

FX Crossroads

12 November 2008

Monetary policy and the link to FX: DKK and GBP

Summary and conclusions

- After two independent Danish rate hikes, major interventions from the Danish central bank, the DKK has received a lot of attention – both from domestic and foreign market observers. We take a closer look at September's flow of funds data, the first Danish 30Y Govt bond auction in 14 years, and evaluate the outlook of a tighter policy rate spread between Denmark and Euroland, and for EUR/DKK. We foresee a narrowing of the rate spread in the near term and see EUR/DKK trading in the 7.44-45 range in the coming months.
- Bank of England's Quarterly Inflation Report was not cheering reading; the UK economy is set to contract in 2009 and inflation could fall below BoE's pain threshold of 1% in the forecast horizon. Despite the downbeat projections, we pencil in four reasons to be GBP bullish against EUR in the medium term.
- We take a look at relative economic surprises compared to movements in exchange rates. Unfortunately, we are unable to detect a strong relationship. However, important qualitative conclusions can be drawn. For example, the strong dollar rally in recent months coincides with a period of much more negative data surprises in Euroland than in the US. Given this observation, it is worth noting that data has recently turned a lot sourer in the US than expected. This suggests that the USD rally could lose steam.
- *FX Crossroads* is published every second Wednesday. Next publication date is 26 November.

DKK: Flow of funds – equity inflow, bond outflow

	C/A	FDI	Equities	Bonds	Basic balance
2006	47.0	-34.0	-168.2	64.9	-90.3
2007	14.8	-47.2	-35.7	1.5	-66.6
Last 12m	32.5	-61.3	53.3	-145.5	-121.0
YTD	23.3	-76.7	52.8	-37.7	-38.3
3m mav	5.4	-7.3	6.1	-15.4	-11.2
July	5.0	-6.9	2.3	-2.5	-2.1
August	3.7	-4.3	-4.3	-17.0	-21.9
September	7.4	-10.7	20.2	-26.7	-9.7

Source: Ecwin, Danske Bank

Sterling's downturn – is the pound cheap?



Source: Ecwin, Danske Bank

DKK: Into the flashlight

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On everybody's lips

The DKK is as interesting as ever. After having had a sheltered existence for years, the DKK danced into the flashlight as it came under pressure in October and Danmarks Nationalbank (DN) had to intervene quite aggressively and raise rates independently twice. This sparked a boom in research on DKK and on Denmark in general: UBS 7 October (Difficult Deed from Denmark), Barclays 30 October (DKK: Temporary pressures) and JP Morgan 31 October (DKK: Bet on recession, not devaluation) just to mention a few.

We released a [Flash Comment](#) after the Danish central bank followed the ECB in cutting rates on 6 November. Our conclusions were that the Danish central bank as expected didn't see a need to extend the already considerable advantage on holding DKK and that the next obvious step probably was to narrow the policy spread between Denmark and Euroland by independently lowering the Danish lending rate. Accordingly, we advised keeping an eye on the Danish central bank's website on Fridays at 10.00 CET since that is the time when the DN announce terms for the weekly market operations (7-day loans against securities as collateral and 7-day deposits by purchasing certificates of deposit). That is still our advice to clients.

What is new? In September, the Danish current account posted a surplus of DKK7.4bn, the reason being that services and income added substantially while goods and current transfers were only modestly negative. FDI flows were negative for the third consecutive month and are now the largest drag on the Danish basic balance. Foreign investors net bought DKK 19.5bn worth of Danish equities and DKK 8.5bn worth of Danish bonds. Danish investors net sold DKK 0.7bn worth of foreign equities but net bought a record DKK 35.3bn worth of foreign bonds – the largest amount recorded since our statistics began in 2005. In total, the broad basic balance turned negative for the third consecutive month.

Besides flow of funds data, we note that the first Danish 30Y Govt bond auction in 14 years was a

success; nearly DKK 30bn was sold at 27bp above the 30Y DKK swap (32bp above German 30Y Govt bonds). Bid-to-cover was 1.48. This looks promising for the coming period in terms of debt issuance.

Danish flow of funds (DKK bn)

	C/A	FDI	Equities	Bonds	Basic balance
2006	47.0	-34.0	-168.2	64.9	-90.3
2007	14.8	-47.2	-35.7	1.5	-66.6
Last 12m	32.5	-61.3	53.3	-145.5	-121.0
YTD	23.3	-76.7	52.8	-37.7	-38.3
3m mav	5.4	-7.3	6.1	-15.4	-11.2
July	5.0	-6.9	2.3	-2.5	-2.1
August	3.7	-4.3	-4.3	-17.0	-21.9
September	7.4	-10.7	20.2	-26.7	-9.7

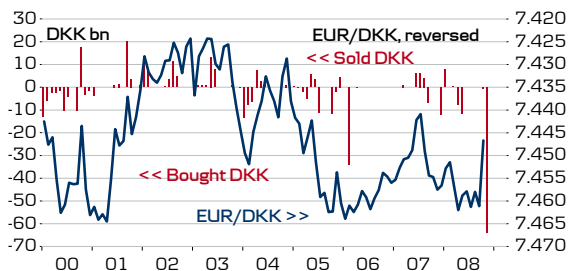
Source: Reuters Ecowin, Danske Bank

What would it take for the Danish central bank to lower rates?

We believe good insight can be achieved just by looking at EUR/DKK. Although deposit spreads, the size of the currency reserve and fluctuations in other Scandinavian currencies serve as important inputs to the rate decision process, the EUR/DKK spot rate is by far the most momentous for the Danish central bank. There are, in our view, four different plausible ranges for EUR/DKK in the coming months:

- **EUR/DKK < 7.44:** Territory almost not seen since 2004. The DN normally purchases foreign currency at these levels (see chart on next page). Possibility for the DN to rebuild the currency reserve. Very likely that the DN will normalise the policy spread here.
- **7.44 < EUR/DKK < 7.45:** Probably the preferred territory for the DN. Also perfect for independent rate cuts. We see this range as the most likely for EUR/DKK throughout the year.
- **7.45 < EUR/DKK < 7.46:** Slightly shakier ground for the DN. Not obvious to us that the policy spread has narrowed as fast and as much as in our base case scenario.
- **EUR/DKK > 7.46:** Independent rate cuts from the DN are not a valid option with EUR/DKK above central parity. Risk of a widening of the policy spread is present.

EUR/DKK and interventions



Source: Reuters Ecowin, Danske Bank

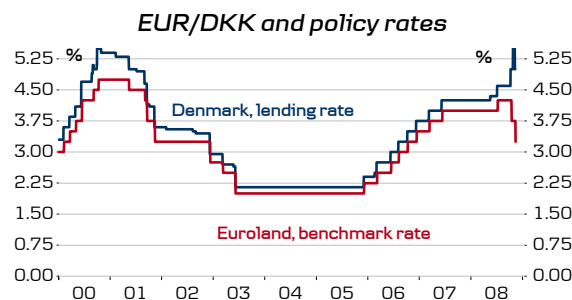
What is the “natural” rate spread between Denmark and the Euroland?

The rate spread between Denmark and Euroland can be interpreted as a risk premium demanded by investors for holding DKK-denominated papers. This risk premium depends upon Danish economic and financial conditions relative to Euroland but also vary with the general level of risk aversion in financial markets.

By the beginning of this millennium, the policy rate spread stood at 30bp. It widened to 110bp after the Danish EMU referendum in 2000 but narrowed to 15bp in the following years – the lowest ever recorded. From 2003-2005 the policy spread remained low but needed to be widened by 10bp in early 2006 after the biggest sale of a Danish company to foreigners, TDC, in history – a rate hike that was never reversed. After having supported the DKK by around DKK 20bn in May, the DN widened the policy spread to 35bp which was the official yield pick-up on DKK relative to EUR by the beginning of October.

It is difficult, if not impossible, to generalise over this millennium in order to detect the natural rate spread at which the market is in equilibrium, and where rates neither overly support DKK against EUR, nor fail to provide the required support. We note that the policy spread between Denmark and

Euroland on average has been 29bp this millennium. But from 2003-2006 risk premiums were perceived to be artificially low – perhaps due to ample liquidity and a general ‘hunt for yield’ – and maybe didn’t truly reflect actual market risk. A natural policy spread might therefore lie above 0.30.



Source: Reuters Ecowin, Danske Bank

Our forecast is that the policy spread will be narrowed to at least 125bp in three months, 75bp in six months and 50bp in 12 months time. Our 12 month estimate is also equivalent to our long-term policy spread projection, in our view the ‘natural’ spread. We believe that the natural risk premium on DKK has risen on the back of the past year’s market movements, including a rise in the general market risk premium.

On the currency side, we expect the DN to show a reluctance to accept the DKK much higher in the short run and will therefore not be surprised to see the DN performing fine-tuning operations in the currency market to keep EUR/DKK below the central parity. There is also a strong signal value in doing this. We anticipate accordingly that EUR/DKK will trade in the 7.44-45 range in the near-term before drifting towards 7.46 in the longer run.

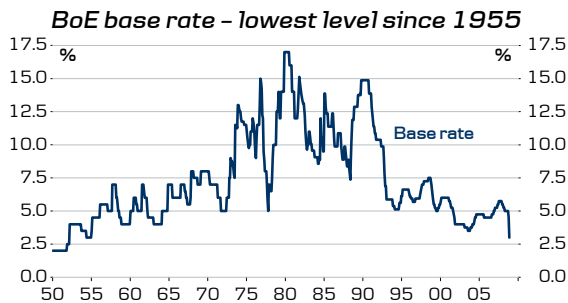
Is GBP still interesting after a downbeat Inflation Report?

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We still like GBP

BoE Inflation Reports should come with a warning notice: Do not read this if you are in a bad mood

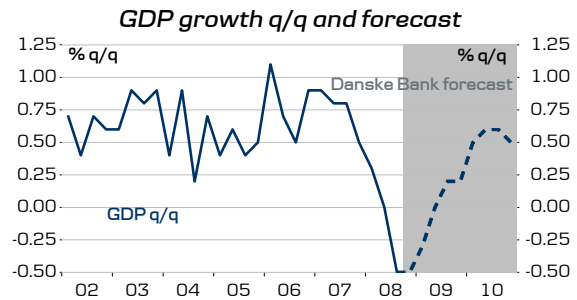
The Bank of England (BoE) released its *Quarterly Inflation Report* today. As expected, the report was downbeat reading – annual GDP is expected to drop 1.8% in Q109. BoE Governor Mervyn King said that the UK economy most likely is in recession and will contract for most of 2009. GDP forecasts were considerably weaker than in the August Inflation report. On inflation, King said that CPI will fall below 1% in two years and risks to CPI are on the downside. This is pretty tough and opens the door for substantial monetary easing – we currently expect three additional rate cuts of 50bp, taking the base rate to 1.5%. King said that BoE is ready to cut rates again and eventually ‘put rates at whatever level needed’. We believe this given the BoE’s slashing of rates last week.



Source: Reuters Ecowin

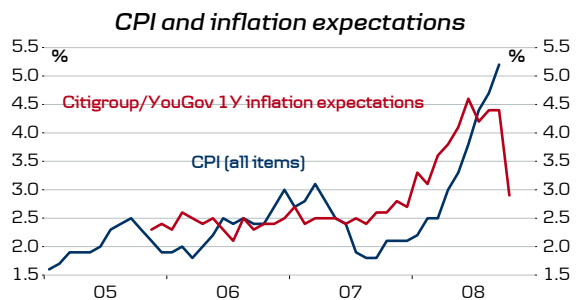
In BoE’s central GDP projection, a pronounced contraction in domestic demand causes output to fall in the early part of the forecast. The key drivers are a sharp tightening in the supply of money and credit, subdued growth in incomes and past falls in asset prices. This is not surprising as most business indicators since spring have pointed towards contraction.

The BoE’s growth forecast is in fact more depressing than our own – already pessimistic – forecast. We will therefore keep a close eye on UK survey data in the coming months.



Source: Reuters Ecowin

In BoE’s central CPI projection, inflation falls sharply in the near term, as the contributions from energy and food prices decline. Further out, inflation falls well below the 2% target, reflecting a larger margin of spare capacity and the waning impact on import prices from the lower level of sterling. We note further that inflation expectations currently are taking their sharpest turn since the survey began in 2005.



Source: Reuters Ecowin

At the end of the press conference King noted that it wasn’t surprising that the pound had dropped against major currencies as it was ‘an inevitable part of rebalancing’.

Sterling is cheap?

The effective sterling index has fallen from 105 to 85 in 15 months. Does this mean that sterling is cheap? Not necessarily.

We observe that sterling is now 13.5% below its mean since 1997, which is the benchmark for the

BoE. We can also see that sterling now meaningfully can be said to have broken out of the trading range in the past 10 years. The recent weakening is in fact comparable with the break-out of the EMS in 1992 (GBP weaker) or in 1997 when former Labour Party leader Tony Blair moved into No. 10 Downing Street and gave BoE's MPC monetary independence (GBP stronger).



Source: Reuters Ecowin

According to REER analysis using data since 1993 (the year in recent history when exchange rates again became free-floating within Europe), the GBP is close to 9% undervalued. The undervaluation is strongest against EUR (around 13%) and CAD (around 16%) but also against USD (around 8%). JPY is now the only currency in the G10 currency universe to which GBP remains slightly overvalued. Also, according to PPP analysis GBP is undervalued; our EUR/GBP estimate is 0.72. We note however that the estimate has risen three big figures over the past decade due to prices rising faster in the UK than in Euroland.

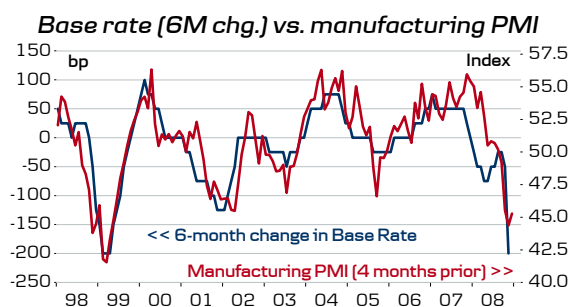
We are still inclined to think that EUR/GBP belongs in the 0.70-0.80 range rather than in the 0.80-0.90 range. This is also confirmed by long-term estimates. Accordingly, we see more downside potential than upside potential for the pair. But what will drive EUR/GBP lower in the medium term?

Factors likely to affect EUR/GBP in the medium term

We believe that good EUR/GBP downside potential emerges in the medium term. Key arguments are:

- 1) **The MPC has been frontloaded – the GBP has already taken its toll.** We knew, for example from activity data, that monetary stimulus was badly need. But that the MPC would act as pre-emptively as it did on 6

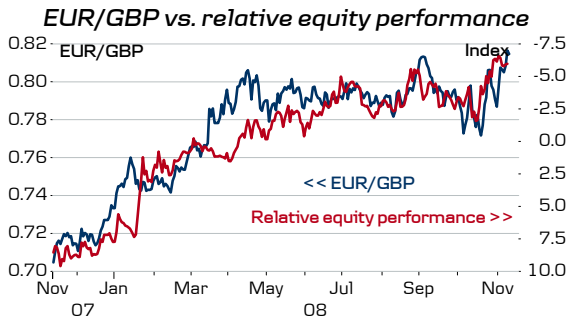
November when it cut the base rate by 150bp was a surprise to most. Although we expect the BoE to ease further (we foresee three additional rate cuts each by 50bp, taking the base rate to 1.5%), we have noticed that the GBP “only” weakened around 1.5% against the EUR. We observe that dynamics are a little different than usual; substantially lower rates doesn't automatically lead to a weaker currency since markets interpret bold monetary moves as helpful to business conditions; this is currently the dominating effect.



Source: Reuters Ecowin

- 2) **The UK has a better chance of surprising positively on the macro front.** Relative macro performance does not seem to support GBP relative to EUR – most agree that the UK slowdown will be greater. But one thing is expectations – to which exchange rates have already adjusted – and another is actual performance. With a higher natural growth rate in the UK than in Euroland, we believe that the UK has the advantage of surprising on the upside, potentially leading to better GBP performance.
- 3) **Risk sentiment is likely to improve.** Definitely a positive for the GBP. We do not believe UK equities will continue to underperform Euroland equities. With the financial sector contributing almost 10% to British GDP, the ongoing financial crisis has been more damaging for the UK relative to other countries with smaller financial sectors. Although we do not expect a major improvement in risk appetite, we do expect a gradual improvement and a continuation of market conditions. This will probably also

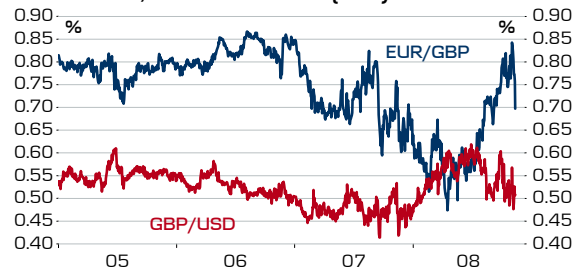
lead to a strengthening of SEK, NOK, AUD and AUD.



Source: Reuters Ecowin

4) **The strong dedication from UK authorities to stabilise financial markets.** The UK rescue package quickly became an object lesson for other authorities in implementing stimulating financial initiatives, and Gordon Brown was invited to give advice at the meeting of Euroland leaders. After the Northern Rock scandal, confidence in UK policy had plummeted and has remained subdued in 2008. The recent initiatives taken by the UK authorities are seen as steps in the right direction and we regard the distinct willingness as supportive for the GBP. We acknowledge that the rescue package includes huge fiscal costs, but do not see this as a significant threat to the UK balance sheet.

GBP still perceived to be closely related to the EUR, but correlation (3M) declines



Source: Reuters Ecowin

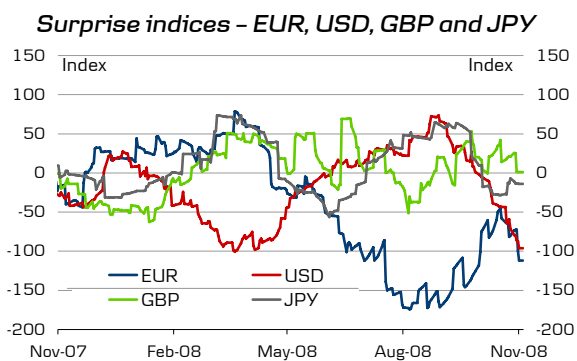
We expect to see EUR/GBP trade sideways throughout the year, i.e. remain in the 0.81-0.83 range. By the beginning of 2009, we expect to see a gradual improvement of market conditions including a decline in risk aversion and a rise in equity performance. We anticipate seeing EUR/GBP drifting towards 0.78-0.79 on the back of this. As the global economy recovers and equity markets establish positive momentum, we foresee EUR/GBP falling further, towards 0.76. This is also consistent with our downward sloping EUR/USD profile with 'sterling in the middle'.

G4: Surprises in economic data vs. exchange rates

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Information from relative economic surprise indices

Economic data has generally been soft in recent months. Since we are facing a global recession, this hasn't been surprising and forecasters have adjusted their expectations accordingly. Still, some areas have disappointed more than others which should lead to movements in exchange rates. In this article we present a relative approach to economic surprise indices in relation to exchange rates.



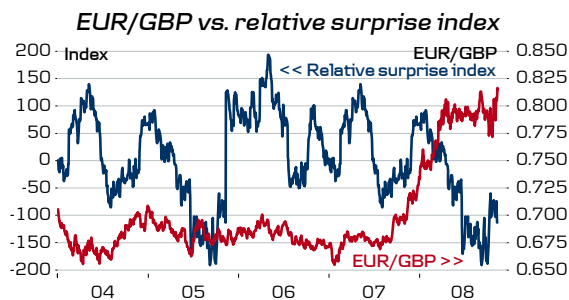
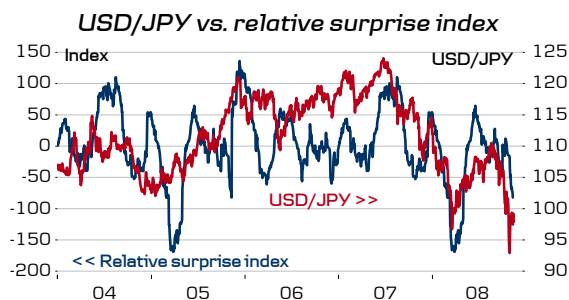
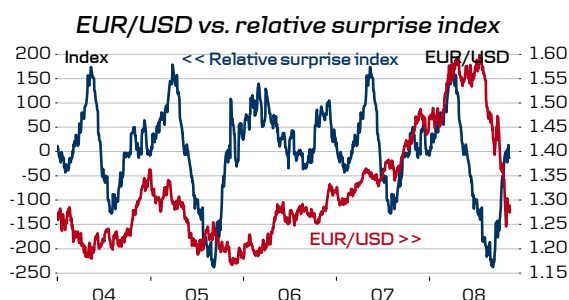
Source: Bloomberg, Reuters Ecowin, Danske Bank

Economic surprise indices are weighted historical standard deviations of data surprises (actual releases vs. Bloomberg survey median). A positive reading suggests that economic releases on balance have been beating consensus *and vice versa*. The indices are calculated daily in a rolling three-month window.

If we look at the surprise indices relatively we get something that can be related to exchange rates. For example, a EUR/USD surprise index should show some co-movements with the EUR/USD spot rate.

By looking at economic surprises within the past year we find that exchange rates do not systematically react to economic surprises. Especially long-run FX trends are poorly captured by relative economic surprise indices. That is perhaps due to the fact that economic forecasters adjust their expectations when a currency is in an up- or downtrend. A graphical analysis suggests that relative surprise

indices better capture short-term fluctuations. That is, for example, the case in the recent decline in EUR/USD, although this came with a rather long lag perhaps due to other off-setting factors, and the two most recent dips in USD/JPY. EUR/GBP seem, however, almost uncorrelated with relative economic surprises.

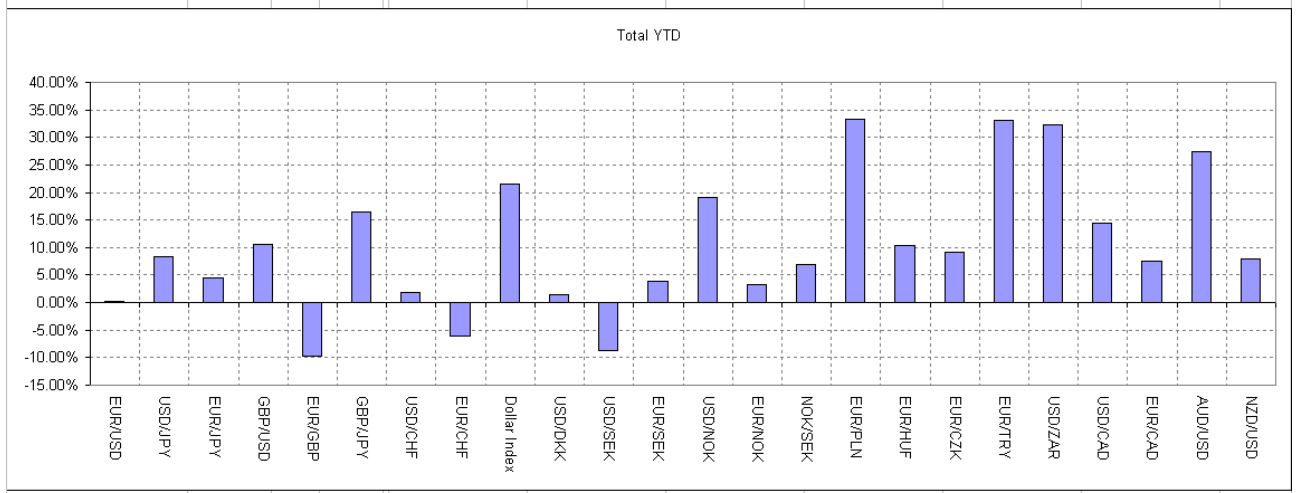


Source: Bloomberg, Reuters Ecowin, Danske Bank

Unfortunately, we are unable to detect any strong econometric relationship between relative economic surprises and exchange rates. Only in the USD/JPY case we are able to find a valid statistical relationship with the expected positive sign. This makes us believe that no strong FX conclusions should be drawn based entirely on surprises in key data.

Trading Points

										12/11/2008	9:32	(CET)
										Strategy (Short-Medium Term)		
MARKET	LAST	Trend	5DCHG	Strategy	Stop/Entry	1st Target	2nd Target	Stop/Reverse	New Target	Total YTD		
CURRENCIES - Majors												
EUR/USD	1.2588	↓	-2.84%	Go Long>	1.2930	1.3228	Go Short<	1.2475	1.2382	0.29%		
USD/JPY	97.86	↑	-0.07%	Go Long>	100.60	102.54	Go Short<	96.71	94.61	8.33%		
EUR/JPY	123.20	↓	-2.92%	Go Long>	131.05	139.70	Go Short<	121.25	117.74	4.39%		
GBP/USD	1.5425	↓	-3.01%	Go Long>	1.5885	1.6166	Go Short<	1.5260	1.4938	10.57%		
EUR/GBP	0.8161	↑	0.20%	Go Long>	0.8210	0.8322	Go Short<	0.8065	0.7970	-9.75%		
GBP/JPY	150.95	↑	-3.10%	Go Long>	154.30	158.96	Go Short<	149.00	145.22	16.46%		
USD/CHF	1.1852	↑	2.35%	Go Long>	1.1897	1.1912	Go Short<	1.1714	1.1620	1.77%		
EUR/CHF	1.4921	↓	-0.51%	Go Long>	1.5177	1.5270	Go Short<	1.4835	1.4630	-6.10%		
Dollar Index	86.856	↑	0.027	Go Long>	87.2450	87.880	Go Short<	83.902	81.195	21.50%		
CURRENCIES - Scandies												
USD/DKK	5.9122	↑	2.92%	Go Long>	5.9635	6.0955	Go Short<	5.7610	5.6783	1.49%		
USD/SEK	8.0025	↑	2.81%	Go Long>	8.0965	8.3428	Go Short<	7.7080	7.6010	-8.70%		
EUR/SEK	10.0736	↑	-0.12%	Go Long>	10.1240	10.1935	Go Short<	9.9425	9.8500	3.91%		
USD/NOK	6.9444	↑	2.64%	Go Long>	7.0410	7.1170	Go Short<	6.7270	3.5945	19.01%		
EUR/NOK	8.7428	↑	-0.25%	Go Long>	8.8031	8.9319	Go Short<	8.6550	8.5400	3.32%		
NOK/SEK	1.1522	↑	0.13%	Go Long>	1.1700	1.1985	Go Short<	1.1240	1.1100	7.00%		
CURRENCIES - Non Majors												
EUR/PLN	3.7314	↑	5.60%	LONG		3.8640		3.7045	3.6610	33.23%		
EUR/HUF	268.40	↑	3.10%	Go Long>	270.67	278.36	Go Short<	260.46	252.42	10.35%		
EUR/CZK	25.366	↓	3.34%	Go Long>	25.630	25.950	Go Short<	24.965	24.691	9.13%		
EUR/TRY	2.0280	↑	2.13%	Go Long>	2.0585	2.1065	Go Short<	1.9600	1.9416	33.14%		
USD/ZAR	10.2828	↑	5.27%	Go Long>	10.4375	10.9490	Go Short<	9.8070	9.6625	32.19%		
USD/CAD	1.2008	↑	2.67%	Go Long>	1.2100	1.2426	Go Short<	1.1650	1.1360	14.49%		
EUR/CAD	1.5119	↓	-0.24%	Go Long>	1.5355	1.5790	Go Short<	1.4967	1.4650	7.62%		
AUD/USD	0.6624	↓	-2.77%	SHORT		0.6392	0.6244	0.6755	0.6903	27.46%		
NZD/USD	0.5779	↓	-2.94%	Go Long>	0.6045	0.6300	Go Short<	0.5685	0.5536	7.97%		



Trading recommendations and G10 central bank overview

Directional trades

Open	Start date	Level	Now	Target	Stop	P/L (incl carry)
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We have currently no open trading recommendations

Recently closed	Start date	Level	Exit date	Level	P/L (incl carry)
Sell AUD/USD	23/09/08	0.842	26/9/08	0.830	1.43
Sell EUR/SEK	02/10/08	9.747	8/10/08	9.722	0.26
Sell EUR/SEK	14/10/08	9.68	15/10/08	9.83	-1.53

P/L 2008	18.44%	Open	0.00%	Closed	18.44%
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# of trades *	118	# of trades 2008	33
- average net gain	0.43%	- average net gain	0.56%
- batting average	0.54	- batting average	0.61

* Since 17 November 2005

Central bank overview

Country	Official interest rate	Policy rate	Next decision*	Last change
United States	Federal funds rate	1.00	16 Dec (-25bp)	29 Oct (-50bp)
Euroland	Minimum bid rate	0.00	4 Dec (-50bp)	6 Nov (-50bp)
Japan	Overnight call rate	0.30	21 Nov (unch)	31 Oct (-20bp)
United Kingdom	Base rate	3.00	4 Dec (-50bp)	6 Nov (-150bp)
Switzerland	3-month Libor	2.00	11 Dec (-50bp)	6 Nov (-50bp)
Canada	Overnight rate	2.25	9 Dec (-25bp)	21 Oct (-25bp)
Australia	Cash rate	5.25	2 Dec (-50bp)	4 Nov (-75bp)
New Zealand	Cash rate	6.50	3 Dec (-100bp)	22 Oct (-100bp)
Sweden	Repo rate	3.75	17 Dec (-50bp)	23 Oct (-50bp)
Norway	Sight deposit rate	4.75	17 Dec (-25bp)	29 Oct (-50bp)

* Expected decision in brackets

G10 central bank forecast overview

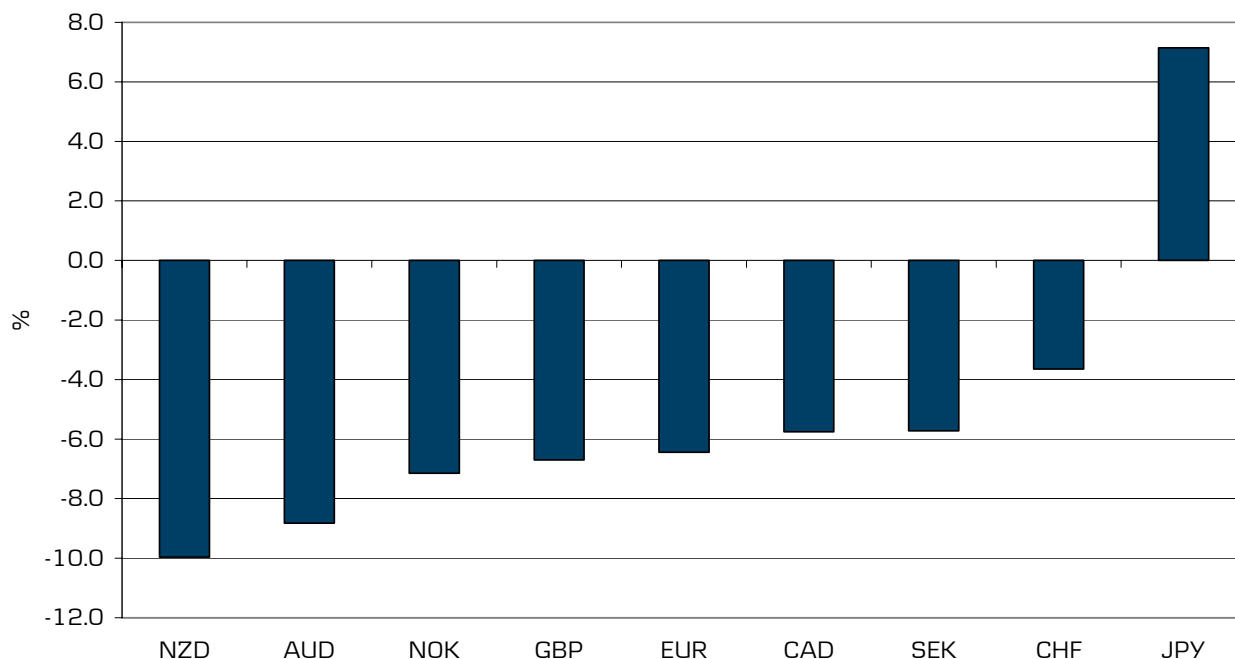
	FED	BOC	ECB	BOE	SNB	RB	NB	BOJ	RBA	RBNZ
Now	1.00	2.25	3.25	3.00	2.00	3.75	4.75	0.30	5.25	6.5
2008 Nov								21-Nov		
Dec	16-Dec	09-Dec	04-Dec	04-Dec	11-Dec	17-Dec	17-Dec	19-Dec	06-Dec	03-Dec
2009 Jan	28-Jan	20-Jan	15-Jan	08-Jan				22-Jan		
Feb			05-Feb	05-Feb		11-Feb	04-Feb	19-Feb	03-Feb	
Mar	17-Mar	03-Mar	05-Mar	05-Mar	12-Mar		25-Mar	17-Mar	03-Mar	
Apr	29-Apr	21-Apr	02-Apr	09-Apr		21-Apr		7+28-Apr	07-Apr	
May			07-May	07-May			06-May	22-May		
June	24-Jun	04-Jun	04-Jun	04-Jun	18-Jun		17-Jun	16-Jun		
July		21-Jul	02-Jul	09-Jul		02-Jul				
Aug	11-Aug		06-Aug	06-Aug						
Sep	22-Sep	10-Sep	03-Sep	10-Sep	17-Sep		23-Sep			
Oct		20-Oct	08-Oct	08-Oct			28-Oct			
Nov			05-Nov	05-Nov						
Dec		08-Dec	03-Dec	10-Dec	10-Dec		16-Dec			
12M	0.75	2.00	2.25	1.50	1.25	2.25	3.75	0.30	4.50	4.75
Rate cut	Rate hike									

Exchange rate forecasts

	Spot	Forecast				Forecast vs forward outright, %			
		+1m	+3m	+6m	+12m	+1m	+3m	+6m	+12m
Exchange rates vs EUR									
USD	1.257	1.23	1.21	1.16	1.16	-2.0	-3.4	-7.2	-7.2
JPY	122.71	118	109	104	110	-3.6	-10.7	-13.9	-8.4
GBP	0.823	0.82	0.80	0.78	0.76	-0.9	-2.6	-5.0	-7.5
CHF	1.491	1.47	1.42	1.44	1.44	-1.2	-4.2	-2.6	-2.2
DKK	7.44	7.45	7.45	7.46	7.46	0.0	0.0	0.1	0.0
NOK	8.79	8.70	8.60	8.40	8.20	-1.1	-2.5	-5.1	-7.7
SEK	10.09	10.00	9.80	9.70	9.50	-0.9	-2.8	-3.8	-5.9
Exchange rates vs USD									
DXY	87.1	88.8	89.1	90.7	91.3	1.9	2.2	4.0	4.8
JPY	97.6	96	90	90	95	-1.6	-7.5	-7.3	-1.5
GBP	1.53	1.51	1.51	1.49	1.53	-1.1	-0.8	-2.3	0.4
CHF	1.19	1.20	1.17	1.24	1.24	0.8	-0.9	5.0	5.3
DKK	5.92	6.06	6.16	6.43	6.43	2.1	3.5	7.9	7.8
NOK	6.99	7.07	7.11	7.24	7.07	0.9	0.9	2.4	-0.5
SEK	8.02	8.13	8.10	8.36	8.19	1.2	0.6	3.8	1.4
CAD	1.21	1.26	1.30	1.30	1.30	4.2	7.5	7.5	7.5
AUD	0.66	0.64	0.60	0.58	0.58	-3.2	-8.9	-11.5	-10.7
NZD	0.58	0.55	0.52	0.50	0.50	-4.4	-9.0	-11.6	-10.1

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

Expected change in USD vs forwards, 3m



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