

Overview

Back to the Future

The debate on how durable the global recovery will be will no doubt continue for the rest of this year, yet one thing appears clear the US will continue to err on the side of keeping policy easy. Indeed, the parallels with 2002-2007 are uncanny. Back then, easy Fed monetary policy contrived to give the US relatively high growth, the ECB was constantly criticised for being behind-the-curve and carry trades were rife. Importantly, the strongest currency trend over that period was dollar weakness. So although some believe the dollar downtrend has raced too far ahead, we don't think the valuations issuing a warning ticket will be enough to stop the trend into year-end.

Yen is back

Maintaining our bias to be contrarian, we think the yen may end up being the biggest winner against the dollar. It has yet to significantly overshoot against the dollar, unlike every other G10 currency. Real yields are moving in its favour and nominal yields versus the US are negligible. The twist this time compared to 2002-2007 is that intervention may be less forthcoming thanks to a new party being on power in Japan and the likely influence of the US auto industry on US tolerance of any intervention. USD/JPY will likely break below last year's low of 87 and could even reach 80 over the next 3-6 months.

Euro marches on as the dollar carry trade returns

The willingness of the Fed to always cut on any whiff of a slowdown has been one of the primary sources of dollar weakness over the past eight years. With rates now close to zero and likely to remain so for the next two quarters, the dollar will likely become the choice funding currency over the yen. Even if the Fed was to hike, history suggests that may not be dollar positive to start with. Risk aversion may not help the dollar much either this time in the absence of dollar shortage issues and US repatriations. A double-dip in the Euro-area would see the euro falter, though that is not our base case. And so hitting a valuation limit would be the more likely break on dollar weakness, but that would not happen until 1.55-1.60, so until then we stay long euro and short dollar TWI.

Rate differentials and growth cycle drives G10 FX

Economic normalisation has led to serious discussion of central bank "exit strategies", including the location and timing of eventual rate hikes across the G10. Norway may be among the first G10 countries to hike due to a relatively strong labour market, lending support to NOK. Meanwhile, Sweden's Riksbank has been among the most aggressively loose central banks during the crisis – any retraction of this aggressive will remove a major

impediment to EUR/SEK lower. By contrast, SNB policy tightening is likely to lag the rest of the G10, and their continuing interest in intervention prompts us to remain short CHF. The dovish Bank of England is also likely to weigh on GBP long-term, but the short-term bounce in UK economic data compels us to remain neutral on sterling. In Australia, due to a front-loaded stimulus, some of the growth in the first half was "borrowed" from second-half activity. Thus, AUD is likely to underperform other risk sensitive currencies such as NZD. Meanwhile, the Canadian dollar appears fairly valued *vis-à-vis* the commodity/growth cycle. The Bank of Canada may hike as early as April or June, but it is too early to establish long CAD positions in interest-rate sensitive crosses.

Signs of life in Asia

We are positive on the "cyclical" Asian currencies (i.e. KRW, TWD, SGD, MYR, and THB); most particularly, on the Korean Won. We believe a recovery in exports, a turn in local monetary cycles, and a likely resumption of RMB appreciation will favor a greater accommodation by central banks of currency appreciation in the next 3-6 months. We thus reiterate our core recommendation to be short USD/KRW (initiated at 1274, target 1180) and short 1y USD/CNY NDF (initiated 6.80, target 6.65). As a hedge, we suggest a 6m short position in the SGD NEER.

EM FX and FX as an asset class

The onset of monetary tightening should also benefit EM FX as the developing world has emerged from the crisis in a strong position relative to the G10. Nominal EM appreciation tends to be contemporaneous with – and does not precede – hiking cycles, causing us to be generally bullish EM FX. In particular, we like BRL, MXN, PEN, and CLP in LatAm. We also like long RUB due to increasing energy exports and attractive carry. On currency beta, we exit carry but stay long valuation and momentum.

How did our last Blueprint Trade recs do?

Our trades were quite successful overall: 13 of 18 (72%) were profitable, and average P&L was 3.0%. The bearish dollar theme paid handsomely, as EUR/USD rose 7.1% and USD/JPY fell 4.5%, while USD TWI fell 6.5%. Short USD/Asia similarly benefited from dollar weakness. The long Scandic trades did well, and in EM, our normalization trades also performed, as BRL, TRY, and HUF returned 14.0%, 3.3%, and 2.1%. On the downside, ILS appreciated (costing us 4.5%), while our intra-EM, long TRY/ZAR trade lost 7.2%. Short CHF, short MXN, long RUB basket, and long GBP/CAD were about flat.

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