Global Macro Strategy

Global FX Atlas: Which views remain after Leave?

Global Macro Strategy

Global

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What has changed since the last FX Atlas?

Leave prevailed in the UK referendum. Interest rates and bank shares have shifted lower, but FX implications have been limited, and mostly concentrated in GBP, which in our view remains the best way to trade the Leave vote. We see the UK's large current account deficit as the main source of risk for GBP, and if FDI funding slows, we think EUR/GBP could reach parity. For year-end, we forecast a move to 0.90 due to pressure on external funding, and as a result of slower growth and easier monetary policy.

What has remained the same?

Trading G10 FX remains extremely difficult. A combination of uncertainty and surprising outcomes drove large moves in GBP and JPY during Q2, but with these exceptions, G10 currencies remain range-bound. With volatility elevated, this makes for a particularly difficult trading backdrop. EUR/USD has traded in a 10 big-figure range during the past 12 months, about half the historical average, and close to the smallest 12-month range since 2000.

We continue to think the USD has peaked on a trade-weighted basis vs. DM FX

USD strength has been limited post referendum. We attribute this to markets having priced more tightening from the Fed than other major central banks, leaving relatively more room for US rates to fall. We continue to see the dollar as having peaked on a trade-weighted basis versus DM currencies, the euro in particular. The Leave vote has increased downside risks for Euro area growth and for EUR/USD on the margin, but we maintain our view for EUR/USD appreciation. The growth gap between the US and Euro area is narrow enough that we still expect EUR/USD to grind higher toward fair value.

Avoid concentrated dollar or risk-on/risk-off positions; remain bearish EM FX

We recommend avoiding concentrated directional dollar or risk-on/risk-off positions, and instead focus on relative value, skew, and portfolio combinations. While the recovery in risk assets outside the US has been uneven, commodity and EM currencies have seen significant benefit. Our view that the dollar has peaked does not extend to EM currencies, where our EM strategists remain bearish. Although a dovish Fed could delay EM currency depreciation, they don't think it can prevent it entirely.

EUR/SEK: Good for all seasons

Bullish EUR/SEK has been, and remains, one of our higher conviction views. With the dollar likely to remain range-bound, we prefer idiosyncratic trades that offer good risk-reward under a variety of potential macro outcomes. EUR/SEK fits the bill in this regard. A high negative correlation with equities means it should perform well as a risk-off hedge. At the same time, low inflation means the central bank should continue to lean against downside in EUR/SEK, presenting good risk-reward.

CAD remains our preferred commodity currency

We foresee US growth accelerating in H2, but with the Fed likely to remain cautious, this should be a favorable backdrop for CAD, which we see as being relatively inexpensive. If oil trades in line with our energy analysts' expectations, we think USD/CAD should trade closer to 1.25 at year end. We have been recommending long CAD versus MXN, but think expressing it versus short AUD makes sense as well.

Signposts for our views

Our broad market views are predicated on global core inflation remaining low, allowing global central banks to remain accommodative. Global and US growth are expected to remain modest, with some pick up in H2, and we expect policymakers in China to be able to manage the growth slowdown.

Contents

Our views remain mostly intact following the referendum

*The authors of this report would like to thank **Amr El Sherif** for his research contribution.*

Interest rates have level-shifted lower and European bank equities have suffered, but FX implications have been limited, and mostly concentrated in GBP. We expect this to continue, and have adjusted our view of GBP lower.

The potential for the Leave vote to weigh on Euro area growth increases risks to EUR/USD, but we maintain our 1.16 year-end forecast. We continue to see the dollar as having peaked on a trade-weighted basis versus DM currencies, the euro in particular, and don't expect it to result in a renewed dollar rally. Convergence between US and Euro area rates has actually increased following the referendum. US growth is likely to accelerate in H2, but we think the Fed should remain cautious.

- **GBP remains the best way to trade the Leave vote, but how low could it go?**

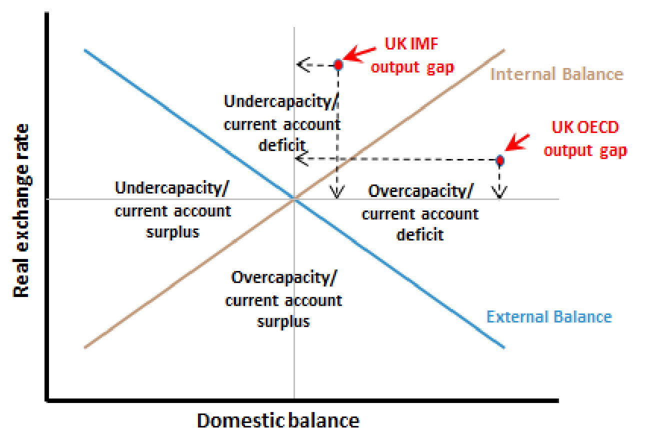
Prior to the vote, we estimated potential EUR/GBP paths. In Leave, we focused on the current account deficit, which at more than 5% of GDP, is the largest among countries with liquid currencies, and well above the 2% averaged during the past 30 years. The details suggest consumers have been spending beyond their means, offset by strength in service exports, high revenues from equity investments abroad, strong earnings from the mining sector, and revenues from banking.

This deficit has been financed through FDI inflows averaging 6% of GDP, well above historical norms. Should this flow moderate (or stall), rebalancing dynamics will likely become key drivers of GBP. A return to balance involves a combination of a weaker GBP and a slowdown in domestic demand (Figure 1). If the currency were to bear the brunt of the adjustment, we estimate that EUR/GBP could rise to parity.

But uncertainty is high, and there are a number of possible outcomes, with considerable uncertainty regarding when (or whether) Article 50 will be triggered. If the UK were to reverse course and stay in the EU, we would expect EUR/GBP to fall below 0.80, though not back to pre-referendum levels, as there has likely been some cyclical impact from the run-up to the vote and post-vote uncertainty.

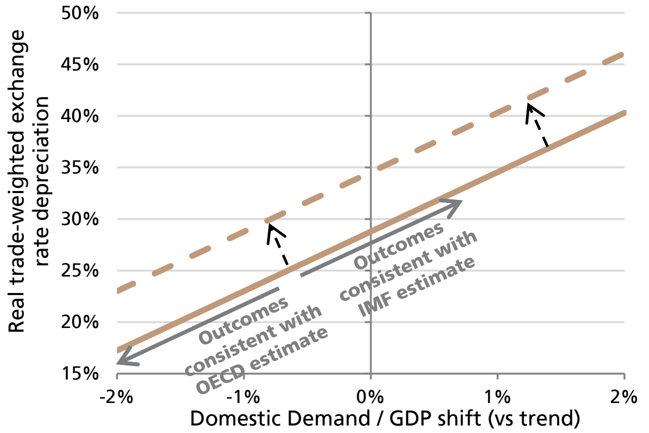
In what we view as the more likely scenario, where there is a significant delay in triggering Article 50, we would expect GBP to weaken gradually, as economic uncertainty and slower growth weigh on the currency. On the macro side, if the domestic demand slowdown were to exceed 2% of GDP, our GBP depreciation estimate would not need to occur fully, as weaker imports absorb some of the adjustment (Figure 2).

Figure 1: Rebalancing likely requires a weaker GBP



Source: UBS. See "Could Brexit be a catalyst for GBP to part the Euro?"

Figure 2: More demand weakness, less GBP adjustment



Source: UBS. (For more, see link in Figure 1.)

- **EUR: Risks have increased, but we maintain our constructive view**

In contrast to the pound, we have argued that the euro is unlikely to see a significant medium-term impact from a Leave vote. Prior to the referendum, we estimated that EUR/USD could fall to the 1.08-1.12 range in the immediate aftermath of a Leave vote. EUR/USD has traded almost entirely in the upper end of this range since then, and we attribute this resilience to two factors:

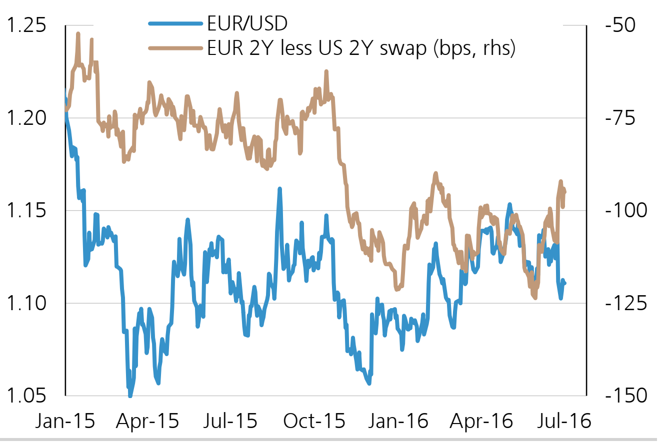
- **Markets have been pricing significantly more tightening from the Fed than other major central banks.** This leaves relatively more room for US rates to fall in a global risk shock, as was the case last August, when fears around China growth led markets to price rates lower globally, and US rates fell more than Euro area rates. Although the location of the shock is different this time, rate differentials have again moved in favor of the euro (Figure 3).

- **Political news/uncertainty has declined as a driver of the euro.** Despite significant market focus on the potential for the Leave vote to cause political stress in the rest of the Euro area, political uncertainty has become a less significant driver of EUR/USD this year. From 2011 to 2013, there was a clear negative correlation between heightened political uncertainty and EUR/USD (Figure 4). But since then, and including during last summer's Greek crisis and the recent run-up to the UK referendum, EUR/USD has not shown a statistically significant relationship with increases in European political uncertainty.

That is not to say that downside risks haven't increased. But we think growth, rather than politics, is key in this regard. Our European economists have cut their 2016 Euro area growth forecast by 10bp to 1.5%. If Euro area growth can remain resilient, as it has throughout this year, we expect EUR/USD to continue its gradual convergence higher toward fair value, which we see as being around 1.25.

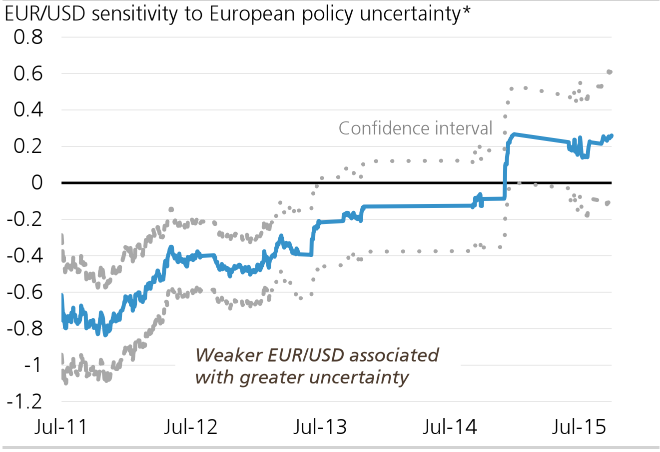
We think it is important not to be complacent about political risks, and it is necessary to watch for similar political movements rising in Europe. That said, we find it worth noting that the Spanish election (a drift toward the status quo) didn't produce a result suggesting contagion, and if growth in the UK slows significantly, that might on the margin dissuade some from following a similar path.

Figure 3: US-Euro yield differentials are narrowing



Source: Bloomberg, UBS

Figure 4: EUR is now less sensitive to political risks



Source: Bloomberg, Haver Analytics, UBS calculations; Baker, Bloom, and Davis.
*Note: Coefficient of a rolling 120-day regression of daily % change in the EUR/USD and a dummy of rising political risk days, identified with European Economic Policy Uncertain index data and widening Euro periphery spreads.

Our year-end EUR/USD forecast remains at 1.16. We see fair value (based on PPP and current account-based models) around 1.25, and expect re-synchronization between US and Euro area growth to gradually push EUR/USD toward it.

- **EUR/SEK: Good for all seasons**

Bullish EUR/SEK remains one of our higher conviction views. With the dollar likely to remain range-bound, we prefer idiosyncratic trades that offer good risk-reward under a variety of macro backdrops, and have argued for EUR/SEK previously based on this. In "risk off", we think Sweden's exposure to global trade and SEK's high correlation with equities should make long EUR/SEK a good hedge (Figure 5), while in a "risk on" backdrop, low inflation should limit EUR/SEK downside.

Low inflation is key, and recent data has been consistent with our view and the empirical work that we have presented in support of it ("Which risks to fade; which risks to take", 8 May 2016). In that piece, we regressed, one-by-one, each of the 67 subcategories of Swedish inflation against the trade-weighted krona, and then against a measure of the output gap. We then sorted the subcategories based on their sensitivities to each variable, allowing us to create two inflation series: an FX-based series that was composed of the 16 subcategories historically most sensitive to the exchange rate; and an output-gap based inflation series composed of the 14 subcategories historically most sensitive to the output gap.

As the krona weakened throughout 2015, the FX-based inflation series rose from flat in late-2014 to +2.7% y/y in March 2016 (Figure 6). This has driven much of the acceleration seen this year in CPIF (the Riksbank's preferred measure of inflation, which adjusts for mortgage interest costs).

However, the trade-weighted Krona index ("KIX") bottomed in August 2015, and has appreciated 5% since then, implying a turn in the FX-sensitive parts of inflation. The May data confirms this. Headline CPI rose just 0.6% y/y, slowing from 0.8% in April, and most important, CPIF rose 1.1% y/y, below the 1.2% consensus, and down from 1.4% y/y in April and 1.6% y/y in March.

Importantly, components of inflation that are driven by the lagged exchange rate showed weakness. As a result, the Riksbank will continue to be sensitive to the exchange rate and eager to prevent the krona from appreciating.

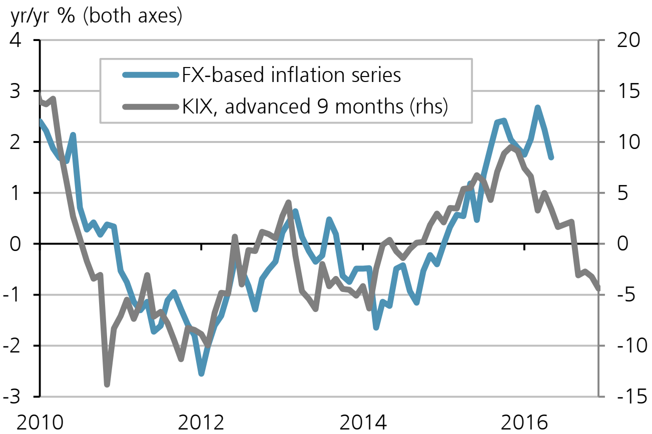
Figure 5: SEK/EUR still most correlated with S&P 500 changes

G10 FX correlation with S&P 500 (weekly % changes), coefficient

Buy → / Sell ↓	USD	EUR	JPY	GBP	CAD	AUD	NZD	CHF	NOK
SEK	-0.31	-0.79	-0.67	-0.01	0.29	0.61	0.32	-0.62	-0.17
NOK	-0.19	-0.53	-0.58	0.10	0.38	0.65	0.38	-0.49	
CHF	0.23	0.10	-0.36	0.41	0.63	0.75	0.67		
NZD	-0.47	-0.62	-0.69	-0.27	-0.03	0.39			
AUD	-0.71	-0.75	-0.73	-0.54	-0.40				
CAD	-0.50	-0.56	-0.65	-0.28					
GBP	-0.23	-0.44	-0.52						
JPY	0.40	0.39							
EUR	0.19								

Source: Bloomberg, Haver Analytics, UBS calculations. 26-week correlation shown.

Figure 6: The prior inflation tailwind is now a headwind



Source: Haver Analytics, UBS calculations. "KIX"= trade-weighted Krona index. Higher KIX means Krona depreciation, lower KIX means Krona appreciation.

- **CHF and JPY: A tale of two central banks**

In contrast to EUR/SEK, EUR/CHF has historically been considered a "risk-on" currency. Notably, although EUR/CHF has retained a positive correlation with the S&P 500 during the past six months, it is relatively low at +10%. The diminished sensitivity is often assumed to be a result of shocks during the past year being concentrated in EM rather than Europe. Yet EUR/CHF has traded well post-referendum, and is only 2.5% from its May high, likely due to effective intervention by the SNB.

We expect the SNB to continue leaning against CHF appreciation, given very low inflation and their view that the CHF remains significantly overvalued. We run a probit model of SNB intervention based on EUR/CHF levels, and find that at around 1.08, intervention becomes extremely likely (Figure 7), at least historically. Similar to EUR/SEK, we find this gives long EUR/CHF good risk-reward.

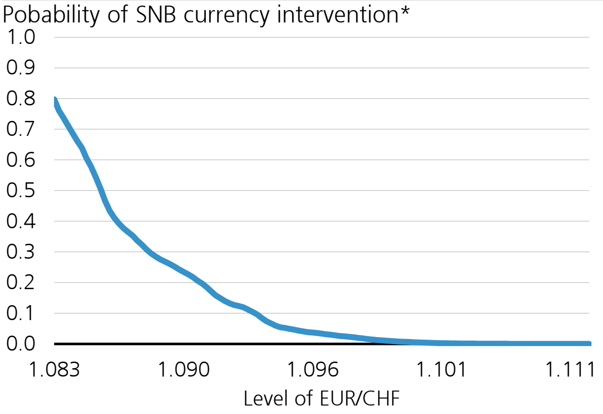
In contrast to the SNB, the BoJ has been much less effective in preventing currency strength. Japanese growth, inflation, and inflation expectations continue to soften in the face of weaker global growth, and all three are being exacerbated by yen strength. USD/JPY fell more than EUR/CHF post-referendum, though one could argue that the implicit threat of intervention around 100 prevented a sharper fall. Going forward, we still expect further BoJ easing, and maintain a modestly higher path in USD/JPY. That said, confidence in the BoJ's reaction function remains low.

- **CAD still our preferred commodity currency**

With favorable valuation and good leverage to a pick-up in US growth in H2 (Figure 8), CAD remains our favorite G10 commodity currency. A combination of accelerating US growth and a cautious Fed should make for a favorable CAD backdrop. If oil trades in line with our energy analysts' expectations, we expect USD/CAD to trade closer to 1.25 at year end.

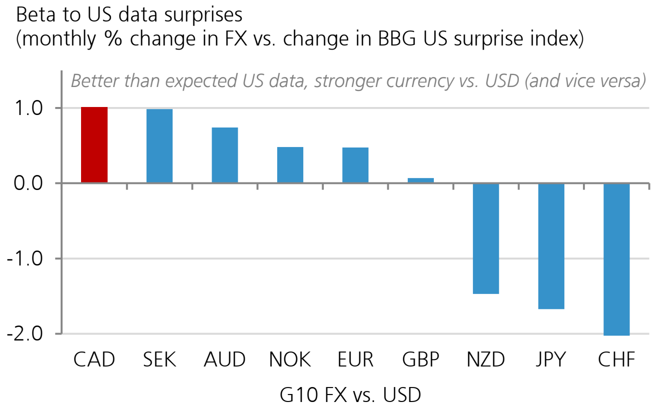
We have been recommending long CAD versus MXN, which is a good expression of our long DM/short EM bias. We also like long CAD versus AUD. We believe Australian inflation should continue to fall, and a dovish RBA should weigh on AUD.

Figure 7: SNB likely to intervene below 1.08



Source: Bloomberg, UBS. *Note: Probit-model based fitted probabilities of SNB intervention, based on daily data of interventions, EUR/CHF and the percent deviation of the current exchange rate from a calibrated threshold value of 1.09 (results robust to this calibration). Daily intervention identified from weekly data of Sight Deposits data paired lowest intraweek daily closes in EUR/CHF as a proxy.

Figure 8: CAD is most responsive to better US data



Source: Bloomberg, UBS calculations. *Coefficient of monthly % changes in FX based on monthly delta in Bloomberg US economic data surprise index.

Dollar

UBS Research THESIS MAP

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PIVOTAL QUESTIONS

Q: Why hasn't the dollar rallied more post-referendum?
The dollar has appreciated against most major currencies post-referendum (yen excluded), but the trade-weighted appreciation has been modest at about 3%. This is consistent with our view that to the extent a Leave vote would lead to lower rates globally, US rates had the most room to fall on a relative basis. This further reduction in "policy divergence" partially offset the benefit to the dollar from higher risk aversion.

Q: Why didn't the dollar rally significantly during the Fed's hawkish turn in May?
First, the hawkish turn was short-lived. Second, and perhaps more important, it didn't occur against a backdrop of especially strong growth. Although it is true that US growth picked up in Q2 relative to Q1, it wasn't strong in absolute terms. This is consistent with our view that the dollar will not benefit much from rate differentials that are not supported by growth differentials.

Q: Do we expect the dollar to perform differently against EM currencies than G10?
Yes. We expect softer USD performance against G10, but broader dollar strength against EM currencies. Our EM strategists think the relationship between broad USD trends and EM returns is less powerful than generally thought, and they find evidence that the negative beta between the USD and EM assets is more reliable in a stronger USD world than in a weaker USD world. A less hawkish Fed and lower USD can postpone the pain for broad EM assets, but with rates and risk premia already low, EM currency gains require better growth to be sustained. We think prospects here remain weak.

UBS VIEW

The dollar has peaked against G10 currencies, the euro in particular, while we expect it to gain versus EM. We expect dispersion within G10 FX, and the trade-weighted dollar to remain range-bound. In the absence of a sharp rise in US growth, the feedback effects from a stronger dollar prevent meaningful trade-weighted appreciation versus DM currencies. Growth and valuation should take on added importance for currencies in this backdrop, and continuing growth re-synchronization between the US and its trading partners should lead to a gradually weaker trade-weighted dollar.

EVIDENCE

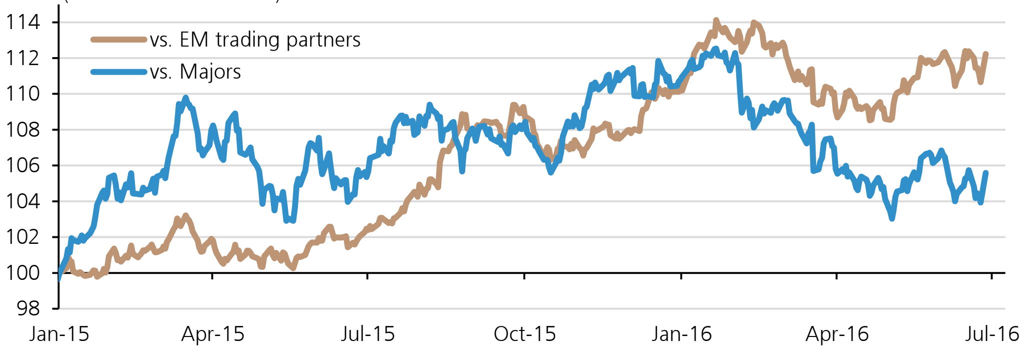
The recent behavior of the dollar. Neither policy divergence nor risk aversion has prompted sustained dollar rallies in recent months. Meanwhile, the dollar remains overvalued against the euro on both a PPP and current account basis, and in our view the growth gap between the two doesn't justify a stronger dollar versus euro. Our economists expect similar US and Euro area growth rates in 2016. They foresee 1.5% Euro area growth, and 1.7% US growth, which would be the narrowest growth gap since 2011.

SIGNPOSTS

US growth. Without a significant improvement in US growth, Fed policy will have less of an impact on the dollar. In our view, it is important to focus on non-farm payrolls (July 8th and August 5th), where an acceleration toward 200k would likely be necessary for the dollar to move toward the upper end of its range.

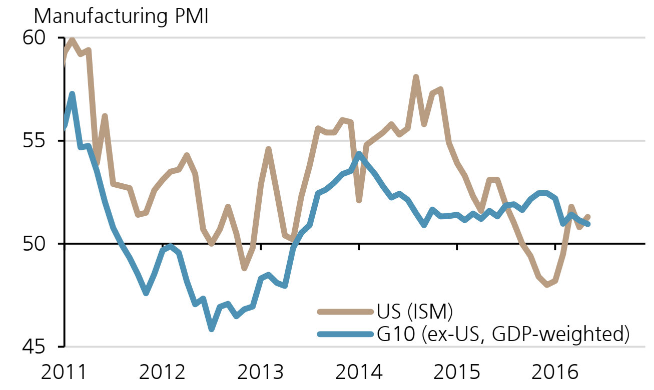
UPSIDE / DOWNSIDE SPECTRUM

Trade-weighted dollar (Federal Reserve)
Index (1 Jan 2015 level = 100)

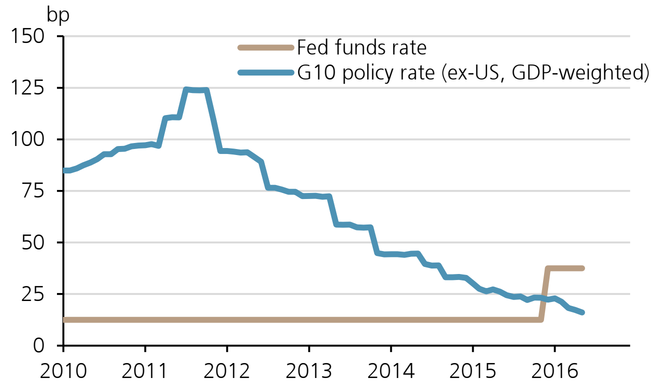


OUR THESIS IN PICTURES

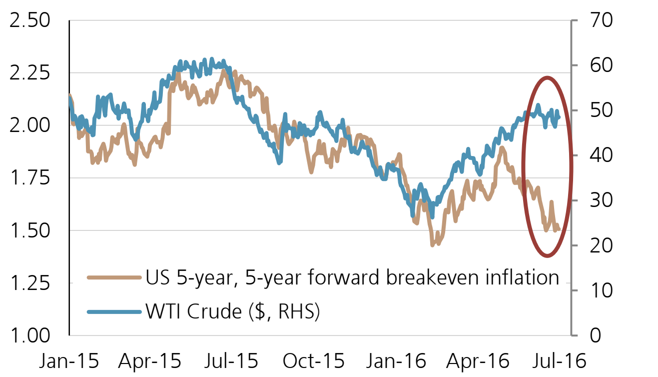
Table of Contents ↑



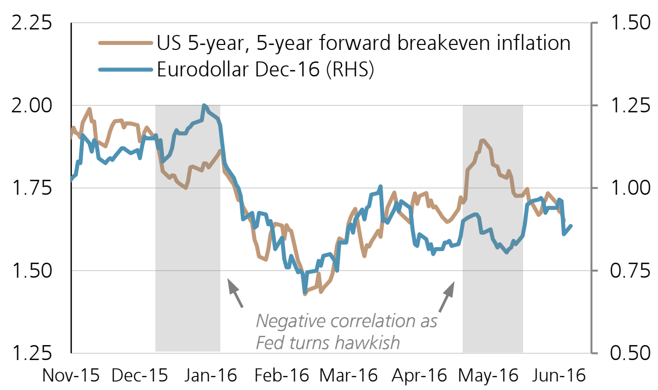
If US activity data is converging with the rest of G10…



…can interest rates meaningfully diverge?



Market-based measures of US inflation expectations have declined, even as oil prices have rebounded…



…and monetary policy may be playing a role. Market-based inflation expectations and Fed policy have diverged twice during the past year: December 2015 to January 2016; and May 2016. This evidence is only circumstantial, but suggests markets have interpreted bouts of Fed hawkishness as "over-hawkishness".

Sources for exhibits above: Haver, Bloomberg, UBS

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PIVOTAL QUESTIONS

Q: Why hasn't the Leave vote impacted EUR/USD more?
In contrast to the pound, we have argued that the euro is unlikely to be impacted significantly over the medium term by a vote to Leave, though it does increase risks. Prior to the referendum, we estimated the immediate reaction to a Leave vote could push EUR/USD to the 1.08-1.12 range, and it has traded almost entirely in the upper end of this range since then. We argued that given the starting point of markets pricing significantly more tightening from the Fed than nearly any other major central bank, there was more room for a reduction in US rate expectations than in most other places. Since then, 2- and 10-year rate differentials have each moved about 10bp in favor of the euro.

Q: Will further ECB easing drive EUR/USD lower?
Not necessarily. The backdrop of policy easing has changed, with the Euro area economy now growing closer to trend, closing the gap versus the US on most measures of activity. The ECB's focus on policy easing has shifted away from deposit rate cuts and toward asset purchases, which is marginally less bearish for the EUR. Empirical evidence suggests a diminishing impact on FX from successive rounds of asset purchases. From a valuation perspective, the adjustment in EUR/USD since 2014 has left the currency cheap.

Q: What will be the key driver of EUR/USD going forward?
Although markets are likely to stay attuned to political developments, negative "news" has become a smaller driver of EUR/USD in recent years. Rather, we expect growth differentials to be key. Following the Leave vote, our European economists lowered their growth forecasts for 2016 and 2017. If Euro area growth can remain near their 2016 forecast of 1.5%, we think EUR/USD should remain supported.

UBS VIEW

EUR/USD has bottomed, and will rise gradually. The Leave vote has increased risks for the euro, but favorable valuation, and growth re-synchronization between the US and Euro area, should drive EUR/USD higher over the medium term. Over a longer time horizon, we expect EUR/USD to continue rising toward fair value, which we see as being around 1.25. This should be very gradual, however, and our forecast for end-2017 is only 1.20.

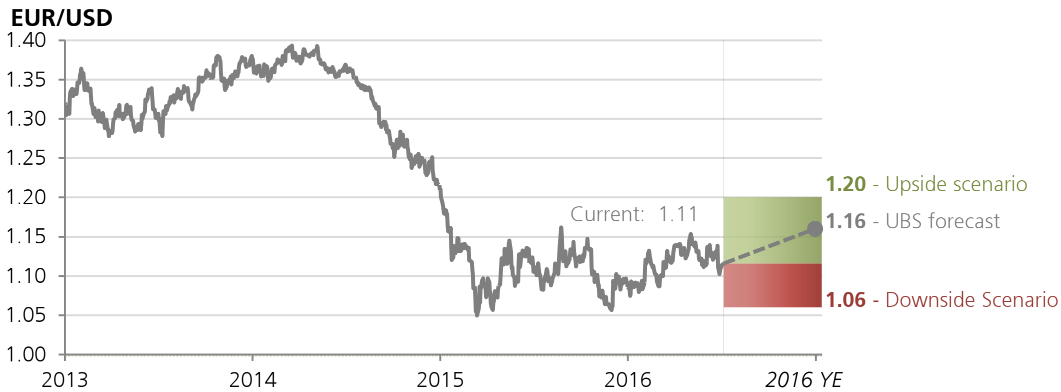
EVIDENCE

Most valuation models, including PPP and current account-based FEER indicate that EUR/USD fair value is around 1.25. Although currencies can remain far from fair value for extended periods of time, that should require greater cyclical differentiation than we have been seeing between the US and Euro area. After significant cyclical divergence in 2014, the Euro area and US economies spent much of 2015 converging. We expect this should continue in 2016, and provide further support for the currency. Our European Economics team forecasts 2016 growth of 1.5% in the Euro area, while our US Economics team expects 1.7% growth, marking the smallest gap since 2011.

SIGNPOSTS

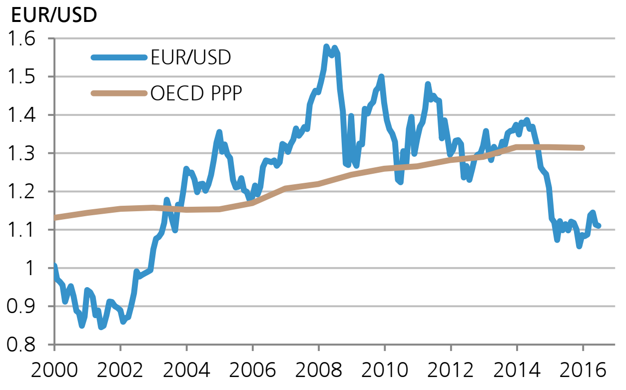
Growth differentials versus the US. Valuation and growth resynchronization have provided support for the euro. The manufacturing PMI gap is currently less than one point in favor of the US, and as long as it doesn't move to more than three or four points (flash PMIs July 22nd; final August 1st), we would expect EUR/USD to continue to grind higher. Post-referendum, we see a wider gap as the key risk to our view.

UPSIDE / DOWNSIDE SPECTRUM

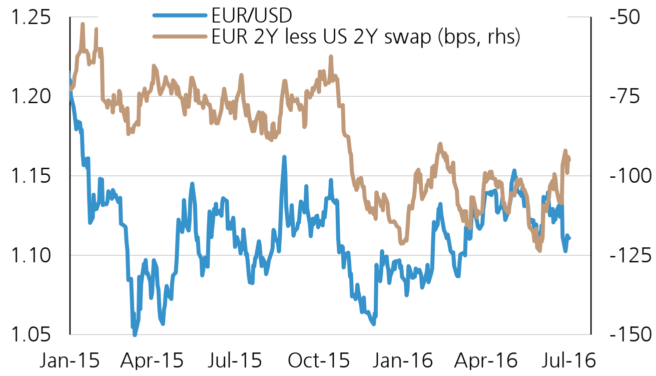


OUR THESIS IN PICTURES

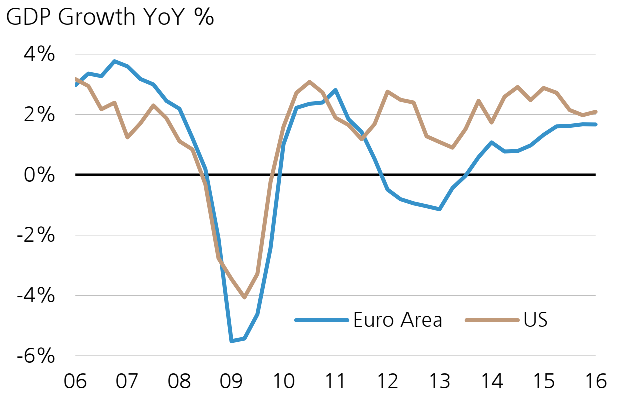
Table of Contents ↑



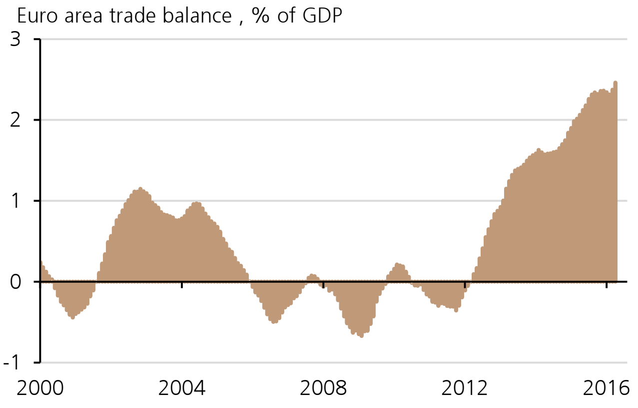
EUR/USD remains undervalued, in our view. Currencies can remain far from fair value for extended periods of time, but that should require some special factor such as extreme cyclical differentiation.



The potential for policy divergence to drive EUR/USD lower is losing traction as rate differentials have been narrowing between the US and Euro area…



…and narrowing US-Euro area growth differentials do not justify a stronger dollar either.



Europe's large and rising trade surplus suggests that lack of currency weakness is not a problem for the region. If EUR/USD were to fall further, this imbalance could gain greater international attention.

Sources for exhibits above: Haver, Bloomberg, UBS

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PIVOTAL QUESTIONS

Q: Has the BoJ's reaction function moved away from the "shock-and-awe" of Abenomics?
It appears likely that it has. Despite a loss of momentum in activity and inflation data, a meaningful decline in inflation expectations, and substantial appreciation of the yen since the January meeting, the BoJ has not added to monetary accommodation. This stands in contrast to the BoJ's overall proactive and reflationary stance since Abenomics was introduced in 2013. On balance, the BoJ appears more cautious than it has been during the past three years.

Q: Do we still expect the BoJ to ease again soon?
Yes. The BoJ will probably add to stimulus at the July or September meetings in response to weaker economic developments and a stronger currency. Additionally, the government's intentions on further fiscal stimulus may also become known by then. The recent UK vote to leave the EU arguably adds to easing pressures. That said, we think it may take further confirmation of economic weakness and pressure from markets before additional easing is introduced.

Q: How would easing of fiscal policy impact the yen?
It depends on whether or not monetary policy is also eased. If both fiscal and monetary policy were eased in a big way and seemingly in conjunction, this could create the impression of coordinated action, prompting substantial yen weakness. That said, fiscal easing might be delivered in lieu of monetary easing. For instance, fiscal stimulus could prompt the BoJ to upgrade its growth forecasts and feel less urgency to ease. In that case, the perceived shift from monetary to fiscal easing could be seen as a hawkish surprise, leading to an even stronger yen.

UBS VIEW

Modest long term upside in USD/JPY. A weaker yen is still consistent with the BoJ's policy objectives, and economic pressures still argue in the direction of further policy easing and USD/JPY rising from current levels. That said, unlike most risk assets, USD/JPY has not recovered from its referendum-driven decline, and the fall in US rates (and room for them to fall further compared to other G10 yields) is diminishing the yen's appeal as a funding currency. Against this backdrop, we lowered our year-end USD/JPY forecast from 112 to 105.

EVIDENCE

There is evidence that the BoJ's reaction function may have changed. Macro data have been weak, and financial conditions have tightened since January. The headline index from the BoJ's manufacturing Tankan survey fell to its lowest level since 2013 in Q2 2016, survey-based and market-based measures of inflation expectations remain subdued, and USD/JPY is trading below 105. All of these are contributing to a tightening in broader financial conditions. Similar developments in the past have triggered significant BoJ easing, yet it has not reacted this time.

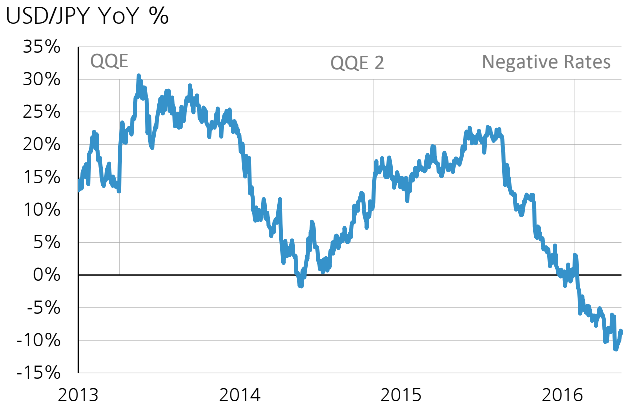
SIGNPOSTS

Policy action. The data suggests the BoJ should already have eased, so the data is less important than what the BoJ actually does. Our Japan economists expect further easing in the future, and whether it occurs will be the key driver of USD/JPY. Focus on BoJ meetings on July 29th and September 21st.

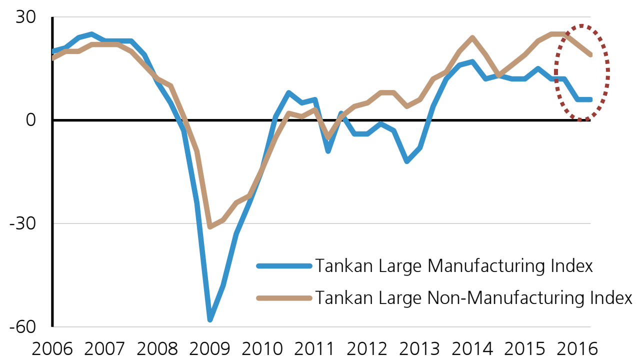
UPSIDE / DOWNSIDE SPECTRUM

OUR THESIS IN PICTURES

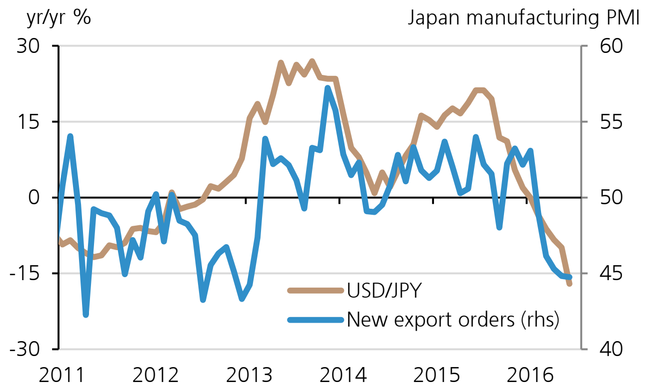
Table of Contents ↑



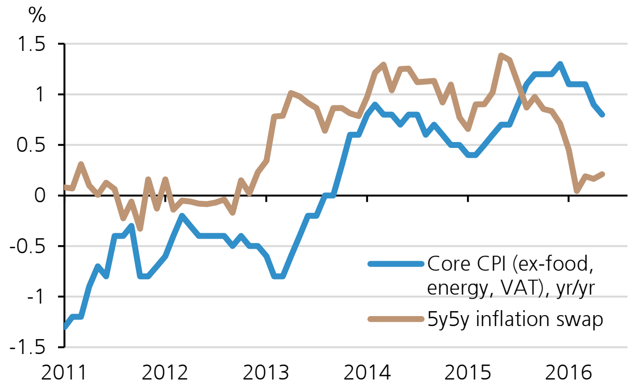
In the past, y/y deceleration in USD/JPY toward zero triggered BoJ action. BoJ behavior was consistent with this in January, when it shifted to negative rates. Since then, however, the BoJ has not spurred a weaker yen, nor have they eased further even as the currency has strengthened significantly.



The Japanese economy has weakened this year, reversing earlier gains from Abenomics.



The currency continues to strengthen, posing challenges for Japanese exporters in an already difficult environment for global trade.



The BoJ's inflation target remains elusive. With market-implied and survey-based measures of inflation expectations slipping, the BoJ should be more worried about core CPI starting to slip. Yen strength introduces further downside risks to inflation.

Sources for exhibits above: Haver, Bloomberg, UBS

UBS Research THESIS MAP

OUR THESIS IN PICTURES →

PIVOTAL QUESTIONS

Q: What is fair value for GBP if the UK leaves?
We think EUR/GBP could rise to parity. Prior to the vote, we provided estimates for EUR/GBP under both Leave and Remain scenarios. In Leave, we focused on the large current account deficit, which at more than 5% of GDP, is the largest among countries with liquid currencies. The deficit has so far been financed by large inflows of FDI, which have averaged 6% of GDP, well above historical ranges. Should this FDI flow moderate (or stall), rebalancing dynamics would likely become key drivers of the currency. If the currency were to bear the brunt of the adjustment (and not domestic demand), we estimate that EUR/GBP could rise to parity.

Q: Why hasn't it reached that new fair value yet?
Entering the referendum, most investors viewed it as a binary event with two specific possible outcomes. Nearly two weeks later, uncertainty remains high, with a lack of clarity regarding when (or even whether) Article 50 will be triggered, and this has likely prevented a larger adjustment in GBP.

Q: What factors could prevent a full adjustment?
In addition to a sharp growth slowdown mitigating some of the needed currency depreciation, if the UK were to reverse course and stay in the EU, we would expect EUR/GBP to fall below 0.80, though not back to pre-referendum levels, as there has likely been some cyclical impact from the run-up to the vote and post-vote uncertainty. If the slowdown in domestic demand exceeds 2% of GDP, the GBP depreciation we estimate may not need to occur fully, as weaker imports could absorb some of the adjustment.

UBS VIEW

We expect EUR/GBP to continue to rise, forecasting 0.90 at year-end. This is due to a combination of weaker growth, easier monetary policy, political uncertainty, and the need for significant further current account adjustment. In the likely scenario, where there is a delay in the triggering of Article 50, we expect GBP to weaken gradually, as the economic uncertainty and growth slowdown weigh further on the currency.

EVIDENCE

The current account deficit remains wide, and growth has already started to slow. The current account deficit swelled to -5.7% of GDP in Q1 (trailing 4-quarter average), well above historical norms, and even before the referendum, growth was showing signs of significant slowing. The composite PMI fell to a 3-year low, dropping 3+ points from late-2015, when it was one of the highest in the G10.

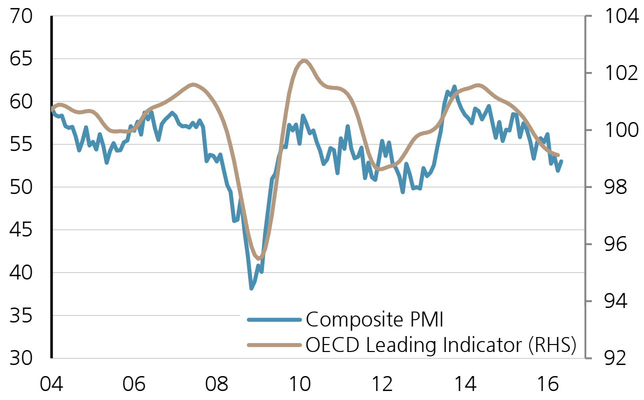
SIGNPOSTS

Growth, current account, and politics. Given how far EUR/GBP is from our estimate of what is needed for current account adjustment, narrow signposts are difficult. We are focused on how sharp the growth slowdown will be. Consumer confidence (July 29th) and the July PMIs (August 1st) should provide a good initial read. The next releases of balance of payments data are July 8th and August 9th (for May and June, respectively), though adjustment will take time. In politics, developments between now and September 9th in the Conservative Party leadership race will be key, as would any triggering of Article 50 (or clarity on it), though most major candidates appear to agree that it won't be triggered anytime soon.

UPSIDE / DOWNSIDE SPECTRUM

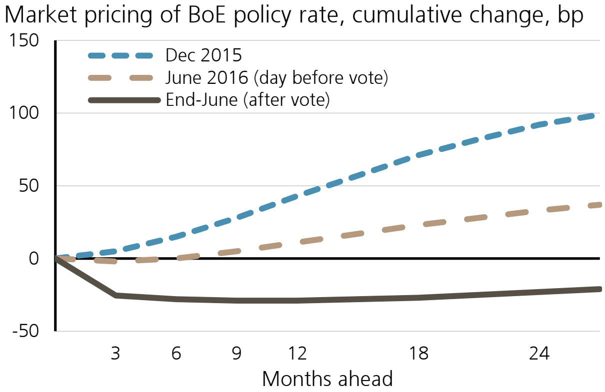
OUR THESIS IN PICTURES

Table of Contents ↑



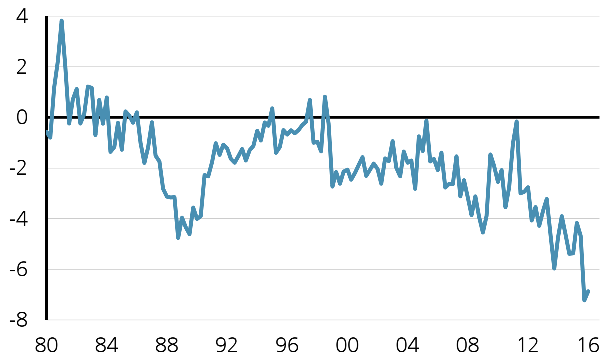
UK economic activity weakened in the approach to the referendum. How much further economic activity slows after the vote will be key.

Market pricing of BoE policy rate, cumulative change, bp

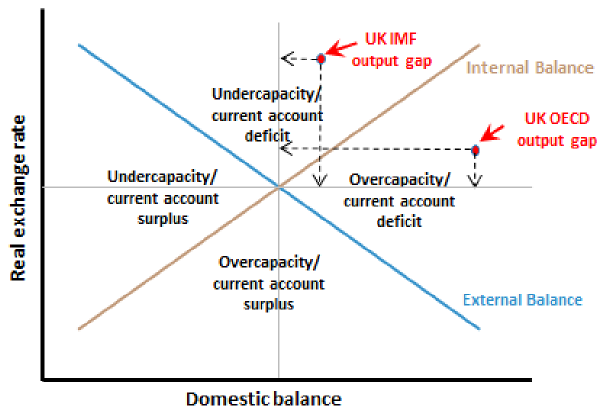


Following the vote to Leave, the market quickly started to price Bank of England easing.

UK current account balance, % of GDP



The UK's current account balance has deteriorated significantly in recent years, and the vote to Leave is likely to make it more challenging to finance this deficit.



Sources for exhibits above: Haver, Bloomberg, UBS

A combination of currency weakness and domestic demand weakness can help the adjustment of the current account. We have estimated if the currency does the bulk of the work, then EUR/GBP could rise to 1.0.

UBS Research THESIS MAP

OUR THESIS IN PICTURES →

PIVOTAL QUESTIONS

Q: Why hasn't EUR/CHF fallen more in light of the vote to Leave?
SNB intervention. The relationship between EUR/CHF and risk assets has diminished during the past year. Many have argued that it was a matter of where the shock was coming from, and that a Eurocentric risk-off move would see CHF return as a safe-haven. That happened around the referendum, but to a smaller degree than usual. This was due to heavy SNB intervention, which likely helped EUR/CHF perform relatively well. Following what was considered a significant shock to European risk sentiment, EUR/CHF is not far from its pre-referendum level.

Q: What level of EUR/CHF could trigger another SNB rate cut?
A sustained move in EUR/CHF towards 1.05-1.07 would likely compel the SNB to cut rates. As a first line of defence, we would expect the SNB to continue with FX interventions, but if interventions are unable to prevent appreciation, the SNB may consider easing policy by cutting the interest rate on sight deposits further (or reducing the exemption threshold on sight deposits). To limit the pain on banks, an interest rate cut may be applied only to newly-created excess reserves (see "Switzerland looking up").

Q: What could drive EUR/CHF out of its nine month range?
The EUR/CHF range of the past nine months (1.08-1.12) has been durable, and periods where the Swiss franc has moved below 1.08 have been short lived. If concerns over the outlook for the Chinese economy or UK-related uncertainty were to increase, EUR/CHF might again test the low end of the range. However, the SNB's commitment to prevent a marked appreciation means that a downside move is unlikely to be persistent, in our view. Ongoing recovery in the Euro Area is supportive of a weaker franc versus the euro, though risks to the outlook have risen following the UK referendum.

UBS VIEW

We remain bullish EUR/CHF, and expect further gradual CHF weakness. Improvement in Euro area growth and an overvalued CHF should drive this weakness. Although near-term catalysts are not obvious, given the likelihood of SNB intervention if EUR/CHF were to fall further, long EUR/CHF offers good risk/reward. With the Swiss economy among the most open in Europe and interest rates deeply negative, a weaker currency remains the best avenue to get inflation to target. That said, given the increased risk to Euro area growth from the Leave vote, and our European economists' reduced growth forecasts, we lower slightly our year-end EUR/CHF forecast to 1.13, from 1.15 previously.

EVIDENCE

PPP measures show the currency is more than 20% too expensive. Headline and core inflation both remain low, and our expectations for stronger Euro area activity should help generate outflows from Swiss assets. The franc has traded less like a safe-haven currency over the past year, though we would expect better Euro area growth to reduce franc inflows. A recent SNB paper has highlighted the importance of foreign bank flows into Switzerland as a driver of CHF performance. These flows correlate with Euro area growth, and we would expect better growth to weaken the franc.

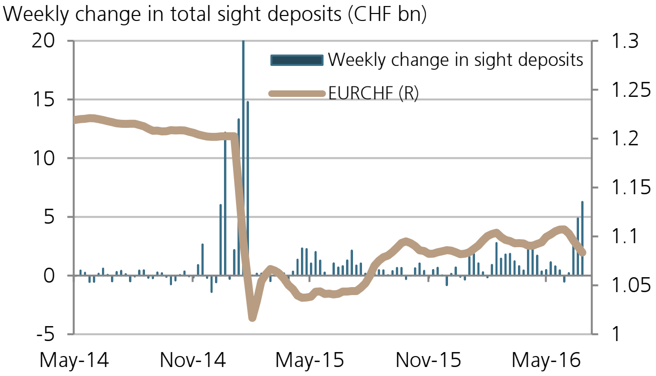
SIGNPOSTS

Intervention and European growth. Inflation is low, and likely to remain so. The key is whether the SNB continues to intervene against further downside in EUR/CHF. We expect they will, and would watch the weekly sight deposits and comments from policymakers. European growth is the other key to our view. Our European economists forecast +0.3% q/q growth in Q2 (July 29th). If growth were to exceed this, it could point to upside in EUR/CHF, while a print below 0.2% could challenge our view.

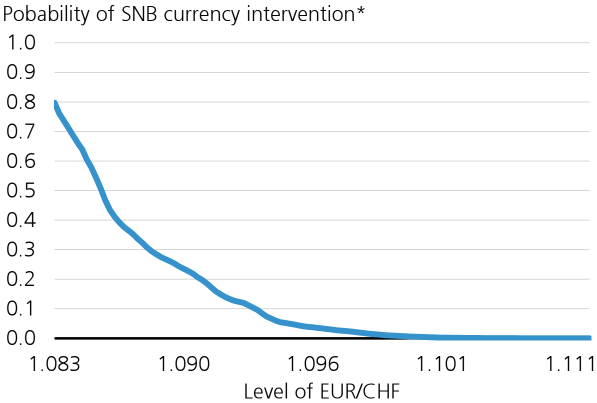
UPSIDE / DOWNSIDE SPECTRUM

OUR THESIS IN PICTURES

Table of Contents ↑

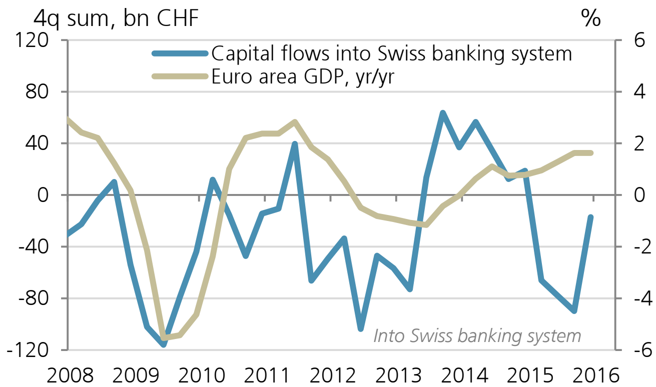


FX interventions by the SNB continue to be the first line of defence to prevent a marked appreciation of the CHF. The average weekly change in total sight deposits (a proxy for FX interventions) has been CHF5.6bn in the last fortnight; much larger than previous weeks. During this period moves in EURCHF below 1.08 have been short-lived.



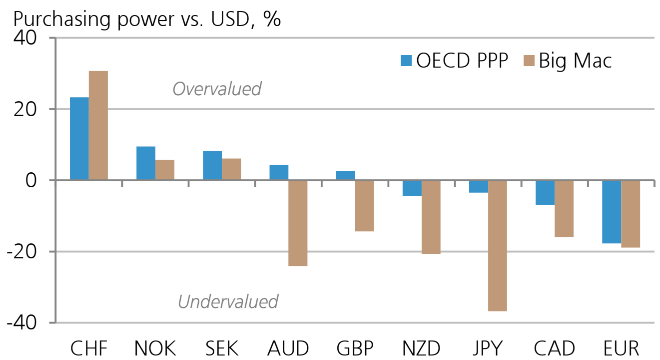
SNB intervention has been critical, reducing the downside in EUR/CHF. We estimate that the probability of intervention picks up sharply around 1.08, and so we would not expect sustained moves below that level.

*See Figure 7 on p. 6 for details on the analysis.



A recent SNB paper has highlighted the importance of foreign bank flows into Switzerland post-2008 as a key driver of CHF performance[1]. These flows have shown some correlation with Euro area growth, and we would expect improved growth to lead to a weaker CHF through this channel.

1. Raphael A. Auer and Cédric Tille, "The banking sector and the Swiss financial account during the financial and European debt crises," SNB Working Papers, 5/2016.



Various purchasing power measures continue to point to CHF overvaluation. On the OECD's measure and *The Economist* Big Mac measure, CHF is the most overvalued in G10. By contrast, the euro appears undervalued, supporting our bullish EUR/CHF view.

Sources for exhibits above: Haver, Bloomberg, UBS

UBS Research THESIS MAP

OUR THESIS IN PICTURES →

PIVOTAL QUESTIONS

Q: Is oil still the most important driver of the Canadian dollar?
Yes, but other factors matter. The correlation between oil and CAD remains significant, even though it has lessened (from -0.8 in March to -0.4 in June, based on rolling 13-week). Policy, both monetary and fiscal, is becoming increasingly relevant for CAD, but we expect oil to remain the most significant driver in the near term. A rebound in US growth, especially if not accompanied by renewed focus on Fed tightening, would also support the Canadian economy and a stronger CAD.

Q: Can fiscal stimulus and improvements in the non-energy sector offset weakness in energy?
Not entirely. Energy weakness continues to feed through to the economy. Following last year's 31% capex decline, energy companies expect a 23% decline in 2016. This is being partially offset by public sector investment, where capex is expected to rise 6.5% this year, and consumer activity, where year-to-date retail sales are running 5.3% above 2015 levels. On the trade side, the weaker currency has provided a lift for some sectors, with autos and consumer goods exports both up 12-13% y/y, though total goods exports weakened in the most recent report (-5% y/y in April).

Q: How will US growth impact the Canadian dollar?
Rebounding US growth should be especially supportive of the CAD, and we see reasons to expect some acceleration in H2, especially if the recent slowdown is attributable to the early-2016 tightening of financial conditions. The Canadian dollar has the highest beta to positive US data surprises. What's more, near-term improvements in US activity are less likely to induce Fed tightening expectations and should not prompt USD strength, providing a good backdrop for USD/CAD to move lower.

UBS VIEW

The Canadian dollar remains our preferred commodity currency. It is inexpensive relative to other commodity currencies, and steady economic adjustment to lower energy prices and the shifting fiscal/monetary policy mix should provide support. In the near term, the direction of oil and the broader dollar are likely to remain the key drivers of USD/CAD. We prefer to express long Canadian dollar positions against other commodity currencies, MXN and AUD in particular.

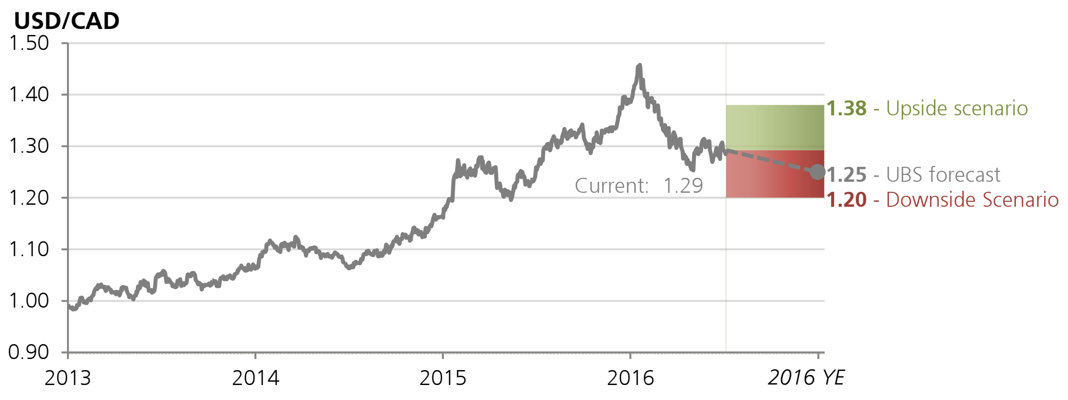
EVIDENCE

The Canadian dollar remains slightly undervalued on a PPP basis (5%), while other G10 commodity currencies remain overvalued. Fiscal easing, in the form of a 1.5% budget deficit for the current year should support growth and keep monetary policy marginally tighter than it otherwise would be, and is likely to keep the BoC from cutting rates. The BoC expects GDP growth of 1.7% this year, in line with potential (which the BoC estimates at 1.2-1.8%). Meanwhile, headline inflation, currently tracking 1.5%, is relatively close to the central bank's target.

SIGNPOSTS

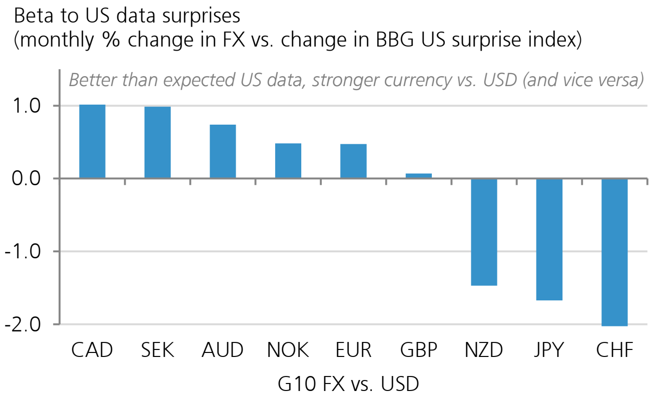
Oil and US growth. Oil remains the key driver of CAD. Our energy analysts forecast stable crude prices through year-end, which would be consistent with USD/CAD closer to 1.25 in our models. US growth and its impact on Canadian non-energy exports is the other key. After a solid rise in the US manufacturing ISM to 53.2 in June, the July data (August 1st) will be important, and a further rise would be positive for Canadian non-energy exports.

UPSIDE / DOWNSIDE SPECTRUM

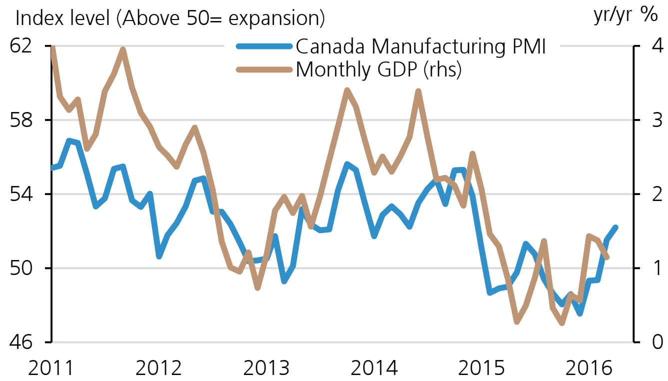


OUR THESIS IN PICTURES

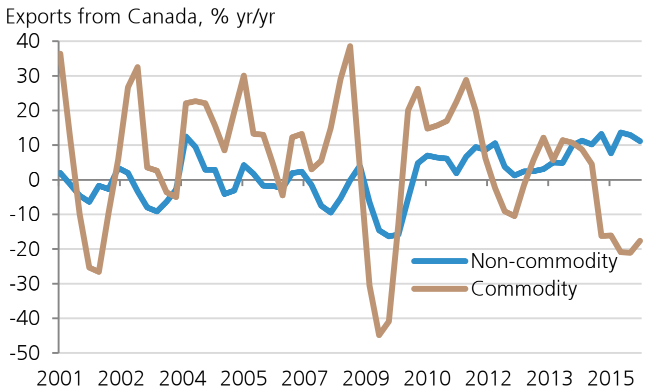
Table of Contents ↑



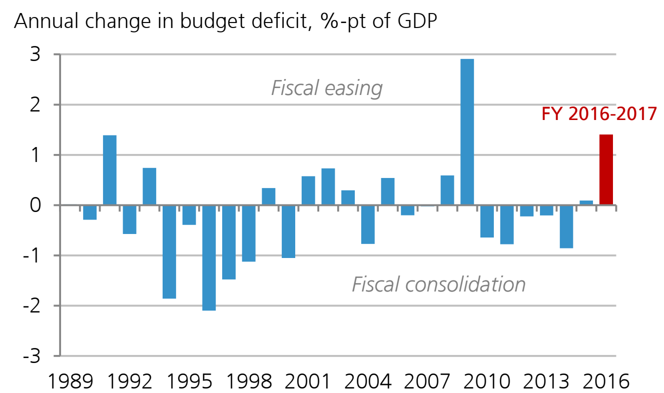
The Canadian dollar is the most responsive G10 currency to US data surprises, and so a rebound in US economic activity in H2 2016 should be supportive.



Canadian growth and manufacturing output are rebounding from depressed levels as the energy drag diminishes and past currency depreciation provides a lift.



Prior depreciation of the CAD is benefitting non-commodity exports, which grew 11% y/y in Q1. The shift in growth drivers helps to offset the income losses from lower energy exports (-18% y/y). The performance of the Canadian economy depends on how much the non-commodity sectors can fill the gap as commodity-producing sectors contract.



Stimulative fiscal policy is helping to provide an offset. The new Canadian government's expected budget deficit of C$29.4bn (1.5% GDP) for the year marks a shift from the less stimulative budgets of the prior government. With fiscal policy supporting Canadian growth and adjustment to cheaper oil, this takes weight off the Bank of Canada to ease further.

Sources for exhibits above: Haver, Bloomberg, UBS

UBS Research THESIS MAP

OUR THESIS IN PICTURES →

PIVOTAL QUESTIONS

Q: What impact will China have on the AUD going forward?
A modest, but persistently negative one. Our China economists recently upgraded their 2016 and 2017 growth forecasts to 6.6% and 6.3%, respectively, and the AUD's bounce earlier this year can partly be attributed to a similar market sentiment. However, with industrial metal prices already reflective of an upside China growth scenario (UBS' base case is for iron ore to end the year lower), the Aussie dollar's sensitivity to China surprises from here is likely asymmetric, with greater risk to the downside.

Q: Will the RBA tolerate a period of sub-target inflation if growth holds up well?
Possibly, but it largely depends on the trend in underlying inflation. The RBA's inflation forecast is now more closely aligned with our view that the move lower in Australian inflation has a significant structural component to it. With slowing domestic trend growth (from 4% previously to levels around 2% now) and an ongoing drag from the capex cliff, occasional positive growth surprises (such as Q1-16 GDP) are unlikely to deter the RBA from easing, as long as underlying inflation is trending lower.

Q: Will the RBA cut and will it impact the AUD?
Yes, we expect RBA easing to weaken the AUD. A cut, as expected by our economists in August, is unlikely to be seen as a one-off event, and should weigh on the currency as the market shifts forward expectations of further easing. We would not view the level of the AUD as a significant priority for the RBA, but rather a marginal factor (a 'complication' to the rebalancing of the economy) that could influence its reaction function when combined with other factors, low inflation in particular.

UBS VIEW

We remain bearish the AUD based on valuation, the trend slowdown in domestic growth, a high likelihood that inflation continues to undershoot the RBA's target, and a domestic economy that is increasingly dependent on a weaker currency to support rebalancing.

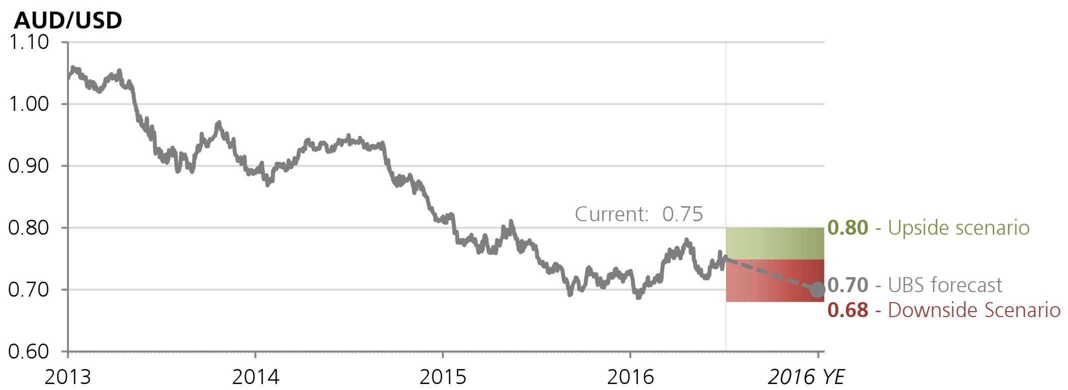
EVIDENCE

Although declines in recent years have brought AUD closer to fair value, in our view it remains overvalued. On our replica of the RBA's fair value model, AUD/USD is 3% overvalued, and it is 5% overvalued on the OECD's measure of PPP. Although these deviations are not extreme in a historical context, our economists have published work highlighting that inflation is likely to continue undershooting the RBA's target.

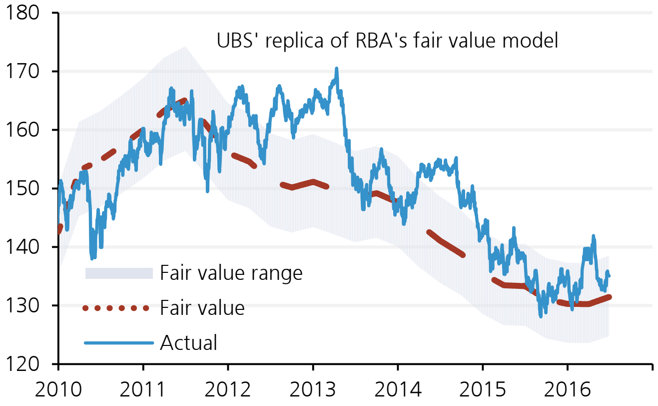
SIGNPOSTS

Inflation, the RBA, and metals prices. Our inflation and RBA views are linked—our economists expect inflation to continue to trend lower and for the RBA to cut again at its August 2nd meeting. Q2 CPI (July 22nd) will be key in this regard. They expect 1.1% y/y and 1.6% y/y in headline and underlying CPI, respectively, and stronger prints would be a risk to both our RBA and AUD views. If the RBA remains on hold at its August meeting, it would signal greater tolerance than we expect for low inflation, and also be a risk to our view.

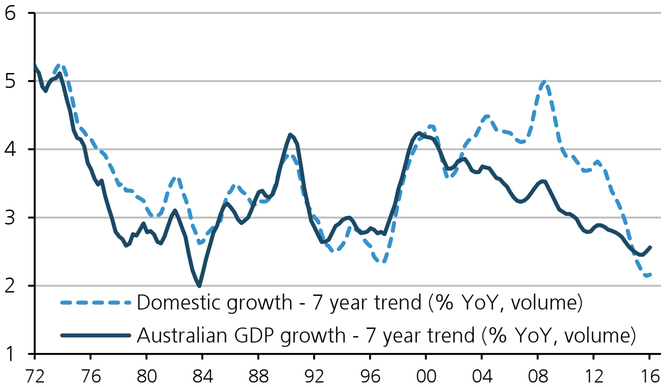
UPSIDE / DOWNSIDE SPECTRUM



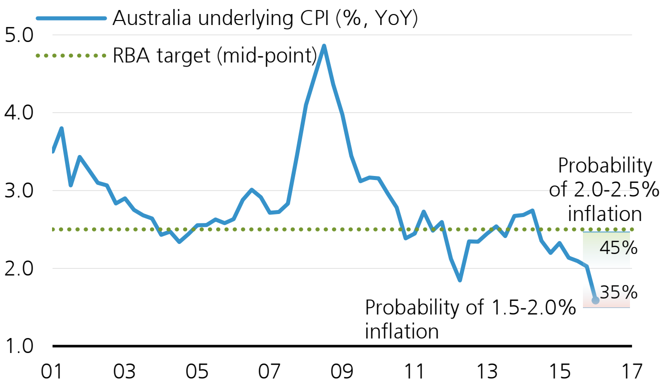
UBS Research



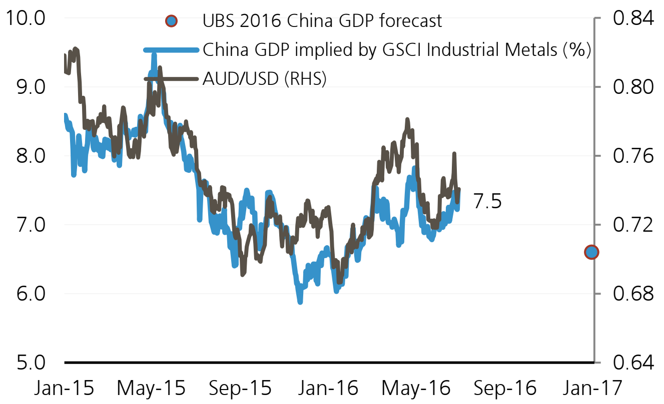
The AUD appears ~3% overvalued vs. UBS' replica of the RBA's fair value model. We believe this should, on the margin, support a more dovish reaction function from the RBA when coupled with lower inflation and the need for further rebalancing of the economy.



The seven-year averages of real GDP and domestic demand growth (i.e., GDP less net exports) have typically not strayed too far from each other. But since 2002 (when China started firing up commodity demand), policymakers have had to deal with an extremely buoyant domestic economy. This has now reversed, and we expect should continue to weigh on yields and the currency.



Structural disinflationary pressures have intensified in Australia, as the effect of heightened competitive pressures from new entrants in a range of sectors, new regulatory resistance to above CPI price rises, slowing rents, and low wage growth feed through. Inflation is likely to stay low, keeping monetary policy loose and putting downward pressure on the AUD.



We estimate that current industrial metal prices are consistent with a 7.5% 2016 growth rate in China, higher than the 6.6% expected by UBS Economics. This suggests that any China surprises from here are likely to impact the AUD asymmetrically to the downside.

Sources for exhibits above: Bloomberg, FactSet, Datastream, RBA, UBS

UBS Research THESIS MAP

OUR THESIS IN PICTURES →

PIVOTAL QUESTIONS

Q: Why has the NZD been so strong?
The NZD trade-weighted index (TWI) strengthened by a notable 4.6% in June, with most of the move occurring in the first half of the month. While the RBNZ's on-hold decision at its June 9th meeting was the main driver, scaled- back expectations for policy normalisation in the US and resilient NZ growth have also played a part, boosting the perceived attractiveness of NZD as a carry currency.

Q: Will the stronger NZD lead the RBNZ to ease?
The NZD has reached a level at which it is likely to impact the RBNZ's reaction function, and is likely to push the RBNZ to ease at its August meeting. The currency is more than 4% stronger than assumed in the RBNZ's upside scenario from June, in which policy rates, ceteris paribus, are seen falling by 60bp this year and a further 70bp in 2017. First quarter GDP came in at 0.7% q/q, and while growth remains strong, inflation has been below target for a considerable period. In addition, dairy prices have been relatively weak, and on balance, our economists think the RBNZ is more likely than not to cut in August.

Q: Why has the solid growth backdrop not translated to a larger rise in inflation?
Global factors aside (e.g., oil), a NZD that has been stronger than the terms of trade would suggest has weighed on tradables inflation. For non-tradables, the unexpected boost to the labor force from record net migration has put pressure on the output gap, muting wage increases. Further, housing-related inflation has not been rising as quickly as in previous building booms.

UBS VIEW

NZD is being pulled in different directions by two key dynamics. First, although growth has been resilient, inflation remains low, and as a result, we expect the RBNZ to remain dovish. The central bank would like a significantly weaker NZD, and with the highest policy rate in the G10, has room to cut. But opposing this, we think the dollar has peaked against G10 currencies, and expect US 10-year rates to remain low, providing some support for higher-yielding G10 currencies. Given these competing forces, we maintain a lower NZD/USD forecast profile over time, but in the near term think NZD/USD could benefit from the global backdrop, at least in the run-up to the RBNZ's August meeting, when we expect them to cut.

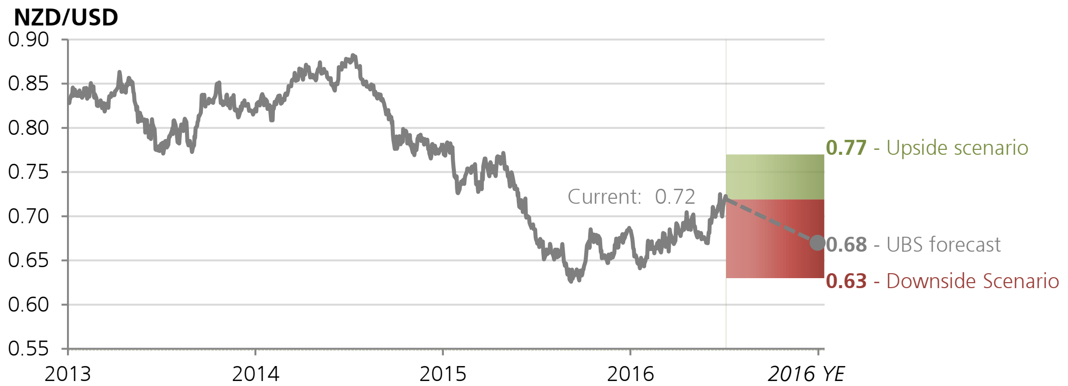
EVIDENCE

Despite strong growth (2.8% y/y in Q1), headline CPI is only 0.4% y/y. Continuing strong growth should in time exert upward pressure on non-tradables inflation, and energy won't be a significant downward contributor to inflation indefinitely. The RNBZ's preferred 'sectoral factor model' of underlying inflation is indicative of some price pressures, and at 1.6% in is at its highest level since 2011. However, rising inflation may not become more of an issue for markets until later in the year.

SIGNPOSTS

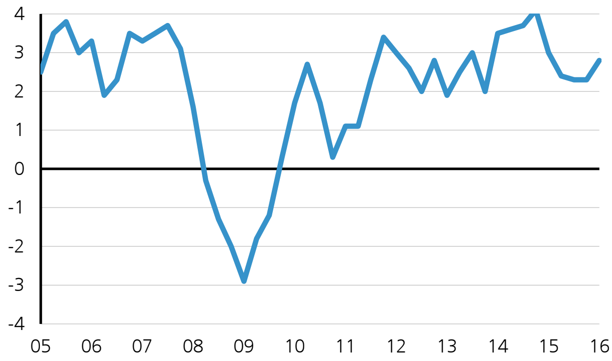
Inflation and the RBNZ. Our economists expect a modest rise in Q2 CPI (July 18th) to 0.5% y/y, below the RBNZ's forecast. If the RBNZ were to leave rates unchanged at its August 11th meeting, we would expect NZD to rise further and more sustainably.

UPSIDE / DOWNSIDE SPECTRUM

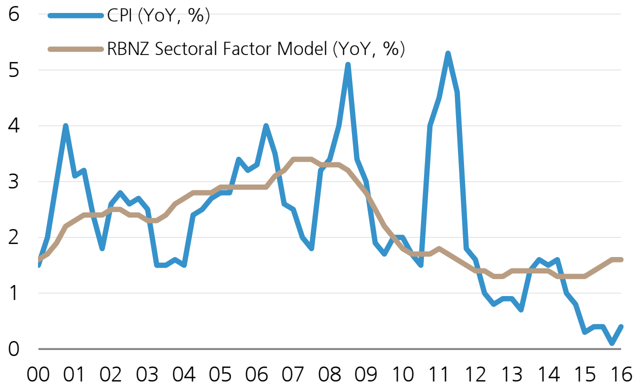


OUR THESIS IN PICTURES

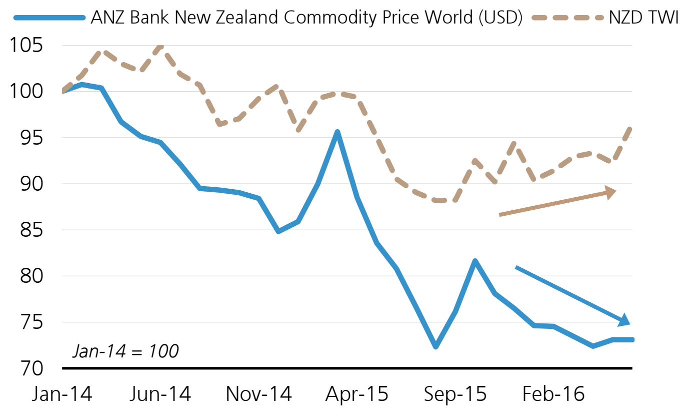
Table of Contents ↑



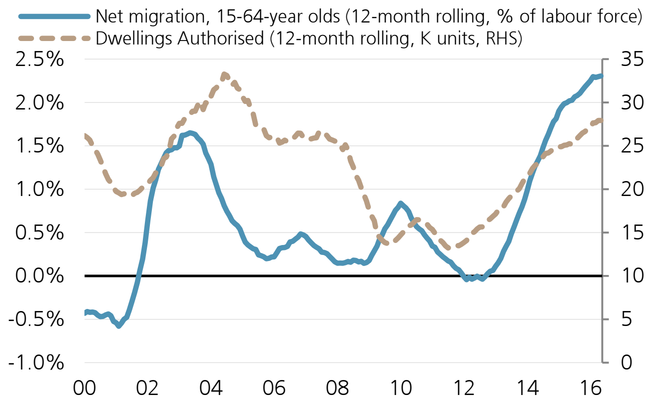
New Zealand growth remains strong, at 2.8% y/y in Q1 2016, but this has failed to translate into rising inflation.



The RBNZ's preferred 'sectoral factor model' of underlying inflation held steady at 1.6% in Q1 2016, the highest level since 2011. Continuing strong growth should exert some upward pressure on non-tradables inflation, and energy is unlikely to remain a significant downward contributor to inflation in the period ahead. However, we think a significant pick-up in inflation may only become apparent in the final quarter of 2016.



Soft commodities, such as dairy, have lagged the 2016 China-driven bounce in hard commodities. However, the NZD has failed to track soft commodity prices meaningfully lower. This should underpin the RBNZ's easing bias.



The spike in net migration is positively impacting construction and growth more broadly. While this trend has the potential to put downward pressure on the output gap in the medium term, the fact that it adds a record 2.3% to the labour force annually risks weighing on inflation in the near term.

Sources for exhibits above: Bloomberg, RBNZ, Haver, GlobalDairyTrade, UBS

UBS Research THESIS MAP

OUR THESIS IN PICTURES →

PIVOTAL QUESTIONS

Q: Why has the NOK underperformed the rise in oil?
Although the correlation between the NOK and oil remains strong, the currency has not kept pace with the move higher in crude in recent months. The divergence between Brent and EUR/NOK is likely to have been caused in part by weak domestic data. Overall household consumption remains weak, held back in particular by anaemic goods consumption. Although Q1 mainland GDP grew at 0.3% q/q (narrowly beating expectations of 0.2% growth), Q4 was revised down by 0.2pp, more than offsetting the positive surprise and leaving overall 2015 growth at just 1%, the weakest annual rate since 2009.

Q: Is the decline in the NOK providing support to the non-energy sector?
Only partially, and in the near term, the oil drag is likely to dominate. Given the significance of natural resources for the Norwegian economy, the steep drop in commodity prices has weighed on growth, most directly through declining oil investment. The uplift to non-oil related exports has been modest, in part due to capacity constraints. Norway's manufacturing unit labor costs remain high on a relative basis after years of an overvalued currency. The prolonged adjustment in non-energy sectors means the currency will continue to be driven by oil.

Q: Can the Norges bank ease further with inflation above target?
At 3.2% y/y, underlying CPI remains well above target and close to the highs of the cycle. This is partly due to krone weakness feeding through to intermediate goods and imported consumer goods, and partly due to temporary factors including elevated airline fares and fresh food prices. Above-target inflation did not stop the Norges Bank from cutting rates in March and indicating the potential for more cuts, yet policymakers may remain on hold following the strong rebound in oil prices. Brent prices are up more than 80% from their January lows, which is likely to help the Norwegian economy stabilize faster than the MPC envisaged when it cut rates in March. On balance the Norges bank is likely to adopt a wait and see approach, so long as oil prices don't decline materially from here.

UBS VIEW

We expect the krone to strengthen modestly. This is based mostly on our oil analysts' forecast for gradually higher oil prices, though Norges Bank's apparent tolerance of currency appreciation to curb inflation helps on the margin. Even as growth moderates, stimulative fiscal policy should partially offset the headwinds from lower energy prices, also providing some potential support for the krone.

EVIDENCE

Norges Bank is one of the very few central banks that is not using its currency to ease, and as a consequence the NOK is likely to face some modest appreciation pressures in a more stable oil price environment. On our model estimates, EUR/NOK may have overshot, and a further rebound in oil prices should lead to additional NOK appreciation.

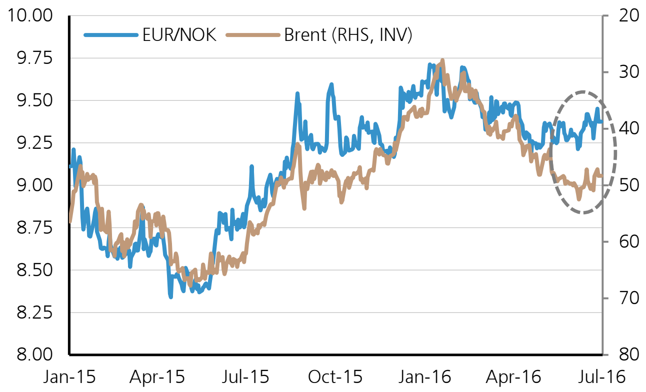
SIGNPOSTS

Oil and inflation. Although EUR/NOK and oil have been less correlated recently, this remains key for the NOK, as it heavily impacts the growth picture, as well as inflation. Our energy analysts expect oil to remain stable through year end, which would suggest a lower EUR/NOK.

UPSIDE / DOWNSIDE SPECTRUM

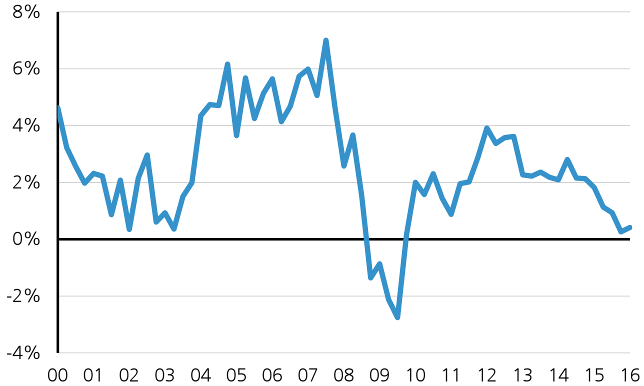
OUR THESIS IN PICTURES

Table of Contents ↑



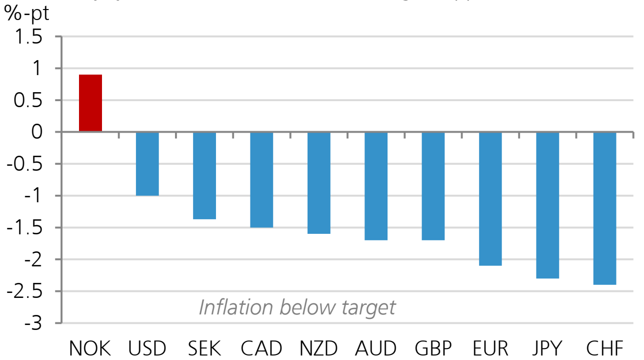
The Krone has not kept pace with the move higher in crude in recent months. The divergence between Brent and EUR/NOK is likely to have been caused in part by weak domestic data.

Mainland GDP YoY %



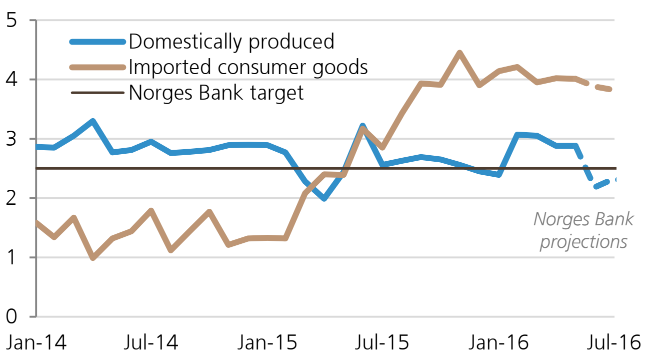
The drag from energy has taken its toll on the Norwegian economy and sharply slowed domestic output growth.

Headline yr/yr inflation less central bank target (upper bound)



Norway is currently the only G10 country where headline inflation is running above the central bank's target. While currency depreciation may help the Norwegian economy adjust to lower oil, it is not needed to boost inflation as is the case in other G10 economies.

Yr/Yr inflation (CPI adjusted for taxes, ex-energy)



Rising imported goods inflation is the main force boosting Norwegian inflation, as prior FX weakness passes through. Domestic goods and services inflation is running at a lower rate and is forecasted to turn negative later this year.

Sources for exhibits above: Haver, Bloomberg, UBS

UBS Research THESIS MAP [OUR THESIS IN PICTURES →]

PIVOTAL QUESTIONS

Q: Will strong growth drive inflation higher?
Not necessarily. Despite an economy that grew 4.5% in 2015, both headline and core inflation have remained low. CPI, CPIF, and CPIF ex-energy all came in below market expectations in May and below the Riksbank's target. In prior research, we found Sweden's open economy is disproportionately exposed to global disinflationary forces, and Phillips curves in advanced economies are relatively flat, which means that even strong growth and limited spare capacity may not drive inflation much higher.

Q: What are likely to be the key determinants of Swedish inflation?
The currency and global inflation. We find that pass-through from SEK weakness in 2013 – 2015 was the key driver of the recent rise in inflation. We estimated an FX-based inflation series (derived from CPI subcategories sensitive to the lagged exchange rate), finding that this measure rose from flat in late-2014 to +2.7% y/y in April, driving much of the recent CPIF acceleration. But importantly, it decelerated to 1.7% in May, as SEK appreciation that started in late 2015 has begun to feed through to lower inflation. The boost from lagged SEK weakness has peaked, and now the impulse from the trade-weighted appreciation of the krona should weigh on inflation through year end. Furthermore, with Sweden the most exposed in G10 to global inflation factors, a continuation of low global inflation should put downward pressure on Swedish inflation.

Q: Which global factors are likely to drive EUR/SEK?
Risk appetite. We find that EUR/SEK tends to rally in risk-off episodes. Of all G10 crosses, EUR/SEK has had the highest negative correlation with changes in the S&P 500 over the past six months (correlation of -0.79). EUR/SEK rallied during risk-off episodes in August 2015 and early-2016, and most recently with the Leave vote. We would expect it to perform well in any further risk-off moves.

UBS VIEW

We remain bearish the SEK, and like paring long EUR/SEK with long equity positions**.** We expect the Riksbank to continue to lean against SEK strength, and as such, we think long EUR/SEK should have limited downside, providing an asymmetric opportunity.

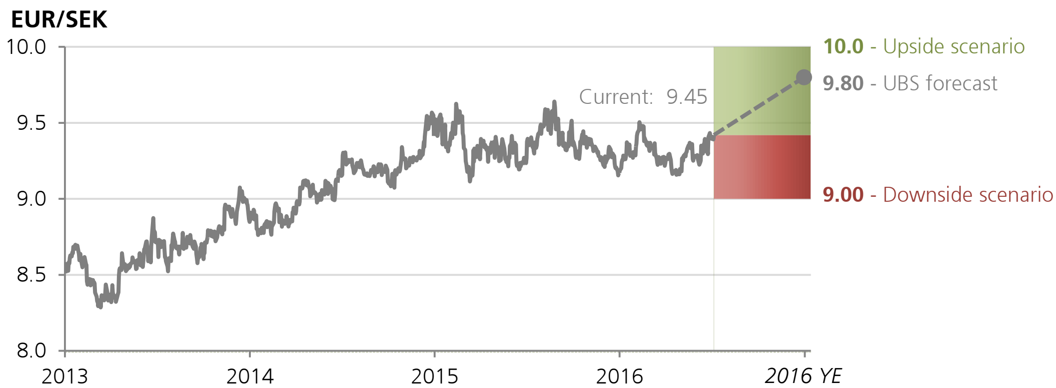
EVIDENCE

Inflation is likely to remain low. Despite strong growth, inflation remains well below target. Although it has been trending higher since 2014, this is largely due to past Krona depreciation which is now fading, as we have shown in our estimation of an FX-based inflation series. Data for May provides further confirmation for our view. Core CPI rose just 1.1% y/y, down from 1.4% in April, and below the 1.2% market expectation. Importantly, components of inflation that are driven by the lagged exchange rate showed weakness. This is consistent with our previous empirical work ("Which risks to fade; which risks to take", 8 May 2016), and serves as an important signpost.

SIGNPOSTS

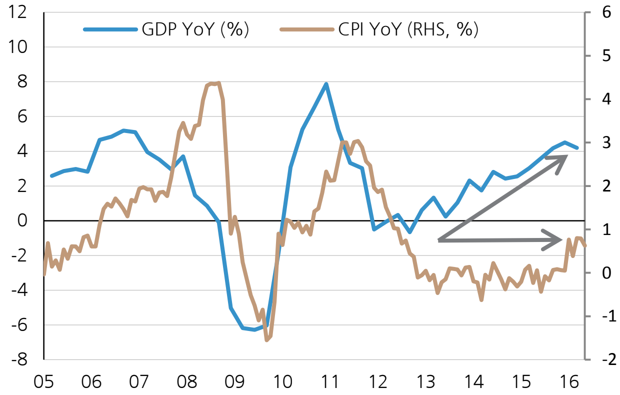
Inflation. In the June data (July 12th) we will be watching to see if the y/y rate again falls below the Riksbank projection (1.4%). In the interim, focus on Riksbank comments and the global market backdrop. We are also watching wage growth as a risk to our view, as wages may have picked up a bit recently.

UPSIDE / DOWNSIDE SPECTRUM

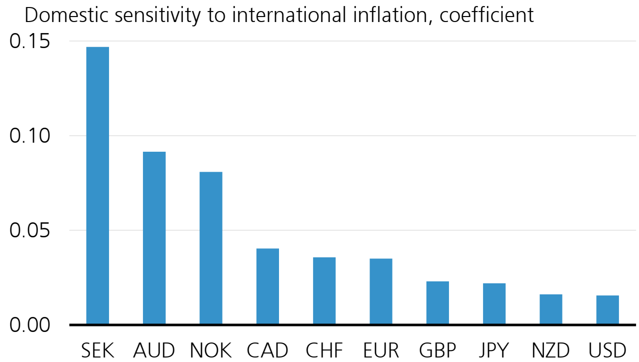


OUR THESIS IN PICTURES

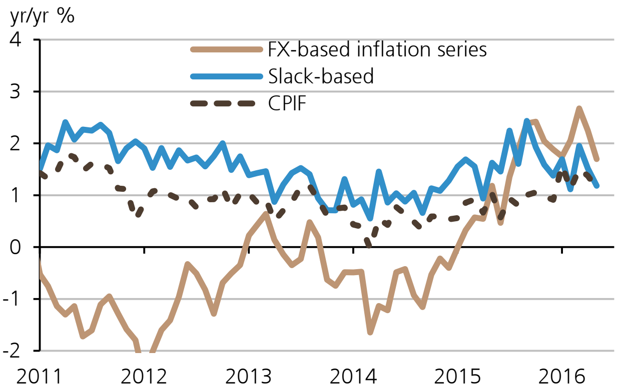
Table of Contents ↑



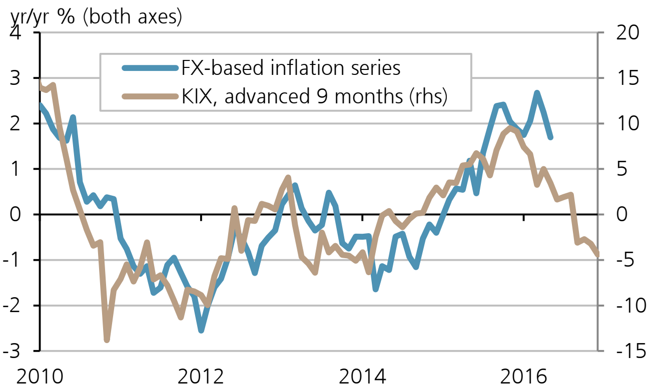
Sweden has experienced a strong economic recovery since 2013, but this has been accompanied by very little inflation.



We find that within the G10, Swedish inflation is the most impacted by global inflation. We estimate this by adding a measure of average OECD inflation to Phillips curve estimations. The consequence is that global disinflationary pressure is likely to continue to weigh on Swedish inflation.



We separate Swedish inflation into subcategories based on their sensitivities to the trade-weighted krona and economic slack. As the krona weakened throughout 2015, the FX-based inflation series (derived from the most sensitive subcategories to the lagged exchange rate) rose from flat in late-2014 to +2.7% y/y, driving much of the recent CPIF acceleration…



…but with the trade-weighted Krona ("KIX") now stronger than a year ago, a turn in the FX-sensitive parts of inflation is likely. The Riksbank communication highlights the important role Krona weakness has played in boosting inflation and this forms the basis of their strong rhetoric (and action) against SEK strength.

Sources for exhibits above: Haver, Bloomberg, Riksbank, TNS Prospera, UBS

UBS Research THESIS MAP

OUR THESIS IN PICTURES→

PIVOTAL QUESTIONS

Q: Has gold entered a new bull-run?
We think so. Key drivers for gold include: 1) low/negative real rates, 2) the view that the dollar has peaked against DM currencies, and 3) lingering macro risks. The UK's vote to leave the EU reinforces these themes – further dovish shifts in monetary policies, consequently lower yields, heightened uncertainty. We expect US real rates to fall from here and ultimately for equilibrium real rates to have limited upside. These factors justify strategic gold allocations across different types of investors and we expect this trend to continue.

Q: Is the gold trade overly crowded?
No, we think there is still room for more. Gold's performance has been driven by very broad-based participation in gold as a portfolio diversifier and hedge. Our sense is that individual positions are not particularly large, but rather the extent of involvement has been quite expansive. It's also worth noting that despite the very strong inflows into gold ETFs YTD, global holdings are still some distance away from record highs. And although Comex positioning reached record volumes, notional values are still not as extended.

Q: Are the risks to the base case symmetric?
No, we think the risks are skewed to the upside. There could be a stronger move if participation broadens even further and if the private wealth community decides to change allocations. Another upside risk is if policies are expected to head towards the 'helicopter money' route and inflation starts becoming a concern again. On the downside, apart from a shift in the macro story, a dramatic gold selloff on the back of an equities correction could tarnish gold's reputation and significantly slow the trend in gold allocation.

UBS VIEW

Strategic gold allocation is warranted given low/negative real rates and macro risks. An environment of low and negative rates narrows the gap between holding gold vs other assets, making having gold in a portfolio an attractive proposition amid heightened global macro uncertainty. Current regime of risk aversion also highlights gold's role as a diversifier, acting as a safe haven when risk aversion is high yet also managing to do well when risk aversion moderates on the back of policy accommodation. Broad-based participation should extend the uptrend. We upgrade our gold price expectations, lifting our 2016 annual average forecast to $1280 from $1225. Our new forecast implies an average of $1340 for the second half of the year (for details see "Upgrading gold expectations").

EVIDENCE

Strong sentiment and resilient positions on the back of a compelling gold macro story. Relatively orderly retracements, which have typically been shallow and brief indicates lurking buying interest. There's an acknowledgment that the floor is likely higher now, amid frustration on the lack of buying opportunities and an even stronger fundamental argument for holding gold after the UK's Leave vote. Despite the build on Comex, anecdotally it seems many market participants are still looking to build positions further.

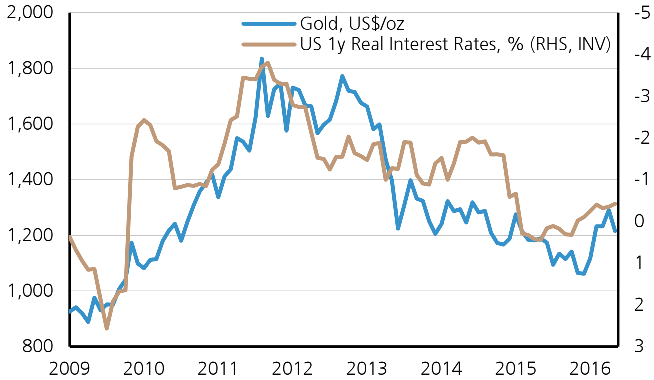
SIGNPOSTS

We will be watching factors that could affect real rates – this would include monetary policies at the Fed and other key central banks, nominal yields, oil prices, inflation prints, among other things. We will also monitor physical trends in physical markets by looking at trade data, differentials between local and international gold prices, changes in the loco swap rate between Zurich and London, as well as scrap and hedging flows.

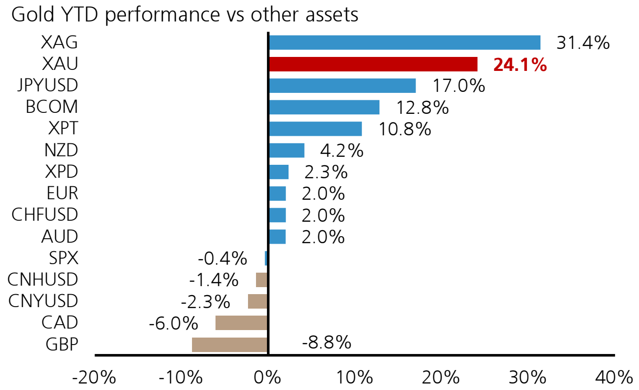
UPSIDE / DOWNSIDE SPECTRUM

OUR THESIS IN PICTURES

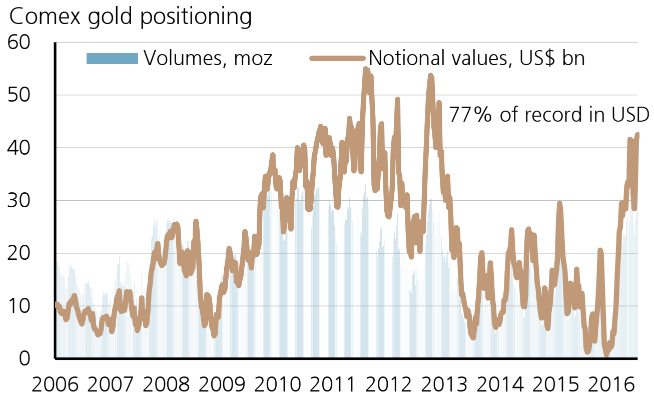
Table of Contents ↑



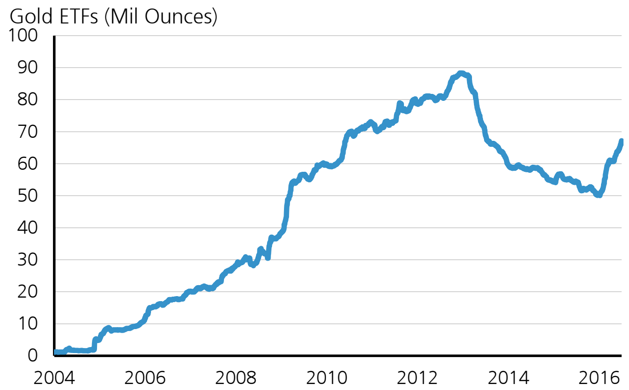
Real rates are the key driver for gold, in our view. As policy relief lifts inflation expectations and limits the upside to nominal yields, real rates are likely to stay low/decline, supporting gold. A dovish shift in policy on the back of higher uncertainty after the UK voted to leave the EU, particularly expectations for lower US real rates, should extend the trend of strategic gold allocation.



Gold has been a top performer YTD amid its attractiveness as portfolio diversifier and hedge. The compelling macro story – especially after the UK's Leave vote – implies positions have more endurance. Although a stronger dollar could also pose a challenge, the overall macro picture should allow both assets to rally. Nevertheless, given the extent of the recent gold moves, we think a brief period of consolidation would be healthy at this point.



The build in positioning on Comex has been a source of concern among market participants, and does warrant some near-term caution. Nevertheless, to put into context, although volumes have reached new highs, notional values are not as extended from a historical perspective. A new phase in gold also suggests that the market could potentially start to acclimatise to a higher base.



ETF inflows have been very strong and resilient, contributing to evidence that gold positions this year are more strategic in nature. That inflows continued in May, despite a decline of 8% in prices was encouraging and highlights the strength in sentiment and durability of positions.

Sources for exhibits above: CFTC, Bloomberg, Various ETFs, UBS

FX Forecast Table

	Spot	3-month	End-2016	End-2017
EURUSD	1.11	1.13	1.16	1.20
USDJPY	102	104	105	110
EURJPY	113	118	122	132
GBPUSD	1.30	1.30	1.29	1.20
EURGBP	0.85	0.87	0.90	1.00
EURCHF	1.08	1.10	1.13 (1.15)	1.18 (1.20)
USDCHF	0.98	0.97	0.97 (0.99)	0.98 (1.00)
EURSEK	9.45	9.60	9.8 (9.5)	10 (9.6)
EURNOK	9.31	9.25	9.1 (9.0)	9.0 (8.75)
AUDUSD	0.75	0.73	0.70 (0.68)	0.70
NZDUSD	0.72	0.70	0.68 (0.63)	0.68 (0.65)
USDCAD	1.29	1.27	1.25	1.23
XAUUSD*	1354	1400	1280 (1225)	1400 (1250)

Source: UBS. ‡Values in parentheses represent previous year-end forecasts. *Year-end Gold forecast represents year average. We recently updated our forecasts for GBP and JPY (see "Recalibrating our views post referendum" 29 June 2016).

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