

Global FX Strategy

Dollar needs more kindling

Nordea Research, 20 February 2014

USD: more kindling needed

The market will need to reappraise its Euro Area outlook, which could trigger EUR-positive flows. The theme of policy divergence remains on track, with the question being how much is priced in already.

JPY: short-term strength – opportunity

While the case for a weaker JPY is solid, it may see temporary tailwinds.

GBP: political headwinds

While BoE Carney is far from dovish nowadays, we see political risks as a significant challenge to the GBP in coming months.

EM FX: CEE risks are underestimated

Last year's trading ranges are not fair representation of this year's risks.

SEK: the Riksbank staring into the abyss

The SEK should remain weak due to the Riksbank's inflation focus in the near term.

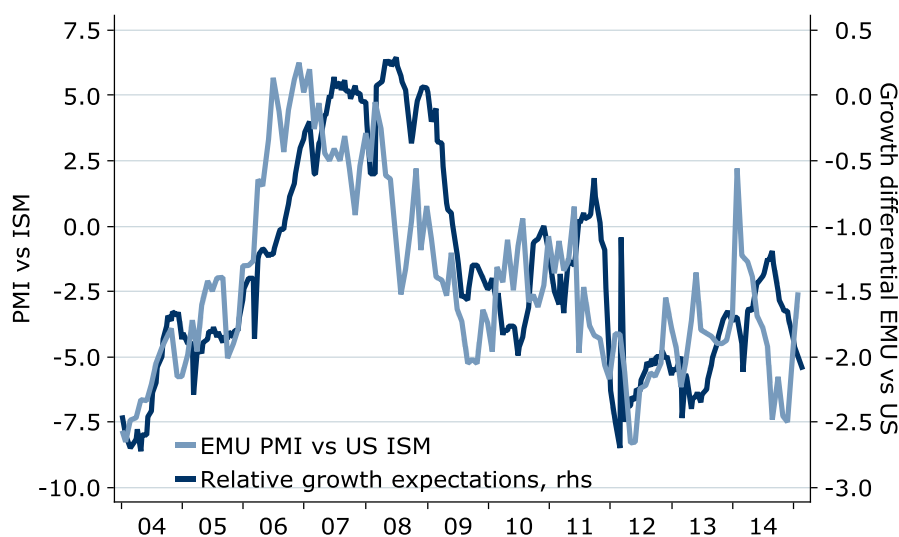
NOK: alternatives to NOK are not attractive

With other central banks entering unconventional territory, foreign interest in the NOK is returning.

DKK: strong defence of the peg

How ECB QE play out will have an impact on Danish rates, and therefore how the Danish central bank can be expected to react.

Chart 1: Market will need to reappraise Euro Area growth outlook



Sources: Nordea Markets and Macrobond

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Global markets – overview

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The USD trend needs more kindling in the near term.

Last year's trading ranges not fair representation of this year's risks

Disinflation and growth worries have led to a wave of central bank easing so far in 2015, with even the Federal Reserve [softening a touch](#) according to the latest FOMC minutes. The short-term risk of a spill-over into weaker core inflation from lower oil prices may have started to put fears in the FOMC.

The USD has been taking a breather over the past few weeks, with sentiment dashed in part due to the worst start of the year (vs. expectations) since 2008. While the normal pattern of the USD is to appreciate ahead of the first rate hike, the trend needs more kindling in the near term.

How the Fed Troika communicates over the next few weeks will be crucial if we are to reignite the USD trend, with the next key event being the Humphrey Hawkins testimony February 24.

In Europe, politics are – as so very often – impacting short-term currency developments. Grexit fears have indeed been on the rise as a result of the lack of progress in Greece's talks with its creditors. To us it's a risk scenario, but one [that should not be forgotten](#), especially as "crunch time" is approaching (March).

Elsewhere, we do not believe the ranges in CEE FX are fair representations of the risks for this year. The list of risks is actually unusually long for the region, which is also reflected in increased implied volatilities this year.

Oil price developments remain crucial. Brent oil prices have risen 30% off their lows in January, and if they continue to trend higher the (for now very dovish) monetary policy outlooks in e.g. Scandis may need to be reappraised, as should the outlook for various commodity currencies if their *terms of trade* is seen reversing course.

In this respect, the recovery in China's property market remains elusive. Various indicators suggest it should slot into place in the first half of this year. Indeed, the combined impact on growth from dropping interest rates, weaker currencies and lower commodity prices will probably become a major (growth-bullish) theme later this year.

USD: more kindling needed

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Growth convergence will not prevent policy divergence

The normal pattern of EUR/USD since 87 is that the pair is under pressure into the first Fed hike

The dollar has been taking a breather after the strong rally over the past few quarters. The dollar has been held back by a weak start to the year in terms of economic data – the worst start vs expectations since 2008 - and profit-taking after ECB in January. The USD has in fact been remarkably resilient given the headwinds it has faced, and the EUR, while appreciating somewhat after ECB's QE announcement has failed to match the decent bounces seen after Fed's QE programs.

We find it likely that economists will have to boost their Euro Area growth forecasts in coming months, while worse US data may prompt some lowering of forecasts (chart 02). On the one hand we'll thus see growth convergence, which on its own is EUR/USD-positive (especially if Euro Area assets are "under-owned" to begin with). On the other hand, growth convergence will not prevent policy divergence (EUR/USD-negative). The question is not if policies will diverge, but rather about what's priced in.

What's priced in? Indicators are mixed. Real rate spreads suggests the pair is fairly valued around these levels, the quantitative outlook (chart 03) supports this view. Money market spreads does however hint at further USD upside when e.g. Libor 3m rates stick higher in a more material way.

What's more, the normal pattern of EUR/USD since 1987 is that the pair is under pressure into the first Fed hike, which we see in September this year.

In the near term, Fed Chair Yellen's comments at the Humphrey Hawkins testimony February 24 could provide a trigger of further USD upside. The most recent FOMC minutes may have provided some [dovish reading](#), but since that meeting, employment data have been stellar, oil prices have surged 30% off lows, and global activity indicators appear to be improving a notch.

Further USD strength down the road

In comparison to the past six months or so, the outlook for the USD is fairly cloudy. A lot of good news is priced in, as is a lot of the policy divergence theme. If global growth (and more important inflation pressures) pick up, as we believe, then it makes sense for the Fed to become more hawkish than it has signalled earlier. This is one reason why we see further USD strength down the road.

Chart 02: EMU vs US: growth convergence?

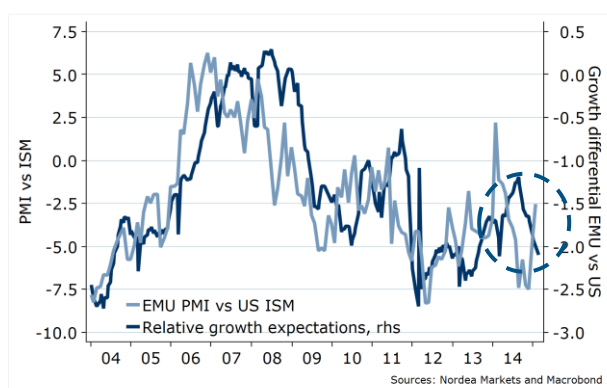
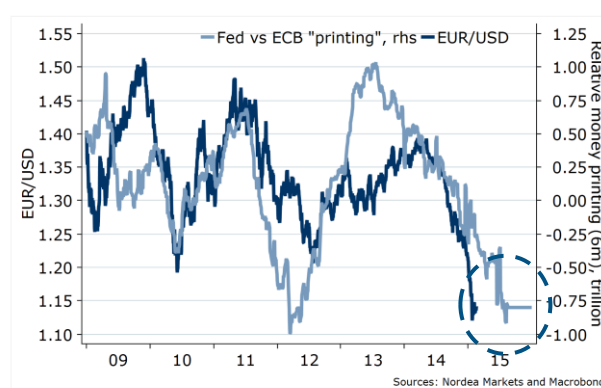


Chart 03: EUR/USD and quantitative divergences



JPY: short-term strength – opportunity

Recovery!

As we wrote in January, the JPY could face some short-term tailwinds. While we still could see it stronger short term [for the reasons outlined](#), a resumption of the downward move is likely ahead.

What is good for consumers is good for stocks and bad for JPY

The data over the past month suggest a gradual recovery. Earnings growth has picked up again, and with inflation declining we will see real wage growth for the first time in two years since QQE was launched. Consumer inflation expectations remain sticky at high levels, and thus even though Japan will see deflation again in coming months, it will likely be transitory. Real wage growth is good news for Japanese households. The Tankan survey (1 April) will be the key data point to watch, as it has been signalling shortage of labour recently.

What is good for Japan, and therefore good for Japanese stock prices, has historically been bad for the Japanese yen (spurs financial outflows), and that dynamic will likely persist.

To fight the imminent deflation, the BoJ will likely continue with the current version of the QQE for now and warn of more if needed, which will be another factor supporting JPY weakness this year.

Key drivers for support

Higher long rates will push JPY weaker

The correlation between USD/JPY and stock prices remains high: over the past year it has been around 0.75. Another key driver is global yields. For example, US Treasury yields have turned back up above 2% again, and should that continue, USD/JPY will go up – so will EUR/JPY likely.

The risks on the downside are limited to USD/JPY at 113/114 (trend from August 2014). That would be an opportunity to reposition for JPY weakness. Our official forecast is for USD/JPY to reach 135 next year and there are few reasons to change it yet.

Chart 04. JPY weaker with stocks and yields higher

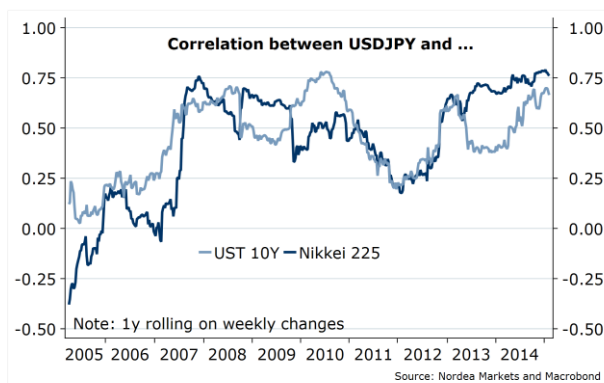
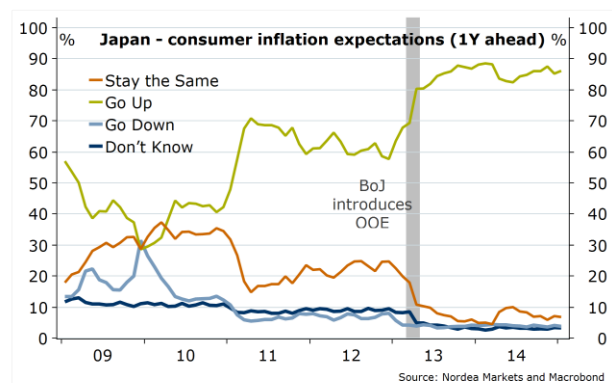


Chart 05. Inflation expectations entrenched



GBP: political headwinds

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BoE Carney's tone is far from dovish

BoE prepping for a hike

We warned in January that the markets got too dovish on the BoE, following their own tone. Since then, some repricing took place: the market has brought forward the first rate hike by six months! Now Q1 2016 is priced for the first lift-off. Our baseline is still Q4 2015, thus there is still room for a bit more tailwind, but definitely less so now.

The BoE inflation report suggests the “slack” in the economy is just 0.5%, down from 1%, and Carney’s tone is far from dovish now. Notably, the BoE has lowered the bar, admitting they won’t be surprised by the negative inflation print in the coming months. And yet Carney noted that “most likely the next move in monetary policy is an increase in interest rates.” And that the recent drop in the oil price is “unambiguously positive for the global economy”. Agreed!

Politics back in play

Now that the BoE is more fairly priced, the market focus could shift to the political risks in the near term, which could hurt the GBP. The general election (May 7) should not be overlooked – “the most unpredictable vote in living memory” could easily become a theme in the coming month. Chances of a hung parliament are high, and should UKIP be part of any administration, a referendum on leaving the EU will likely be brought forward from 2017 (baseline if Conservatives dominate the election) to as early as this summer.

One should not forget that the UK is running twin deficits

One should not forget that the UK is running twin deficits, with both the current account deficit and the budget deficit close to 5% of GDP. With the government’s plan to tighten public finances more, the economy will face some more headwinds – particularly challenging if the May election is successful for Cameron’s Conservatives. Another extreme, a Labour-led coalition will likely slow down austerity measures ... but thereby raise fiscal credibility concerns. No easy outcome!

Stick to forecasts

In short, we see significant near-term risks against the GBP for political reasons.

Chart 06. More room for pricing convergence

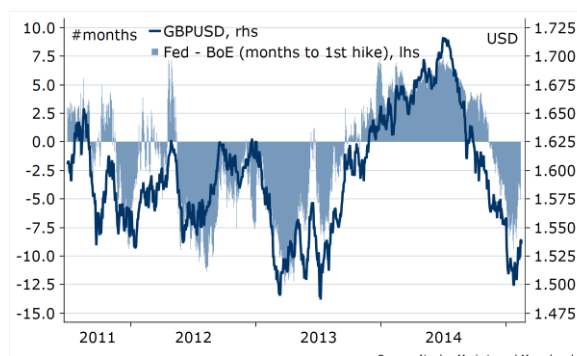
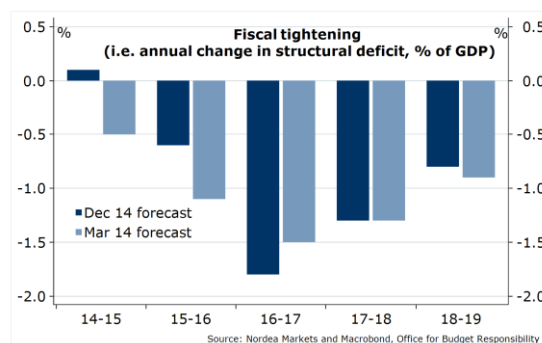


Chart 07. More tightening ahead



EM FX: CEE risks are underestimated

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Last year's trading ranges are not a fair representation of this year's risks

Risks for this year include:

- ECB QE
- CHF loans
- Greece
- Russia
- Polish elections
- Czech devaluation
- Hungarian politics
- Too many rate cuts

After a bit of volatility around the end of 2014 and around the SNB's decision to scrap the EUR/CHF-floor in mid-January this year, EUR/PLN is now back in the middle of the very narrow range from around 4.10-4.25 that prevailed during most of 2014. That is a 4% range!

Similarly EUR/HUF is back in the middle of the range from around 300-316 where it traded during most of last year and EUR/CZK is back in the middle of its a much narrower range from around 27.3-28.0.

However, we do not believe these ranges are fair representations of the risks for this year. The list of risks is actually unusually long for the region, which is also reflected in increased implied volatilities this year (see chart 08).

EUR/TRY is a slightly different story. Yet realised volatility for 2014 was "only" around 10 and a EUR/TRY-level around 2.8 is not far from what could be called the range of the second half of last year.

ECB QE is mainly positive for CEE FX because 1) QE drives rates lower in the Euro area and hence increase the CEE rate spread 2) QE pushes investors out of the risk curve which increases demand for CEE assets 3) QE improves growth prospects for the Euro area and, in turn, for the CEE economies.

Central banks in the CEE have already stepped up defences against stronger currencies stemming from ECB QE. The Polish and Hungarian central banks have re-opened the door for more rate cuts, the Czech central bank talks openly about a "devaluation" in terms of moving the floor higher, and the Turkish central bank cut rates in January and will cut again next week.

Polish elections are due this year. 10 May is the date for the first round of presidential election and end-October is the deadline for the general elections. The PLN weakened significantly in the run-up to the two latest elections (see chart 09) and usually strengthens after elections. Polls suggest a close race after former PM Tusk has left domestic politics and several high-ranking ministers were involved in "waitergate" this summer.

Finally, Greek banks still have a large presence in especially the Balkans and a negative outcome of current negotiations could trigger fresh financial stability woes all over the region. CHF loans are already a concern. And the Russian crisis is far from over. The list of risks is long!

Chart 08: Volatilities have increased so far this year

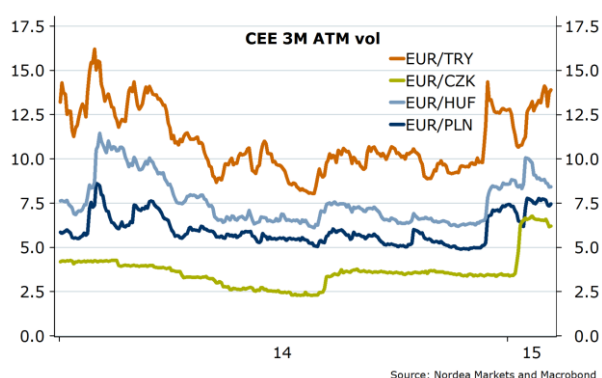


Chart 09: EUR/PLN before and after elections

Date	Election	Spot	% change in EUR/PLN before and after elections			
			3 months before	2 weeks before	2 weeks after	3 months after
09/10/2011	Parliament	4.38	10.2	-2.5	0.4	3.1
04/07/2010	President 2nd round	4.14	7.6	1.8	-1.3	-3.8
20/06/2010	President 1st round	4.07	4.1	-0.6	1.8	-3.4
21/10/2007	Parliament	3.68	-2.3	-2.3	-0.9	-2.2
23/10/2005	President 2nd round	3.90	-5.0	-0.9	1.8	-1.7
09/10/2005	President 1st round	3.94	-3.6	0.8	-0.9	-3.5
25/09/2005	Parliament	3.91	-3.0	-1.2	0.8	-1.9
23/09/2001	Parliament	3.81	12.0	0.8	-0.2	-6.5
08/10/2000	President 1st round	3.98	-3.0	0.6	-0.9	-1.9
Average			4.2	-1.3	0.0	-1.9
			-0.8	0.3	0.0	-2.9
			1.3	0.4	0.3	-2.7

Note: red fill and text means weaker PLN vs EUR; green fill and text means stronger PLN vs EUR

Scandi corner

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How inflation expectations develop in the next quarterly survey will be key

The best SEK-bulls could hope for is a distinct turn-around in the global commodity cycle.

EUR/SEK – the Riksbank staring into the abyss

The Riksbank opening up the trap-door to the basement of negative rates make it less appetizing to buy the SEK. Both in July and October 2014 the SEK appreciated after the surprisingly large rate cuts, partly as a result of the markets' in retrospect misplaced perceptions that rates had hit rock-bottom. Alas, that was far from the case. Today, the Riksbank's alternative scenario in which inflation expectations ease, and comments from Governor Ingves that it could go "much lower" and that it's far from any "lower threshold" support the notion that the Riksbank could go deeply negative if warranted.

How inflation expectations develop in the next quarterly survey will be key. The best guess according to our models is that we'll see another decline in March. As long as inflation expectations remain here, or deteriorate, the pressure is on the Riksbank to act further. Continued pressure on the Riksbank is likely in the near term, we think.

While "fair value" of EUR/SEK is around 9.60 based on our view of another rate cut, we could see substantially higher levels if inflation disappoints – prompting larger rate cuts. A Riksbank rate cut to -50bp and some overshooting could prompt a temporary move to as high as 10.

If, however, we start to see surprisingly large currency effects in inflation, or a continued turn-around in global commodity (especially energy) prices, this would reduce the pressure on the Riksbank and hence on the SEK. The best SEK-bulls could hope for would be a distinct turn-around in the global commodity cycle.

In the short term the SEK is likely to remain weak owing to the Riksbank's inflation focus. Further EUR/SEK dip-buying makes sense unless the inflation outlook improves markedly. In the medium term (by summer / autumn), the SEK should appreciate markedly as the Riksbank is implementing monetary policy fit for a deep crisis. Since there is no crisis in Sweden, policies are put into place solely due to disinflation worries.

In short, when the inflation situation improves, a markedly different set of monetary policies will be put in place, all of which would be SEK positive.

Chart 10. Swedish inflation expectations will be crucial

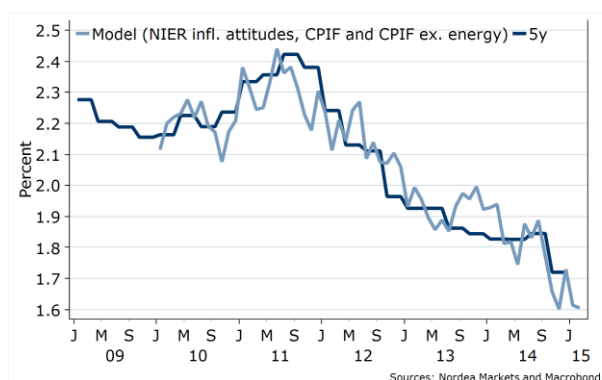
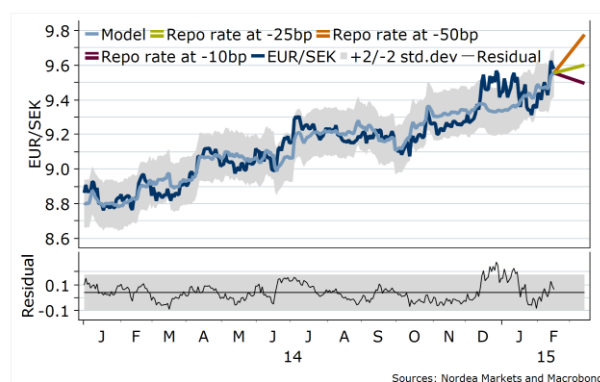


Chart 11. EUR/SEK fair value in different scenarios



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We expect Norges Bank to cut the target rate in March

EURNOK: the alternatives to NOK are not attractive

With oil prices rebounding we are seeing foreign interest for the extremely weak NOK again. Another contribution to the idea is the other central banks entering unconventional territory and turning the alternatives to NOK less attractive. Weaker growth will of course create consequences, but at least for now you don't need to pay up for depositing NOK. The same could be said about NZD and AUD. In all these three currencies the main driver has been commodity prices. One should probably expect that to remain the case, but a general rebound in commodity prices could create an even bigger turnaround due to the positive carry.

We expect Norges Bank to cut the target rate in March and based on history EURNOK normally does not start the falling trend in an environment with falling rates. It makes sense to expect EURNOK to keep on grinding lower slowly and with large corrections. In such an environment, realized volatility should come down and implied volatilities even more taken their level into consideration. Add to this that there still is quite a decent skew for the upside in EURNOK, it should make sense to keep doing what we also wrote about in the last edition of Northern Light: buy puts and sell calls further out of the money at higher volumes.

With spot at 8.58 one can buy 1y puts at 8.45 and sell 1y calls at 8.90 (Zero cost). If EURNOK falls hard and fast this will quite obviously work and there is some protection against the upside until 8.90. If EURNOK falls slowly and implied volatility goes with it (it normally does) the sold calls will decrease quite fast in value and could offset at least some of the time decay in the puts. This strategy will also make timing less of a pressing issue.

Chart 12: Options market heavily skewed for calls



Source: Nordea Markets and Bloomberg

Chart 13: Implied volatilities at extreme levels



Source: Nordea Markets and Bloomberg

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The Danish Central Bank has yet to find the CD rate equilibrium that will be able to neutralize the pressure for a stronger Danish krone

EUR/DKK – A struggle to keep the DKK fixed vs the EUR

Since mid-January the Danish central bank has put up a brave struggle to keep the Danish krone stable versus the euro. So far, the defense has consisted of independent rate cuts of 70 bp and intervention worth more than DKK 230bn. In addition to these “traditional” instruments, the Danish central bank has announced a suspension of issuance of new government bonds and a de facto stop for issuance of new T-bills. All instruments used in order to keep the DKK stable versus the EUR.

Despite repeated rate cuts and a temporary stop to the issuance of government bonds, the central bank has still not succeeded in stabilizing the krone versus the euro. Our calculations based on the daily net position data show that since its latest official currency reserve data for January, the bank has intervened further to the tune of DKK 125bn. The figures moreover show that since the last rate cut on 5 February the bank has been selling Danish kroner worth around DKK 70bn. This suggests that the bank has yet to find the CD rate equilibrium that will be able to neutralize the pressure for a stronger Danish krone. Therefore, we believe that the central bank will lower rates again in the near future, bringing its CD rate to -1.00%.

In our view, there are neither any formal nor any informal limits as to how far the bank will go in its defense of the Danish fixed exchange rate policy. Continued inflows into the currency will therefore be met with intervention and/or further rate cuts. And the central bank is also likely to resort to more unconventional means, for example mortgage-bond purchases. If this happens, they are likely to focus on the short end of the curve both due to immediate supply, but also due to the fact that shorter rates are the most important ones to press down

Chart 14: EUR/DKK and central bank intervention

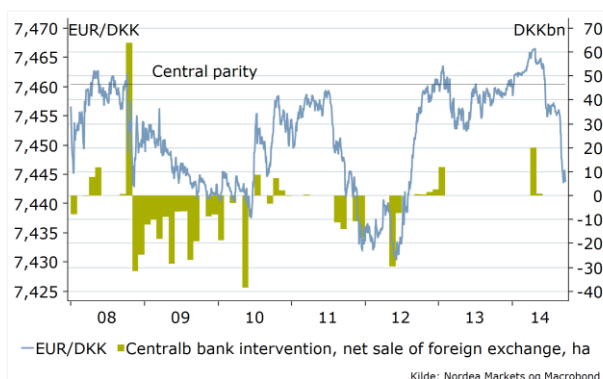
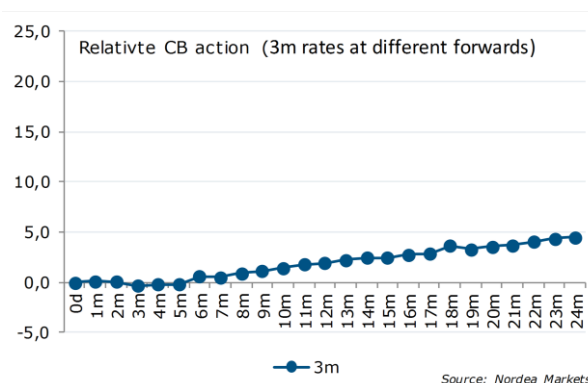


Chart 15: No Danish relative hikes factored in



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