Overview

The next twelve months will see policymakers attempt to take back some of their unprecedented array of policy actions from the last two years. The positive pulse of global growth should allow some to delay and yet others to speed up the tightening of monetary or fiscal policy. Inflation and heightened concern over sovereign risk likely will force the hand of some. Determining which ones will be key for 2010.

Fed to Help Dollar (Initially)

Ironically, the mix of risks does not suggest a strong trend in the euro. We expect weakness, but with only a modest target of 1.35-1.40 for the H1. It may end up being one of the smaller range years in a while. The reason is that short-term US yields have already risen sharply, and though the broader growth picture is weaker in the Euro-area than the US, the ECB is likely to hike not too far behind the Fed. A moderation in equity flows to the Euro-area and increasing concern over Greek and other Euro-area bond markets should be enough to keep the pressure on the euro.

Against the Tide, Yen to Abide

By far the strongest consensus view for 2010 amongst G10 is a weaker yen, whether one looks at forecasts, trade recommendations or market positioning. We like to go against the tide and be short USD/JPY (and long the JPY TWI). In our opinion, a move to 95 or higher cannot be ruled out in near-term given the momentum of US data and yields, yet our target is 80-85, so the potential gains on being short USD/JPY outweigh the potential mark-to-market losses. The likely moderation in the rise in US yields and importantly a decline in correlation with yields should support our view. In fact, on the initiation of Fed tightening, USD/JPY has shown a strong tendency in the past to reverse course and decline sharply. Importantly, this time, an unwinding of some of the unconventional policy measures by the Fed may be viewed as the first "hike", so the timing may be sooner than many expect.

Though many are concerned about Japan's fiscal picture, it is worth remembering that a fiscal crisis is almost unheard of in current account surplus nations with deflation. Possible intervention is more of a risk, but even there history shows the yen strengthening during intervention phases, and one should not forget about last year's CHF strength in the face of intervention.

Playing the Shift in Growth Engines

As the dollar becomes more correlated with the US growth, we believe that simply selling the dollar against growth currencies is no longer the thing to do. Instead, we prefer to be more selective on growth trades. We like exposure to Asia, not least because we believe policymakers will be more tolerant of currency appreciation. Specifically, we would go long IDR (vs. JPY), KRW (vs. G3) and short USD/TWD. Last year, AUD was one of the best global growth trades, but this year we prefer to fade AUD against a basket of currencies and instead look to short USD/CAD as a catch-up trade. That shift in focus would also capture the shift in growth momentum from China to the US. Other commodity currencies such as BRL and RUB will likely perform, though we would play the former against the EUR and the latter against a basket.

European Issues

The European currencies provide a nice array of issues. The GBP will likely perform moderately well versus the EUR on an exit of QE by the BoE - though at some point has the risk of a fiscal crisis. We therefore look for GBP rallies to find the right level to sell GBP. The Swiss meanwhile appear comfortable to allow some near-term CHF strength, but will likely be one of the last central banks to tighten policy, so CHF weakness will likely be a theme further out. Both Sweden and Norway have strong balance sheets, which should be rewarded this year. Policymakers in Norway appear wary of NOK strength, so we prefer to be long SEK which should also be helped by the global growth backdrop.

Elsewhere in EMFX and FX as Asset Class

In emerging markets, we like to be long TRY, PLN, RON and ILS versus EUR, long EGP versus USD based on a combination of favourable capital inflows, monetary divergence and valuations. As a hedge we like to be long EUR/HUF which is most vulnerable to a dollar rally, and has potential funding problems.

Finally, we like to be long our currency benchmark index, the dbCR. Last year it returned over 6% above cash, and we expect positive returns once again in 2010. Our analysis also shows that the dbCR tends to perform well during Fed tightening years.

How Did Our Last Blueprint Trade Recs Do?

Our trades were profitable overall with notable gains made by our short EUR/NOK, short USD/KRW and short USD/MXN recommendations. Our long EUR/USD and short USD/JPY trades ended up in the red on the late dollar rally in December, while our short AUD basket saw the largest loss.

The above represent unfunded trades; thus the relevant benchmark is "no trade" (i.e., 0%). Performance calculated excluding transaction costs. Past performance is no guarantee of future results. Additional information available upon request. Last Blueprint was dated 17 Sept. 09.

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