FX Strategy

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FX forecast update: Better safe than sorry

Here are our latest thoughts on the G10 currency markets:

- **Panic!** The financial crisis unfolded beyond our wildest imagination over the past month. The VIX index, a measure of expected volatility in equity markets, rose to a record-high of 77; the US Ted spread, the difference between secured and unsecured lending, sky-rocketed to 4.6 percentage points and the credit default swap spreads widened substantially. Most financial institutions – some more than others – found it hard to get short-term funding and perceived counterparty risk rose considerably. Global financial markets were balancing on the brink of a systemic meltdown and had "ceased to function" as Britain's Prime Minister, Gordon Brown, put it. Clearly, something had to be done.

- **Three out of three ain't bad.** From economic theory (see for example Kindleberger: Manias, Panics and Crashes) we know that three things are typically observed in the final phase of a financial crisis (the discredit phase). Firstly, prices usually fall to clear the market. That has indeed happened: from 19 September to 10 October, global equities lost one-third of their value. Secondly, trading is usually cut off. Stock exchanges have been closed in Russia (-61% year-to-date), Indonesia (-44%) and Iceland (-89%). Finally, lenders of last resort step in and cut policy interest rates and ensure liquidity. Central banks in the US, UK, Euroland, Canada, Sweden and Switzerland announced a coordinated 50bp rate cut, see Coordinated rate cuts, and after a genuine dollar shortage and several additional liquidity injections, the Fed, ECB, BoE and SNB joined forces and provided unlimited dollar liquidity (full allotment) at fixed interest rates. In our view, financial markets are still dizzy and trying to get a hold on things. We remain in the discredit phase, and we believe it remains premature to consider the financial crisis over, as no obvious indicators to this have been observed. Accordingly, our well-known theme of financial deleveraging remains central to our approach to currency markets.

- **Rescue packages.** Since the last edition of FX forecast update, governments across the world have discussed and agreed on rescue packages, all designed to curb the financial crisis' effect on the real economy. How should we think of the packages in relation to FX? Firstly, the packages will eventually unfreeze conditions in money markets. Spreads should therefore eventually narrow and market participants should expect fewer difficulties with getting transactions through. Secondly, it is still hard to compare the packages to get the relative picture right and draw strong conclusions on specific currency crosses. Thirdly, even though the rescue packages don't eliminate risk aversion completely, they reduce the systemic risk substantially. Safe-haven currencies that have appreciated due to a scale-down of risk-taking are accordingly put more at risk, ceteris paribus. There is however other factors benefitting these, see *Why defensive currencies are still your friends*.

- **Closer to PPP.** One of our key observations during the past year's financial crisis is that spikes in uncertainty (i.e. spikes in volatility) have usually been associated with G10 currencies moving towards long-term fair value levels. This was the case during the fall in risk appetite around the Bear Stearns rescue in March, and has also been the case in the past few weeks. Does this mean that we should use deviations from PPP as a short-term indicator? No, we do not believe so! But it does indicate to us that even though spot movements in the past week have been significant, at least they do not appear excessive by long-term valuation standards. Currently, EUR/USD remains too high, as does EUR/CHF and USD/JPY.

- **R-e-c-e-s-s-i-o-n.** Global economic data have been extremely poor recently and even darker clouds have gathered on the horizon. That has made us revise down our growth forecasts for both this and next year, see for example *Financial crisis tipping into US recession* and *Euroland: Financial crisis killing off growth*. We now expect recessions (as defined by two or more subsequent quarters with negative growth) in the US, UK, Euroland, Japan, Australia and New Zealand. We see a 50:50 risk of Switzerland and Sweden joining the club, but attach less than 50% probability for Norway and Canada to dip into recession. A global recession remains a key element in our FX analysis, and even though the link to exchange rates is complex, the three most recent global recessions (1990-93, 1998, 2001-02) provide us with some stylized facts: Low-yielders, JPY and CHF, have on average outperformed other G10 currencies while riskier currencies AUD, NZD and SEK, have underperformed. We think the task going forward is to detect how deep the countries will sink into the mire and spot turns in business cycles.

- **EUR/USD set to go lower.** We argued last month that (i) the euro was overvalued at a time when the Euroland economy was deteriorating rapidly, (ii) Euroland was seeing a sharp outflow of capital and (iii) the USD typically has been a good defensive currency. All three arguments remain true today. In terms of net capital, not only are we seeing a further deterioration of the euro equation, we are also seeing an improvement in the US. We are now able to detect two additional weighty arguments: Firstly, while the Fed eventually is coming to an end of the easing cycle, the ECB has only just begun. We do see a non-negligible risk that the ECB needs to cut the benchmark rate substantially in order to stimulate the struggling economy and we find it likely that markets will price more rate cuts than the ECB actually will deliver. Secondly, the outlook for Eastern European countries is worsening and some countries (most notably the Baltics, Bulgaria, Romania and Hungary) are in danger of a very hard landing. On the other hand, the Latin American countries outlook is less frightening. Combining these outlooks, more downside potential for EUR/USD emerges. FX historians might like to add that dollar cycles tend to be quite long; often surpassing by a wide margin the typical length of the US and foreign business cycle. Dollar cycles have historically lasted for five years or even longer. We believe that EUR/USD will trade sideways throughout the year and have therefore lowered our three-month forecast to 1.36. On the six-month horizon, we think that the EUR needs to depreciate further to reflect relative monetary conditions and we have pencilled a move to 1.32. In twelve months time, we see EUR/USD just above its long-term fair value level, i.e. at 1.26.

- **Risks to our main scenario.** Arguments in favour a higher EUR/USD should not be overlooked: (i) Using technical yardsticks, the fall from 1.60 to 1.35 looks more like a downward correction than a violation of the strong upward trend that began in 2002. Our FX technicians see EUR/USD rebounding and look out for 1.70 in 12 months time; (ii) A stock market rally is most likely to be seen in combination with a higher move in EUR/USD; (iii) The US is still burdened by a substantial trade and current account deficit which is incompatible with the savings ratio; (iv) Speculative investors are now long USD, suggesting that chances of a further rapid dollar strengthening is reduced since no fuelling effect from a swing in speculative positions is present any longer.

- **JPY support will eventually fade.** Let's face it: The star performance of the JPY is not due to domestic factors. Economic data out of Japan has disappointed over the past month and if it wasn't for the already super-accommodative monetary policy, Bank of Japan had to cut the target rate (currently at 0.5%). But due to a spike in risk aversion and a continued rapid deleveraging, the JPY has outperformed all other G10 currencies with lengths. Given that markets probably will be nervous throughout the year, we think the JPY can continue to be the darling of FX traders. But as the financial crisis draws to an end, some yen support will wane. Looking at the sharp deterioration of the Japanese trade balance that historically has moved closely with USD/JPY, very little downside potential for the pair remains in the longer run. In fact, trade data suggests a USD/JPY move towards 130. While this may sound a bit exaggerated, we think it points toward the true direction in the pair at the somewhat longer horizon. We have lowered our 3M USD/JPY forecast to 100; we have kept out 6M forecast unchanged at 105 and raised our 12M forecast to 108.

- **CHF potential remains in place.** Since our latest FX Forecast update, CHF has strengthened significantly against EUR taking EUR/CHF to a new multi-year bottom at 1.5079 on 10 October. As a result EUR/CHF is currently trading below our old 12 month forecast of 1.56. Despite this appreciation, we still see the fundamental case for a stronger CHF, as global financial deleveraging is set to continue, as CHF remains undervalued, and as relative economic growth, interest rates, inflation, and external balances continues to lend support. Given our (now even more) bearish view on EUR, we have opted to lower our 12 month EUR/CHF forecast to 1.52. However, we also see the risk of a short term correction on the market following the latest rescue packages – it will be difficult, though, for EUR/CHF to move above 1.60. Due to this short-term risk, we are forecasting EUR/CHF at 1.56 in 3 months and 1.54 in 6 months. The main risk to our bullish CHF view is a marked improvement in market sentiment or potential distress in the Swiss banking sector – no government plan has been put forward yet in Switzerland to secure the financial sector.

- **The SEK has by and large been a function of risk sentiment in the last few months.** In relative terms, however, Swedish equities have not underperformed and do not justify EUR/SEK at levels around 9.70. Neither is it clear that momentum in Swedish macro data has been worse than Euroland, rather the opposite and if anything Sweden is probably relatively well positioned from a fundamental perspective to deal with the current global crisis. The Swedish macroeconomic outlook is bleak though. We forecast almost zero GDP growth in 2009 and multiple rate cuts from the Riksbank, 150bp, by the end of next year. In Euroland we see recession looming. As long as currency markets are closely associated with the financial crisis outlook and risk sentiment we are not sure that lower central banks rates will necessarily weigh on the currency. Proactive policy actions might instead be considered positive for confidence and growth. Conversely, currencies backed by stubbornly hawkish central banks in times when markets hope for - and price - the opposite could be punished. Now, we do consider the unprecedented measures taken by the US and European (including Swedish) governments to rein in the financial crisis and restore confidence as being SEK supportive. A global recession scenario is likely to keep SEK on the weak side going forward, but the way markets have developed in the last few days lower rather than higher levels seem fair near term. SEK selling in the last few days has partially been driven by rebalancing flows but as these fade EUR/SEK should stabilise. In our view EUR/SEK is becoming stretched on the upside and our short-term models suggest potential is for the downside.

- **Bleak domestic outlook puts GBP at near-term risk; better long-term outlook.** Bank of England (BoE) participated in the coordinated rate cut among major central banks. And a rate cut in the UK was more needed than anywhere else. We have for several months pointed out that the UK is "burdened by a rapidly deteriorating growth outlook" and argued that "substantial monetary easing" was required when the peak in inflation was truly past. Inflation is indeed the last factor that should worry British policy makers at present; the spending outlook is extremely dim and the downturn in the real estate market is set to exceed the housing recession in the early nineties. The current downturn is partially driven by a slump in the housing market – normally associated with the longest economic recessions. Growth wise, we anticipate a negative H208 and do not expect 2009 to be a year to remember either. We think the BoE will cut the base rate down to 3.00% within the next six months – and risk is skewed to the downside. Rate cuts of this magnitude will eventually nail the GBP as a carry target currency. The only reason why EUR/GBP isn't drifting higher is the bleak Euroland outlook. As we expect the dollar to advance vs. euro, so will sterling – just to a somewhat smaller extent. We have lowered our EUR/GBP profile and cut our 12-month forecast to 0.76.

- **NOK interesting at the longer horizon.** Deleveraging, risk aversion, dollar appreciation and a decline in oil prices are an unhealthy cocktail for NOK. A strengthening of the Norwegian krone vs. the euro has in the past half year been one of our clearest calls. The forecast has been based on a booming Norwegian economy and underlying price pressure, forcing Norges Bank to keep monetary policy tight. We have underestimated the impact of the financial crisis on NOK and have had little idea on the forced selling / unwinding of assets' effect on Scandivian currencies. We stick to our view of better economic conditions in Norway relative to other countries but do not see a widening of the Norway-Euoland policy spread anymore. We have raised our EUR/NOK forecast, mostly in the short-term, and now expect 3M 8.40, 6M 8.30 and 12M 8.10.

- **AUD and NZD have been oversold, but the fundamental outlook remains dim.** The $-block currencies continued to weaken during the past month taking AUD/USD and NZD/NZD below our old 12 month forecast. The large depreciation of AUD and NZD implies that both currencies are no longer overvalued by long term valuation measures. Nevertheless, we still see a large current account deficit and a turn in the monetary policy and economic cycle as weighing on both AUD and NZD. While long positions have been unwound on a broad scale, even on Japanese margin accounts, we do not expect an immediate return to significant carry trading, as global financial deleveraging is set to continue, also on the currency market, and as short term interest rates are expected to come further down in both Australia and New Zealand making interest rate arbitrage less attractive. That said we do see the latest AUD and NZD sell-off as overdone, which is likely to have increased the probability of a short term correction. We have therefore opted to lower our forecast profile for AUD/USD and NZD/USD, while leaving our 3 month forecast slightly above spot.

- **Oil=CAD.** The marked fall in oil prices has been main driver behind the rise in USD/CAD. We see a good chance that movements in the oil price continue to be *the* driving factor for CAD. As we see risk of oil prices adjusting further down, more near-term USD/CAD upside potential emerges. In the somewhat longer term, relative economic prospects favour CAD to USD and we have therefore pencilled a 'kinked' profile for USD/CAD.

Exchange rate forecasts

		Forecast				Forecast vs forward outright, %			
	Spot	+1m	+3m	+6m	+12m	+1m	+3m	+6m	+12m
Exchange rates vs EUR									
USD	1.365	1.36	1.36	1.32	1.26	0.1	0.1	-2.7	-6.8
JPY	137.26	136	139	137	136	-0.6	2.0	1.6	1.9
GBP	0.778	0.790	0.79	0.78	0.76	1.4	1.3	-0.3	-3.2
CHF	1.547	1.56	1.56	1.54	1.52	0.9	1.2	0.1	-0.7
DKK	7.45	7.45	7.46	7.46	7.46	-0.1	0.1	0.1	0.1
NOK	8.62	8.50	8.40	8.30	8.10	-1.5	-2.8	-4.4	-7.2
SEK	9.82	9.70	9.60	9.50	9.40	-1.2	-2.2	-3.4	-4.5
Exchange rates vs USD									
DXY	81.5	81.5	82.0	83.2	85.2	-0.1	0.6	2.2	4.6
JPY	101.0	100	102	104	108	-0.7	1.9	4.4	9.2
GBP	1.75	1.72	1.72	1.69	1.66	-1.3	-1.2	-2.4	-3.8
CHF	1.14	1.15	1.15	1.17	1.21	0.8	1.0	2.9	6.5
DKK	5.49	5.48	5.49	5.65	5.92	-0.1	0.0	2.9	7.6
NOK	6.35	6.25	6.18	6.29	6.43	-1.6	-2.8	-1.6	-0.2
SEK	7.23	7.13	7.06	7.20	7.46	-1.3	-2.3	-0.7	2.6
CAD	1.16	1.16	1.17	1.16	1.15	0.0	1.0	0.4	-0.3
AUD	0.70	0.72	0.72	0.70	0.67	3.7	3.8	1.2	-2.1
NZD	0.62	0.63	0.63	0.60	0.58	2.1	2.6	-1.4	-2.8

Note: GBP, AUD and NZD are denominated in local currency rather than USD

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