

Global FX Strategy

The EUR is not “risky” anymore

Nordea Research, 20 February 2014

EURUSD – Toward 1.40

In an environment of low volatility, the underlying driver for the EURUSD is still the relative flows. Until April, expect EURUSD to drift higher, next to 1.385, then above 1.40 on relative equities and current account gap.

GBP – Risky Business

The GBP tends to be a “drama-queen”, moves tend to be fast and downward corrections tend to be brutal. With GBPUSD and EURGBP correlation strengthening, weakness in stock markets is now associated with broadly weaker GBP.

USDJPY – Fine-tuned on BoJ

This week’s USDJPY reaction to the BoJ meeting showed how eager investors are to continue to play the long USD theme, also known as the “Fed easing less, while ECB and BoJ easing more”.

AUD & CAD – Slightly improving mood

Recent events have moved market towards less anticipated dovishness from both the Australian and Canadian central banks. Both the AUD and CAD have gained a bit of fresh air on the heels of these events.

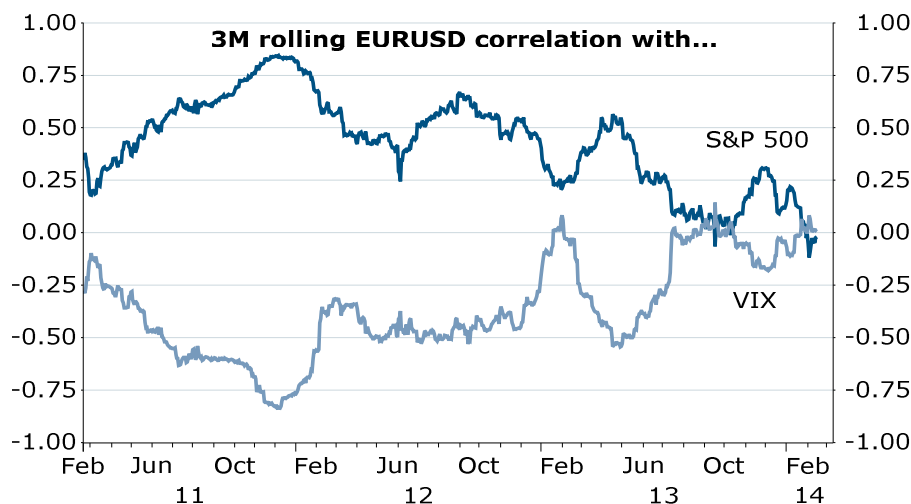
Sweden – Weaker on Riksbank cut speculation

Our preliminary assessment is that the Riksbank will stay on hold, despite the weak CPI development. But reopened speculation of more easing from the Riksbank will likely weigh on the SEK ahead of the April meeting.

Norway – Investments leaving Norway

The NOK will stay weak over the coming months, as we will see a rush of maturities in foreign-owned bonds—up to NOK 50bn could leave.

Chart of the month – EUR is not “risky” anymore



Editors

Aurelija Augulyte, CFA

Senior Analyst

+45 3333 6437

aurelija.augulyte@nordea.com

Nils Rosendahl

Senior Analyst

+46 8 614 9936

nils.rosendahl@nordea.com

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Global Markets - overview

Authors

Johnny Bo Jakobsen

Chief Analyst
+45 3333 6178
johnny.jakobsen@nordea.com

Holger Sandte

Chief Analyst
+45 3333 1191
holger.sandte@nordea.com

*Once the weather clears,
we expect a rebound in the
data...*

...but it might take a while.

*Better times already arrived
for the Euro area.*

*ECB inflation forecast
for 2016 important.*

Macro

Weak US data not changing our longer-term outlook

Weak numbers from the US are causing concern about the US recovery losing steam. We think these concerns are misplaced. Growth is slowing a bit from the inventory-juiced pace in H2 2013, but the main drag is likely to be the recent bad weather, which is weighing heavily on activity and new jobs. After all, the economy's strong fundamentals are unchanged: household debt loads are at a 10-year low, business balance sheets are about as strong as ever, credit conditions are improving and overall financial conditions are still very lenient.

Thus, once the weather clears, we expect payrolls growth to return around 200k per month and the ISM manufacturing index to rebound to around 53-54. If these data improvements do not materialise, we would need to adjust downward our optimistic US GDP growth forecast for 2014.

However, with the weather having been just as severe in February, the improvement may not happen until March (reflected in data releases in April). In other words, we might not see significantly stronger US data for still some weeks to come. History suggests that estimating the economic impact of unusually severe weather is particularly uncertain. This time is not different. Still, we believe that spring will bring better times for the US.

Better times (in terms of growth) have already arrived for the Euro area. With growth coming back and no major Euro-area country in recession anymore, very low inflation is now clearly the ECB's main concern. In January, consumer prices were just 0.7% higher than one year ago with the core rate hitting an all-time low of 0.8%. ECB president Draghi mentioned a worsening of the medium-term inflation outlook as one of two possible triggers for new policy easing, the other being an unwarranted tightening of money market conditions.

On 6 March, the ECB will publish its first inflation projection for 2016. We would not be surprised by a projection of 1.6% or 1.7% - i.e. still below the ECB target. However, as we see it, that would not trigger policy action because the ECB has already been expecting a longer period of subdued inflation for quite a while (just as we do). So all in all, while there is risk of further policy easing, our baseline scenario is that the ECB will not take any new easing steps in March (or later). Support for no further action should also come from an unchanged inflation print for February (0.7%).

If we're wrong, the most likely steps in our view are a cut of the main refi rate to 0.10% or 0.15% and/or the suspension of the liquidity absorbing operations resulting from the bond purchases under the Securities Markets Programme.

Overview - Last push for weaker USD

Authors

Aurelija Augulyte, CFA

Senior Analyst
+45 3333 6427
aurelija.augulyte@nordea.com

Nils Rosendahl

Senior Analyst
+46 8 614 9936
nils.rosendahl@nordea.com

Andreas Steno Larsen

Junior Analyst
+3333 1501
andreas.steno.larsen@nordea.com

A string of disappointing US data releases has sparked concerns that the US recovery is losing steam. For now, the lingering hope that it's temporary weather effects should keep the risk sentiment slightly positive, and USD broadly weaker, in particular against the majors. In this low volatility and low commitment environment we should see the EURUSD make its last stretch toward 1.40-1.42 area. This is consistent with the European data coming in slightly stronger than the majority expected in Q1, and our economists calling no change in monetary policy stance from ECB.

Once dollar begins appreciating again later in spring - with key reason being risk aversion – the first currency to be hit will be the GBP, which has recently become the most beloved currency among the market participants. The good news is old news from the UK – from now on, any data disappointments, or even no positive changes, will work against GBP. As such, short term tailwinds are for EURGBP to go up.

Versus JPY, we remain a bit on the cautious side of the “Fed easing less while ECB and BoJ is easing more” game. Most importantly CPI being in an upward trend might leave BoJ side-lined for now, despite hesitating growth. Hence, risk to the downside for USDJPY remains. The cross took a slight hit by the global risk aversion in January; another hit could be in the loop due to continued concerns on US growth, if things do not start to look better soon.

The Emerging Market and commodity currencies could benefit in the coming few weeks, but come there is more clarity on the US data – first in April - there is potential for more weakening. Both too good and too bad data from the US is other things constant, bad for the EM and commodity FX (either USD rates go up or commodity prices go down).

The CAD has suffered severely vis-à-vis the USD since the tapering story started, as rates spreads between US and Canada have widened as a consequence. The diverging labour market reports on February 7th, although marked a short-term game-changer, as much of the markets anticipated easing bias for the Canadian central bank, were taken of the table. Short-term this will probably underpin the CAD, but past the next Bank of Canada meeting in March, the widening rates spreads story will probably drive USDCAD again.

The story is a bit the same for the AUD, as the Reserve bank of Australia made an end to their easing regime at their first meeting of the year. This turn in policy makes the pricing of a large policy rates spread in AUDNZD seem even more exaggerated. Even with a spread between RBA and RBNZ policy rates of around 40-50 bps for first half of 2014, the upside in AUDNZD seems large. The aussie is still vulnerable versus majors, but in case that widespread risk appetite settles in currency markets, the potential for the aussie is large.

EURUSD – toward 1.40

US macro is key uncertainty

Author

Aurelija Augulyte, CFA
Senior Analyst
+45 3333 6427
aurelija.augulyte@nordea.com

A string of disappointing US data releases has sparked concerns that the US recovery is losing steam. But our economists, just as many others (including Fed), do not worry too much – temporary weather effects. Patience is needed, to figure out the truth: with the weather having been just as severe in February, the improvement may not happen until March (releases in April). In other words, we might not see significantly stronger US data for still some weeks to come. But for now hope remains, and keeps the risk sentiment intact, allowing the USD grind broadly weaker (risk on).

The European recovery, though weak, still managed to surprise on the upside, and so far the key figures are encouraging for the Q1: no reason to see it weaker than Q4 2013 so far.

Will ECB get worried about strong EUR? So far, the ECB has been rather quiet; Draghi hasn't mentioned EUR strength as a negative factor in contrast to this time last year when EUR strength was explicitly named as risk to growth. This is likely due to the fact that ECB also sees some positives related to it – e.g. cheaper imports, effectively more purchasing power.

“Safe haven”

In the environment of low volatility, the underlying driver for the EURUSD is still the relative flows – the current account gap - is in EUR favour, and the relative equities ratio is beginning to move higher, supporting the EUR again. The EUR has become a bit of a “safe haven” currency lately, with EURUSD broadly neutral: 3M correlation with the S&P 500 has declined to zero.

It does take a larger sell-off (probably later, in spring) in risk to make people shift funds to the largest liquid market - US Treasury bonds - and bring the EURUSD down which, if we do see some improvement in the US data, won't happen. Even in such correction, expect the downside in EURUSD limited to low 1.30s: this time around, the shock will unlikely be a European crisis.

Until April, expect EURUSD to drift higher, next to 1.3850, then above 1.40. The risks are for a sharper move up, since the bias in the markets is a lower EURUSD – consensus forecast for 1Y ahead still is around 1.25.

Chart 1. Relative current accounts – to EUR favour

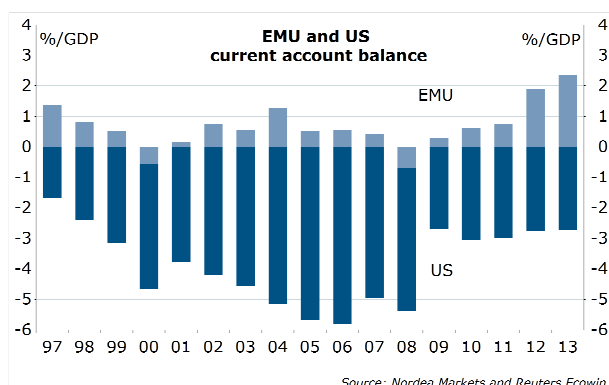
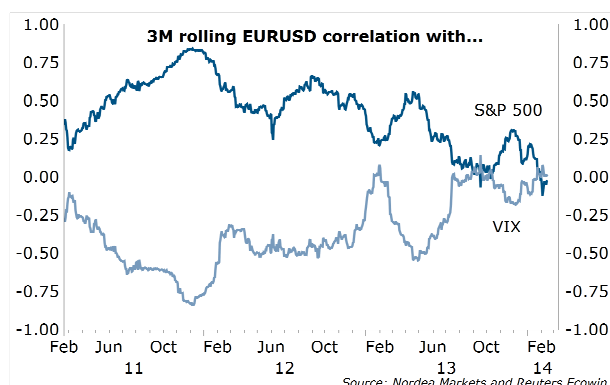


Chart 2. EUR is not “risky” any more



GBP - risky business

Good news is old news

Author

Aurelija Augulyte, CFA
Senior Analyst
+45 3333 6427
aurelija.augulyte@nordea.com

The UK economy delivered a great U-turn last year. But it seems the “wow” effect is about to fade: some data is already turning softer, e.g. PMIs have come down off peaks, inflation has moved lower. The housing market is still booming – indicators suggest further upside. Macroprudential measures, not rate hikes, will likely be used if house prices keep accelerating. This could be disappointment for many who expect rate hikes (in Q1 2015 or before).

With their latest Inflation Report, the Bank of England (BoE) switched to the “old school” data-dependent targeting: instead of one single indicator they will now monitor and make forecasts on 18. The BoE will likely put most focus on prices, which will ultimately indicate the size of the output gap. According to the Inflation Report, the BoE sees output gap at 1-1.5% of GDP. The key indicator to watch, in our view, is the wage growth, recently at 1% y/y – should come up to 2.75% this year to live up to BoE’s projections.

The BoE is not indifferent with the currency strength. The GBP recent strengthening has overshoot the BoE’s expectation. According to Carney, *“net export performance is the most difficult...There is the persistent strength of - the strength of sterling...adds to those challenges.”*

Risks for GBP downside

Now it seems the GBP is one of the most beloved currencies in the market. The speculative positions, as measured by the futures data (IMM), the net GBP long positions are highest since end of 2012 – just before the GBP weakened sharply. The GBP tends to be a “drama queen”: when things move, they move fast, downward corrections have been brutal. Note, the correlation between GBPUSD and EURGBP have strengthened lately, so that the weakness in stock markets is now associated with broadly weaker GBP.

We maintain our 3M forecast of 1.66 for the GBPUSD. The upside move in the very near term, if any, will probably be driven by the USD side, and will be capped by 1.7330, which is 50% retracement from the pre-Lehman peaks. Expect EURGBP to drift higher in the very short term – if above 0.8300 again, the risks are for a sharper move up toward 0.8650.

Chart 3. Key data point to watch – wage growth

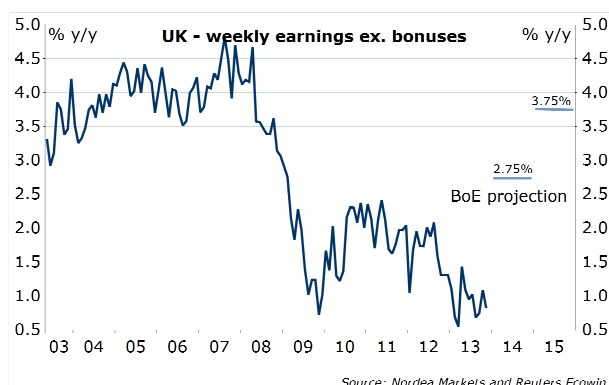
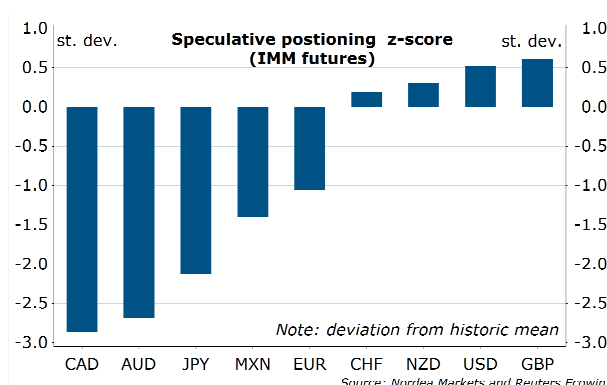


Chart 4. GBP net long positions highest among G10



USDJPY: Fine-tuned on BoJ

Do not jump onto the train

Author

Nils Rosendahl

Senior Analyst

+46 8 614 9936

nils.rosendahl@nordea.com

Despite not delivering any outright easing measures earlier this week BoJ managed to weaken the Japanese currency somewhat. Maybe this points out how eager investors are to continue to play the long USD theme, also known as the “Fed easing less while ECB and BoJ is easing more”- theme. However, our take on this is a bit to the cautious side.

BoJ decided to adjust its two loan programs and it extended the deadline of the “Stimulating Bank Lending Facility” and the “Growth-Supporting Funding Facility”. BoJ also doubled the amount private banks can borrow under the first one. However, the extension of these facilities was rather expected, as these were scheduled to end by the end of March, and Tuesday’s decisions are unlikely to have a large impact on the economy. The action taken rather shows BoJ’s dedication to support the economy, while keeping its key policies unchanged. CPI being in an upward trend might leave BoJ side-lined for now, despite hesitating growth.

In addition, BoJ not revising its economic outlooks at last meeting (which would have been reasonable with recent weak GBP and export figures) suggest the central bank being on the optimistic side. More importantly, not revising growth forecasts down pushes expectations of any new easing further into the future. All in all, we do not see this as simulative as the initial market reaction in USDJPY and Nikkei suggested.

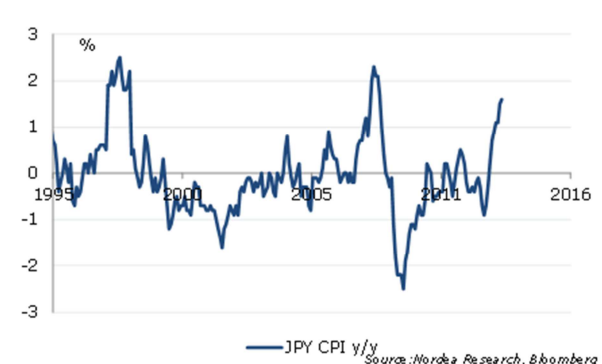
So what will be the next main driver for the cross? For investors to jump onto the long USDJPY trade with full commitment again would likely need at least one of: US growth clear out of current weak data stream, or BoJ increasing the pace of its monetary expansion. As for the latter, the upcoming sales tax hike in April might be a trigger, dependent on how harmful this will be for the Japanese economy.

Risks to the downside in USDJPY remain. The first leg down in the cross seen earlier this year was caused by global risk-off; another could be caused by continued US growth worries, if things do not start to look better in the US soon. The weak growth and industrial production numbers from Japan do not bode well for prices and inflation, increasing the demand for cash pushing JPY higher.

Chart 5. Rates up needed, to push USDJPY higher



Chart 6. With CPI up, BoJ might be on hold for a while



AUD & CAD - Slightly improving mood

Author

Andreas Steno Larsen
Junior Analyst
+3333 1501
andreas.steno.larsen@nordea.com

Less anticipated BoC easing bias, is mirrored in rates now.

With RBAs easing bias off the table, too much policy divergence versus peers is priced into the AUD.

The broad-based USD weakness over the last weeks has also spilled into stronger AUD and CAD versus USD. The rise in AUD and CAD is although about more than just USD weakness. Recent events have underpinned less anticipated dovishness from the Australian and Canadian central banks.

CAD: Diverging labour market reports

The labour market reports on 7th of February marked an important short-term game changer for USDCAD, as the Canadian labour market surprised severely on the upside, while the US equivalent surprised negatively. Already ahead of the diverging labour market reports momentum in the rates spread between US and Canadian 10Y treasuries, had started to turn. Some of the anticipated easing bias of the Canadian central bank now seems to be off the table, which is mirrored in the retracement of the 10y spread. The 10y govie spread has probably been the best leading indicator of USDCAD moves recently. Currently the spread points at a further retracement towards the 1.087 area (chart 1), but underlying momentum in the rates spread should still be in favour of long USDCAD beyond the very short-term up until the next BoC meeting the 5th of March.

AUD: Too much is priced in

The Australian central bank (RBA) called off its easing bias at the first monetary policy review of the year the 7th of February. Even though some indicators could point at more cuts to come (e.g. unemployment), recent price development (CPI 2.7% y/y) will be enough to keep RBA side-lined. Clearly at least AUDNZD has attempted to front run a rather large policy divergence, which after the turn in policy from RBA now seems even more exaggerated. Even with 40 to 50 bps policy spread priced in, the AUDNZD fair value would be something closer to 1.15 (Chart 2), leaving a lot of room to the upside.

Vis-à-vis other majors, the upside potential also seems rather large as well, if momentum starts to turn for the AUD. Usually, AUD would have followed the US ISM index up, alongside increasing risk appetite. This has not happened, partly due to RBA talking down the value of the AUD, risks associated with the Chinese outlook and finally due to the fact that increasing risk appetite from better fundamentals has not really settled into currency markets due to tapering from Fed.

Chart 7. 10 year govie spread is leading USDCAD

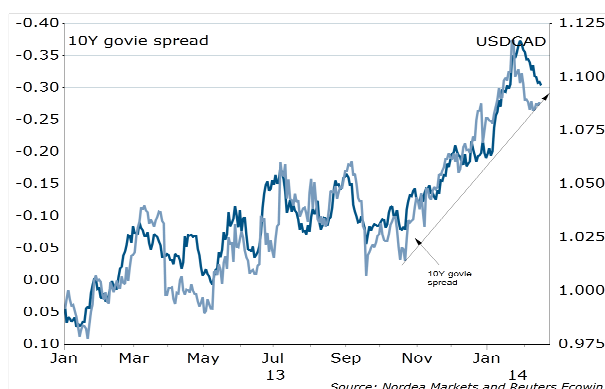
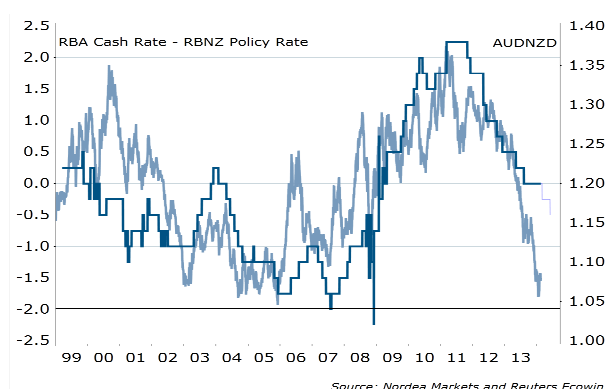


Chart 8. Too much policy divergence is priced in



Scandi Corner

Author

Torbjörn Isaksson

Chief Analyst

Tel +46 8 614 8859

torbjorn.isaksson@nordea.com

Sweden – inflation surprises again

Inflation once again surprised on the downside. CPIF-inflation stood at 0.4% y/y in January, thus as much as 0.3% points below the Riksbank's view. There is one additional inflation figure ahead of the Riksbank's April monetary policy meeting (the February reading due 11 March). This will be the most important key figure in the coming weeks. Our preliminary assessment is that the deviation to the Riksbank's forecast will decrease. We still expect the Riksbank to stay on hold, although the surprisingly low inflation means that a rate cut can't be ruled out.

Growth prospects are also important for the Riksbank. If growth fails to recover, the probability of a rate cut increases further. However, much suggest that GDP growth is strengthening. At present, the Riksbank's Q4 forecasts of 0.6% q/q and 1.1% y/y appear to be within reach, and the overall outlook for 2014 is bright.

Labour market fluctuations have been significant recently. Employment growth accelerated in 2013, but employment contracted at the turn of the year. This was further reflected in unemployment, which was as high as 8.2% in January.

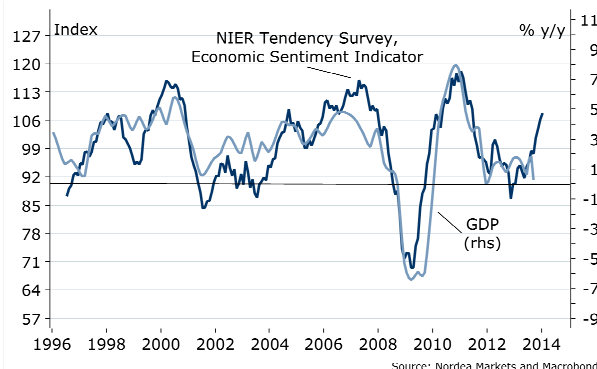
We believe the labour market weakening seen in the past two months is temporary. Indeed, GDP growth looks set to recover and labour market indicators have improved. We consequently believe that the labour market will improve going forward.

The current recovery should be reflected in the data releases in the coming weeks. Sentiment should stay relatively optimistic, although household and corporate optimism may fade somewhat the past month (figures out 21 February). We will also monitor closely the GDP figures (28 Feb.) and the Labour Force Survey (13 March). But as already mentioned the most important key figure is February inflation figures due 11 March.

Chart 9. Inflation well below the Riksbank's in January



Chart 10. Growth prospects improving



SEK: Weaker on rate cut speculation

Authors

Henrik Unell

Chief Strategist
+46 8 534 910 97
henrik.unell@nordea.com

Mikael Sarwe

Director
+46 8 614 99 09
mikael.sarwe@nordea.com

Rate cut speculation should mean SEK prone for weakness short-term

Strong Swedish macro momentum should strengthen SEK towards the summer

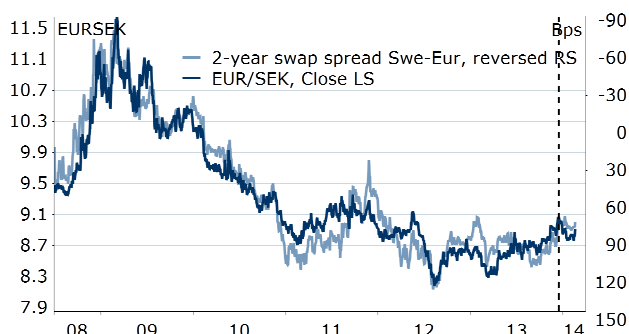
You could argue that the transition towards more normal markets suggest that EURSEK should trade in its historically normal range of 9.00 – 9.40. We do agree that history should be a guide for the future but we disagree on the EURSEK range for that normality. We do suggest that the medium-term outlook for the SEK is one of pro-cyclicality where Sweden is leaving a soft patch and the EURSEK should eventually go lower as activity picks up. But the low inflation print for January tilts the view in the short-term towards markets hunting for a rate cut in April. There is scope for Swedish bond yields to outperform German. During the similar run up to the December rate cut EURSEK touched 9.10 – this could happen again. That said a rate cut in April is far from the “done deal” that December turned into due to stronger underlying economic data which makes us favor an on hold decision. But the December cut was still an indication that the Riksbank for now has abandoned the financial stability “lean hawkish” rhetoric in favor of more traditional inflation targeting. So markets should speculate in a rate cut or a repo rate path from the Riksbank that pushes the first hike even further out in time than the February 2015 date from the latest monetary policy report.

Also, movements in EURSEK and USDSEK and NOKSEK have for the past year been more of a USD, EUR and NOK story rather than a pure SEK story. Whether ECB delivers something or not in March, the US weather story and developments of Norwegian house prices and growth will be of importance.

Looking past the April rate decision, we still feel that the growth outlook for Sweden is more positive than for Eurozone. During the first half of 2014 growth should improve markedly and our economists believe that inflation will start to gradually trend up. EURSEK continues to be heavily influenced by relative monetary policy expectations, i.e. the 2-yr spread between Sweden and Eurozone, and data surprises. The Riksbank is considered to be one of the first central banks able, at some distant point in time, to hike the policy rate which should benefit the SEK later on this year.

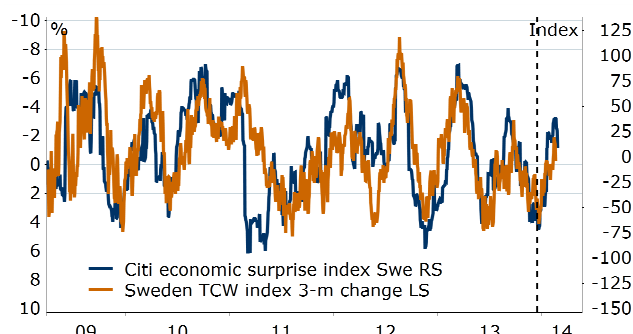
The view is thus schizophrenic. Markets love a good story and will be inclined to try to play a rate cut theme that should make the SEK prone to weakness the coming month. In time, however, Swedish macro data will show quite strong momentum and strengthen the SEK towards the summer.

Chart 11. Rate spread still main driver of EURSEK...



Source: Nordea Markets and Reuters Ecowin

Chart 12. ...combined with Swedish data surprises



Source: Nordea Markets and Reuters Ecowin

Norway – Continued Slowdown

Author

Erik Bruce

Chief Analyst

Tel: +47 2248 4449

erik.bruce@nordea.com

Lower growth and capacity utilization argues for lower rates.

We see no reason to change our view of a continued slowdown in the Norwegian economy. Mainland GDP grew 0.6% in Q4 which was more than expected, but we would not give too much weight to that as inventory growth was high in Q2 and Q3 and mainland demand was unchanged through H2 2013. Add to this that the levelling out of oil investments is now on its way with nearly unchanged investments in the second part of 2013. Housing investment is still growing due to past growth in housing start, but builders are reporting that it is very hard to sell new projects. Housing starts will most likely fall soon and with some lag building of new houses.

We continue to forecast growth far below Norges Bank's forecast both this year and next. With slow growth in production, growth in demand for labour will also slow. But so will supply and that is why our forecast for unemployment is not that much higher than Norges Bank forecast.

We think a weaker NOK will counteract the real economy for Norges Bank. Currently trade weighted NOK is only marginally weaker than Norges Bank's forecast but they forecast NOK to strengthen throughout the year while we forecast the opposite. Furthermore, we believe a general stronger SEK, GBP and USD will keep the trade weighted NOK weak.

Late March we will receive a new interest rate forecast from Norges Bank based on a more optimistic view on the economy than ours. Their view on price and wage growth could also be somewhat higher. If we are right that the 0.3% point higher core inflation in January compared to Norges Bank's forecast was temporary then inflation should be no argument for higher rates.

However, this year's wage negotiations could be tougher than previously believed. The negotiations will be based on an inflation forecast of 2 ½% which at least at the margin argue for higher nominal wage growth. Higher educated employees in manufacturing got significantly more than the average wage growth last year which will raise demand for the same groups in other parts of the economy this year.

In conclusion, we could see a moderately higher rate path in the March report with a somewhat earlier first hike (say early 2015) than in the Dec report. But the main message will still be that rates are on hold for now.

Chart 13. Downside risk to Norges Bank's forecasts

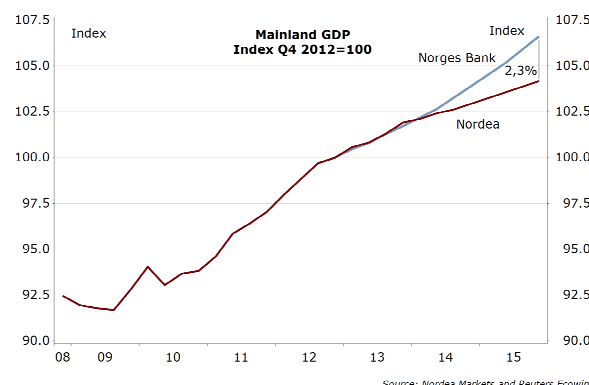
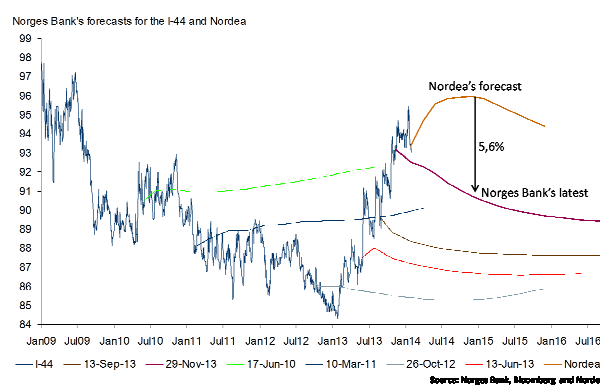


Chart 14. A weaker NOK will be the result



NOK: Investments leaving the (not so) safe haven

Author

Ole Håkon Eek-Nielsen
Chief Analyst
+47 2248 7869
ohen@nordea.com

We might look at more than NOK 50bn on its way out of the country

With improved risk sentiment and better than expected Norwegian key figures, EURNOK came down from the 4 ½ years high around 8.54. It seems quite clear that NOK is behaving like an emerging market asset. Low liquidity is one factor contributing, but the picture of decreasing oil investments might also make the case for comparison with countries like Russia, South Africa and Brazil. Weak Norwegian macro figures (and weaker than Norges Bank expects) and flows argues for a rather high EURNOK the coming months.

The flow picture in NOK for the coming months could also become a negative contribution. Foreign investors piled into the NOK-trade in several channels after the financial crisis. The perception of NOK as the safe haven made EURNOK-bonds quite attractive. These are bonds issued by foreign companies with high credit rating in NOK mostly attracting investors with a positive NOK-view. The issuance activity came to a halt in second half of last year, and this spring we will see a rush of maturities. The combined volume is around NOK 30bn during April and May. In addition to this we will see redemption of Norwegian T-bills in March of which foreigners own NOK 9bn. Add the dividend payments in May of around NOK 13bn and we might look at more than NOK 50bn on its way out of the country.

The positions in NOK have already been reduced quite a lot, in our estimates close to NOK 170bn, but the coming reduction could add to the already weak NOK. That will of course depend on the themes in the market. If our forecast for a weak economy fails then these amounts might get reinvested, but it seems hard to see NOK strengthen in the environment we forecast.

Chart 15. Foreigners on their way out of NOK

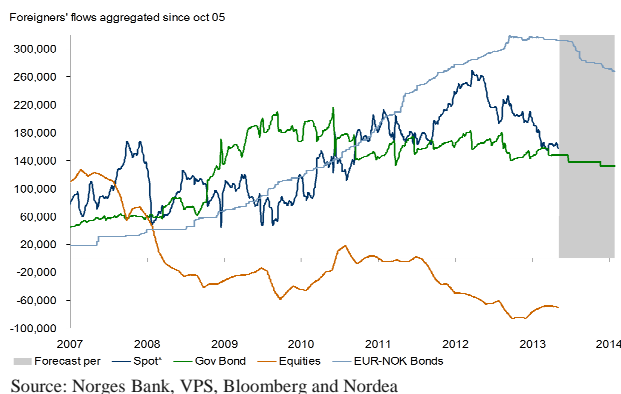
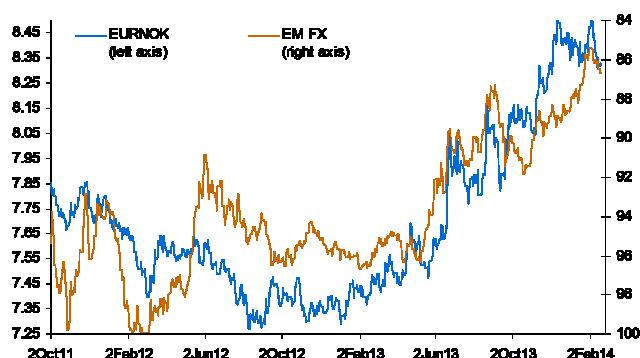


Chart 16. NOK; part of (not so) emerging market



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