

Global FX Strategy

FX Perspectives – The Lonely Greenback

FX

Global

Fed only central bank left with capacity to tighten

Since the beginning of the year extraordinary measures taken by some central banks have prompted us to revise short-term targets for several pairs, mostly to the dollar's benefit. While much has been priced in, we expect further adjustments in this direction, providing the Fed does not see dollar strength as an outright risk to their own inflation mandate. We also adjust our three month EURGBP forecast to 0.75 (from 0.77 previously) to reflect a larger than expected quantitative programme from the ECB, on top a rise in sterling liquidity preference if front-end UK rates remain non-negative.

Pre-emptive measures expected in risk group

For risk currencies the ongoing commodity price declines are becoming ever harder to manage for exposed central banks. Earlier this month, we revised sharply higher our EURNOK forecast in anticipation of a March rate cut by Norges Bank. We have now done the same for our short-term targets for USDCAD in the wake of the Bank of Canada's surprise interest rate cut in January and stress that risks to the pair remain to the upside as long as oil prices fail to recover. We also adjust lower our targets for AUDUSD and NZDUSD – arguably the only two 'higher-yielders' left in G10 – to reflect wider global demand concerns and rising risk of pre-emptive central bank activity to deter yield-seeking flows.

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UBS FX Strategy Forecast Table

	Spot	1m		Previous	3m		Previous
EURUSD	1.1235	1.13	=	1.13	1.10	=	1.10
USDJPY	118.28	120	=	120	124	=	124
EURJPY	132.89	136	=	136	136	=	136
GBPUSD	1.4982	1.47	=	1.47	1.47	↓	1.43
EURGBP	0.74984	0.77	=	0.77	0.75	↓	0.77
EURCHF	0.9806	1.00	=	1.00	1.00	=	1.00
USDCHF	0.8728	0.88	=	0.88	0.91	=	0.91
EURSEK	9.3401	9.40	=	9.40	9.40	=	9.40
EURNOK	8.7428	9.40	=	9.40	9.20	=	9.20
NOKSEK	1.0683	1.00	=	1.00	1.02	=	1.02
EURDKK	7.4434	7.44		n/f	7.44		n/f
AUDUSD	0.7965	0.80	↓	0.84	0.79	↓	0.83
NZDUSD	0.7479	0.75	↓	0.76	0.73	=	0.73
AUDNZD	1.065	1.07	↓	1.11	1.08	↓	1.14
USDCAD	1.2411	1.25	↑	1.14	1.25	↑	1.15

Source: UBS FX Strategy, spot correct as of January 23rd, 2015, 11:30 GMT

Any references to options in this document refer to over-the-counter options

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Will the Fed push back?

The ECB QE decision has come and gone. Irrespective of the realities surrounding mutualisation, seniority and the full capabilities of a programme, not to mention fair value levels for EURUSD the market has chosen to go with the 'flow' argument in the meantime, turning relative balance sheet dynamics against the euro. We expect the pair to trade down to 1.10 over the medium term – closer to our current long-term forecasts – before the market may choose to reassess (see *Macro-Strategy Key Issue: ECB: a convincing start to QE*, Jan 22nd 2015). Any short-term recoveries above 1.13 would provide openings for investors who missed the move to possibly reallocate into currencies with more favourable yields.

The problem right now is that within G10, the dollar now stands alone in yielding non-zero (barely) across the entire curve with a central bank in a position to continue normalisation based on domestic considerations. While Fed officials have been broadly supportive of their G10 counterparts' attempts to reflate, the risk they run is that external demand does not recover rapidly enough to mitigate the strengthening disinflation headwinds in the US. Falling oil is already an issue and the near 20% gain in the dollar TWI since June may just prove a step too far. Much as the FOMC needs to defer dollar policy to the Treasury, we do expect the relevant price impact to be addressed head-on in the January 28th decision. After all, many other central banks have started to cite global policy divergence as a factor behind currency movements, but it seems the Fed is the only central bank heading in a 'divergent' direction. For similar reasons, we are now expressing a much more cautious view on GBP as CPI will likely continue surprising to the downside. Due to EURGBP's decline, the sterling TWI is only 1.3% or so off last year's highs and GBPUSD falling in itself is not enough to serve as an offset. EURGBP should remain heavy through Q1 due to ECB QE effects, and we adjust our three-month target to 0.75 (from 0.77) accordingly, but additional declines would almost necessitate a BoE response. EURCHF will likely maintain wide daily ranges as the market absorbs the floor's removal but we expect parity to hold as an anchor point as negative rates on franc sight deposits have begun to take effect.

Recent USDJPY range trading should not obscure the risk of further BoJ easing in the face of softening actual/expected inflation readings in Japan, particularly in the wake of the downward revision to the fiscal year 2015 core CPI projection to 1.0% from 1.7% in the Bank's latest Outlook Report. As noted in our January 12 *FX Comment* (JPY: Crude reality), Governor Kuroda's comments since last October's surprise easing have clearly indicated that the BoJ will be more sensitive to the negative shorter-term effect of lower oil prices on inflation expectations than the positive longer-term effect on growth via the improved terms of trade. Against this backdrop, it would be dangerous to assume the BoJ has run out of options or will wait at least another 6 months before expanding its QQE programme again. We would expect another USDJPY break higher into the new fiscal year starting in April, reinforced by accelerated portfolio diversification by Japanese investors in search of better returns beyond the JGB market. Our respective 1m and 3m targets remain at 120 and 124, respectively.

The central banks of 'risk currencies' now will be under near-unprecedented pressure to act pre-emptively. We have pushed our USDCAD one-month and three-month targets to 1.25 (from 1.14 and 1.15, respectively) in the wake of the surprise Bank of Canada cut and the risk to the pair remains to the upside. While not taking a view on whether oil prices manage to find an anchor, the Bank of

Canada is choosing to act now to prevent a structural shift lower in potential output, or at least limit the adjustment to the greatest possible extent. The ECB and SNB decisions may have also featured heavily in the BoC's decision as outside of the G5, the Canadian dollar is the most attractive destination for liquidity rotation away from the euro and franc. The RBA and RBNZ could find themselves in a similar position, while the ongoing correction in commodity prices due to demand fears will add to the pressure on the antipodeans' terms of trade. We expect 0.80 and 0.75 to be the anchor points (also our one month forecasts) for AUDUSD and NZDUSD, respectively, over the medium term, but with risks to the downside. We continue to express preference for AUDNZD higher, marginally, due to the greater valuation pressures on NZD.

Finally, the Nordic currencies have all found some level of demand in recent days in anticipation of the rotation flows mentioned above, and EURDKK in particular has been under undue stress in the wake of the SNB's floor removal. We continue to see stability in DNB policy though the cross will likely trade wider below the 7.46 target due to ECB QE leakage and like their Swiss counterparts, additional rate cuts cannot be ruled out. Norges Bank and Riksbank are also expected to continue easing to maintain policy differentials versus a quantitative ECB and discourage inflows, thereby keeping both EURNOK and EURSEK at elevated levels. We expect Norges Bank to cut by 50bp in March (or even earlier) while the Riksbank has explicitly warned that quantitative options may at least be pre-announced at their February meeting.

Forecast Scorecard Update (accurate as of January 23rd 11:30 GMT)

	Spot	1m Forecast	3m Forecast	3m Option Delta	3m Skew Z-score	1y rate pricing (bp)	Valuations Z-Score
EURUSD	1.1235	1.13	1.10	35.90	-4.3736	-48.84	0.3404
USDJPY	118.28	120	124	19.40	-1.0997	45.84	0.6820
EURJPY	132.89	136	136	33.50	-3.4673	-3	1.3292
GBPUSD	1.4982	1.47	1.47	35.40	-1.2638	-31.48	-0.0932
EURGBP	0.74984	0.77	0.75	49.70	-2.0944	-17.36	0.3844
EURCHF	0.9806	1.00	1.00	36.60	-5.8640	40.3	-0.9202
USDCHF	0.8728	0.88	0.91	26.00	-5.7745	89.14	-0.9980
EURSEK	9.3401	9.40	9.40	43.70	1.7464	3.21	1.3069
EURNOK	8.7428	9.40	9.20	24.50	2.1140	26.37	0.3188
NOKSEK	1.0683	1.00	1.02	23.20	-1.9493	-23.16	1.4141
AUDUSD	0.7965	0.80	0.79	50.00	-1.9962	-82.38	1.1914
NZDUSD	0.7479	0.75	0.73	42.10	-1.6092	-57.81	1.6206
AUDNZD	1.065	1.07	1.08	39.50	-1.6807	-24.57	-0.2907
USDCAD	1.2411	1.25	1.25	45.30	-0.2462	67.17	-0.4612

Forecast Change	New forecast not aggressive	Strongly -ve skew, upside f/c bias	Strongly +ve skew, upside f/c bias	IRD, +ve f/c bias	Strongly Undervalued, +ve f/c bias
No Forecast Change	New forecast aggressive	Strongly +ve skew, downside f/c bias	Strongly -ve skew, downside f/c bias	IRD, -ve f/c bias	Strongly Overvalued, -ve f/c bias

Source: UBS FX Strategy, Bloomberg OVML pricing

The sharp rise in volatility since the beginning of the year has limited the scope for low-delta forecast targets, even if in percentage terms the targets are more aggressive than previous iterations. As such, our scorecard appears very conservative and only our 124 target for USDJPY over three months is looking aggressive at just under 20-delta. We note that unlike most other pairs, however, USDJPY implied volatility is actually *lower* compared to the beginning of the year and options positioning is also very neutral. This is somewhat inconsistent with the general view that volatility will continue to escalate on a cross-market basis, suggesting there is some value in the yen options market if there is convergence towards a general uptrend in currency volatility.

Options positioning measured by the Z-score in three-month 25-delta risk-reversal skew has continued to head towards extremes for many pairs. As expected, EURCHF and USDCHF options markets experienced multi-standard deviation moves due to asymmetric positioning before the SNB decision and current pricing in risk reversals to some extent reflect residual imbalances, though appreciation risks for the franc due to Eurozone quantitative easing is still an anchoring factor. Meanwhile, skew in other EUR pairs such as EURUSD, EURJPY and EURGBP (to a lesser extent) have also reached extreme levels (in bids for euro puts) according to our scorecard. While we do not doubt the ability of ECB quantitative policy to sustain such deviations in the near future, the risks of a positioning reversal are rising. In contrast, despite current price action AUDUSD and NZDUSD are not showing signs of extreme positioning relative to the sustained downside bias, suggesting that policy action beyond current market anticipation have a strong effect on corresponding exchange rates.

Interest rate expectations, unsurprisingly, have been pushed back across G10. Even the dollar has not been able to escape as current Fed pricing is very conservative but other central banks have moved more and as the SNB and DNB have both shown, the zero bound is not a problem when it comes to increasing the cost of

carry to undermine a currency. The market is now pricing in further outright cuts for AUD, NOK, CAD and NZD. GBP stands out awkwardly here as the only currency G5 not at the nominal zero bound without easing being priced and the BoE will struggle to manage such expectations if CPI continues to weaken.

Finally, our valuations Z-scores, which do not encompass the moves in January, already show that no currency pair is presently aggressively at levels beyond fair value, measured by deviation from REER trend. We expect the next refresh, with January levels, to show significant undervaluation for some currencies, especially in the commodity bloc. However, rather than treat them as a counteracting input for our bearish forecasts for these currencies, we have to take into account the potential for structural adjustments in terms of trade. In addition, while not in explicitly our forecast scorecards, if commodity prices are in secular decline, output gaps and potential growth could also be affected in small open economies, which would require new fair value estimates based on other models.

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