

JULY 14, 2014

FX Morning

Policy in focus. Monetary policy will be in focus this week as several of the G10 central banks meet or release statements, with the major event being Fed Chair Yellen testimony. The *WSJ* suggests in an article by Hilsenrath that the debate regarding an earlier rise of interest rates is now intensifying in the wake of the strong labour market data. However, yields at the front end of the US curve have pulled back after testing the highs of the year, as the FOMC minutes were consistent with Yellen's message that the recent rise of inflation was "noise". While this week's testimony is also likely to see continuity in the message from Yellen, further data strength could make it difficult for the Fed too continue to push back, and we would see any softening of the USD in the near term as providing a renewed buying opportunity.

Canada not benefitting from the US recovery. Meanwhile, the BoC meeting will gain plenty of attention following the much-weaker-than-expected Canadian labour market data at the end of last week. Indeed, the sharp deterioration in the headline employment data (the detail gave some comfort, given that the deterioration came from part-time jobs) is consistent with our view that Canada is not in a position to benefit from the improvement in the US recovery as fully as seen in recent cycles, given the recent loss of competitiveness. Indeed, the weakness in Canadian leading indicators points to a less favourable picture for the Canadian employment picture and the CAD (see exhibit).

Long USDCAD. Hence, we expect CAD to come under pressure and we have re-established long USDCAD positions at the end of last week (see [Reloading USD/CAD Longs](#), July 11, 2014). However, the BoC minutes are likely to reference the higher-than-expected inflation data, which is one of the reasons why market expectations have been focusing on the potential for the BoC to shift towards a more hawkish stance. But we believe that there is also potential for BoC Governor Poloz to look through the current higher inflation data, taking Yellen's approach of describing current developments as noise. Hence, this has the potential for the BoC to remain on the dovish side, keeping the CAD under pressure. We look for USDCAD to recovery to the 1.0815 level initially, with a further move above here opening the way for a more sustained move higher over the medium term, target 1.1200.

AUD and RBA minutes. The RBA minutes tomorrow will also be important for the AUD, given that the currency remains at the centre of the policy debate. RBA Governor Stevens has reiterated that the AUD remains overvalued and that investors are underestimating a material fall in the AUD. However, Stevens sees the trigger for such a sell-off in the AUD coming from international events such as a risk-off environment in financial markets or a rise of US interest rates. Also of interest is that the RBA has released a research paper suggesting that individuals are better off renting rather than purchasing a house. This could take the steam out of the Australian housing market, which many had been looking to for a rebalancing of the economy. The New Zealand house price data also showed further weakness with both house prices and sales continuing to fall.

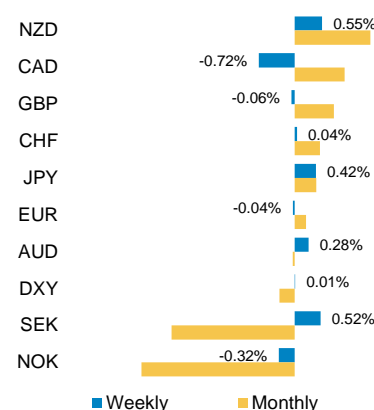
EUR still vulnerable. Yield volatility in Europe is likely for a very different reason as uncertainty remains, especially given the increased risk events in the periphery of EMU. While the latest events in the Portuguese banking sector are seen as contained, it will be interesting to see how Draghi responds to the situation in his speech today. Any sign that foreign investor inflows are being deterred by the latest events could put the EUR under renewed pressure. A move below the 1.3575 level would give the next bearish signal, opening the downtrend towards 1.3500 initially.

GBP setbacks to remain limited. Tomorrow's UK CPI data are likely to show a slightly pick-up in the year-on-year rate of inflation, which could support rate hike expectations. However, it will be the labour market data later in the week, which will be the most important. Although we expect another robust employment picture, softness in the earnings data would take the edge of the positive news, in line with the moderation seen in the UK data more broadly recently. But overall, we expect setbacks in GBP to remain limited. Although short-term positioning, as expressed by the CFTC data, suggests that GBP longs had become overextended, this has adjusted lower over the past week. Moreover, our own FX Positioning Tracker, which covers a broader range of inputs, shows more moderate positioning, suggesting that longer-term investors have not yet participated in GBP gains. Hence, we maintain our GBP bullish view, especially on the crosses and see near-term setbacks as buying opportunities.

Morgan Stanley Research

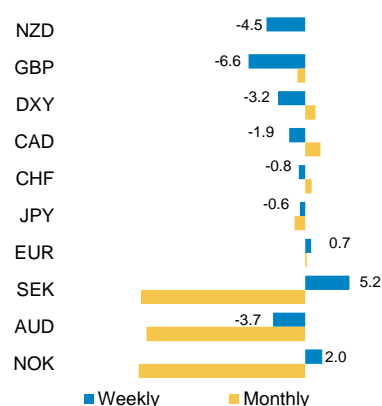
For important disclosures, refer to the Disclosures Section, located at the end of this report.

Recent Currency Performance (against USD)



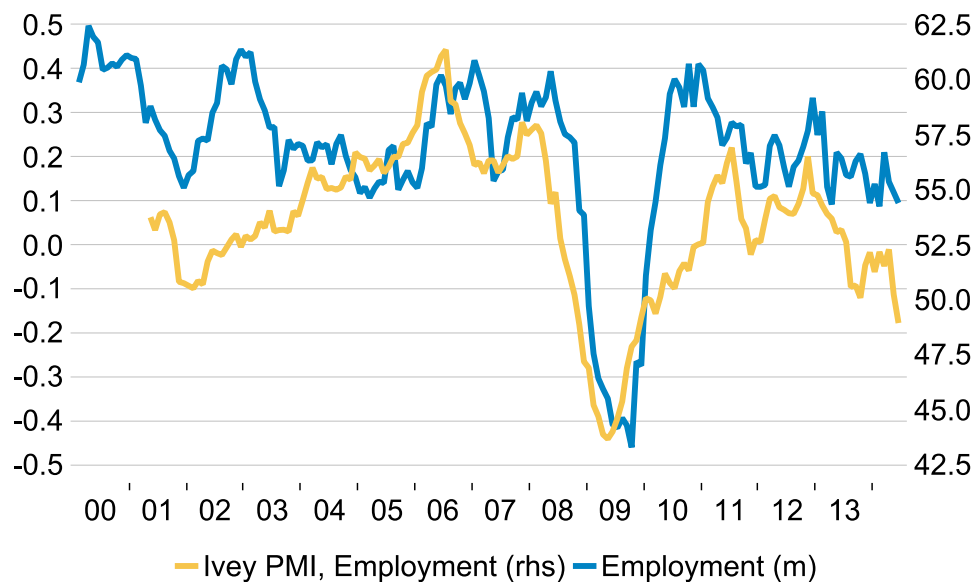
Source: Bloomberg, Morgan Stanley Research

Recent Rates Performance (Two-Year Sov. Swaps, bp)



Source: Bloomberg, Morgan Stanley Research

Employment Survey Points to Worsening Situation for CAD



Source Macrobond, Morgan Stanley Research

DAILY CALENDAR

Click here for an interactive calendar: [Morgan Stanley Matrix](#)

Date	Time (Ldn)	Ccy	Event	Ref. Period	MS forecast	Market	Previous
14-Jul	10:00	EUR	Industrial Production (MoM)	May	-1.2%	-1.2%	0.8%
14-Jul	13:00	INR	CPI (YoY)	Jun	7.9%	7.7%	8.28%
14-Jul	18:00	EUR	ECB's Draghi spks (Strasbourg)				
15-Jul	N/A	JPY	BoJ Rates Decision		0.1%		0.1%
15-Jul	00:01	GBP	BRC Sales Like-For-Like YoY	Jun		1%	0.5%
15-Jul	02:30	AUD	RBA Minutes	July			
14-Jul	07:30	INR	Wholesale Prices (YoY)	Jun	5.8%	5.78%	6.01%
14-Jul	10:00	EUR	Industrial Production (MoM)	May	-1.2%	-1.2%	0.8%