Global FX Strategy

Markets in a QE mood

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Editors

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EUR/USD: QE premium to be priced in

EUR/USD does not appear to be pricing in a larger QE announcement, and hence we may see further downside in the cross if we are right that the market will increasingly bet in this direction.

JPY: Too fast, but not too far

The sudden JPY weakening was "too much of a good thing" for Japan as it seems the policymakers are beginning to curb further JPY weakness.

GBP: First mover advantage

The Scottish referendum risks are now behind us, and while the story is not over, focus now turns to the Bank of England.

EM FX: Generally weaker

EM FX continues to suffer and more Fed-related general weakening is ahead.

SEK: Near-term "risk premium"

Riksbank easing, government crisis and regulation are three arguments for a near-term risk premium in the SEK.

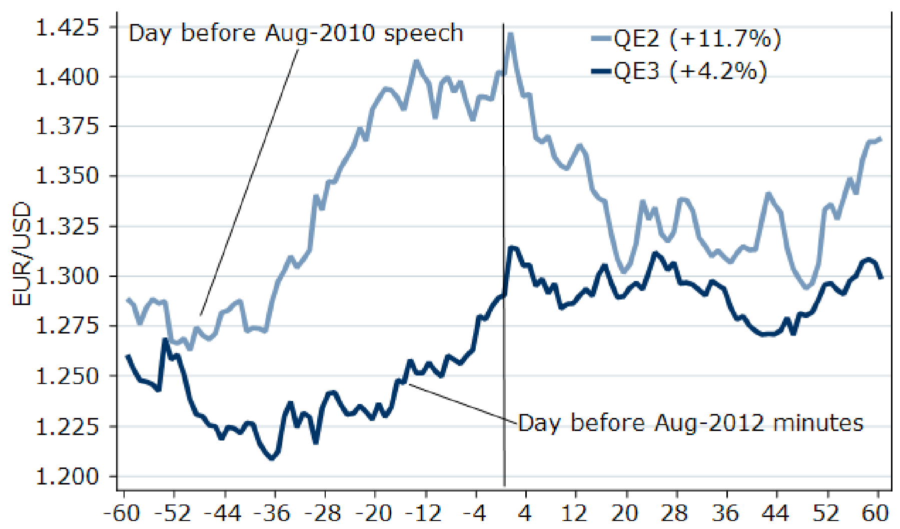
NOK: Room for further downside

We continue to see arguments for a lower EUR/NOK cross.

DKK: Stronger DKK and sub-zero deposit rates

Intervention and unilateral CD rate cut if the DKK strengthens further.

Chart 1: Higher EUR/USD ahead of Fed QE



Sources: Nordea Markets and Macrobond

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The lacklustre take-up in the ECB's first TLTRO has further fuelled expectations that it may need to launch an expanded QE programme, and comments from the ECB's Draghi have done nothing to counter these expectations – rather the opposite. At the September meeting he said the ECB aims to "significantly steer the size of its balance sheet towards the dimensions it used to have at the beginning of 2012". At the European Parliament he added that the ECB is "starting a transition from a monetary policy framework predominantly founded on passive provision of central bank credit to a more active and controlled management of our balance sheet". In other words, the ECB appears to be shifting the way it conducts monetary policy: if the set targets cannot be met with the measures announced so far, more will be needed. The market has rightly been rife with QE speculation.

It's tricky to disentangle QE expectations from financial markets, but for what it's worth, neither the EUR nor the bond market seems content with the measures launched so far in sharp contrast to what was seen in US markets after eg Fed Chair Bernanke's QE hints. In short, the lack of a "QE premium" in the EUR means that we may see further downside.

As for the US, large chunks of the world economy have slowed down recently, begging the question how long US macro can keep performing this strongly. Another low inflation number or another weak NFP print could bring about a pause in the dollar rally.

As for the UK, with the Scottish risks away, there is nothing to prevent the BoE from starting policy tightening. If one follows the forward "guidance", it seems that the BoE is willing to be the first major central bank to raise interest rates. This should be GBP supportive versus Europe.

After months of consolidation, the Japanese yen weakened broadly and sharply. Now it looks as if policymakers are trying to dampen the move somewhat. The key drivers of the JPY nonetheless suggest further weakness.

EM FX continues to suffer. We believe rising US bond yields have been the main reason for the recent round of EM sell-off. The big EM central banks have started to be more active with liquidity being provided from the PBoC and CBR, while the BCB has stepped up intervention to support the BRL. We see more general EM FX weakness ahead.

EUR/USD: QE premium to be priced in

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EUR to remain under pressure

The lacklustre take-up in the ECB's first TLTRO has further fuelled expectations that it may need to launch an expanded QE programme, and comments from ECB's Draghi have done nothing to counter these expectations – rather the opposite.

It's tricky to disentangle QE expectations from financial markets, but for what it's worth, EUR/USD does not appear to be pricing in a major QE announcement. EUR/USD has tracked relative 3M interest rates so far this year, with the ECB's rate cuts and liquidity provision undermining the EUR since May (Chart 2). Nor are Euro-area inflation markets, or the German yield curve, sending signals that the ECB is doing "enough".

Lack of a QE premium in the EUR suggests that we may see further downside

The lack of a QE premium in the EUR suggests that we may see further downside in the cross if we are right that the market will increasingly bet in this direction. Furthermore, if the ECB's QE hints are aimed at restoring confidence in the inflation target, then, *when* a QE premium is priced in, the cross would become extraordinarily sensitive on the upside to any positive surprises in HICP inflation – as said the QE premium would then decrease.

Using experiences from the Fed's QE2 and QE3 as a guide, the EUR is likely to depreciate until the day *after* a formal QE announcement (Chart 3). Taking Draghi's Jackson Hole speech as a starting point, EUR/USD should eventually visit 1.19 if the EUR copies the USD's performance ahead of QE2. Intriguingly, this level is exactly what is needed according to the ECB's scenario analysis in September if 2016 HICP inflation is to reach the "below, but close to, 2% level".

As for the US, large chunks of the world economy have slowed down recently, begging the question how long US macro can keep performing this strongly. The US economic surprise index is at fairly lofty levels, and the USD is at technically extended levels. Another low inflation number or another weak NFP print could easily bring about a pause in the dollar rally.

We alter our EUR/USD forecast to 1.24 on a 3M horizon (from 1.32), based on expectations of a QE premium.

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

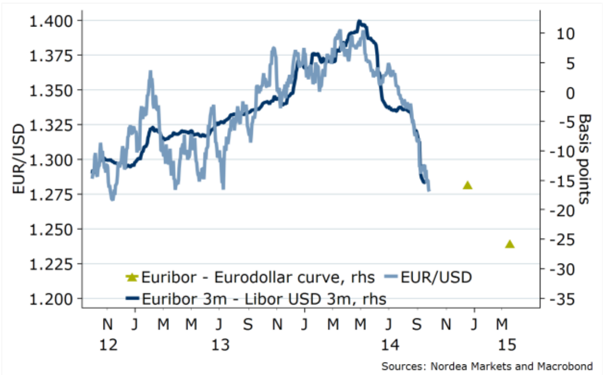
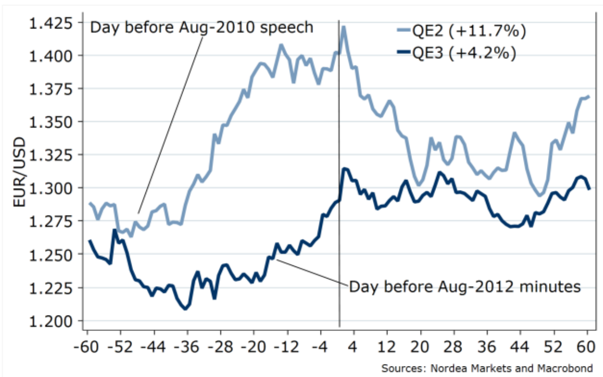


Chart 3: Higher EUR/USD ahead of Fed QE



JPY: Too fast, but not too far

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Time to pause …

JPY could strengthen short term

After months of consolidation, the Japanese yen suddenly weakened broadly. "Too much of a good thing" for Japan as it seems the policymakers are beginning to curb further JPY weakness. BoJ head Kuroda said that *"What's important is for exchange rates to move in a stable manner*", just as Japan's PM Abe and Economy Minister Amari hinted over the past week that abrupt moves in currencies are not good for the Japanese economy.

… but just a pause

While 2013 was the yen story – seen from the positive high EUR/JPY and USD/JPY correlation – this year, it has been mainly a "strong USD" story since June as EUR/JPY and USD/JPY have decoupled. But now that the USD looks stretched, the next leg down could come due to domestic issues.

If inflation remains sticky, the JPY will hurt further, broadly

The key JPY-negative factor will be inflation. It seems now that inflationary pressures are building up, at least cyclically. The labour market has tightened, with the unemployment rate close to 20-year lows, the output gap has been closed, and nominal wages are back growing at the fastest rate since 1997. Barring recent disappointments, mostly due to the VAT tax hike in April, consumer confidence has recovered since, and inflation expectations are firmly on the upside. Counter-intuitively to some, this positive backdrop is the environment supporting a weaker JPY, not a stronger one.

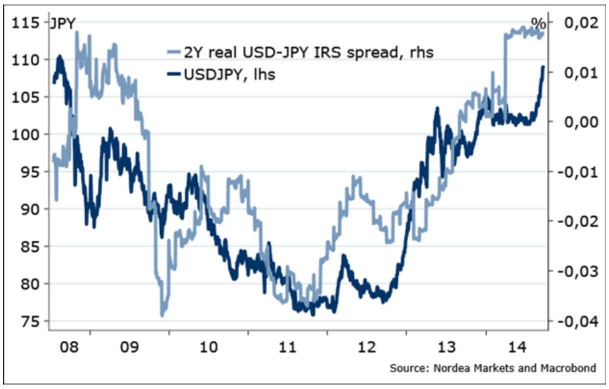
Drivers

Higher USD yields and Japanese stock prices will bring a weaker JPY

The two key drivers of the JPY crosses remain "risk-free" long-term yields and stock markets. Our forecasts suggest a further rise of the US 10Y Treasury yield in the coming months, which would be USD/JPY and EUR/JPY supportive. Also, if the stock markets keep rising, celebrating a recovery in Japanese data (note that the macro surprise index is the lowest one among G10), that will bring USD/JPY and EUR/JPY higher in coming months. As noted before, one should be ready to see USD/JPY at 120 or even 130 next year (realistic risk scenario).

Chart 4: Inflation pressures building

Chart 5: Inflation hurts JPY



GBP: First mover advantage

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BoE showtime

The Scottish referendum risks are now behind us, and while the story is not over, this will not affect the GBP in the foreseeable future.

BoE to hike first?

The key now is that, with the Scottish risks away, there is nothing to prevent the BoE from starting policy tightening. If one follows the forward "guidance", it seems that the BoE is willing to be the first major central bank to raise interest rates. As Carney recently indicated, if forecasts are met, that could happen "by spring", which will be earlier than the Fed indicates currently (June). Our economists also note that risks have now increased that the Fed will only move in June, consistent with their own guidance.

Our economists' baseline is that the BoE will hike rates in Q2, but that will unlikely keep markets from speculating about an earlier move, taking hints from the BoE. We already have two dissenters on the BoE board, voting for a hike. Also, the BoE lowered the bar significantly – the forecast of their single most important indicator, wage growth – to just 1.25% this year. Thus, it does not take much upside (indicated by some survey indicators) for them to execute, or at least threaten to execute, the plan. This will support the GBP.

Technically speaking

1.6000 a huge support level for GBP/USD

GBP/USD is now at a very important juncture as it rebounded from the 1.6000 level, which is a support level from the downtrend that started in 2008, also the 50% retracement level of the rise from the previous year's bottom to the recent peak. If this level holds, and our forecasts envision that, GBP/USD has much more potential on the upside than we currently foresee in 2015.

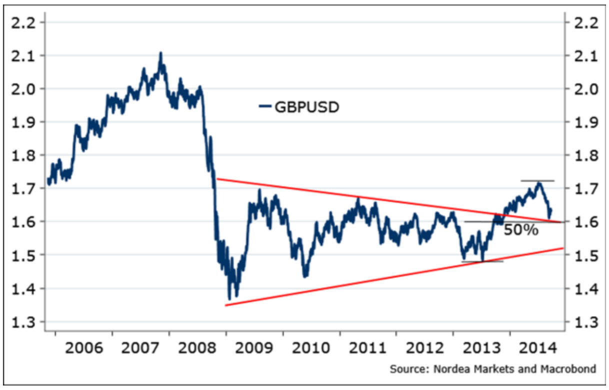
Strong against easing counterparts

GBP strength against European counterparts – at risk

The GBP strengthened against the European currencies over summer, notably the EUR and the SEK, which should be seen as the weakness of the latter rather than GBP strength. This is due to the ECB switching its language and introducing more easing since June, which spilled over to its European peers. Thus, the turn of the GBP against the European currencies – and if it comes – will likely be consistent (not our forecast). The ECB should disappoint for this to happen (rates move up).

Chart 6: Lower wage bar for BoE in 2014

Chart 7: GBP/USD bounced from important support



EM FX: Generally weaker

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EM FX continues to suffer. Just so far in September, the BRL has weakened almost 7% vs the USD, the ZAR and the RUB around 4% and the TRY 3%.

As mentioned two weeks ago in EM FX: From divergent to generally weaker, we believe rising US bond yields have been the main reason for the recent round of EM sell-off. EM FX correlations with US 10Y bond yields have indeed risen after the latter started increasing, and while the Fed still intends to keep its main policy rates near zero for a "considerable time," the FOMC members' own forecasts (dots) remain much above what is priced into the markets. Thus, more Fed-induced EM FX weakening is likely.

We are less inclined to blame weaker Chinese numbers for the recent poor EM FX performance (see Chart 9). Especially when it seems that the Chinese authorities will be fairly fast with more support, should growth drift away from the full-year target. We still see a stronger CNY ahead.

Interestingly, we have already seen big central banks being more active in recent weeks. The PBoC added 3-month liquidity to the five biggest banks, while the CBR added USD liquidity to its banks and the BCB stepped up its FX support yesterday after USD/BRL went through 2.40. The RUB may also soon start finding central bank support as the upper end of the basket corridor is nearing.

This supports our view that EM central banks are likely to allow gradual and controlled EM FX depreciation in response to rising US yields – as most EM economies are too weak for rate hikes – but not dramatic sell-offs, if possible.

There are several important events over the coming month. The first round of the presidential election in Brazil is on 5 October, where Ms Rousseff and Ms Silva are polled to head on to a second round on 26 October, where they are neck and neck. The Fourth Plenum in China may result in new reforms being announced and markets will be looking for signs of a new mini stimulus package, though probably in vain. The Ukrainian parliamentary election is on 26 October. Kiev will try to make the truce hold at least until then. Finally, the Polish central bank is most likely to resume its easing cycle with some MPC members calling for a 50 bp cut at the October meeting.

Chart 8: General EM weakening in September

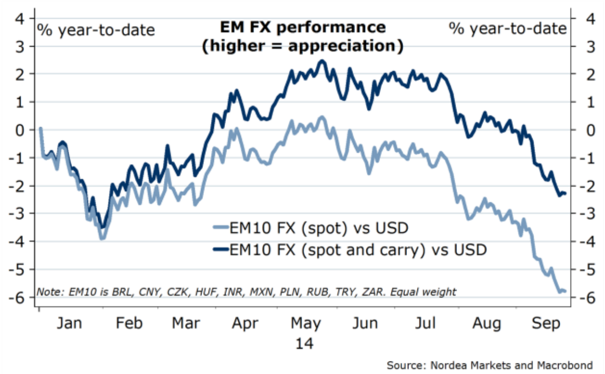
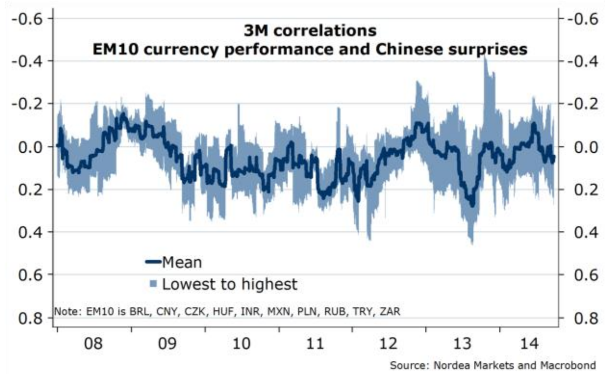


Chart 9: Limited EM FX correlation with China surprises



Scandi corner

EUR/SEK – three arguments for near-term "risk premium" in SEK

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Over the next few months we see three risk premium-based arguments why the trend is still your friend in EUR/SEK: 1) the Riksbank could opt to lower rates further in Q4, 2) the parliamentary situation may result in a government crisis and 3) further regulation aimed at cooling the housing market could be a net bearish surprise for the economy on the margin.

Some Riksbank members wish to react asymmetrically: higher inflation not affecting monetary policy

Swedish inflation will trend higher in coming quarters. This suggests that a turnaround in EUR/SEK could be on the cards as it will become easier for the market to ponder rate hikes. However, the global environment is interfering with this thesis, especially when seen in light of the minutes from the Riksbank's September meeting. For instance, some Riksbank members wish to react asymmetrically to inflation, with higher inflation not affecting monetary policy. It was also noted that "monetary policy abroad is an absolutely central precondition for monetary policy in Sweden". This hints at substantial downward revisions to the Riksbank's rate path – and a large enough revision could coincide with another rate cut.

Turning to politics, the Swedish election resulted in a parliamentary nightmare. We expect a red-green government to be formed. It will try to pass a fairly uncontroversial budget by mid-November at the latest. The right-wing coalition will present its own budget proposal, which could result in a government crisis if the Sweden Democrats support this alternative budget. An extra election can't be ruled out but is still unlikely near term. In short, "headline risks" regarding the parliamentary situation remain high.

Tough enough macro-prudential measures could push SEK in a weaker direction

Swedish house prices are rising at the fastest pace since February 2010. According to Riksbank Governor Ingves, the situation is acute, and further measures to cool the market are needed immediately. The Financial Stability Council will meet in November and discuss eg amortisation requirements. Tough enough measures could push the SEK in a weaker direction.

When it becomes clear that the Riksbank is done easing, focus will turn to rate hikes. The Riksbank's Ekholm outlined five conditions before she would consider lifting the repo rate: 1) the Fed has hiked rates, 2) the BoE has tightened policy, 3) Sweden is growing strongly, 4) unemployment has dropped markedly and 5) inflation is close to 2%. Most if not all of these will slot into place during 2015, eventually triggering SEK strength. For now, we keep our EUR/SEK forecast of 9.30 in the short term, while advising investors to use such weakness to position for a stronger SEK in 2015.

Chart 10: What if the Riksbank cuts rates once more?

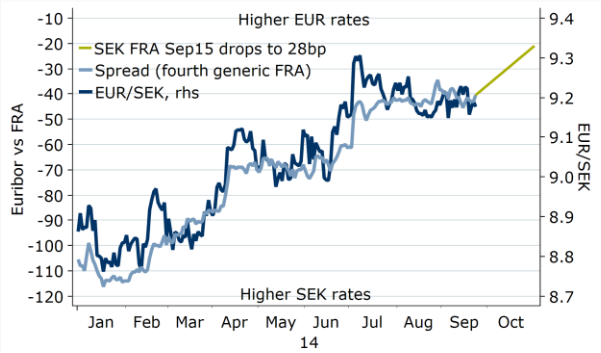
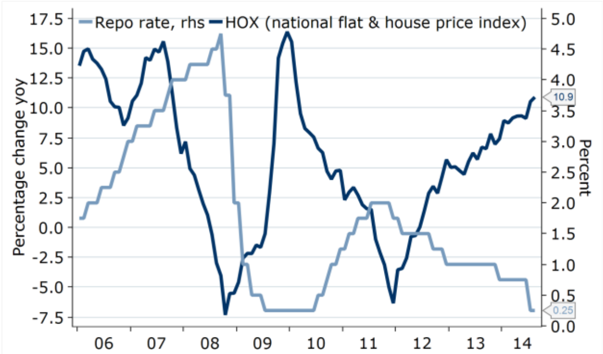


Chart 11: "Acute" situation according to Governor Ingves



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EUR/NOK – room for further downside

EUR/NOK has over the last couple of years turned into a game of betting on the signals Norges Bank will send in its monetary reports. The upside we have seen since 2012 has of course been a question of the trend in the Norwegian economy and partly the improvement in the Euro zone since the debt crisis, but most large movements in EUR/NOK have come on the back of Norges Bank meetings. Last week was no exception. There are 18bf from the top before the meeting conference to the bottom a little more than 24 hours later.

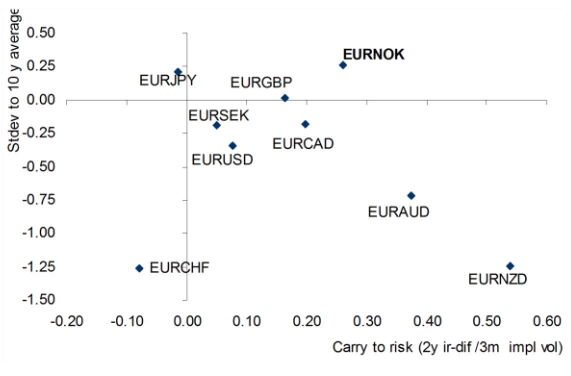
EUR/NOK on the downside

The trend for the downside in EUR/NOK seems quite clear; we are seeing lower highs and we are trading below most moving averages. There are also some good arguments for the downside. The level itself is one of them. EUR/NOK is the highest EUR cross in the G10 universe, despite the fact that carry to risk in EUR/NOK is the third highest. Carry could end up being an even more important theme when the ECB balance sheet starts growing. Short term, Norges Bank could get some help from lower margins at the banks, but their forecast for a lower I-44 (stronger NOK) will also keep them from cutting rates even if the NOK goes stronger from here. From our trading with foreign speculative players we don't see the market as very long NOK either.

Low risk from being short EUR/NOK despite facing slow downside

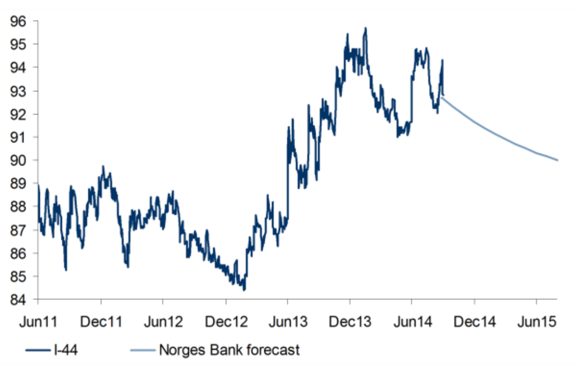
So what could possibly go wrong being short EUR/NOK? In our view, not that much, but one should keep in mind that the downside is normally quite slow. We have tried breaking through 8.10 on two separate occasions without succeeding. Both 8.05 and 8.00 could prove long-lived as support levels. From a macro point of view we would also say that there is downside risk for Norges Bank's forecasts on a longer-term horizon. Some risk of a EUR rebound could also play against the downside idea. All taken into consideration, a seagull looks interesting. For a 3M maturity one could buy an 8.10 put, sell an 8.33 call and sell a 7.95 put at zero cost (spot ref 8.15). This position should satisfy a view of the cross slowly grinding lower and at the same time offering a decent cushion for upside corrections.

Chart 12: EUR/NOK high levels despite good carry



Source: Nordea Markets and Bloomberg

Chart 13: Norges Bank forecasting stronger NOK



Source: Nordea Markets and Bloomberg

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EUR/DKK – stronger DKK and sub-zero deposit rates

Since early June the DKK has strengthened markedly versus the EUR. The DKK appreciation followed in the wake of the spread widening caused by the Danish central bank's unilateral tightening during the spring. Growing speculation about further monetary policy measures by the ECB has only intensified the trend towards a stronger DKK versus the EUR. But so far, the DKK appreciation has not been strong enough to prompt the central bank to intervene in the currency market (most recent data cover period until end-August).

Recently, EUR/DKK has been trading at levels that previously would lead to central bank intervention. Consequently, if the DKK strengthens further, the central bank will most likely start to sell DKK and in the process boost its currency reserves. Short term, there is a risk that further DKK strengthening could prompt the central bank to sanction a unilateral CD rate cut.

Chart 14: EUR/DKK and central bank intervention

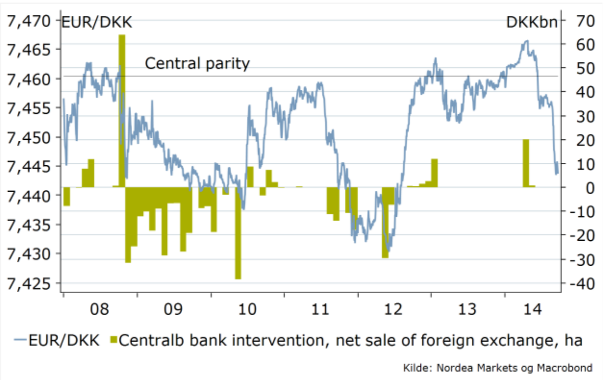

Chart 15: No Danish relative hikes factored in