Global FX Strategy

BOJ untapered the Fed taper

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EUR/USD: see you below

The pressure on Draghi et al to deliver more will persist while reverse Fed QE could become a driver of a stronger USD in coming months and quarters.

JPY: time to resume depreciating

We now see cyclical and structural arguments in favour of a weaker JPY.

GBP: housing market a risk

It may make sense to position for some short-term weakness of the GBP owing to for instance a slowing housing market.

EM FX: central bank divergence a focal point

For Emerging Markets the coming month promises to be less eventful than the month that just passed. Central bank divergence could become a focal point.

SEK: fewer headwinds for the krona

The Riksbank tried its best in October to submarine the Swedish krona. We now see fewer headwinds for the SEK but see fair value around here.

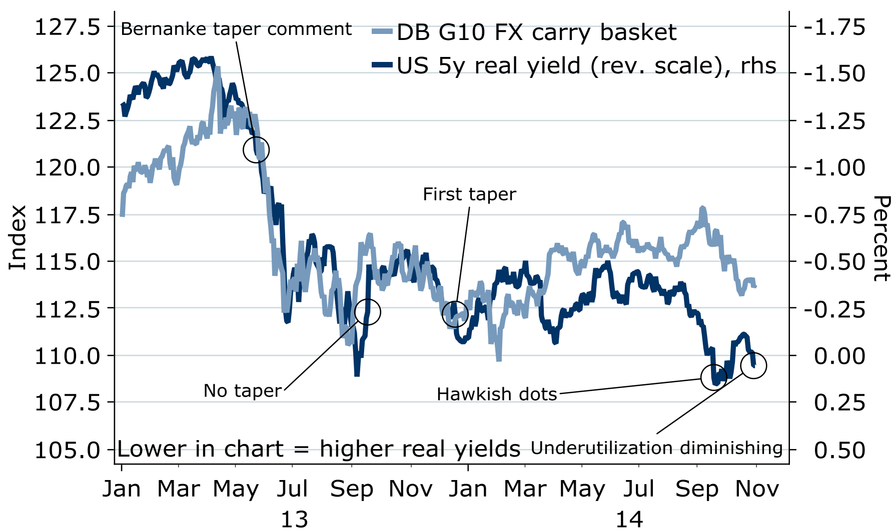
NOK: too much too soon

Global worries and weaker oil prices have unduly weighed on the NOK.

DKK: Denmark in a state of alert

In the event of mounting downward pressure on EUR/DKK we expect the central bank to allow the krone to appreciate further before cutting rates.

Chart 1: Higher US real rates a threat to carry currencies



Sources: Nordea Markets and Macrobond

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Volatility came back with a vengeance in October as global markets were wrong-footed on the back of disinflation and QE hangover worries. Overall, we expect volatility to be back for good, especially now that the Fed is nearing a time in which it will cease its calendar-based guidance.

The EUR/USD has spent most October consolidating as the market has been disappointed by Eurosystem liquidity as well as by somewhat weaker US data (September retail sales apparently became the straw that broke the camel's back). That Federal Reserve officials fanned speculation that the Fed would soften either due to a too-strong dollar or due too-low inflation expectations did not help the USD strengthen either. Looking ahead, we continue to see downside risks to the cross, as well as upside risks for the USD overall. Indeed, if the Fed keeps to its recent hawkishness, US real rates are likely to climb further which would indicate potential downside risks to high-yielding G10 currencies (Chart 1).

Scandis have had a hard time recently, with the Riksbank submarining the Swedish krona and global disinflation worries and weaker oil prices sinking its Norwegian counterpart. We think the Norwegian krone has been unduly pummelled. The Swedish krona now faces few headwinds but should remain around current levels in the near future.

For Emerging Markets the coming month promises to be less eventful than the month that just passed. No election in any major economy, no annual policy convention in China and no planned crisis meetings between President Putin and Western leaders about Ukraine are scheduled at this point. Yet, not much seems more certain.

Chinese growth woes are likely to continue and oil prices are likely to be this low for a while. The only comfort is that the first Fed hike seems to be further away than previously thought. For EM FX this probably means a bit longer wait-and-see period, which should be moderately supportive for non-commodity carry currencies such as the TRY and maybe the INR, while we may see more pressure on commodity currencies. In general terms, we remain cautious on EM FX and expect more weakness over the coming quarters. Central bank divergence could become a focal point.

EUR/USD: see you below

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Further downside beckons for the EUR

The EUR/USD has spent most of the past few weeks consolidating as the market has been disappointed by the ECB and Eurosystem liquidity while Federal Reserve officials had boosted speculation that the Fed would be about to soften as a result of a too-strong dollar or too-low inflation expectations. The Fed did not soften in October, and instead opted to send a fairly hawkish message. Looking forward, we expect a Fed rate hike by the middle of 2015, that is, unless we see very adverse events impacting negatively on the economy.

Any substantial rise in Eurosystem liquidity would weigh on the EUR

Looking at the Euro Area, risks remain tilted to the downside for the EUR: i) a substantial rise in Eurosystem liquidity should drag EUR/USD below 1.24 – though admittedly the timing is here in uncertain, ii) if the market starts to truly expect QE the cross would drop substantially until the run-up of a formal ECB announcement (we find few signs that QE is priced-in, see EUR Rates & FX: QE – perspectives on what's priced in). Furthermore, the depreciation of the trade-weighted EUR compared to what the ECB staff forecasts assumed in September, yields a mere 0.15 percentage point boost to Euro Area inflation over the next two years - far too little to bring inflation back to target. The ECB probably needs at least a further 5% weakening of the EUR for this. In short, the pressure on Draghi et al to deliver more will persist.

Reverse Fed QE a potential driver of a stronger USD

The dollar is far from levels where it would pose a problem for the US.

As for the other side of the cross, the potential for reverse QE from the Fed, i.e. liquidity absorptions, has the potential to boost the USD via increasing its scarcity. If the Fed needs to absorb e.g. 500bn worth of liquidity to control money market rates in 2015, this would hint at EUR/USD below 1.20. See USD: QT – the underappreciated dollar tailwind for more details on this theme..

Moreover, the dollar is far from levels where it would pose a problem for the US. While the DXY index shows a dollar 7 percent stronger than at the start of the year, the Fed's trade-weighted dollar index shows an appreciation of four percent – no game changer.

We keep our EUR/USD forecast to 1.24 on a 3M horizon.

Chart 2: EUR/USD has tracked relative 3m rates in 2014

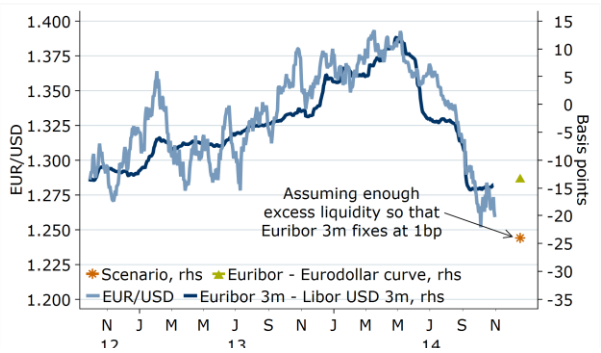
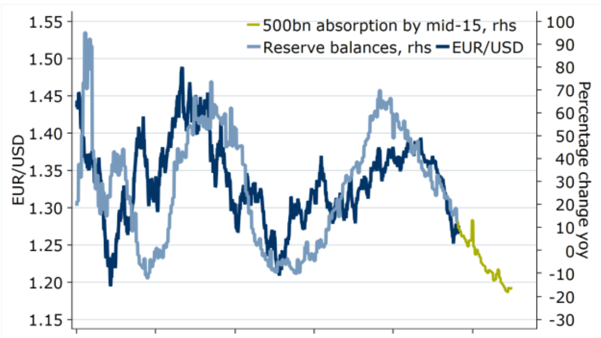


Chart 3: Fed liquidity absorption will weigh in 2015



JPY: time to resume depreciating

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Ready for the next round of weakening

Now time to move on

After briefly declining close to 105 (the target level outlined in the last monthly) USD/JPY has rebounded, with further fuel added to the fire by Bank of Japan in October. The surprising stimulus expansion in October constitute an additional impulse for JPY weakness in the near term, even if mostly via its psychological effects as well as its positive impulse to stock markets and the rates spread between the rest of the world and Japan. Remember, stock prices and US Treasury yields, the usual “drivers” or coincident indicators for USD/JPY, are now set to increase again, as global growth headwinds dissipate by year-end.

Inflation entrenched

Inflation expectations to remain sticky

The key domestic JPY-negative factor recently has been inflation. Even though markets are sceptical the BoJ will be able to meet its inflation target there is evidence that “this time is different”: the unemployment rate is close to 20-year lows and the output gap has been closed. It is thus no wonder that wages are rising again. Most importantly, consumer inflation expectations have become entrenched (Chart XXX), and the Bank of Japan’s expansionary policy should make sure this remains the case.

Apart from the cyclical support for a weaker JPY, it is also worth remembering the structural dynamics now supporting the JPY weakening trend: the current account deficit has turned negative after many years of surpluses; the savings rate has turned negative after many years of excess savings; and private sector debt has started to grow after many years of deleveraging.

Where to?

Forecasts adjusted for a weaker JPY

We have adjusted our forecasts to somewhat weaker JPY in the coming few years. We expect USD/JPY to rise to 120 by mid-2015 (vs 115 earlier) and to 125 at the end of 2016 (vs 120 earlier), This corresponds to EUR/JPY at 150 by the end of 2016.

Chart 4. Inflation expectations entrenched

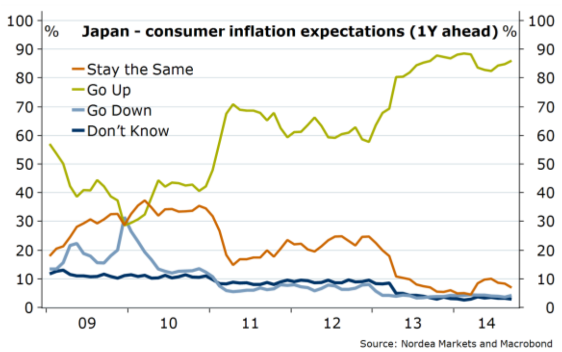
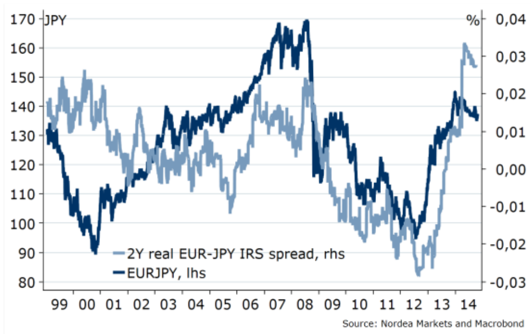


Chart 5. Downside capped by real rate spread



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GBP: housing market a risk

BoE backs off as housing market turns

The Bank of England has become more dovish over the past few months, as inflation data are at new lows since 2009 (1.2% y/y). Weak wage growth is also a point of key concern to the BoE. In its most recent dovish minutes (8-9 October meeting), the BoE states that there is *"little sign of domestically generated inflationary pressure",* for which the GBP is to blame, too.

Slowing housing market

At the moment the BoE is expected to hike first: although the first rate hike has been postponed to the end of 2015 according to market pricing, the expected cumulative hikes are still among most pronounced in the G10 (32 bp for next year vs 43 bp for the Fed and -4bps for ECB). Our economists' baseline scenario is that the BoE will hike rates in Q2, and that should remain the baseline scenario. But if data were to disappoint, hikes will be further delayed according to markets which would spill over negatively to the GBP. That said, we probably need to see more global risk aversion on the back of global growth fears for the GBP to weaken considerably.

Apart from wages and inflation, which have been weak for a while, there have been some disappointments from the housing market more recently, as home price growth has slowed, and the recent mortgage application data suggest that the slowdown will continue in the coming few months. This may seem surprising as the BoE has not even hiked rates yet!

May weaken towards year-end

GBP could weaken against EUR short term

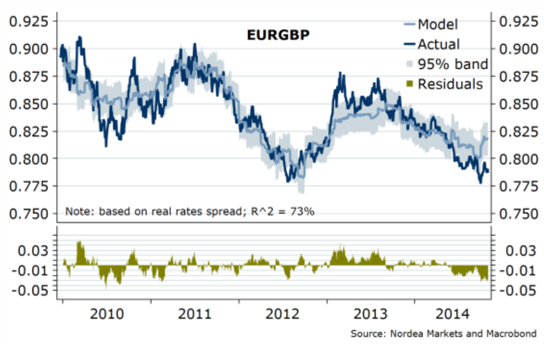
Tactically we think it makes sense to position for a slighly weaker GBP. Notably, the 0.7700/30 levels in EUR/GBP have been crucial support for the uptrend since 2000, hence the spot to place stops, and reverse for major downside.

1.6000 support for GBP/USD

Meanwhile, GBP/USD is challenging the 1.6000 level, which is support from the downtrend starting in 2008, also the 50% retracement level of the rise from previous year's bottom to the recent peak. We expect it to hold on the 3M horizon.

Chart 6. Tell me where the housing market goes…

Chart 7. EUR/GBP undervalued



EM FX: Central bank divergence

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The Brazilian Presidential election was won by Ms Rousseff, but the opposition candidate, Mr Neves, left a clear footprint in the sense that markets now seem to expect reforms to a much larger extent than ahead of the election. Wednesday's surprise 25 bp rate hike could be the first attempt by Ms Rousseff to paint a more market-friendly picture of her second term. There are enough challenges for the president. The economy is in recession, commodity prices are falling and there is no room for economic policy easing. We believe the BRL will find some support in the near term given that election uncertainties have abated, the central bank has stepped up support with a 25 bp rate hike on top of FX interventions and the BRL has already weakened a lot in recent months. However, the medium-term outlook for the BRL depends to a large extent on Ms Rousseff's success in reviving growth, reforms or no reforms.

More RUB weakening likely, but not at this pace

The Russian central bank (CBR) hiked sharply interest rates by 150 bps at today's meeting to support the RUB and protect its FX reserves. It did not change its intervention policy, though, which means that speculation against the RUB can continue to go "unpunished." The intervention rule may be changed in January as previously signalled. More pressure on the RUB in the near term is needed to prompt the CBR to shift to a discretionary intervention policy earlier or to hike rates further. The RUB is likely to weaken further in the coming months, but at a slower pace than recently.

Polish rate decision a very close call. We go for unchanged.

The Polish central bank decision next week will be a very close call. So far five out of the ten MPC members have publicly said that they do not support another rate cut. However, the remaining five include the governor, who has the decisive vote in case of a split. The decision to cut rates by 50 bp in October was probably also taken with half the members voting against this move. We go for rates to be kept on hold, but it will be a very close call. Almost two full rate cuts are priced in and hence the PLN is likely to strengthen if we are right.

The Chinese economy is still slowing when looking at the annual growth rate which dropped to 7.3% y/y in Q3. House prices remain at risk of a bigger setback and the authorities loosening regulation a bit to support it. More concern seems ahead for China, but also the risk of more support, though we still see a low risk of rate cuts and a high risk of a stronger CNY.

Chart 8: Some support for the BRL in the near term

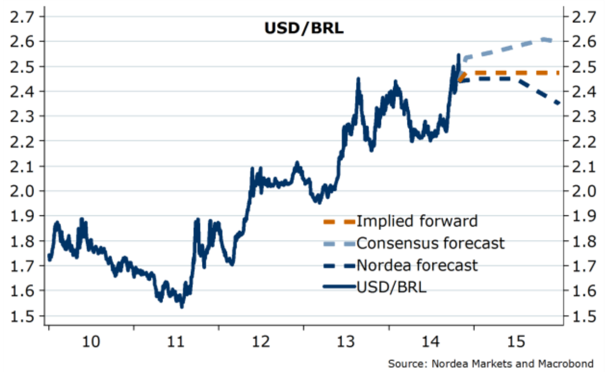
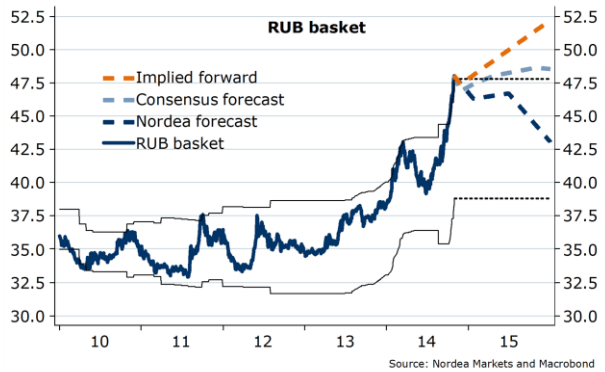


Chart 9: RUB likely to remain under pressure



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Scandi corner

EUR/SEK – FX interventions only a tail risk scenario for now

Further boosts to Eurosystem liquidity and the potential for ECB QE pose downside risks to EUR/SEK

After the Riksbank's rate cut to zero, a fair value approach to EUR/SEK suggests that 9.35 is a reasonable level given what's priced in money markets. However, looking ahead a few months, short-term rates in the Euro Area should come under downward pressure on the back of further boosts to liquidity via bond purchases or TLTROs. This poses a mild downside risk to EUR/SEK even though the timing is uncertain (Chart 10). The largest downside risk to the cross stems from ECB QE: if the market starts to believe in a truly significant QE program, we would see significant downside in EUR/SEK. For now, we keep our short-term forecast of 9.30.

The Riksbank currently seems quite far away from mulling extraordinary measures, arguing that "[p]resent conditions in Sweden differ from those in other countries where central banks have adopted complementary monetary policy measures. " They then outlined several conditions that differ: i) financial markets are working well, ii) interest rates are low and the krona is not remarkably strong and iii) GDP is increasing at a normal rate.

The krona is currently some 5 percent weaker than its long-term trade-weighted average

Table 1 compares the current situation in Sweden with the prevailing situation in the Czech Republic and Switzerland, where central banks started FX interventions in 2013 and 2011 respectively. The only distinct difference is found in currency valuation: whereas the CHF and the CZK where overvalued, by 20 percent and 6 percent respectively, the SEK is currently some 5 percent weaker than its real long-term trade-weighted average.If the SEK needs to be as overvalued as that of the CZK before the Riksbank implements a floor in EUR/SEK, we thus need a 10 percent appreciation of the krona before the Riksbank reacts.

With the trade-weighted krona seven percent weaker over the course of the past 12 months, the Riksbank is quite reasonably hoping that the recent depreciation will help buoy both inflation rates as well GDP growth in coming months and quarters. For now then, a FX floor in EUR/SEK should be seen as a tail risk scenario, albeit admittedly a very interesting one.

Chart 10. EUR/SEK to glide lower if Euribor rates drop

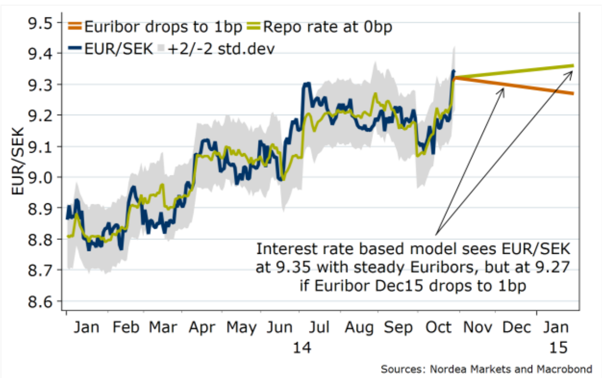

Table 1. How does the situation in Sweden differ?

	Switzerland	Czech Republic	Sweden
CPI inflation (percent)	0.2	0.9	0.3
GDP growth (percent yoy)	Q2 11: 2.2%	Q3 13: -1%	Q2 14: 2.6%
Unemployment gap (percentage points)	-1.2	1.5	0.7
FX valuation (percent REER deviation from 10y	21.5	6.1	-4.7
Policy rate (percent)	0.125	0.05	0.00
FX			
EUR/x 1m before intervention	1.12	25.7	na
EUR/x 1m after intervention	1.23	27.5	na
Impact on EUR/x (percent)	9.8	7.2	na
Impact on REER (percent)	-9.7	-4.9	na

Sources: Bloomberg, Nordea Markets

NOK Rates and EUR/NOK: Too much too soon?

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How fast will falling oil prices hit the Norwegian Economy? Soon according to current market pricing. We estimate that markets now price a 40% chance for a cut at the December meeting.

Furthermore, the FRA strip is about 40bp below the rate path from next summer. Add to this that trade weighted NOK (I-44) is 6,5% weaker than Norges Bank is forecasting for June next year, something that would typically give a contribution of 65bp up in the rate path, and markets have discounted bad data worth a total of about down 100bp on the rate path.

Only the disappointing global growth outlook and falling global markets, in particular the oil price has surprised to the downside

Domestic developments have been pretty much as expected since the last rate path was published in September, so it is only the disappointing global growth outlook and falling global markets, in particular the oil price, that has surprised to the downside. The question is whether markets have gone too far?

We think this so, or at least too soon. As we have discussed in the previous section there are reasons to worry about the outlook for the Norwegian economy, but this is a medium term story and Norges Bank will allow itself time to see whether the worries materialise into something more than downside risk.

The Dec14 FRA contract has started trading below the fixing, implying that there is a meaningful chance for a rate cut in December

The Dec14 FRA contract has started trading below the fixing, implying that there is a meaningful chance for a rate cut in December. The current fixing overlaps the meeting so it too is affected by the chances for a cut. We estimate that a neutral NIBOR fix today would be about 1.63%. Hence, Dec14 FRA at 1.52% implies that the short end is pricing 40% chance for a cut in December. The FRA settles after the December meeting and the next meeting takes place on 19 March, so the FRA will settle on the basis of the outcome of the December meeting alone, and not reflect the chance of a cut on a later meeting. As such, this contract offers decent risk/reward for expressing our too much, too soon view without being exposed for developments that increase the chances of a cut later next year.

DKK is getting stronger

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Since end-August the Danish krone has strengthened markedly versus the euro. After remaining fairly stable around 7.456 from mid-June to mid-August, EUR/DKK declined to the current level around 7.444.

We do not think that an independent Danish rate cut is imminent

With the DKK appreciation, EUR/DKK is trading at levels that could likely prompt the Danish central bank to defend its fixed currency regime through further intervention, if necessary. But still we do not think that an independent Danish rate cut is imminent. So far, the bank's intervention has been limited (DKK 700m) and far from the levels seen on previous occasions when the central bank has made use of the interest rate weapon. Typically, the bank moves to change the level of interest rates if it has spent about DKK 10-15bn over a short period of time in an attempt to defend the currency regime. In the event of mounting downward pressure on EUR/DKK we expect the Danish central bank to allow the krone to appreciate to further before sanctioning an independent rate cut.