بنك الإمارات دبي الوطني
Emirates NBD

Weekly
14 July 2013

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FX Week

FX overreacts to Fed

FX markets were abruptly affected by the Fed's June minutes released last week, as well as by comments from Fed Chairman Ben Bernanke, with the USD selling off sharply, taking EUR/USD from 1.28 to above 1.32 at one stage. However, we saw this reaction as exaggerated, as the central thrust of the Fed comments was largely similar to the Fed statement made in June (following the same FOMC meeting) in our view, as well as to Bernanke's press conference at the same time. It was also largely consistent with the message from a number of Fed officials made over the last month aimed at calming the reaction in financial markets. In fact, the FX market reaction on Wednesday evening seemed incongruous to us as it was not mirrored in similar moves elsewhere. In fixed income markets for example, yields only fell back marginally compared to the overreaction in FX. It might be expected that bond yields would be more likely to be affected if a material change to Fed tapering policy had been announced, but this was not the case with the 10-year yield ending the week only 17bps below the July peak. With the USD also recovering its poise on Thursday and Friday, with EUR/USD falling back to 1.3050 from 1.32, it seems as if this has already started to be recognized, with the USD's initial weakness more a reflection of thin liquidity than any substantial alteration of Fed tapering prospects.

Illiquidity and excessive expectations to blame

The other cause of the USD's reaction was related to expectations. Markets were probably looking for more clarity about Fed intentions from the June FOMC minutes, but what they actually got was uncertainty, and maybe even confusion. Mixed messages are almost inevitable when reflecting the views of nineteen different Fed officials into one set of minutes, with only twelve of these being voting members. But after the June policy statement and Bernanke's press conference had distilled some core messages from the two-day June meeting, the minutes laid bare the differences that lay behind the discussions. Thus while the June statement and Bernanke's press conference had created expectations of a hawkish bias in the minutes (which with hindsight also could be said to have been exaggerated), it seems that the FOMC was actually quite divided about how to proceed with slowing asset purchases. 'Many' wanted to see further labour market gains, and 'more evidence that the projected acceleration in in economic activity would occur' before starting to taper, although several others said that a reduction would be warranted soon.

EUR/USD rejects years lows again

Source: Bloomberg, Emirates NBD Research

The subsequent comments from Bernanke only added to the confusion when he said in a speech that highly accommodative monetary policy is needed for the foreseeable future.

QE 'tapering' still in store for Q4

However, when looked at in the context of the June statement, the June press conference, and the totality of what has been said in the last few weeks by other Fed officials, it does not look to us as if much has actually changed, and certainly nothing to justify the outsized reaction by the USD. We still see the overall message as being consistent with an intention to start reducing QE beginning in Q4, and still possibly as early as September. The Fed will of course remain data dependent, which we already knew. It is also still emphasizing that tapering is not tightening, which we also knew, and that policy will remain accommodative even after tapering starts, again something that should by now also be understood. At a time when communication is becoming one of the key policy instruments of central banks (something that the minutes showed the Fed spending a lot of time discussing), the outcome was ironically something of a communications disaster. But perhaps it was also one of the unavoidable consequences of placing so much emphasis on 'forward guidance', attempting to oversimplify quite complicated relationships and policy reactions into easily digestible sound-bites and projections. This is probably something the Bank of England and the ECB should take note of as they begin to go down the same 'forward guidance' policy route.

Fed again centre-stage

Chairman Bernanke will at least have another opportunity to rectify matters in the coming week, when he delivers his semi-annual testimony to Congress. In this testimony he will be seeking to reflect the collective view of the Fed, and can be expected to repeat the three key principles; that Fed tapering will be data dependent, that tapering is not tightening, and that tapering is not inconsistent with ongoing monetary accommodation. It is to be hoped that the markets should finally be able to understand these without overreacting. The USD should also continue to recover, with long positions now of course much lighter, especially as the data seen since the FOMC meeting largely supports the timetable for monetary policy normalization that the Fed has begun to lay out.

Data to keep USD underpinned

More evidence of this improving economic momentum should also be on offer in coming days with US retail sales, industrial production, housing starts and the Philly Fed index all due out and expected to show further strength. The contrast between the US and the Eurozone economies should also be reinforced by a weaker Eurozone trade balance, following an already weak German trade surplus in May. The EUR/USD's upside should also be limited by ongoing dovish rhetoric by ECB officials, which has been an increasingly recognizable feature following the July ECB press conference at which President Draghi made it clear that interest rates would stay at current levels or lower for an extended period. Structural worries over Portugal are also returning, only one week after it seemed a government reshuffle had stabilized things there. Bond yields rose sharply again at the end of last week after President Anibal Cavaco Silva reopened political differences by calling on the government and opposition to unite over austerity policies, with disagreements between the rival parties having already forced the government to delay a Troika review of the country's progress.

BOE minutes important for GBP

The GBP will also have economic data and important event risk to contend with in the coming week, including retail sales, labour market and public finance data. Perhaps most important will be the release of the July Bank of England MPC minutes, where the interest will fall on whether new Governor Mark Carney voted for more QE. Having warned that the recent rise in UK yields was 'unwarranted' earlier this month it would be a surprise to the market if Carney voted with the MPC 'hawks' for no change in monetary stimulus, although he may want to keep his powder dry until the formal unveiling of 'forward guidance' on August 7th.

JPY focus turns to politics

In Japan it will be a relatively quiet week, dominated more by the run-up to the July 21st Upper House elections, which should see the LDP government reinforce its mandate for economic reforms by winning a majority in the Upper House. Following on from the BOJ's upgraded outlook for the economy last week the likelihood of the government being able to implement more reforms will stand local markets in good stead and should keep sentiment towards USD/JPY largely positive, but mostly dependent on the USD's gyrations in the short term.

Adjustments to AUD, INR forecasts

Finally, the start of the week will see Chinese Q2 GDP data which is expected to show a further deceleration in growth to 7.5% y/y consistent with our forecast for the whole year. The news will be important for risk as well as for commodity currencies like the AUD, whose economies have been dependent on strong Chinese growth in the past benefiting Australian exports. Monthly Chinese industrial production and retail sales data for June will also be watched closely to see if the momentum in the economy continued to dip towards the end of the quarter, which seems likely given the recent clampdown on credit markets.

The markets will also see minutes from the last RBA monetary policy meeting this week, which should provide clues about the likelihood and possible timing of the next interest rate cut in Australia. Last week we changed our outlook for the AUD, seeing downside risks extending to 0.80 over the coming year. This may seem extreme given the already sharp fall since May, but it is worth remembering that most long-term estimates of fair value for the AUD are even lower, closer to 0.70. We have also adjusted our USD/INR forecast recently seeing it as likely to remain underpinned in the short term in line with other emerging market currencies. Indian WPI inflation data for June at the start of the week is expected to tick up slightly, something that the authorities may be sensitive to while INR weakness remains.

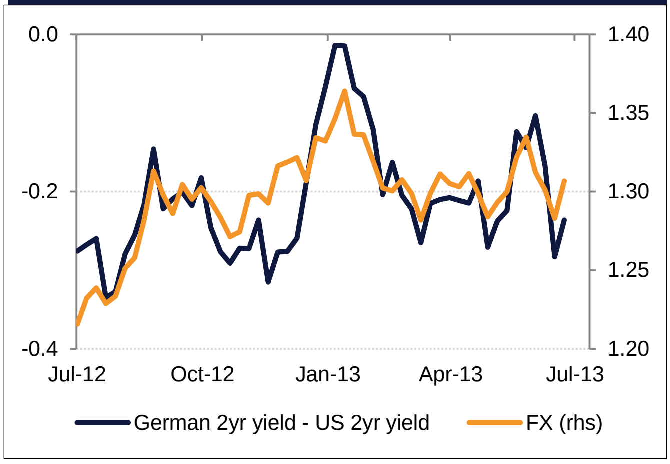
FX Forecasts - Major						Forwards		
	Spot 12.07	1M	3M	6M	12M	3M	6M	12M
EUR / USD	1.3067	1.27	1.25	1.20	1.15	1.3072	1.3079	1.3099
USD /JPY	99.22	103.0	105.0	107.0	110.0	99.17	99.09	98.83
USD / CHF	0.9465	0.98	1.00	1.04	1.08	0.9457	0.9447	0.9419
GBP / USD	1.5107	1.48	1.47	1.45	1.45	1.5098	1.5090	1.5078
AUD / USD	0.9049	0.90	0.88	0.85	0.80	0.8991	0.8938	0.8840
USD / CAD	1.0395	1.03	1.05	1.07	1.10	1.0419	1.0441	1.0484
EUR / GBP	0.8649	0.84	0.85	0.83	0.79	0.8658	0.8667	0.8687
EUR / JPY	129.66	131.0	131.0	128.4	126.5	129.66	129.66	129.66
EUR / CHF	1.2368	1.24	1.25	1.25	1.24	1.2362	1.2355	1.2336

FX Forecasts - Emerging						Forwards		
	Spot 12.07	1M	3M	6M	12M	3M	6M	12M
USD / SAR*	3.7505	3.75	3.75	3.75	3.75	3.7505	3.7509	3.7515
USD / AED*	3.6730	3.67	3.67	3.67	3.67	3.6729	3.6730	3.6735
USD / KWD	0.2859	0.282	0.285	0.282	0.28	0.2892	0.2897	0.2952
USD / OMR*	0.3850	0.38	0.38	0.38	0.38	0.3842	0.3835	0.3824
USD / BHD*	0.3770	0.376	0.376	0.376	0.376	0.3778	0.3781	0.3788
USD / QAR*	3.6412	3.64	3.64	3.64	3.64	3.6433	3.6445	3.6468
USD / INR	59.6300	62.00	61.00	59.00	57.00	59.6410	59.6514	59.6680
USD / CNY	6.1382	6.15	6.15	6.20	6.20	6.2128	6.2373	6.2250

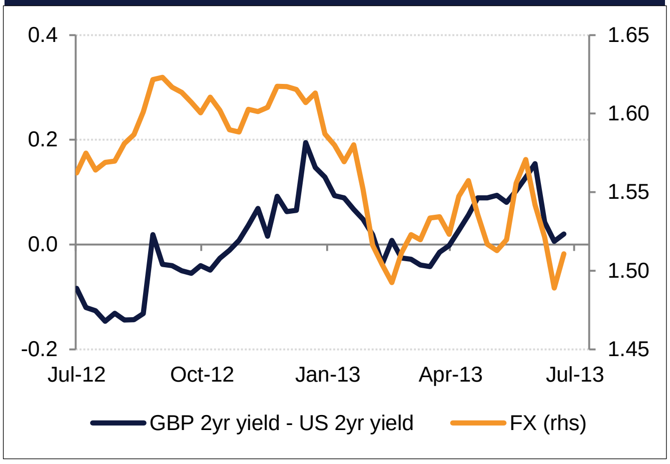
**Denotes USD peg*
Source: Bloomberg, Emirates NBD Research

Major Currency Pairs and Interest Rates

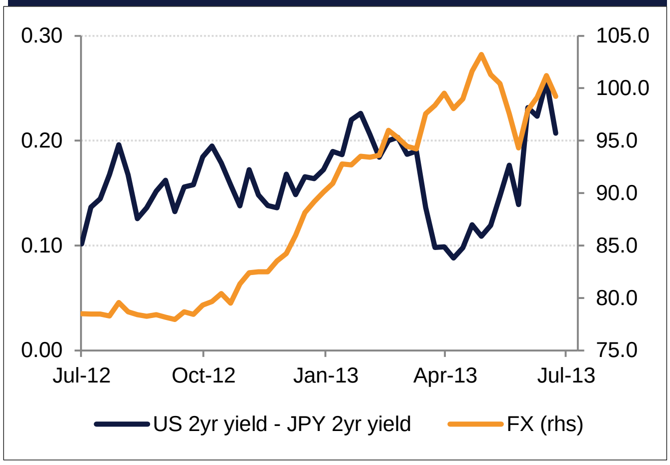
Interest Rate Differentials - EUR



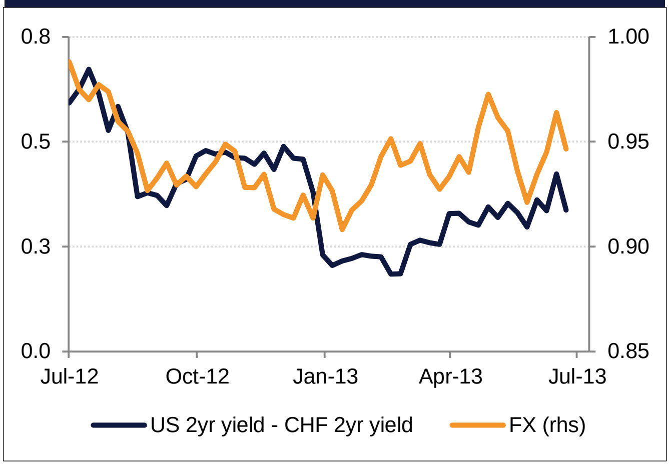
Interest Rate Differentials - GBP



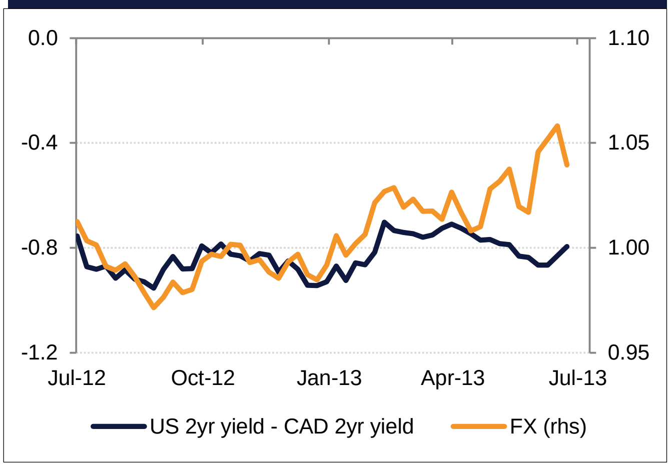
Interest Rate Differentials –JPY



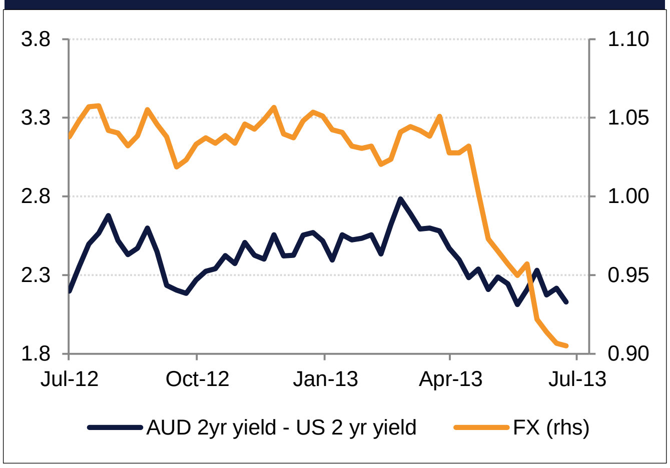
Interest Rate Differentials - CHF



Interest Rate Differentials - CAD



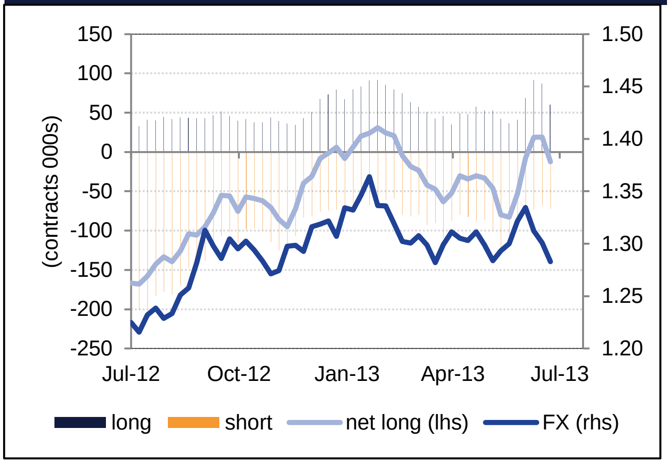
Interest Rate Differentials - AUD



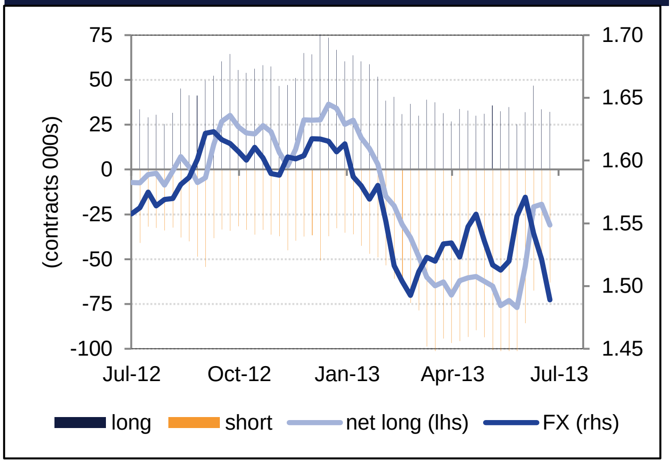
Source: Bloomberg, Emirates NBD Research

Major Currency Positions*

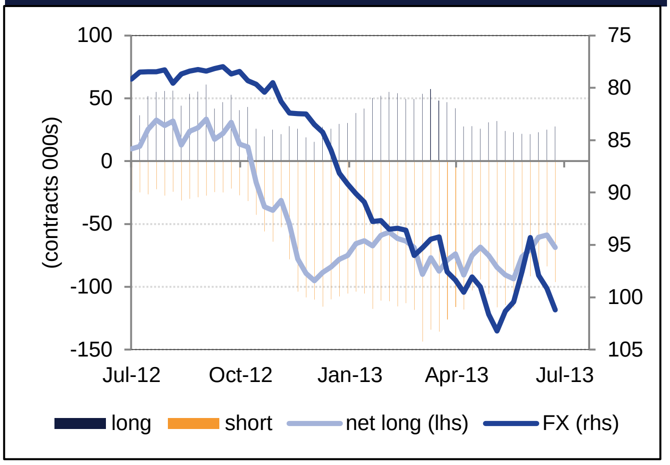
CFTC – Speculative Positions - EUR



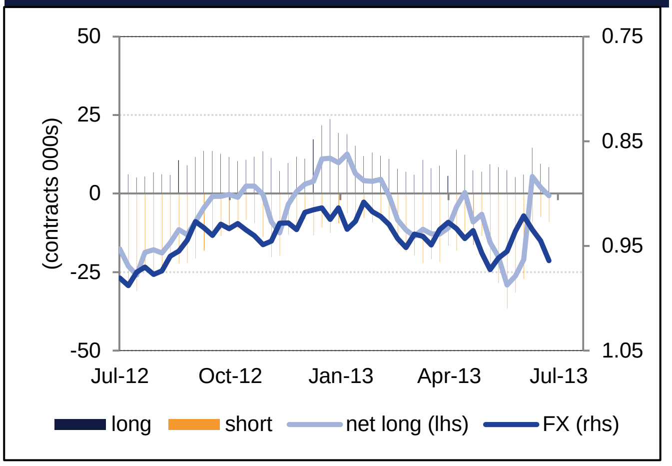
CFTC – Speculative Positions - GBP



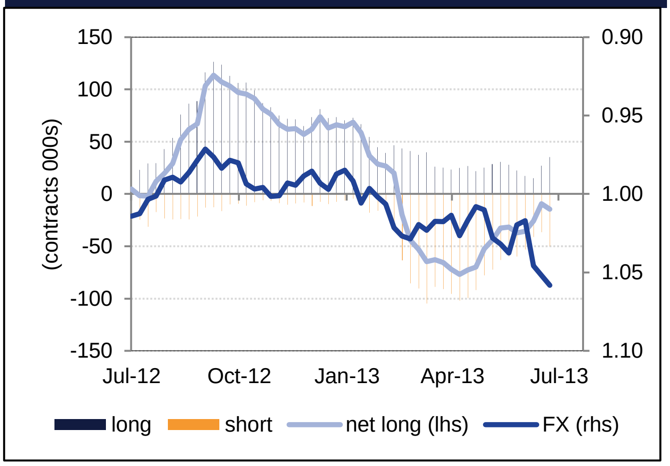
CFTC – Speculative Positions - JPY



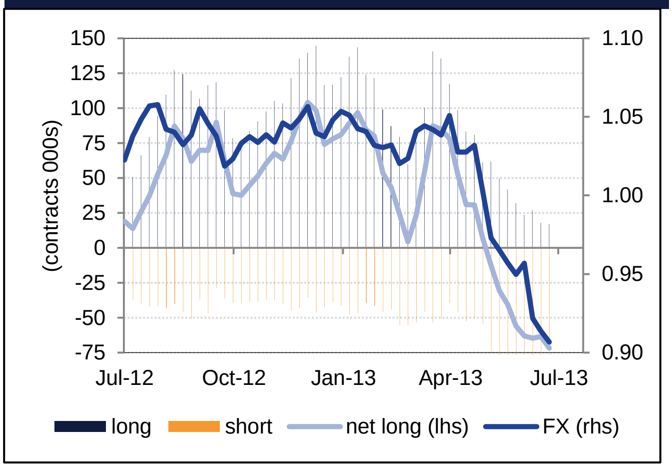
CFTC – Speculative Positions - CHF



CFTC – Speculative Positions - CAD



CFTC – Speculative Positions - AUD



Source: Bloomberg, Emirates NBD Research
**Data as of 25th June, 2013*

Economic Calendar

Date	Country	Event
15-July	China	GDP
	China	Industrial Production
	China	Retail Sales
	India	Wholesale Price Index
	US	Empire Manufacturing
	US	Advance Retail Sales
	Canada	Existing Home Sales
16-July	Australia	RBA July Meeting Minutes
	Italy	Trade Balance
	UK	CPI
	UK	Retail Price Index
	Eurozone	CPI
	Eurozone	Trade Balance
	Germany	ZEW Survey
	US	CPI
	US	Industrial Production
	US	NAHB Housing Market Index
17-July	UK	Bank of England Minutes
	UK	ILO Unemployment Rate
	US	MBA Mortgage Applications
	US	Housing Starts
	Canada	Bank of Canada Rates
	US	Federal Reserve Beige Book
18-July	Switzerland	Trade Balance
	UK	Retail Sales
	US	Initial Jobless Claims
	US	Philadelphia Fed
19-July	Japan	All Industry Activity Index
	UK	Public Finances
	Canada	CPI

Source: Bloomberg

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