Global FX Strategy

FX Bi-Weekly: Key Themes and Trades

FX

Global

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In our first FX Bi-Weekly, we introduce four key FX themes:

- **DM versus EM**: The global economy is likely to be marked by a notable degree of growth divergence between developed and emerging economies in 2015. We think this has important market implications, and are broadly bearish EM currencies versus DM currencies. Short ZAR is a good expression of EM growth underperformance and structural EM issues, while we think long CAD pairs well with it, and takes advantage of better DM fundamentals.

- **Stay with the Reflation Trade in Japan**: We remain bullish USD/JPY, and think it is the best expression of a bullish USD view in the G10 space. Although questions remain regarding progress on the Third Arrow, we still believe the long USD/JPY and Nikkei trade will perform well into Q2, feeding off two critical drivers - further BoJ easing and a stronger portfolio rebalancing effect among Japanese investors. The fact that Japan is off many investors' radar screens at the moment has merely strengthened our conviction that risk-reward favors USD/JPY upside.

- **Trading ECB QE**: We remain bearish EUR/USD, but at close to 1.06 we find ourselves with less conviction than we've had in the recent past. Monetary policy divergence between the Fed and ECB will further widen rate differentials at the front end of the curve, and this should continue to weigh on EUR/USD. We see some cyclically positive developments in the Euro area, but think long European equities is the better way to trade this. A combination of long European equities and short EUR/USD should benefit from ECB QE, and is likely to perform well under a variety of macroeconomic backdrops.

- **Global Disinflation and Small Open Economies**: With disinflationary pressures persistent in the global economy, we think it makes sense to be short currencies from small open economies where policy rates are at or below zero, and inflation remains very low. In such cases, currency weakness is a logical policy response and outcome. CHF and SEK both fit this profile.

FX Macro Thoughts

Daniel Waldman

Head of FX Strategy

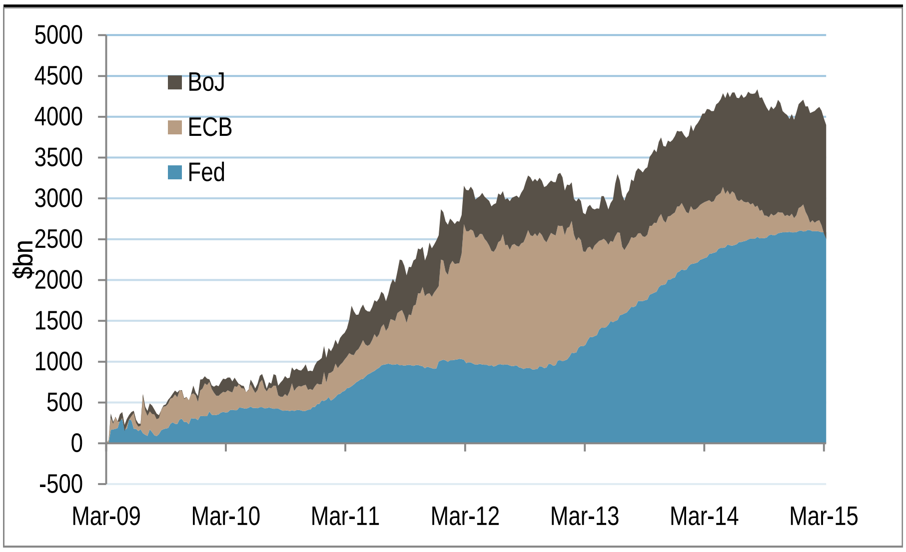
I am pleased to introduce our first FX Bi-Weekly. Our goal here is to produce thematic global macro research with actionable market expressions.

In this issue, we focus on four global macro themes that we think will be important for FX markets in the coming three-to-six months. Going forward, we will expand upon these themes and introduce additional themes and trades. We will also establish a trading portfolio to track performance, and give a better sense of how we would structure trades and manage risk.

To start, it is worth outlining the key global macro assumptions that form the basis of our FX views. We are constructive on risk markets over the next three-to-six months, as the global backdrop of moderate growth, low inflation, and easy monetary policy remains intact, and is supportive of asset markets. Consistent with the work of our equity strategists, although global equity markets are not cheap, valuation doesn't appear stretched to the point of being a key risk either.

Although the Fed has ended QE and is moving toward an exit from zero rates, asset purchases by the BoJ and ECB are offsetting the loss of Fed purchases, at least in volume terms. In March, and for the foreseeable future, the BoJ and ECB will be expanding their balance sheets by a total of around $125bn per month, above the G3 average during 2013 and 2014. This should remain a support for risk markets, particularly in Europe and Japan.

Figure 1: G3 balance sheet expansion (USD equivalent) since January 2009



Source: Bloomberg

Fed QE is likely more important for global asset markets than ECB or BoJ QE, but the impact of ECB and BoJ purchases should not be underestimated. The Euro area is a key global trading partner, and is in significant need of monetary stimulus. Although QE can't cure all of Europe's ills, it is better than the previous policy of keeping policy too tight in the presence of significant disinflationary forces.

This is perhaps why the Fed has been supportive of expansionary policy by the ECB and BoJ. As Figure 1 shows, the Fed has accounted for nearly 60% of net G3 central bank balance sheet expansion since January 2009, leaving significant scope for the ECB and BoJ to catch up and substitute.

The global economy is likely to be characterized by a notable divergence between DM and EM growth in 2015. While growth should accelerate modestly in the US, Europe, and Japan, we expect EM growth to slow further as decelerating Chinese growth weighs on Asia, lower oil prices slow growth in oil-exporting EMs, and structural impediments keep growth weak in EMs such as Brazil.

EM remains a key risk for markets, and our EM strategists remain broadly bearish. They note that if EM couldn't perform well in 2014, when the macro backdrop was particularly favourable, it is difficult to see strong EM performance in 2015. Despite significant nominal FX depreciation in many EM currencies, trade deficits suggest that real appreciation has left many EMs with overvalued exchange rates and further FX adjustment to come. It is also worth noting that consumption has risen in many EMs in recent years, and this is another channel through which the first Fed rate hike could have a negative impact.

Inflation should remain low throughout 2015, as global disinflationary pressures persist. The most recent US employment report emphasized that it is possible for wage and price growth to remain persistently low, even as output gaps become less negative. This combination of better activity data and still-low inflation should support asset markets, and act as a partial restraint on market volatility.

In FX, we remain generally bullish the USD, though at these levels we find ourselves with less conviction than we've had in the recent past. Long USD/JPY and USD/EM are our preferred expressions of the view. We are still bearish EUR/USD, as further monetary policy divergence should support the USD and weigh on the euro. However, at these levels we think long USD/JPY and USD/EM offer better risk-reward.

Our bullish USD/JPY view is based mostly on Japan-specific factors, though higher US rates could add a bit of juice to the trade. A weaker yen has been perhaps the key component of monetary policy under Kuroda's BoJ, and it is very likely to remain so. Although the Euro area benefits from a weaker euro, we think it is less critical to ECB policy than it is to BoJ policy.

Key Macro Themes for FX Markets

FX Strategy Team

Below, we discuss four global macro themes that we think are going to be important drivers of FX markets during the next three-to-six months. We briefly outline each theme in three or four pages, and discuss what we think are the best market expressions of each.

In future publications, we will provide more detail on each theme, as well as unveil a framework for managing and keeping track of the p&l associated with trades that we recommend. Given the importance of trade-entry points, we will issue specific trading recommendations and structures when we get to levels that we believe present strong risk-reward.

As a quick summary, the four market themes we write about below are:

(1) **DM versus EM**: The global economy is likely to be marked by a notable degree of growth divergence between developed and emerging economies in 2015. We think this has important market implications, and are broadly bearish EM currencies versus DM currencies. Short ZAR is a good expression of EM growth underperformance and structural EM issues, while we are bullish CAD due to its leverage to the US economy, shrinking output gap, dovish rate-market pricing, and much of the decline in oil prices already being priced in.

(2) **Stay with the Reflation Trade in Japan**: We remain bullish USD/JPY, and think it is the best expression of a bullish USD view in the G10. Although questions remain regarding progress on the Third Arrow, we still believe the long USD/JPY and Nikkei trade will perform well into Q2, feeding off two critical drivers-- further BoJ easing and a stronger portfolio rebalancing effect among Japanese investors. The fact that Japan is off many investors' radar screens at the moment has merely strengthened our conviction that risk-reward favours USD/JPY upside.

(3) **Trading ECB QE**: We remain bearish EUR/USD, but at these levels find ourselves with less conviction than we've had in the recent past. Monetary policy divergence between the US and Euro area will continue to increase as large-scale QE from the ECB and the start of Fed rate hikes widen rate differentials at the front end of the curve. This will weigh on EUR/USD, but we see some cyclically positive developments in the Euro area. We think long European equities is the better way to trade these emerging positives. A combination of long European equities and short EUR/USD should benefit from ECB QE, and is likely to perform well under a variety of macroeconomic backdrops.

(4) **Global Disinflation and Small Open Economies**: With disinflationary pressures persistent in the global economy, we think it makes sense to be short currencies from small open economies where policy rates are at or below zero, and inflation remains very low. In such cases, currency weakness is a logical policy response and outcome. CHF and SEK both fit this profile.

Theme # 1: DM versus EM

- **Summary:** We remain broadly bearish EM versus DM currencies. This is based on the dispersion between EM and DM growth that is likely to characterize the global economy in 2015, unresolved structural problems in many EM economies, still-overvalued real exchange rates, and higher FX sensitivity to Fed rate hikes in the developing world.

- **Trades:** Long CAD/ZAR is our preferred expression of this theme. Our EM strategists remain bearish nearly all EM currencies against the USD. Paying 1yr1yr in Canada rates is another way to express the Canada view.

Those looking for a compelling alternative to "consensus" long USD trades should consider long CAD/ZAR. Given the dispersion between DM and EM growth that is likely to characterize the global economy in 2015, structural EM issues, and real FX overvaluation in many EMs, we think EM currencies are likely to continue their underperformance. Canada's links to US growth outperformance (which are not confined to energy exposure), strong fundamentals, and FX undervaluation make CAD a good long position against short EM currencies.

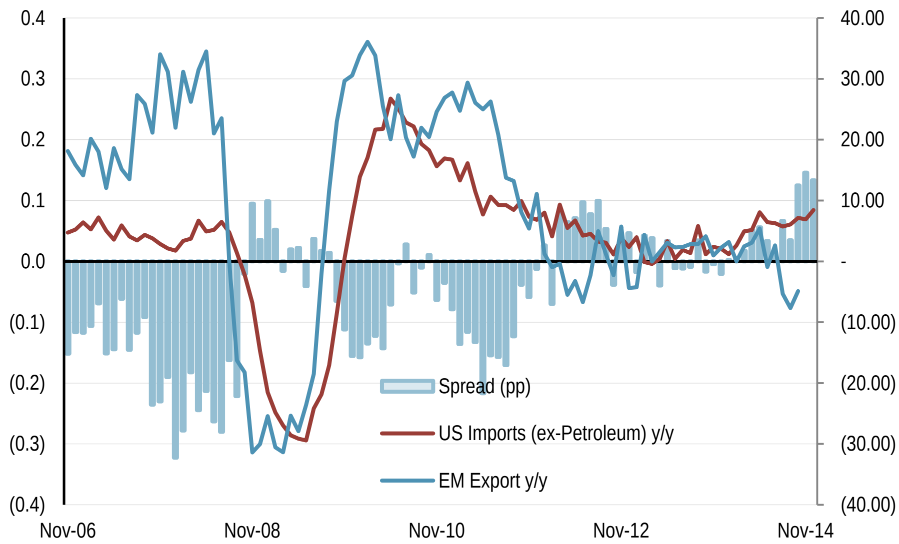
While modest growth accelerations are likely in the US, Europe, and Japan, we expect EM growth to slow further in 2015 as decelerating Chinese growth weighs on Asia, lower oil prices slow growth in oil-exporting EMs, and structural impediments keep growth weak in a number of EMs including Brazil. Such an outcome for the global economy would surprise few in the market, but we think will still have important market implications.

As our EM strategists have been noting, 2014 was a relatively benign backdrop for EM currencies. Low financial market volatility and ample central bank liquidity would ordinarily be good for EM FX, yet EM currencies weakened consistently. A further narrowing in the growth differential between emerging and developing economies, sluggish global trade, and relatively low real rates keep us bearish in 2015. Although nominal exchange rates have depreciated across the EM universe, weak trade positions suggest that more work needs to be done. In many EMs, despite nominal depreciation, real exchange rates remain overvalued, as real appreciation has taken a toll on competitiveness.

The weakest links in EM are economies with significant commodity export exposure and current account deficits. For such economies, the fall in EM export volumes requires weaker exchange rates as an offset. The US consumer, often the savior of EMs in the past, has been less cooperative this time. Even stripping out petroleum (Figure 2, next page), US import demand growth is not translating into better EM export growth. If we see a secular rise in US savings, the growth environment for EMs will become even more difficult.

High aggregate leverage and weak growth make it difficult for EMs to use higher rates to attract funding, and we doubt DM demand ex-US will be able to pick up the slack. As such, the burden of adjustment for EMs will fall on currencies. This is particularly true in places with large current account deficits. Low US rates and generally benign financing conditions helped EMs increase consumption in recent years. Even with Fed normalization likely to be very gradual, higher US rates could put pressure on EMs where consumption has risen too fast. There is no painless way for this adjustment to occur, but the exchange rate offers a logical avenue.

Figure 2: US demand divergence versus EM exports



Source: UBS Emerging Market Strategy

If EM policymakers are able to accelerate productivity-enhancing reforms, that would help rebalancing. But this seems unlikely to happen fast enough to alleviate downward pressure on EM currencies as US rates gradually normalise. With US real yields at low levels relative to EM, the risk premia on structural deficiencies in the EM world has risen, and is reflected in rising implied volatility in EM assets.

We would also note that concerns regarding the Fed's ability to control the impact of interest rate normalization remain valid, and this is a significant risk for EM assets. A rise in volatility for EM assets exposed to dollar funding would make rebalancing even more difficult.

Although we remain bullish the USD versus nearly all EM currencies, given the large move most of these crosses have seen, we think it is worth broadening the long component of the trade. The Canadian dollar stands out in this regard, with a number of bullish factors lining up for the currency.

On the rates side, which was an important driver of the 20% rise in USD/CAD since July, we see room for optimism. The market is currently priced for another rate cut this year, and a start to hikes only in December 2016. While the BoC may yet cut again, we think the risk-reward relative to market pricing is in the other direction. The Canadian output gap is probably smaller than generally perceived, and is unlikely to justify such a dovish path for rates. At 6.8%, unemployment is 70bp below its 20-year average, while in the US it is 50bp below. More importantly, core CPI has been above 2.0% y/y for each of the past six months, suggesting there may not be much slack in the Canadian economy. Wage growth remains modest at only 3.1%, but with unemployment below its longer-term average and core CPI above 2.0%, it will be difficult for the BoC to justify keeping its policy rate below 1.0% for an extended period of time. If oil prices were to rebound, or if US growth were to accelerate, the BoC could reverse course quickly.

Oil has contributed to the sell-off in CAD as well, and here too we see room for optimism. Although oil remains below the BoC's suggested breakeven of $60 per barrel, we think at current levels in the CAD, much of the damage is already in the price. Even at current levels ($45 per barrel) oil prices would only widen the output gap by an additional 0.25pp of potential GDP, and it is important to note that

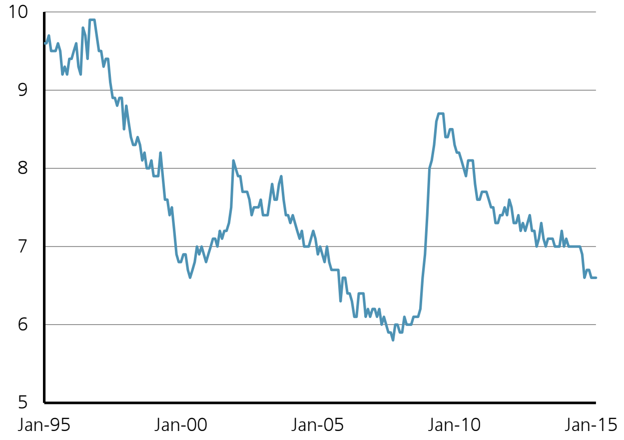
there are offsets in other areas of the economy, particularly in industries where exports are sensitive to the exchange rate. With non-energy exports of goods growing at 6% in 2014, terms of trade in Canada have remained resilient.

While further downward adjustment in the terms of trade is likely, as the impact of lower oil prices is yet to feed through fully, structural changes in the Canadian economy suggest that the hit to terms-of-trade will be less severe than in the past, as Canada is less of a pure commodity exporter than before. Between 2002 and 2009, declines in WTI prices would have generated increasingly negative shocks to Canada's terms of trade. However, post-2009, absolute exposure to oil and US demand has fallen, underscoring that the shock to the output gap is lower than in the past. As such, Canada is now experiencing diminishing 'negative returns' to terms-of-trade arising from an oil shock.

The Bank of Canada estimates that oil in a US$50-US$70 range would cause a net terms of trade decline of between 7% and 12%. With USDCAD having rallied 20% from July 2014 to January 2015, in the absence of a collapse in demand in the non-energy sector, it is difficult to justify further FX adjustment.

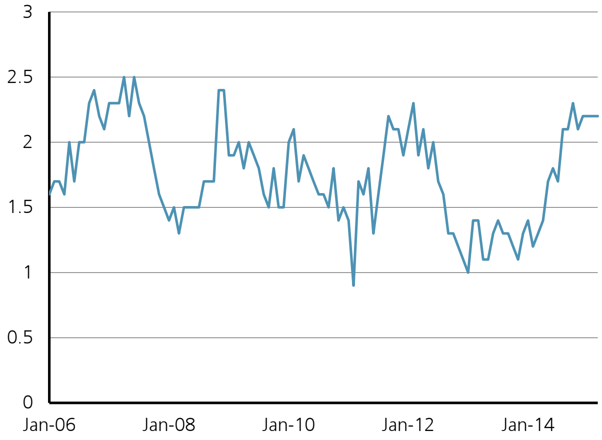
Finally, it is worth noting that BoC Governor Poloz is moving financial stability up the agenda, stressing that the Bank would be willing to accept a longer period of disinflation in order to prevent household leverage from reaching excessive levels. This further increases the likelihood of tightening before the output gap has turned meaningfully positive.

Figure 3: Canada unemployment rate (%) is below its 20-year average



Source: Bloomberg

Figure 4: Canada core CPI (% Y/Y) has been above 2.0% for 6 consecutive months

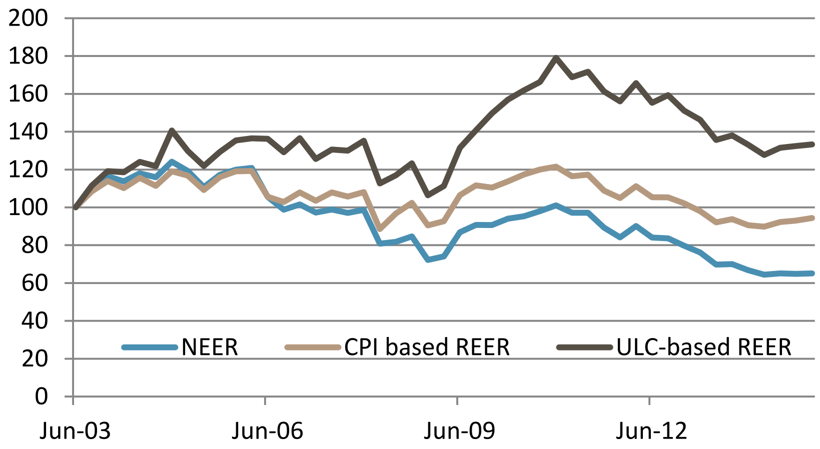


Source: Bloomberg

In the opposite direction, bearish ZAR is a good expression of EM growth underperformance and structural headwinds for EM currencies. Despite the ZAR's depreciation, there has been a very shallow pass-through to export volumes, including in non-commodity sectors such as vehicles and machinery equipment. Our EM strategists have previously highlighted that structural impediments such as the oligopolistic structure of exporter firms, strained industrial relations, and power and infrastructure constraints for example are weighing on South Africa's competitiveness and stand by that view today (Bhanu Baweja and Manik Narain from EM Cross Asset Strategy contributed to this section, see **here** for more details on their views).

Second, after accounting for relative growth in unit labour costs, we find that the ZAR REER is trading almost bang in line with its 10-year average-- there has been no major depreciation in real terms. Third, South Africa's basic balance (net FDI and current account receipts) remains the worst in mainstream at -6.5%/GDP (as of Q3-2014, 12-month rolling). Financing remains heavily dependent on portfolio flows and external debt that can be sensitive to further FX weakness and/or deterioration in external credit markets.

Figure 5: ZAR valuations: no major depreciation in real terms



Source: EM Strategy

In terms of trading implications, we think long CAD versus short ZAR offers good risk-reward, and can perform well in a variety of global macro backdrops. In our base case, where risk assets perform well, the US economy continues to outperform, and the Fed normalizes rates gradually, long CAD/ZAR should perform well as stronger US growth supports CAD, and the generally negative tone for EM FX persists. At the opposite extreme, in the case of global sell-off in risk, the Canadian dollar should be lower beta than ZAR, and outperform. This could make the trade a good hedge to a portfolio that is positive beta to global equities.

In thinking about scenarios in which long CAD/ZAR would underperform, we focus on two. First, a negative idiosyncratic shock to the Canadian economy that leads to further rate cuts from the BoC. This is a risk with any trade, but we would note that the Canadian economy has generally strong fundamentals, and with growth averaging 2.8% and 2.7% during the past two and eight quarters, respectively, it has a buffer to external shocks. The Canadian housing market is often cited as a risk to financial stability, but we think these concerns are overdone. There are demographic explanations for some of the building activity in recent years, and a combination of high levels of mortgage insurance, a well-capitalized Canada Mortgage and Housing Corporation, generally low loan-to-value-ratios on Canadian mortgages, and the recourse nature of many loans, make the housing market less vulnerable than is often perceived.

The second risk scenario would be a return of the EM carry trade, with investors reaching for higher yielding currencies. While certainly possible, given the lack of an EM carry trade in 2014 when fundamentals were more supportive, our EM strategists think this is unlikely in 2015.

Theme # 2: Stay with the Reflation Trade in Japan

- **Summary:** We remain bearish the yen, based on the view that the BoJ will ease further, and that a stronger portfolio rebalancing effect among Japanese investors is on the way. USD/JPY is key to Japanese reflation, and we think the BoJ wants to keep the pair moving continuously higher.

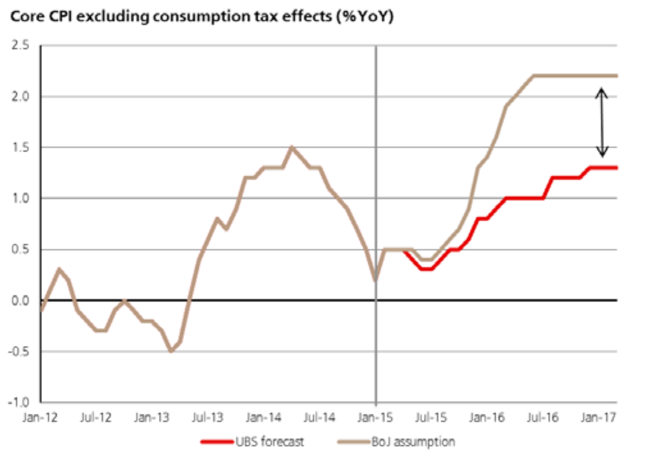
- **Trades:** Long USD/JPY and long Japanese equities. The two trades are similar, both relying on Japanese reflation, though we think they offer slightly different risk-reward profiles. We think there is a higher floor in USD/JPY but potentially more upside in Japanese equities.

It's time to consider Japan again. In many respects, FY15 will be a 'make or break' year for Abenomics. While questions will remain over progress on the Third Arrow front, we still believe the long USDJPY/Nikkei trade will perform well into Q2, feeding off two critical drivers - further BoJ easing and a stronger portfolio rebalancing effect among Japanese investors. The fact that Japan is off many investors' radar screens at the moment has merely strengthened our conviction that risk-reward favours USDJPY upside. Our 3-month USDJPY target is 128, with the door open to further gains over a longer-term horizon.

Easing from the ECB, BoC, RBA and Riksbank may have dominated the central bank spotlight so far this year, but one should not underestimate the ability and willingness of the BoJ to ramp up its Quantitative and Qualitative Easing (QQE) programme another notch. Those not convinced should consider the following:

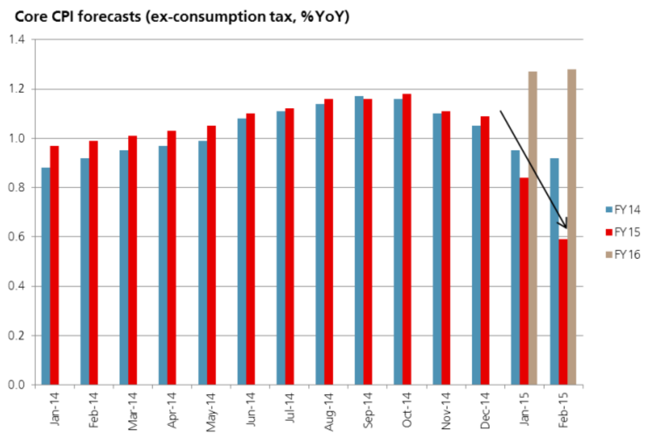
- Actual and expected inflation measures still suggest the BoJ will fall well short of its 2% target. Figure 6 highlights the considerable gap between the core CPI profiles assumed by the BoJ and UBS, with YoY prints likely to fall dangerously close to zero in Q2. Now take a look at Figure 7, which depicts the sharp softening in core CPI projections for FY15 based on the JCER's *Monthly Survey of Professional Economic Forecasters*. Street forecasts peg a re-acceleration in FY16 as oil effects subside, albeit to levels still below 1.3% - not enough to alter the BoJ's easing bias. Inherent here is the risk of downward revisions to the Bank's inflation forecasts in the next Outlook Report due on April 30, which would leave the door wide open to further easing. As Governor Kuroda has frequently stressed, the BoJ is attempting to eradicate the 'deflationary mindset' in Japan. That will require more heavy lifting from monetary policy.

Figure 6: The BoJ has more work to do



Source: BoJ, MIAC, UBS

Figure 7: Still well off target

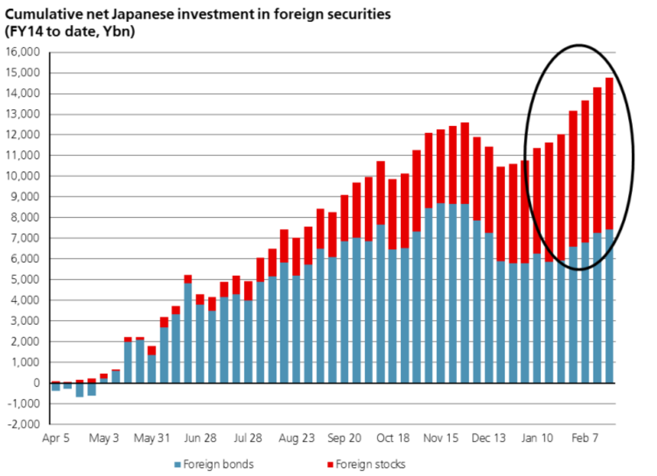


Source: JCER (Monthly Survey of Professional Economic Forecasters), UBS

- The BoJ is clearly not afraid to surprise markets – and in turn, one cannot safely assume it will wait another 6-12 months before acting again. The latest JCER survey puts the 'consensus' call in October, which may actually reduce the odds of action at that time. The UBS base case pegs July, but an earlier move – as soon as April 30 – should not be categorically ruled out.

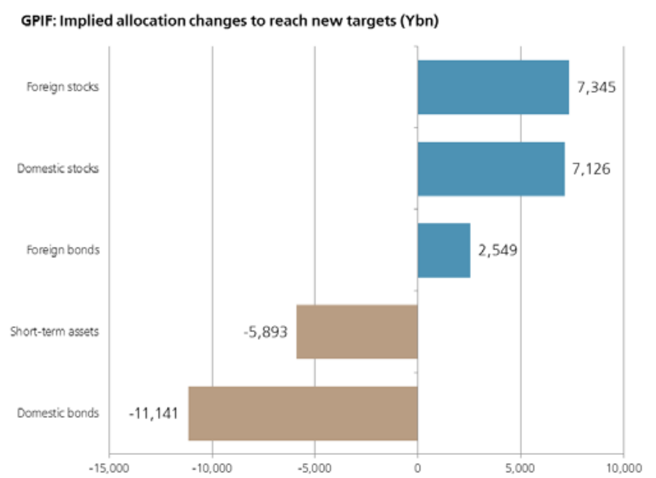
- While last October's split 5-4 vote underscored the divisions on the Policy Board, we believe Kuroda will continue to command a majority this year. Recall that the terms of two members will expire within the next 4 months – Ryuzo Miyao on March 25 and Yoshihisa Morimoto on June 30. Here, the appointment of Yutaka Harada as the successor to Miyao is telling. Cynics may counter that one dove is simply being replaced by another, but Harada's explicit links to key Abe advisor Koichi Hamada and Deputy Governor Kikuo Iwata make this a more conspicuous choice in our view[1]. Instead of targeting greater diversity, the Cabinet appears to have selected someone who will be closely aligned with Kuroda to strengthen the 'reflationist' core on the Policy Board. And if Prime Minister Abe truly believed that the First Arrow had run its course and further yen weakness would seriously undermine his public support, a more 'neutral' candidate could have easily been selected. The message is clearly dovish, particularly if another pro-reflation candidate is chosen to replace Morimoto (one of 4 dissenters last October) as we suspect come June.

Figure 8: Growing interest in foreign stocks



Source: MoF, UBS (weekly data)

Figure 9: More room to buy stocks than bonds



Source: GPIF, UBS (comparing end-Q414 levels with core targets)

One intended side effect of QQE is to generate a stronger portfolio rebalancing effect, underlining the scope for increased purchases of JGBs, ETFs and J-REITs. Recent JGB volatility is unlikely to dissuade the BoJ from stepping up bond purchases, as a key tenet of the portfolio rebalancing strategy is to buy whatever is necessary to effectively push domestic investors out of the JGB market in the first place. Weekly MoF data in Figure 8 reveal the growing bias towards foreign stocks over foreign bonds; the Japanese have been net foreign stock buyers for 16 successive weeks to the cumulative tally of Y4.8trn, in contrast to net foreign bond sales of Y539bn over the same period. Inherent here may be the growing aversion to the unattractive bond yields in G10 markets and a move by private institutions

[1] Harada, a Tokyo University graduate and Waseda University economist, co-authored a book entitled "Reflation Will Revive the Japanese Economy" with Hamada and Iwata.

to take their cue from the GPIF, which boasts more room to expand exposure to foreign/domestic stocks than bonds – as detailed in Figure 9.

Granted, there are a number potential spoilers – repatriation triggered by a global macro shock; a protest against US dollar strength by the US Treasury; an internal challenge to Abe's leadership; back-tracking by the BoJ on its inflation target; a 'Buy Japan' (buy Nikkei, buy yen) paradigm if Abenomics gains real traction – but we still believe the path of least resistance is to the upside for USDJPY.

One additional and important consideration for investors is whether our view on Japan is best expressed in USD/JPY or Japanese equities, as both should benefit from reflationary policies. Our equity strategy team remains overweight Japan within APAC on the back of solid earnings momentum and improving pricing power[2].

We think USD/JPY and Japanese equities are good expressions of the Japan reflation view, and are bullish both. Although both offer significant upside, and are very similar trades, we think they offer slightly different risk-reward characteristics. We think USD/JPY has a higher floor than Japanese equities, as it is a key policy variable for the BoJ. A continuing rise in USD/JPY is necessary for reflation in Japan to take place, and we think the BoJ is generally of this view as well. As a result, although there is no formal (or informal) BoJ floor for USD/JPY, the BoJ is likely to guard aggressively against significant downside in the pair, especially on a y/y basis.

Japanese equities likely offer more upside, as they are not expensive and are highly leveraged to reflation and reforms in Japan. However, Japanese equities probably offer more downside than USD/JPY, as the BoJ is targeting them less directly, and is less likely to react to a sell-off. Our strong view is that the BoJ will continue to try reflationary policies. We have a much less strong view on whether these policiies will be successful. In turn, for choice the best way to exploit the Abenomics theme is through USDJPY upside; simply put, we have more confidence in the First Arrow than the Third Arrow.

Prospective Fed policy normalisation should add even more fuel to the USDJPY rally. This would serve as a key catalyst for conservative Japanese institutions to bring down still-elevated currency hedge ratios, so long as Fed rate hikes are sufficiently well telegraphed and gradual so as not to trigger broader risk reduction moves.

In the final analysis, position for a USDJPY breakout towards 128 on a 3-month horizon, with risks skewed towards the upside beyond that. The ability to hold above 120 is encouraging in the face of negative press headlines and softness on the yen crosses. Short yen positioning in the fast money community is far from extreme. BoJ easing risks appear under-priced. The portfolio rebalancing process will likely gather steam in FY15. And Fed rates hikes would simply be icing on the cake. Although an April easing from the BoJ is not the base case for our economists, we think the market is underpricing such a possibility.

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[2] Please refer to the February 25 *Macro Keys* ("Why Japan's working for now. What next?") for details.

Theme # 3: Trading ECB QE

- **Summary**: We remain bearish EUR/USD, though at close to 1.06, our conviction in the risk-reward of the trade is lower than before. We see some emerging positive signs in the region, but think long European equities is a better way to trade this than long EUR/USD, as monetary policy divergence will benefit European equities and continue to weigh on the currency.

- **Trades**: Long European equities, short EUR/USD. We think this combination will benefit from ECB QE, has good skew, and should perform well under a variety of macroeconomic backdrops.

As FX strategists, we are expected to have a view on EUR/USD, the most widely traded currency pair. We remain bearish, but at these levels find ourselves with less conviction in the trade than we've had in the recent past. Monetary policy divergence between the Fed and ECB will continue to increase as ECB QE and the start of Fed rate hikes widen rate differentials at the front end of the curve.

Although some of this is likely already priced into EUR/USD, we think it is important to note that the very front-end of the US yield curve (three months and below) has not yet reacted to the prospect of a first Fed hike. That isn't surprising, as lift-off is likely still more than three months away, which is beyond the lifetime of these contracts. However, as the clock ticks down, 3-month USD Libor should start to react, widening trans-Atlantic yield differentials at shorter tenors. This hasn't happened yet, and so probably isn't fully priced. But as higher yields percolate to the very front-end, this will tend to weigh further on EUR/USD, and we believe ultimately push it lower.

So, why is our bearish EUR/USD view not as high conviction as before? First, at these lower levels, risk-reward is not as good. Second, we may be reaching the point of diminishing impact of rate differentials on EURUSD. Recent experience in the US and UK has shown that QE isn't necessarily contemporaneously negative for a currency, as there was little or no correlation between Fed and BoE balance sheets and the USD and GBP, respectively.

We think QE will continue to be a significant negative for the yen, but the FX impact of ECB and BoJ QE may be different going forward. Much of the portfolio rebalancing the ECB wants to generate is internal. The decline in EURUSD from 1.40 to 1.05 has likely reflected an expectation that some of the excess savings in core Eurozone countries would be pushed overseas.

However, in the long run, the ECB is trying to achieve greater cross-Eurozone investment flows from core to periphery. Many of the ECB's targeted programmes to boost loan growth and origination (TLTRO, ABS purchases) are designed with this goal in mind, and liquidity pools in the 'core' can achieve yield enhancement without any FX risk. Japanese investors do not have this luxury, and it appears Abenomics is starting to generate higher external allocations. We expect the next phase of ECB QE-driven rebalancing to have a more significant impact on domestic transfers, with less cost to the euro itself than was seen in the initial stages.

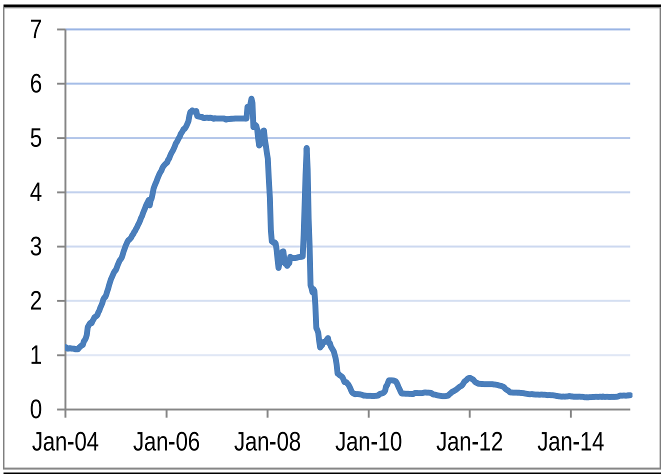
Finally, it is worth noting that the BoJ has stronger alignment between political and monetary authorities with regard to its QE program than does the ECB. The Governing Council is more fractious by design than its G10 peers, and political tolerance for unorthodox policy is less than at the BoJ. As such, we believe the 'perpetual easing' anchor story for euro downside – especially in the medium to longer term – is less strong than in Japan.

At the same time that rate differentials are likely to see diminishing effect, some euro-positive cyclical factors are beginning to emerge, with encouraging signs for a moderate growth recovery. Better bank credit data, reduced fiscal drag, and still-to-come positive effects from a weaker euro all suggest that European growth is likely to show further modest improvement in the near term. This is starting to show in PMIs and ECB lending data. European data surprise indices are improving as well, and given depressed starting points, room for further improvement remains.

The Euro area's external position may also provide support. The 12-month rolling trade surplus reached almost €200bn in December, leaving the current account surplus at 2% of GDP. In Germany, it is 6%, and with some of the positive impact of the weaker euro yet to be felt, the current account may improve further.

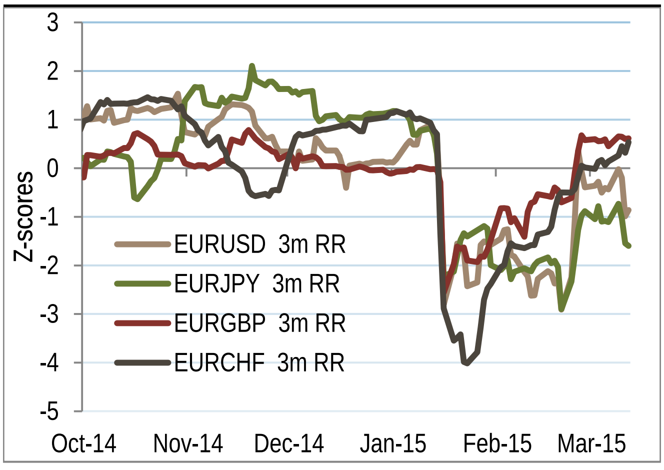
Finally, to the extent that QE is a better policy choice than what the ECB was doing previously-- letting inflation grind toward zero-- it should be positive for European assets. Not doing QE might have had a temporary positive impact on the euro through the interest rate differential channel, but we find it difficult to argue that such a policy would be good for the euro or European assets over time. Rather, we think QE is a better policy choice, and is better for asset values in the region.

Figure 10: 3m USD Libor



Source: Bloomberg

Figure 11: Deviation in skew from 1-year trend



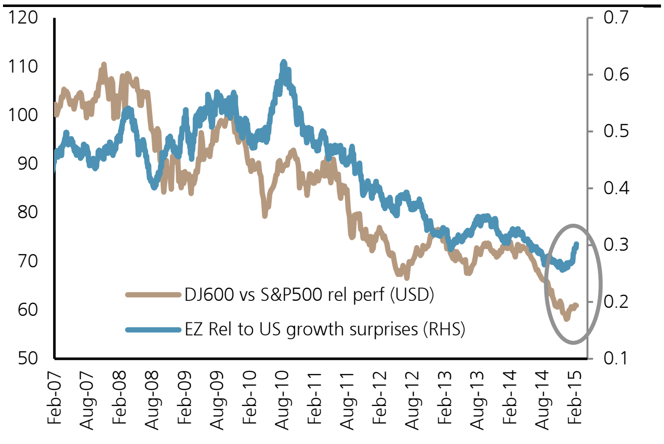
Source: Bloomberg, UBS Calculations

Given these positives, why are we are not calling a bottom in EUR/USD? First, we don't think risk-reward at these levels is good for long EUR/USD positions, as short euro positioning is likely not as extended as the price action suggests. Much of the euro selling in recent months came from the real money community, and so the risk of a rapid positioning-induced rebound is lower than commonly assumed. In the options market, skew in major EUR pairs has normalised after a significant move towards bids for puts ostensibly triggered by the surprise SNB floor removal. This has cheapened the cost of new positions looking to express downside views.

Second, we think it is difficult to make a short or medium-term market call in FX based on current account positions. Third, and perhaps most important, we think there is a better way to trade the positive factors discussed above. The combination of better growth data and very easy monetary policy should be good for asset prices, equities in particular. QE was more of an equity trade than a currency trade in the US, and we think the same is likely to be true in Europe. To the extent that better growth and QE are euro-positive, we think they will be even more equity-market positive. Our equity strategists are bullish European equities,

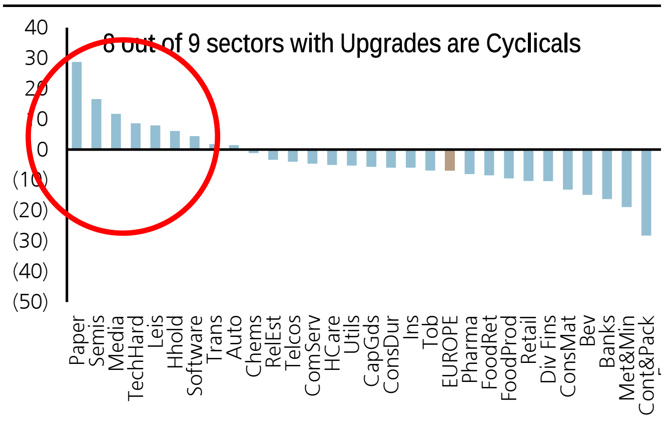
seeing three main supports (Nick Nelson and the European Equity Strategy team contributed to this section. See **Time to Zone into the Eurozone?** 9 March 2015, for more details on their views).

Figure 12: Eurozone vs US growth surprises and DJ Stoxx 600 vs S&P 500 relative performance (USD)



Source: Datastream, UBS European Equity Strategy

Figure 13: European Sectors: Earnings Momentum (3 month average)



Source: Datastream, UBS European Equity Strategy

(1) The pickup in the macro backdrop. PMIs are turning and the UBS Economic surprise index appears to have hit an inflection point. Economic growth in Europe is not strong – but we are starting to see positive surprises, rather than negative ones. The lower oil price, weaker euro, less fiscal austerity and improvements in credit availability should support this.

(2) An end to the earnings downgrades. European equities have seen 47 months in a row of analysts downgrading earnings estimates. We think we are close to an end in the downgrade cycle. If you strip out the Energy sector, earnings estimates appear to be stabilising. Also, margins are rising from a low level – suggesting strong operational leverage for companies when top-line growth returns. The tailwind from the weaker euro is only just starting to kick in.

(3) Relative valuations. Whilst straight P/E multiples are no longer obviously attractive at c.16x forward earnings, this is based on depressed earnings that are close to trough with little recovery from the 2008/09 crash and no growth at all over the last 5 years. Additionally, any cross-asset valuation that compares the European equity dividend yield of 3.3% against 10yr Bunds at c.25bps or IG Corporate Bond yields at 1.1% looks attractive.

Putting this all together, we think long European equities and short EUR/USD is a trade that can provide good expected return and risk-reward, and perform well under a variety of scenarios. As our equity strategists have noted, even at current levels in EUR/USD, the boost to Q1 earnings will be significant. The Q4 results season saw a 3% tailwind to corporate profits from the fall in the trade-weighted euro – in Q1 this is likely to increase sharply to a c.9% tailwind. As a result, a moderate grind lower in EUR/USD and higher equity prices is our base case, and we think the likelihood of being profitable on both legs of the trade is significantly higher than the likelihood of losing on both.

Theme # 4: Global Disinflation and Small Open Economies

- **Summary**: Global disinflationary pressures remain, and will continue to have an important effect on FX markets. We think this is likely to be particularly true for small open economies where inflation and interest rates are both close to zero, leaving further currency weakness as a logical path.

- **Trades**: Short CHF and SEK.

The global disinflation story is not a new one, but it is a persistent one. Despite continuing improvement in the US labor market, wage and inflation data are yet to show any upward trajectory in the US. The story is similar or worse globally. Although Chinese CPI surprised on the upside in February, it is still running at only 1.4% y/y, and PPI has fallen for 14 consecutive months. We don't expect core CPI in Japan to rise above 1.0% this year, and in Europe, where disinflationary pressures are most severe, inflation is running well below 1% nearly everywhere.

While there have been idiosyncratic elements to it, the disinflationary impulse has been global in nature. Global excess capacity, inflation persistence, lower commodity prices, and the strong dollar should continue to keep downward pressure on inflation this year.

This will continue to have important market implications, especially in small open economies like Sweden and Switzerland, where inflation and interest rates are at or close to zero. These countries would benefit significantly from weaker currencies, both through imported inflation and improved export competitiveness.

Attempts to weaken currencies have taken many forms in recent years, with the most direct being in places like Switzerland and the Czech Republic, where formal or informal currency ceilings have been enforced by central banks. But exchange rates have been influenced in less direct ways as well, including verbal intervention and interest rate cuts. During the past year, every G10 central bank except the Fed and BoE has either eased policy, or made reference to preferring a weaker exchange rate. A number have done both.

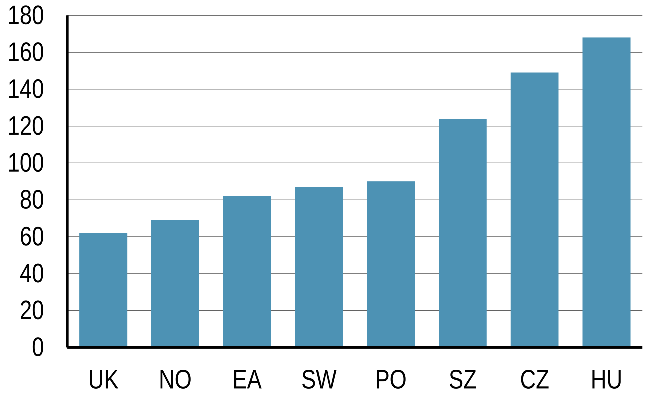
In the media and markets, much has been made of this, with the phrase "currency war" being used often. We are a bit sceptical of both the term and the idea, as neither the Fed nor the US Treasury is actively trying to influence the dollar.

That is not to say that policymakers in some countries aren't trying to influence their exchange rates-- they clearly are. But thus far, this has mostly been related to monetary policy goals. If a central bank in a small open economy has pushed rates to the lower bound, yet inflation is still forecasted to remain well below target, a weaker exchange rate is a reasonable part of the policy toolkit.

The SNB's franc ceiling, for example, was more about inflation than gaining a competitive advantage in exports. In fact, while the SNB was among the most aggressive in weakening its currency, Swiss exports are among the least responsive to changes in the exchange rate in the G10 due to their high value-added content.

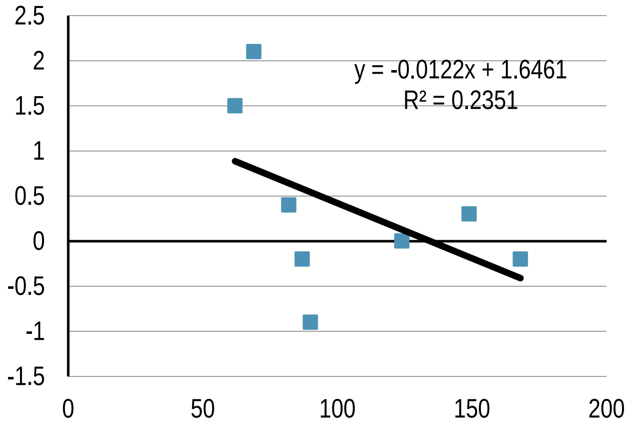
Having said that, the point of this note is not to opine on the topic of "currency wars"; we will do that at a later date. Rather, the aim is to make a narrower point on the relative openness of economies in Europe, and the potential FX market implications.

Figure 14:Exports + imports as % GDP



Source: Bloomberg

Figure 15: Exports + imports as % GDP (horizontal axis) versus average Y/Y CPI in 2014 (vertical axis)



Source: Bloomberg and UBS FX Strategy

As Figures 14 and 15 show, there is significant dispersion in the relative openness of economies in Europe, and there has been a noticeable relationship between relative openness and inflation rates across European economies in recent years.

Of the eight European countries in our sample, Norway and the UK are the least open. They also had by far the highest rates of inflation in 2014. At the other end of the spectrum, Sweden, Switzerland, Hungary, and Poland all saw zero or negative inflation rates throughout most of 2014, and are four of the five most open economies in the sample. Exports + imports average 117% of GDP in the four countries, versus 69% in Norway and 62% in the UK.

This contributes to our bearishness on CHF and SEK. In Switzerland, the case for a weaker exchange rate is clear. On the SNB's own forecast, inflation isn't expected to hit 1% until 2017, and that forecast was made before the EUR/CHF floor was removed. The combination of a significant liquidity surplus in the Swiss banking sector, a scarcity of private assets available for purchase, and already-low yields on long-term government bonds makes FX a better tool for the central bank to achieve its inflation target than QE.

Of course, this argument isn't novel, and January's removal of the EURCHF floor shows that there are limits to FX intervention. However, even with, and possibly because of the removal of the EUR/CHF floor, we think short CHF positions offer good risk-reward. A weaker currency is very likely the desired path for the SNB, and the fact that there isn't a formal floor in EUR/CHF doesn't mean there aren't levels at which the SNB will intervene in some form. Further, over time, negative rates should push CHF lower.

Sweden also fits the category of small open economies with low inflation and negative rates that would benefit from a weaker currency. Like Switzerland, Sweden has negative front-end rates, a lack of private-sector financial assets, low national net-debt burden, and very low 10-year government bond yields (80bp). All of this means that currency weakness should be a more effective way to get inflation back to target than QE.

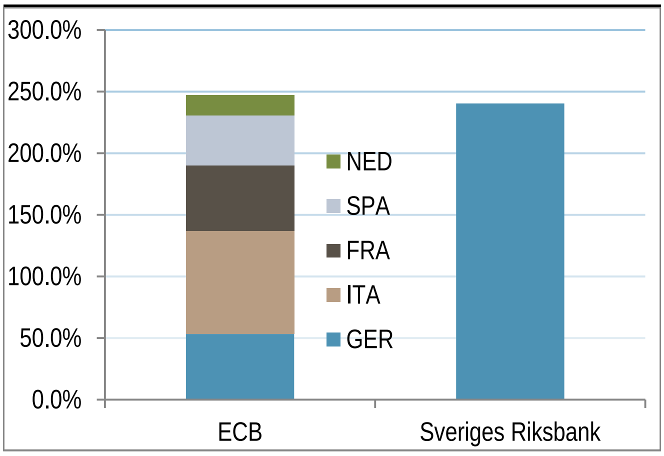
That said, we would note three things with regard to Sweden. First, the banking sector liquidity surplus in Sweden is smaller than it is in Switzerland. While Sweden has a savings surplus, it is domestic, and is not a liquidity preference driven by safe-haven demand. Second, although the effectiveness of QE in getting Swedish

inflation closer to target is low, we still expect asset purchases to be scaled up, and think that the Riksbank would cut rates again before considering FX intervention.

While the first round of Riksbank QE is almost already complete, and resulted in the central bank buying close to 85% of 2015 net issuance in Swedish government bonds, gross government bonds outstanding (across all maturities) stands at 240% of the Riksbank's balance sheet, so there is significant scope for an expansion if net issuance limits no longer apply. The political considerations which may have constrained the SNB are also less problematic in Sweden. As it stands, Sweden's small balance-sheet-to-nominal-GDP ratio may be inhibiting further weakness in the SEK, resulting in conditions being too tight. Rather than pushing on rates and risk financial instability, using the balance sheet (in both domestic and foreign markets) is a better option.

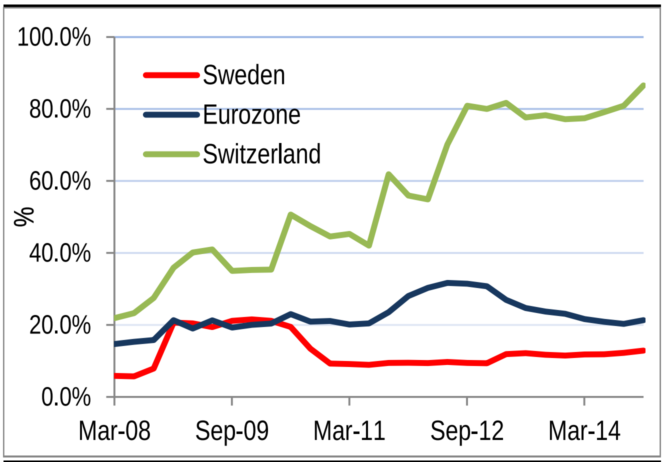
If rate cuts are indeed necessary, the renewed push towards macro-prudential policies to contain growth in household debt – which have been called for repeatedly by the Risksbank – will provide enough room for manoeuvre to go further into negative territory.

Figure 16: SGB market vs. Eurozone bond market depth



Source: Bloomberg DDIS (bond market size to balance sheet ratio)

Figure 17: Balance sheet to GDP ratios



Source: UBS Calculations, Bloomberg

That leaves the question of what to be long against short CHF and SEK. We are bullish USD and CAD, though it makes more sense to trade CHF and SEK against other European currencies, such as GBP and EUR. We are bullish both against CHF and SEK on a three-month horizon, with the best risk-reward combination being long GBP/CHF. Although UK inflation has fallen sharply, with unemployment down 150bp in the past 12 months and wage growth starting to perk up, we think the market is under-pricing the potential for a rate hike later this year.

Next Two Weeks

North America

In the US, the key event for markets during the next two weeks should be the March FOMC meeting (March 18). The skew from this meeting is likely to be USD positive, particularly in USD/JPY. Market expectations for the first Fed rate hike are around September, and given the strong NFP data, it seems unlikely that the FOMC statement or Chair Yellen's press conference will move expectations later than this. There are a number of US data releases during the next two weeks as well, though the market implications from these are likely to be limited, as they are mostly second tier. February CPI data (March 24) is likely to show that inflation remains benign.

In Canada, the spotlight in the next two weeks will be on Governor Poloz's speech in London scheduled for March 26, particularly in the wake of the more upbeat tone of the BoC's most recent policy statement. The March 20 CPI report headlines the domestic data calendar, but any further oil-driven moderation in the overall figure should not seriously concern the BoC so long as the core reading stays on a 2% handle as seems likely. Also out on March 20 will be the retail sales report, which should help to guide expectations for the January GDP report on March 31 – one of the key focal points ahead of the BoC's April 15 meeting.

Asia-Pacific

In Japan, the key event during the next two weeks will be the BoJ decision on March 17. Though we suspect it will be too early to expect any major dovish concessions in the face of the stronger Nikkei and weaker yen, the continued softening of inflation projections in the JCER's latest Monthly Survey of Professional Economic Forecasters should keep the BoJ on the defensive into the new fiscal year starting on April 1. Further insights into the policy debate will be gleaned from the minutes of the BoJ's February gathering on March 20. Core y/y nationwide CPI prints have already slowed to 0.2% in January (excluding consumption tax effects), so any further moderation in the February report due March 27 would simply magnify the 'policy divergence' theme to the benefit of USDJPY – one of our higher-conviction calls in the G10 space.

In Australia, the RBA chose not to cut at the March 3 policy meeting, but the minutes due on March 17 may indicate how close a call that was, and crucially what the likelihood of a rate cut in May might be. An explicit easing bias already appears in the policy statement, and any reinforcement of that stance in the minutes could add to further downside pressure on the Australian dollar. Importantly too, with the currency much weaker now, investors remain alert for any dilution of the central bank's perennial complaint that the currency remains above levels implied by most fair value estimates.

In New Zealand, with the latest RBNZ policy decision out of the way, and the notion firmly implanted that future rate adjustments (up or down) will be dependent on incoming data, the Q4 GDP report (March 19) will command greater attention than usual. If weaker milk prices last year, localised drought conditions, and a still relatively strong currency really hurt growth then we can expect to find out here. The February trade balance (March 25) will be another focus, and may show the first positive impact from the milk price rebound seen in recent weeks.

Europe

In the Eurozone, with QE finally underway the focus has shifted to the implementation of the bond purchases. Investors still have a lot of questions as to who will buy, how many bonds will they buy, and on which parts of the curves. From a currency point of view though what likely matters most is the ECB delivering on the overall target of €60bn a month. Any suggestion of missing out on the target, deliberate or not, would probably be taken as a euro positive while a strict adherence would be seen as a sign of determination not least to keep the currency in check. Greece will probably remain in the headlines too as time is very short to the conclusion of the programme review scheduled for end-April.

In Switzerland, domestic economic data have not been a major driver for the franc ever since the introduction of the EUR/CHF floor in September 2011. This might now slowly change. The trade report (March 19) will be the most important release over the next couple of weeks. The focus for the market, however, will be the SNB quarterly monetary policy assessment on March 19 that unusually for the March decision will come with a press conference. This will likely be due to the SNB trying to step up its communication rather than any intention to announce any further measures. The market however will likely continue to speculate about further interest rate cuts particularly following media reports that negative rates of as low as 150bp might be a possibility.

In the UK, data releases through the second half of March will test the BoE's robust case for the economy and policy normalisation detailed in the February inflation report. As such, any inconsistency in the minutes to the March MPC decision (March 18) with this outlook could once again cause rate expectations to re-price.

In Sweden, the Riksbank has explicitly stated that monetary policy changes could now be announced between officially scheduled meeting dates. As the current QE programme has largely been completed, in the immediate future there is the possibility of the Riksbank announcing a sudden expansion in asset purchases if deemed necessary to stabilise inflation expectations.

In Norway, the Norges Bank is expected to cut rates again at their upcoming meeting (March 19) and our economists are against consensus in expecting a 50bp cut (cons. 25bp). Admittedly, the risks of an aggressive move have fallen in the wake of stabilisation in oil prices, investment intentions for 2015 and underlying inflation holding at target. However, the belated push for macro-prudential measures could give the central bank some more room to act in the future should conditions deteriorate.

Forecasts (as of March 16th, 2015)

	Spot	1m		Previous	3m		Previous
EURUSD	1.0590	**1.04**	↓	1.13	**1.02**	↓	1.10
USDJPY	121.20	**124**	↑	120	**128**	↑	124
EURJPY	128.40	**129**	↓	136	**131**	↓	136
GBPUSD	1.4800	**1.49**	↑	1.47	**1.51**	↑	1.47
EURGBP	0.7150	**0.70**	↓	0.77	**0.68**	↓	0.75
EURCHF	1.0650	**1.07**	↑	1.00	**1.10**	↑	1.00
USDCHF	1.0060	**1.03**	↑	0.88	**1.08**	↑	0.91
EURSEK	9.1540	**9.25**	↓	9.40	**9.40**	=	9.40
EURNOK	8.7360	**8.80**	↓	9.40	**8.60**	↓	9.20
NOKSEK	1.0480	**1.05**	↑	1.00	**1.09**	↑	1.02
EURDKK	7.4637	**7.45**	↑	7.44	**7.45**	↑	7.44
AUDUSD	0.7660	**0.75**	↓	0.80	**0.75**	↓	0.79
NZDUSD	0.7390	**0.73**	↓	0.75	**0.74**	↑	0.73
AUDNZD	1.0405	**1.03**	↓	1.07	**1.01**	↓	1.08
USDCAD	1.2770	**1.26**	↑	1.25	**1.23**	↓	1.25

Source: UBS FX Strategy

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Outlook	Positive; Stable; Negative	Up to 6 months	UBS' expected trend in a company's creditworthiness
	Security Recommendations		
Bond Recommendation	Outperform; Marketperform; Underperform	Up to 3 months	A corporate bond's expected relative performance versus a defined reference
CDS Recommendation	Buy Protection; Sell Protection	Up to 3 months	Recommendation to hedge a company's creditworthiness

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