

Overview

Euro Stuck

In the months ahead, the market may start to more aggressively price a hike by the Fed, and as we pointed out in our January Blueprint, this should provide some support for the dollar. Indeed, the dollar has fared well, yet partly because of this performance we would be cautious in jumping on to a bullish dollar trend. Some resolution appears to be coming together for Greece and contagion appears to be limited. Meanwhile, the US swaps market appears to be raising some concerns over US sovereign risk and US real yields appear too low given the size of the US's "twin deficits". Of course, the market may ignore sovereign risk and instead focus on cyclical issues in the months ahead. Even there, despite higher US growth, capital is flowing as well to the Euro-area as it is to the US and Euro-area growth pulse has picked up. In our view, the offsetting forces of US twin deficits and possible Fed hikes should keep the euro relatively range-bound.

Not Falling for Yen Bear Trap

The anticipation of an imminent Fed hike will likely help the dollar more against the yen than any other currency. So we would be cautious in expressing our bullish yen view solely against the dollar. We therefore recommend buying the yen against the dollar, euro and pound. All four currencies belong to countries or regions that have poor debt dynamics. But we believe Japan's current account surplus and deflation backdrop makes it the least likely to suffer a fiscal crisis. So maintaining a core long JPY position should benefit whenever sovereign risk rears its head as the major market theme. Indeed, the return of bond risk premia in the US could also see the JPY-yield correlation break down.

On the cyclical side, Japanese growth has been picking up, and we expect it to surprise to the upside over 2010. Already, analysts have been forced to revise up their forecasts (along with the US) in contrast to the static forecasts for Europe. Consequently, Japan is seeing larger equity inflows than both the US and Euro-area (as a share of GDP). Finally, we must not forget that the yen weakened significantly between 1995 and 2007, the golden period for the yen carry trade, and so far we have only unwound the performance seen since 2004. For the yen to return to its 30-year average level against the majors, it would need to strengthen a further 20%. We think this is a possibility as the world has fundamentally changed since 2007.

A Sterling Battle

Elsewhere in the G10, GBP remains trapped in a battle between UK economic out-performance versus sovereign risk concerns. In the absence of a clear resolution to that battle, EUR/GBP should range trade over the summer. Not so for the loonie, as we remain bullish CAD – holding our AUD/CAD short from the last Blueprint. We would also be long CAD versus EUR and USD, while short AUD/NZD going into the Q1 HLFs on 6 May, as we believe AUD has priced in global growth that is well-above trend. By contrast, the SEK rally still has legs, as this cyclical currency is still undervalued despite signs of recovery in recent months. We expect NOK to rise more gradually, as the Norges Bank is cautious of any further NOK appreciation. Finally, we note the SNB has been unable to halt the appreciation of the franc, but that 1.40 would be an attractive level to buy EUR/CHF.

Emerging Markets: Judging the interventions

Due to relatively strong growth and cheap valuation, TRY remains our core long in EMEA. Poland has now joined the many other emerging markets globally that intervene in their FX markets. We expect the NBP to continue to lean against the wind but do not see the Bank altering the currency's direction. In Hungary we see a chance of a policy of intervention designed to accumulate reserves and facilitate HUF underperformance relative to the rest of the region, while Czech is the least likely to intervene. We remain short EUR/PLN (target 3.75) but long EUR/HUF (target 285).

Asian currencies should do well in an environment where regional central banks are tightening ahead of the Fed. INR, SGD, KRW, PHP and IDR are our top picks. Go long an equally weighted basket of KRW, TWD and SGD as proxy for CNY adjustment.

Currency returns correlation to carry should subside

Finally, we observe that the Deutsche Bank Currency Returns Index (dbCR) has gained over 6% in the past 12m, driven mostly by carry, which is up nearly 26% in this period. In the future, expect "strong balance sheet" currencies (NOK, SEK, CAD) may soon replace carry pairs in the momentum index. We stay long the dbCR.

How did our last Blueprint trades do?

Our feature trade from January was also long JPY. USD/JPY is nearly flat since early-Jan, while the JPY TWI is up about 2%. Elsewhere, our top performers were long NOK, SEK, and BRL against EUR; in EM, long MXN, IDR/JPY, COP/CLP, and RUB basket. On the downside, our EUR/CHF call finished OTM, and AUD is still rising.

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