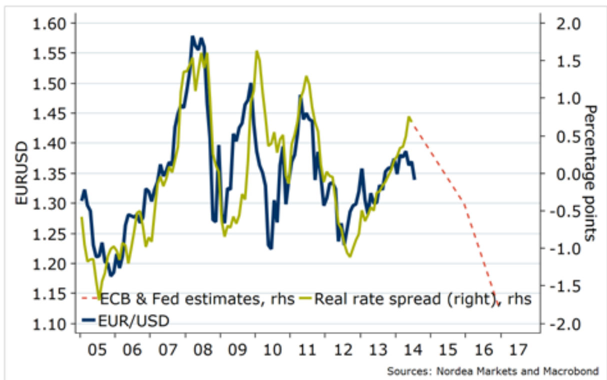


Chart 2. EURUSD and the real rate spread



GBP: Swervin' Carney

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Wage-focused BOE still on a diverging path compared to the ECB

British data had fared quite favourable over the past few months and Bank of England's (BOE) Carney in June warned markets that the Bank Rate could be hiked sooner than markets expects, this unsurprisingly propelled the GBP in a stronger direction. However, in August the BOE back-tracked, and now interest rates are lower than before Mark Carney's speech in June – verbal intervention from central banks isn't always a good thing.

The main factor deciding the future path of the BOE will be wage growth – if/when we see a pick-up in wage growth *(Chart 3)* it will start to hike rates, with our base line being next spring. EURGBP should thus have potential to fall later on, as the BOE and the ECB are on diverging paths.

Potential for underperformance vs non-European currencies

GBPUSD ought to remain fairly steady. It is however possible that one under-appreciated driver of recent low European inflation pressures, including the UK, is the proximity to the Euro Area where high unemployment is acting as a dampener on wage growth and inflation. This is a potential for further GBP underperformance in the medium term, but primarily vs non-European currencies.

EUR/GBP forecast lowered

We lower our EUR/GBP forecast from 0.83 to 0.79

We lower our official 3m forecast from 0.83 to 0.79, primarily due to us changing the outlook for the EUR in a more bearish direction: the EUR should remain under pressure in the short term until the first TLTRO dust settles, and in the medium term due to diverging central bank paths.

Positioning and less geopolitical uncertainty risks to our forecast

The main risk to our new outlook stems from positioning. A conclusive and peaceful resolution in Ukraine would lower the geopolitical uncertainty and boost both Euro Area activity as well as inflows into the EUR. Still, we would regard a squeeze higher in EURGBP as temporary

September 18 the Scots will vote on staying in the union. Markets are expecting the union to hold but in the unlikely event of a 'No' vote we expect the GBP to weaken up to 10% (see our research note "Scottish independence from the UK: what if?" dated 30 June).

Chart 3. Wage growth where art thou'?

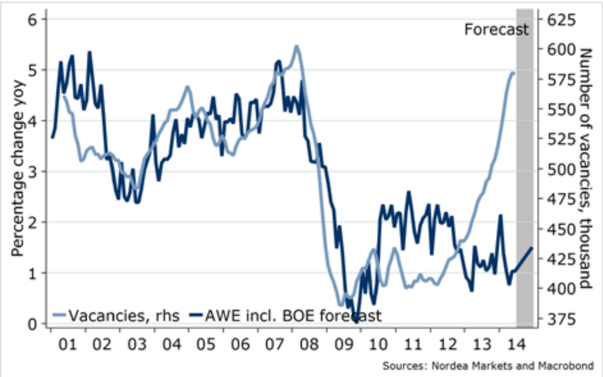

Chart 4. EURGBP undermined by higher GBP rates

EM FX: Risks on the horizon

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Summer liquidity weigh on EM FX

EM currencies have generally weakened over the past month. Summer liquidity may explain part of the weakness and certainly exacerbated the reaction to the event risks that have materialised, including the escalation of the Russia/Ukraine conflict and the Argentine default. The election of Mr Erdogan as the first Turkish president was not a major surprise, but risks remain elevated until it becomes clear how powers will be divided in the new political system.

EM FX risks will remain elevated for some time

The first firm confirmation from the Fed that rate hikes are drawing nearer could prompt another general EM sell-off similar in size and duration to the one in May/June last year

Numerous risks weigh on the horizon and we are generally cautious on EM FX for the remainder of the year. The first firm confirmation from the Fed that rate hikes are drawing nearer could prompt another general EM sell-off similar in size and duration to the one in May/June last year. Thus, the Jackson Hole Symposium will be crucial, though it may be slightly premature to expect clear Fed signals. For lack of better, the knee-jerk reaction is likely to be most weakening in currencies with large current account deficits or external financing requirements weakening the most. On the positive side, EM FX is not generally overvalued and EM economies are not overly vulnerable in general. However, on the negative side, the global monetary adjustment needed is unprecedented in size. Risks are obviously huge.

The Russia/Ukraine conflict has had bigger impact than we had expected on the real economic outlook for all of Central and Eastern Europe

The Russia/Ukraine conflict has had bigger impact than we had expected on the real economic outlook for all of Central and Eastern Europe (see *chart 6* on the change in PMIs so far this year) and the next few months are likely to see downward revisions to the growth outlook from several central banks. At the same time, inflation continues to fall, to zero or lower in Poland, Hungary and the Czech Republic. Risks are clearly skewed towards an autumn rate cut in Poland, more cuts in Hungary, and perhaps even a higher EUR/CZK floor. We have no more easing in our forecasts, though. At the other end of the spectre, the Russian central bank hiked rates during summer citing FX risks related to an escalation of the conflict with Ukraine and monetary developments abroad (read: Fed tightening). More hikes cannot be excluded if the RUB weakens further, even though inflation may finally be trending downwards.

Chart 5. EM FX generally weaker over the last month

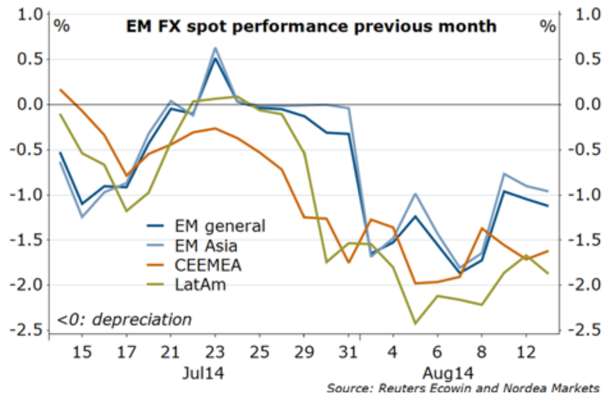
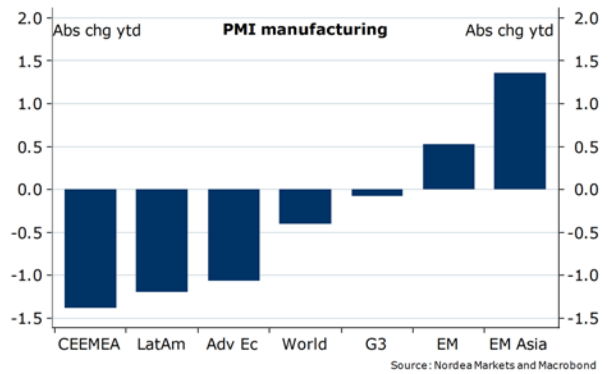


Chart 6. Russia related uncertainty



Scandi Corner

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EURSEK and the election puzzle

The Riksbank cut by 50 bps in July collapsed the SEK but on the other hand it left the Riksbank with considerably less room for further maneuver. It was a decisive action but from here the law of diminishing returns in terms of betting against the krona and substantial weakening should prove to be marginal. In that sense, analyzing the EURSEK based on relative monetary policy have more or less reached its end destination.

The fixation from the central bank on one of its targets, 2% inflation, and disregarding the other, financial stability, have been the driver of the EURSEK

The major imbalance in the Swedish economy is presently zero inflation despite relatively strong growth. The fixation from the central bank on one of its targets, 2% inflation, and disregarding the other, financial stability, have been the driver of the EURSEK. And since there is no fast track escape from the present low inflation (the devaluation of the SEK will not in a meaningful way prop up inflation) we see little scope for SEK appreciation in the immediate future. Considering the fact that the Riksbank has a bias for an additional rate cut going into the September meeting (30% chance for 10 bps) risks are tilted towards further SEK weakness.

The Swedish election is taking place on the 14th of September. We fear that the immediate election outcome and the period after the election could evolve into a political thriller that would justify a political risk premium being factored into the SEK.

The Swedish election could evolve into a political thriller that would justify a political risk premium being factored into the SEK.

The leading political bloc in the opinion polls is a red-green "mixed stew" rather than a potential political platform. Prime Minister Reinfeldt and his coalition parties are most certainly heading towards a defeat but the presumed red and green victory should not be equated to them seizing the power to govern. We believe the Social Democrats initially would favour a government coalition with a consensus-aligned Green Party that is passively backed by the Left Party. But Left Party leader Jonas Sjöstedt has on several occasions made it clear that he will not support a government in which the Left Party holds no ministerial offices. Consequently, a minority government comprising the Social Democrats and the Green Party could risk being ousted before it got started in earnest. We forecast a EURSEK moving toward 9.30 in the short term.

Chart 7. Clear majority win for the Red and Green

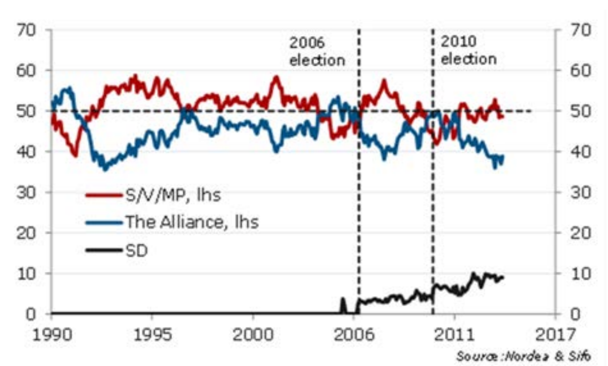
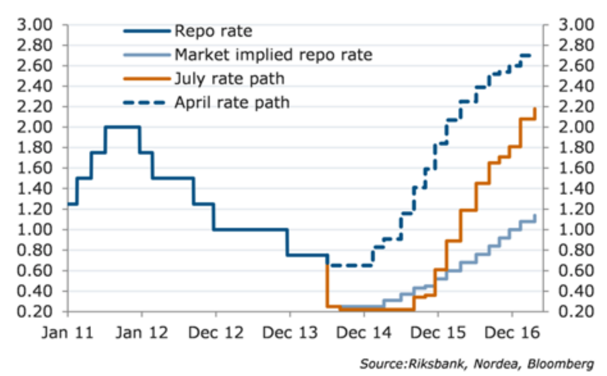


Chart 8. "Low for long" killed the EURSEK carry trade



EURNOK: Norges Bank could lead the way again

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Norges Bank's June rate path surprised markets by implying that a rate cut was far from unlikely during the first part of 2015. The NOK of course weakened significantly and has spent the summer hovering around the 8.40 level reached in the beginning of July.

July inflation was strong, and inflation will probably remain on the high side going forward

After the recent strong July inflation EURNOK has however moved lower. Before this figure the interest rate market was pricing a fairly big probability for a rate cut from Norges Bank despite that we have seen improving macroeconomic figures through the summer. With the strong inflation figure markets became less aggressive in pricing a cut, thus interest rate difference moved in NOK favor. The market reaction is completely reasonable. The rise in inflation was due to high growth in food prices, which is something that tends to last. So this is not something temporarily, but will keep inflation elevated the next year.

We think Norges Bank will have to take this into account and revise upwards its inflation forecast at the upcoming September monetary policy meeting. All else equal this will pull the new interest rate path upwards. Through the summer we have also received signals of a tighter labour market. Norges Bank expects higher unemployment, but the recent figures have been trending downwards. As we have received these figures markets have left the NOK unchanged, giving room for potential downside.

Also the NOK itself can give some contribution for a higher rate path as import weighted NOK (I-44) is on the weak side of Norges Bank' forecast (*Chart 9*). This effect could however easily be close to zero if NOK moves toward Norges Bank's forecast ahead of the September meeting.

NOK should perform in a low volatility environment

NOK has come down from its latest peak, but we expect the cross to continue somewhat lower going forward. The argument is not only a higher rate path, but also volatilities in the FX market are low. The CVIX index, measuring implied volatility in 9 major FX crosses, is at pre-financial crisis levels. NOK, as carry trade, should keep performing in such a risk willing environment. Our 3 month EURNOK forecast is 8.20.

Chart 9. NOK on the weak side of Norges Bank

Chart 10. Expect further move in IR diff in NOK favor

EURDKK – wider repo spread works

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Since the beginning of the year the Danish central bank has made two independent rate hikes – one explicit in late April and one implicit by not following the ECB lower on 5 June. Together with a substantial intervention of more than DKK 20bn. in late spring this has helped stabilize the EUR/DKK just below the central parity.

Near term we do not expect to see more action from the Danish central bank as we expect the EUR/DKK to stay around the current level towards year end. In Q2 2015 we expect the Danish central bank to continue its gradual normalization of the monetary policy thereby making another independent rate hike of 10 bp.

Chart 11. EURDKK and central bank intervention

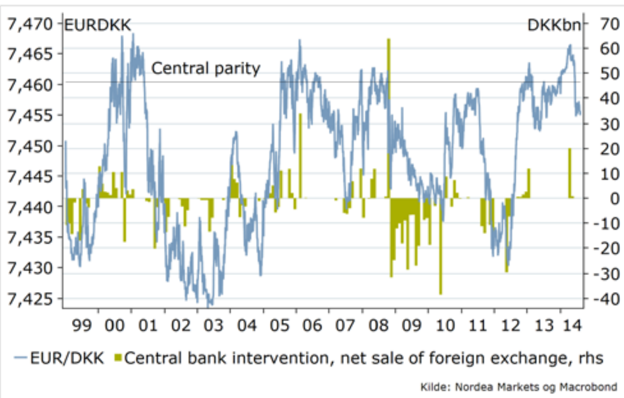

Chart 12. No expectations of DK rate hikes in end 2014