Emirates NBD

بنك الإمارات دبي الوطني

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FX Week

FX landscape turning more volatile

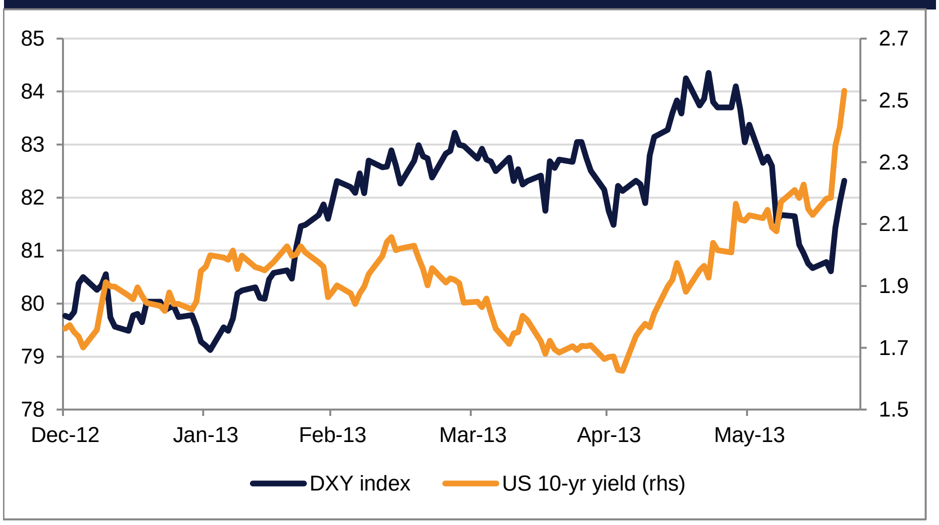
With the Fed having signaled its willingness to start tapering QE, Japan continuing its ‘monetary policy revolution’ and Eurozone stability coming back under the spotlight, currency markets are likely to have a hot summer and a volatile H213. Emerging markets are already reflecting the renewed uncertainty, with China’s growth slowing and its financial markets under stress. As the end of H113 approaches the USD is already resuming the trend gains it saw earlier in the year, with USD/JPY in particular recovering recently lost ground. EUR/USD should also eventually break out of its H1 range to the downside, as both cyclical and structural issues continue to bear down on the single currency.

….With the USD back in the ascendancy thanks to the Fed

The USD is back in the ascendency as H2 approaches helped by the Fed’s ‘tapering’ announcement last week. The DXY dollar index rebounded strongly back above its 200-day moving average to 82.30, up from 80.50 less than a week ago. While the Fed left monetary policy unchanged as expected, maintaining its USD85bn of asset purchases per month, Fed Chairman Bernanke gave the clearest hint yet about the likely timeline for the reduction and eventual removal of Quantitative Easing (QE) in the US. Bernanke noted that if the recovery continues as predicted, the Fed could start reducing its QE purchases later this year and finish them by mid-2014, contingent on the unemployment rate falling to 7.0%. Bernanke said that this would not amount to a tightening of monetary policy, but likened it to taking the foot off the accelerator and not hitting the brakes. Forward guidance on interest rates were unchanged, with most Fed governors not looking for the first rate hike until 2015, and with Bernanke portraying the 6.5% unemployment rate target as more of a threshold for discussing higher rates rather than as formal ‘trigger’ for tightening.

The Fed also updated its economic projections, lowering its growth forecast slightly for 2013 but raising it for 2014, and also lowering its forecast for unemployment. The Fed also said that the risks to the economy and to the labour market had diminished. Accordingly, economic data will be watched even more closely going forward, serving as an ongoing stress test about the likelihood of QE ‘tapering’ starting on time in Q4. The latest releases have been reassuring on this front with the Philly Fed index rising sharply in June to 12.5 from -2.0 in May and with existing home sales also up by 4.2% in May.

USD stages impressive rally as yields rise on Fed



Source: Bloomberg, Emirates NBD Research

This may be just as well as there are already reports that the cost of mortgages in the US has started to rise in the wake of the increase in bond yields, with 10-year Treasury yields reaching above 2.50% on Friday.

But continued USD strength is still dependent on data

The USD will continue to strengthen while the data remains supportive of growth in excess of 2.0%, but it could be vulnerable if the momentum begins to be lost. The week ahead will see a number of important data releases, including the Fed's closely watched core PCE inflation reading. This will be particularly important as one of the dissenters from last week's FOMC decision, St Louis Fed Governor Bullard, disagreed with the move because inflation is still significantly undershooting the Fed's 2.0% inflation target. Headline CPI rose to 1.4% in May, up from 1.1%, but the core PCE measure is the Fed's favoured inflation reading and it remains at 1.1%. Durable goods orders, consumer confidence and a variety of other regional activity indicators will also provide a rain-check on the strength of the recovery.

USD/JPY's impressive bounce

USD/JPY's snap-back from lows of 94.0 a week ago was perhaps the most impressive, with a return to the highs of May (103) already looking distinctly possible in the coming weeks, as widening yield differentials work in its favor. With the Bank of Japan succeeding in stabilizing JGB yields below 1.0%, even as US Treasury yields soared, the yield advantage should eventually work in the USD's favour despite data revealing that Japanese investors remained net sellers of foreign bonds for the fifth consecutive week. In addition Japanese economic data is continuing to underpin the stimulus policies of the Japanese government, with further evidence of this likely to be seen in the data releases due in the coming week. Further signs of recovery are expected, but most important will be the inflation data which is expected to shift from deflation of -0.4% in April to a flat reading in May. This would allow the government to claim that it is on its way to reaching its 2.0% target in two years' time, supporting the Nikkei and in the process giving further endorsement to a firmer USD/JPY.

EUR structural issues back in focus

Also coming back under the spotlight is the EUR, which forcefully rejected the 1.34 area last week and ended it within sight of 1.30. Our 1-month forecast is for 1.28, with our long standing 3-month forecast remaining at 1.25. The EUR will lose ground despite its current account surplus status (approximately 2.0% of GDP), as both cyclical and structural concerns come back to the fore. Admittedly, the cyclical outlook has improved marginally in recent weeks, but with structural concerns over Greece, Cyprus and Portugal returning, it may not be too long before the recent revival in confidence runs out of steam as well. Bond yields in the periphery are on the rise again, in the wake of the Fed's announcement, but also as a reflection of the renewed concerns about financing and the state of progress of reforms.

There is already speculation that Cyprus' EUR10bn bailout will need to be revised higher (with a EUR exit still a possibility), and that Greece will need further assistance as the IMF holds out against making its payments due to a EUR3-4bn budget shortfall. Portugal is also believed to be at risk of requiring further aid. With Germany facing elections in September, the timing of this renewed pressure could not be more damaging, with Chancellor Merkel likely to hold out against providing further aid at least before the election, effectively postponing any discussion of these issues until October. Perhaps, more worrying is the move higher in Spanish yields, back towards 5.0%. With Spain expected to be the principal beneficiary of the (yet to be used) OMT bond-buying mechanism, doubts about its legality and about the extent of any purchases that might take place under it are also clouding the picture, should Spain eventually make a request for a bailout.

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Discussions over a proposed banking union will also continue to be held in the week ahead, with EU leaders holding a two-day meeting on Thursday. Policymakers will be seeking to reassure markets that measures are underway that will break the link between sovereigns and the banking system. Last week saw some progress as it was agreed by finance ministers the ESM bailout-fund could inject EUR60bn into the regions banks. However, governments and investors will also share part of the burden, and it may take time for the scheme to become fully operational. Furthermore, efforts to create a Eurozone deposit guarantee system, which would provide some confidence to investors, still remain far-off. Data releases, such as the EC economic sentiment indicator and the German IFO index in the week ahead, may continue to provide some short-term encouragement, but with these bigger issues looming in the background the benefits for the EUR are likely to be marginal at best.

GBP weaker despite better UK data

GBP has also lost ground, despite recent economic data in the UK providing some grounds for optimism, with retail sales rising by 2.1% in May and house prices continuing to firm. However, with a new regime at the Bank of England from July, and a new 'monetary policy framework' on its way, it is too soon in our view to rule out renewed easing pressure later this year. The GBP also loses out within a strengthening USD environment due to the UK's large current account deficit expected to be around -3.7% GDP this year, and due to the conflicting policy pressures emanating from a high inflation rate, with CPI having moved back up to 2.7% y/y in May. UK data in the coming week is unlikely to reverse recent sentiment, or perhaps even alter the outlook for a gradual moderate recovery, with final Q1 GDP expected to be unrevised at 0.3%, while the Bank of England will release its Financial Stability Report and the Chancellor will present his Spending Review.

FX differentiation will be key

In fact differentiation based on economic fundamentals will be an increasing feature of the new FX landscape in the wake of the Fed's announcement about QE. No longer can emerging market, high-yielding currencies, or developed ones for that matter rely on easy US money to bolster them without scrutiny being made of the economic fundamentals that lie beneath. Commodity FX should remain vulnerable to the Fed moves on the one hand, as the USD price of raw materials tends to fall. Some of them, such as the AUD will also have the disadvantage of running a wide current account deficit, as well as having exposure to a weakening and volatile China.

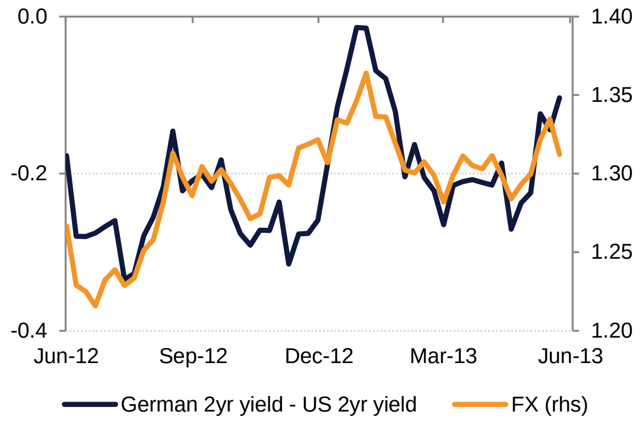
Indeed, concerns about China may also impact a wider array of economies and currencies going forward, with worries about its financial system in the wake of the spike in interbank rates last week, likely to dampen broad EM risk appetite. The BRL, ZAR, TRY and the INR have all witnessed sharp losses in the run-up to the Fed's announcement, often for domestic reasons, but situations which will not be helped by the anticipated reduction in Fed stimulus. The Indian authorities last week downplayed the impact on the INR, with Finance Minister Chidambaram claiming that Fed Chairman Bernanke had been misunderstood by the markets. However, with interest rates having ominously been raised in recent weeks in Indonesia as well as in Brazil, there may be some fears that currency weakness could yet force a similar reaction at a time when India's economic performance would least require it.

FX Forecasts - Major						Forwards		
	Spot 21.06	1M	3M	6M	12M	3M	6M	12M
EUR / USD	1.3122	1.28	1.25	1.20	1.15	1.3128	1.3135	1.3151
USD /JPY	97.90	100.0	105.0	107.0	110.0	97.84	97.76	97.48
USD / CHF	0.9345	0.96	1.00	1.04	1.08	0.9336	0.9325	0.9296
GBP / USD	1.5419	1.51	1.48	1.45	1.45	1.5410	1.5401	1.5385
AUD / USD	0.9219	0.92	0.90	0.88	0.85	0.9157	0.9099	0.8991
USD / CAD	1.0457	1.03	1.05	1.07	1.10	1.0480	1.0503	1.0550
EUR / GBP	0.8508	0.85	0.84	0.83	0.79	0.8517	0.8526	0.8545
EUR / JPY	128.45	128.0	131.0	128.4	126.5	128.45	128.45	128.45
EUR / CHF	1.2261	1.23	1.25	1.25	1.24	1.2255	1.2246	1.2223
FX Forecasts - Emerging						**Forwards**		
	Spot 21.06	1M	3M	6M	12M	3M	6M	12M
USD / SAR*	3.7505	3.75	3.75	3.75	3.75	3.7505	3.7512	3.7513
USD / AED*	3.6730	3.67	3.67	3.67	3.67	3.6729	3.6731	3.6715
USD / KWD	0.2835	0.282	0.285	0.282	0.28	0.2862	0.2863	0.2902
USD / OMR*	0.3850	0.38	0.38	0.38	0.38	0.3848	0.3848	0.3843
USD / BHD*	0.3770	0.376	0.376	0.376	0.376	0.3776	0.3777	0.3785
USD / QAR*	3.6415	3.64	3.64	3.64	3.64	3.6427	3.6438	3.6457
USD / INR	59.2675	56.75	55.50	55.00	53.75	59.2785	59.2869	59.3016
USD / CNY	6.1329	6.23	6.22	6.20	6.25	6.2185	6.2460	6.2938

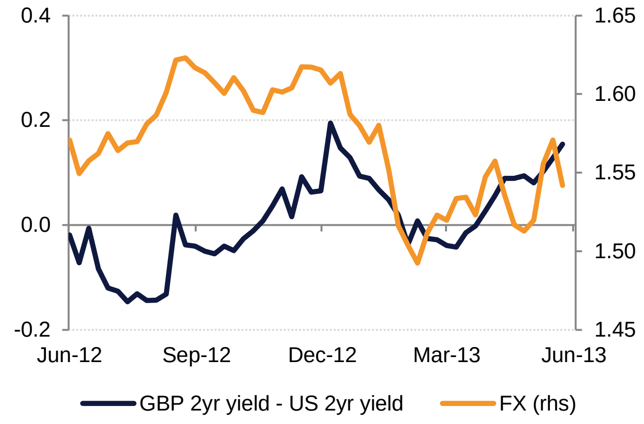
**Denotes USD peg*
Source: Bloomberg, Emirates NBD Research

Major Currency Pairs and Interest Rates

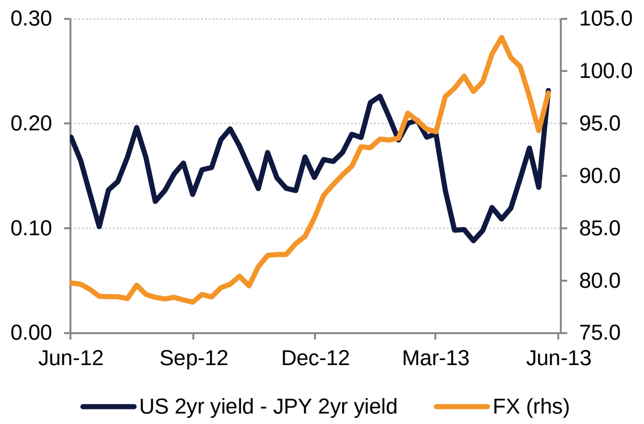
Interest Rate Differentials - EUR



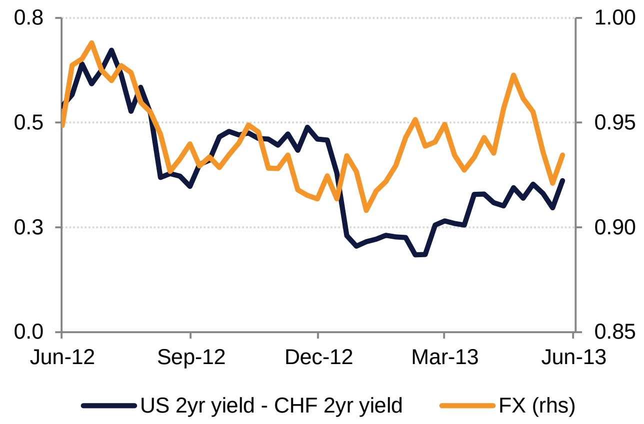
Interest Rate Differentials - GBP



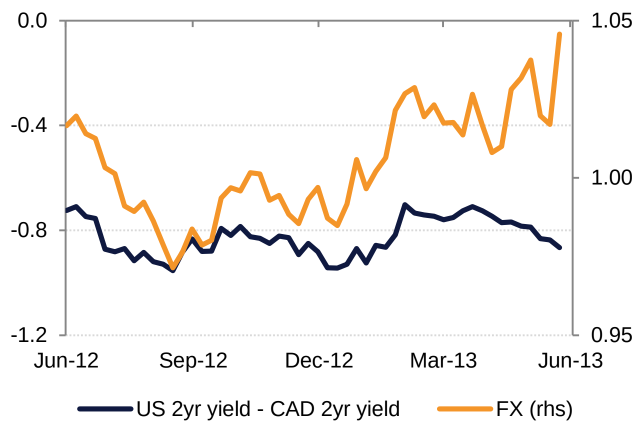
Interest Rate Differentials –JPY



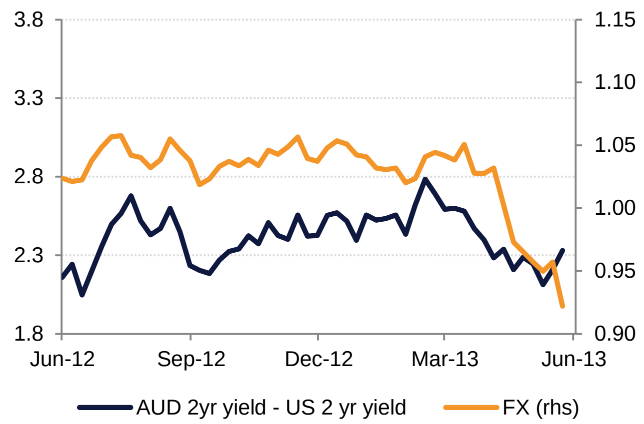
Interest Rate Differentials - CHF



Interest Rate Differentials - CAD



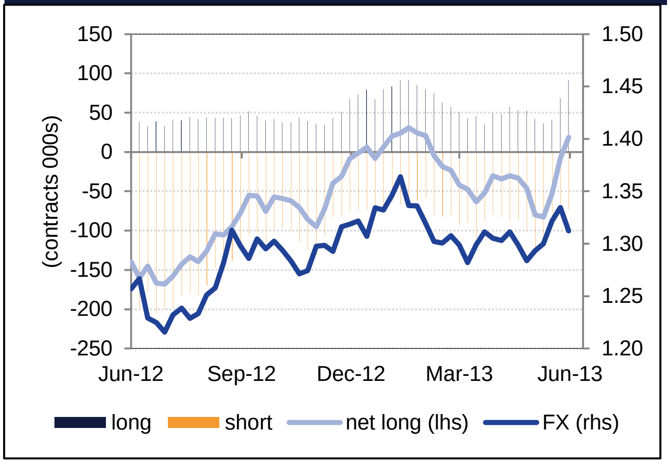
Interest Rate Differentials - AUD



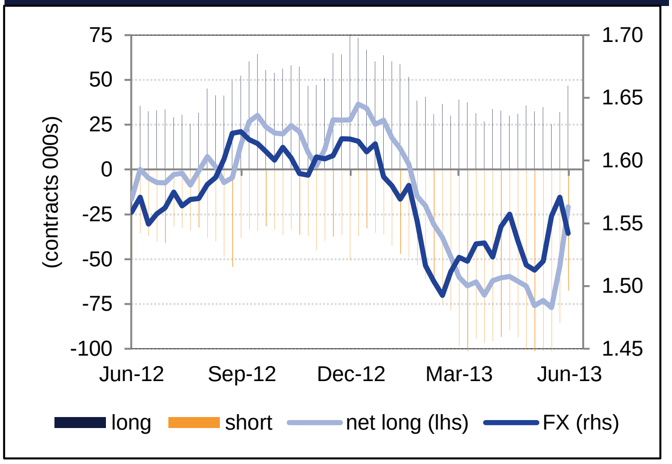
Source: Bloomberg, Emirates NBD Research

Major Currency Positions

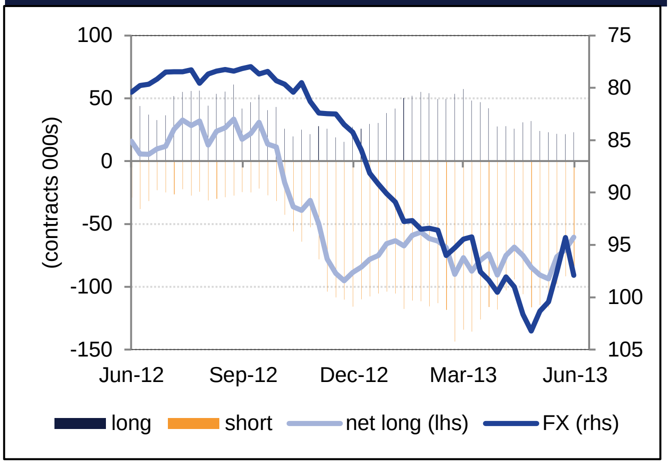
CFTC – Speculative Positions - EUR



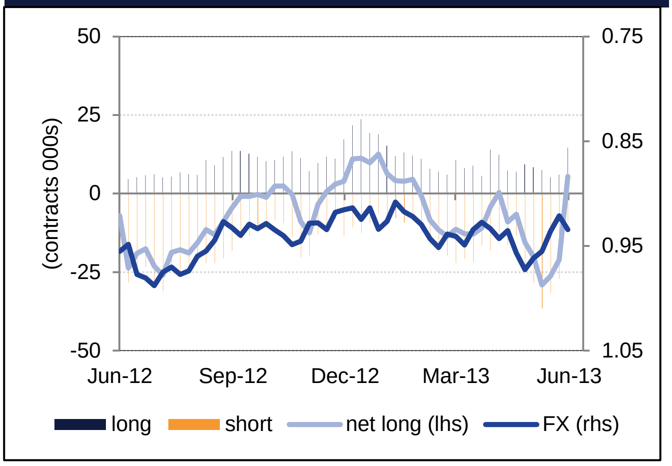
CFTC – Speculative Positions - GBP



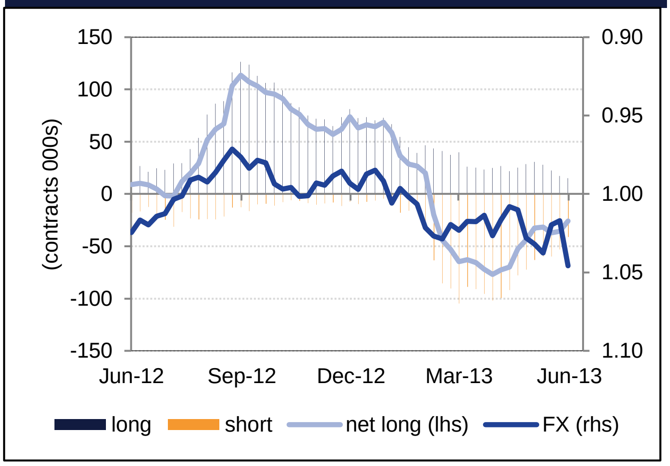
CFTC – Speculative Positions - JPY



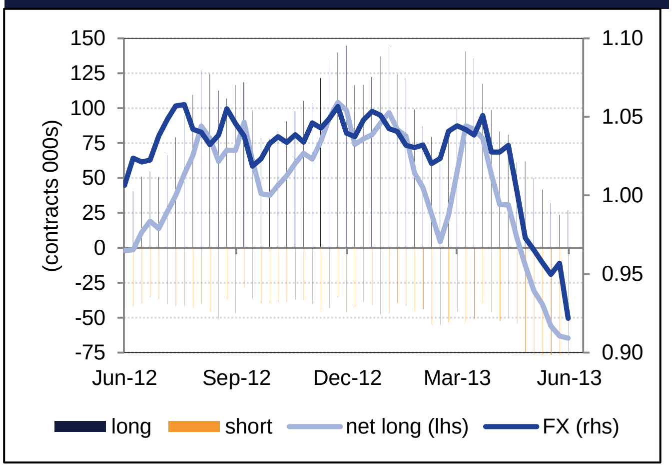
CFTC – Speculative Positions - CHF



CFTC – Speculative Positions - CAD



CFTC – Speculative Positions - AUD



Source: Bloomberg, Emirates NBD Research

Economic Calendar

Date	Country	Event
24-June	Germany	IFO Business Climate
	Italy	Consumer Confidence
	US	Chicago Fed Nat Activity Index
	US	Dallas Fed Manufacturing Activity
25-June	Italy	Retail Sales
	US	Durable Goods Orders
	US	S&P CaseShiller Home Price
	US	Richmond Fed Manufacturing Index
	US	Consumer Confidence
	US	New Home Sales
26-June	Germany	GfK Consumer Confidence Survey
	France	GDP
	UK	CBI Reported Sales
	US	MBA Mortgage Applications
	US	GDP
	US	Personal Consumption
	US	Core PCE
27-June	Japan	All Industry Activity Index
	Germany	Unemployment Change
	UK	GDP
	US	Personal Income / Spending
	US	PCE Deflator
	US	Initial Jobless Claims
	US	Pending Home Sales
	US	Kansas City Fed Mfg Activity
28-June	UK	GfK Consumer Confidence Survey
	Japan	Jobless Rate
	Japan	CPI
	Japan	Industrial Production
	Germany	Retail Sales
	Germany	CPI
	Italy	CPI
	Canada	GDP
	US	U. of Michigan Confidence

Source: Bloomberg

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