27 August 2014

FX Strategy

EUR/USD ahead of ECB – a dead cat bounce

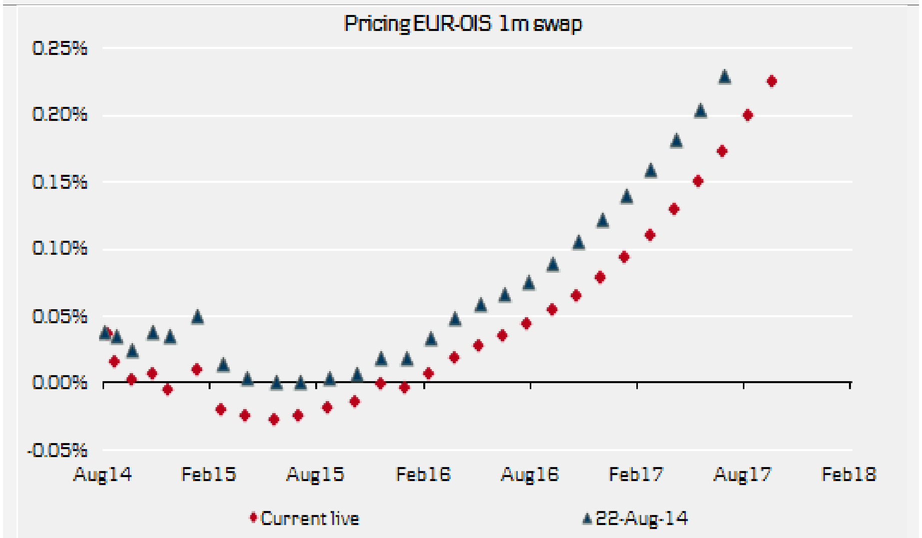
- **We expect the ECB to deliver a very dovish statement next week but not cut interest rates or enact QE. This could trigger a bounce in EUR/USD but we expect it to be short-lived given the USD's increasing potential as an asset currency.**
- **We lower our EUR/USD forecasts to 1.30 on 1M, 1.27 on 3M and 1.26 on 6M from 1.33, 1.30 and 1.27, respectively, previously on ECB easing expectations and the superior expected return of USD-denominated assets.**
- **We lower our target and stop-loss on our short EUR/USD recommendation to 1.27 and 1.35, respectively. Leverage funds should stay short EUR/USD and use a possible bounce around the ECB meeting to add to positioning.**
- **DKK-based real money funds should lower FX hedges on USD exposure and treat the USD as a core part of their portfolio. DKK-based exporters should hedge USD-denominated income via forward extras. DKK-based importers should hedge USD payables via FX forwards.**

FX economics

USD set to rally despite ECB caution

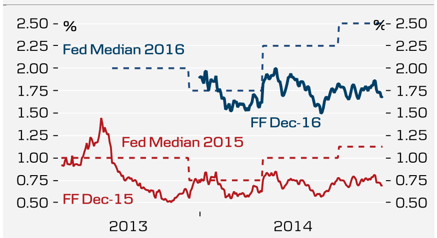
We do not expect the ECB to cut rates or enact QE at next week's meeting. ECB President Mario Draghi's dovish speech at Jackson Hole represented his take on the euro area outlook but, in our view, he will not be able to convince the ECB Governing Council only three months after the June meeting (see *Flash Comment: Draghi increases likelihood of further easing*, 25 August, and ECB's policy going forward, 29 August).

Chart 1: The market is pricing in a dovish ECB but not a rate cut



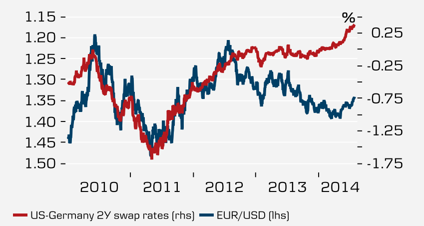
Source: Macrobond Financial

Chart 2: The market underestimates the Fed



Source: European Central Bank

Chart 3: Rates spread supports a lower EUR/USD



Source: Macrobond Financial

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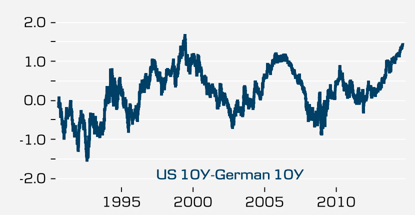
However, we expect the ECB statement to be very dovish and believe it is likely to state that there are signs that medium- to long-term inflation expectations have started to become de-anchored. This would be a major departure from the previous statement. The money market is currently pricing in roughly 25% probability of a 10bp cut, while EUR/USD has fallen to 1.3180 from 1.3240 before Draghi's speech (see Chart 1). As such, the market is, at least, expecting a very dovish Draghi, while the market will be disappointed if there are no major changes in the ECB statement and the press conference. The bottom line, in our view, is that the market will focus on the ECB having to deliver more, no matter what.

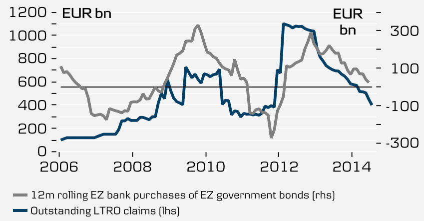
In contrast, we continue to believe that the market is underestimating the Fed (see Chart 2). This should further widen rate spreads between the US and the eurozone (see Chart 3). Importantly, we believe that EUR/USD will continue to fall, with or without diverging monetary policy. The USD simply delivers a higher expected return no matter whether you invest in bonds, equities or real assets. The rally in the USD has coincided with the rally in risk appetite in line with the USD developing the characteristics of an asset currency. For example, the spread between 10Y UST and 10Y Bund yields is at its highest level since 1999. (See Chart 4). Also in volatility-adjusted terms, US yields support the USD relative to the EUR. We still see the ECB's TLTRO as negative for the EUR, as euro area bank buying of periphery bonds may 'crowd out' foreign buying (see Chart 5).

Chart 4: 10Y UST-Bunds spread at its widest level since 1999 (%)



Source: Macrobond Financial

Chart 5: TLTRO may 'crowd out' foreign buying of periphery bonds



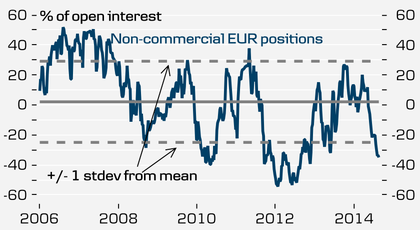
Source: Macrobond Financial

FX outlook

Short-term (0-3 months) – EUR to falter

We have been bearish on EUR/USD for a long time but it has fallen faster than we had expected (see *FX Strategy: EUR/USD targets 1.30/1.26 on Fed, portfolio flows*, 29 July). We acknowledge the risk that the market will be disappointed with the ECB decision on 4 September. Given heavy EUR short positioning, this could trigger a bounce in EUR/USD (see Chart 6). Our short-term quantitative EUR/USD models also warn of a bounce. However, we expect the market to see through a less dovish ECB as the expectation is likely to be that the central bank will eventually have to deliver. In light of the ECB President Draghi's Jackson Hole speech and continuing disappointing euro area data, we move forward our bearish EUR/USD forecasts, expecting it to reach 1.30 in 1M, 1.27 in 3M, 1.26 in 6M from 1.33, 1.30 and 1.27 previously (see Table 1).

Chart 6: EUR shorts at stretched levels



Source: CFTC

Table 1: Danske Markets USD Scandi FX Forecasts as of 27 August 2014

		Forecast				Forecast vs forward outright, %			
	Spot	+1m	+3m	+6m	+12m	+1m	+3m	+6m	+12m
Exchange rates vs USD									
EUR	1.318	1.30	1.27	1.26	1.25	-1.4	-3.7	-4.5	-5.5
DKK	5.66	5.73	5.87	5.91	5.96	1.4	3.9	4.7	5.8
NOK	6.18	6.23	6.26	6.23	6.20	0.8	1.0	0.2	-0.9
SEK	6.95	7.08	7.17	7.14	7.04	1.8	3.1	2.8	1.3

Source: Danske Bank

Medium- to long-term (3-12 months) – lower and then stabilisation

We maintain our 12M EUR/USD forecast at 1.25. The EUR will weaken sooner rather than later, as diverging monetary policy expectations and US outperformance playing out now. As usual, markets may overshoot and price this divergence in now. Our EUR/USD PPP is currently around 1.28, indicating that the EUR is slightly overvalued. We expect euro area GDP growth to bounce sharply in 2015 to 1.9%, while CPI inflation should tick higher into year-end and in 2015. This should help to provide a floor under EUR/USD, which we expect to come in around 1.25.

FX strategy

Leveraged funds

We have been recommending that leveraged funds sell EUR/USD spot, entry 1.3626, target 1.30 (see *FX Research: ECB will surprise the markets – two FX Trades: short EUR/USD and short EUR/NOK*, 28 May). We acknowledge the risk of a bounce in EUR/USD around the ECB meeting but this should be short lived. We lower the target for our short EUR/USD recommendation to 1.27, stop-loss 1.35. Leverage funds should stay short EUR/USD into the ECB meeting and use a possible bounce to add to positioning.

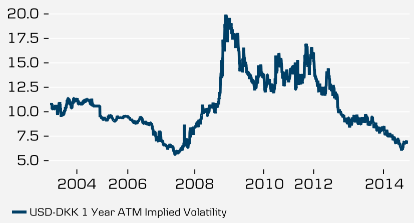
Real money funds

DKK-based real money funds with USD assets should maintain low FX hedge ratios. We forecast USD/DKK at 5.91 in six months and 5.96 in 12 months, significantly outperforming forwards. USD strength is a clear macro call based on relative growth and interest rate divergence between the US and the euro area. Hence, DKK-based real money funds should treat USD exposure as a core part of their portfolio.

Corporates

For DKK-based exporters with USD receivables, we recommend hedging USD-denominated income via forward extras. This will retain a profit potential while securing a worst-case exchange rate. DKK-based importers should hedge USD payables through USD/DKK forwards. Danish importers with USD payables should also consider USD/DKK calls given low implied volatility (see Chart 6). To mitigate the negative time delay effect, we recommend that Danish importers with USD payables buy long-dated USD/DKK calls. Specifically, we recommend that DKK-based importers buy a 1Y USD/DKK call, strike 5.75, cost 38 USD pips. (This is an indicative price and clients should check live prices with their sales manager.) Note that the suggested strike price is substantially below our 12M USD/DKK forecast at 5.96.

Chart 7: USD-DKK implied vols close to 2007 lows



Source: Macrobond Financial

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