Emirates NBD

بنك الإمارات دبي الوطني

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FX Week

EUR gains unravel

The end of last week saw a sharp reversal in EUR/USD undoing all of the strength it received in the past fortnight on the back of the US October government shutdown. The move down followed a less dovish tone taken by the Fed following its latest FOMC meeting, but more importantly it reflected a sharp deterioration in Eurozone economic data, with inflation, unemployment and sales data in the single currency area all disappointing markedly and putting another ECB rate cut at this week's Council meeting into play. Increasingly investors have been viewing EUR/USD purely through the prism of the US economy alone, ignoring the broader themes and risks associated with the Eurozone. These are concerns and risks which we have we have frequently highlighted, however, despite the EUR's rally, and having closed last week at 1.3486 EUR/USD is now back within striking distance of our one-month forecast of 1.34.

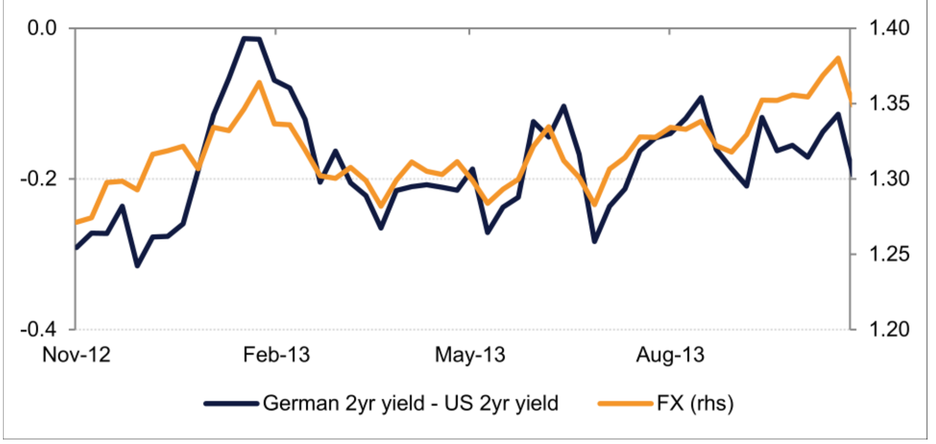
EUR/USD not just a function of US fundamentals

Investors received a salutary reminder late last week that exchange rates are more than a judgment on just one currency, but are a ratio of two. The EUR has been creeping higher in recent weeks largely on the back of the vulnerability of the USD, with the fragilities of the Eurozone being largely ignored or overlooked. Thursday's Eurozone economic data, however, reminded that the US is not the only major economy with significant problems. In fact the US Treasury appears to have been at pains to point this out as well, signaling out Germany last week in its latest currency report for building up a huge trade surplus and calling for it to boost demand. This message was subsequently echoed by the IMF, which is likely to keep the EUR in the spotlight for the near term at least.

An ECB rate cut is back in play

Eurozone inflation dropped from 1.1% in September to 0.7% in October, its lowest rate since late 2009, with core inflation accounting for the bulk of the decline, falling itself to 0.8%. Both readings are now well below the ECB's 2.0% inflation target, and flirting with deflation, making it increasingly difficult for the ECB to argue that the decline is due to temporary factors as Draghi suggested in October. Meanwhile the unemployment data rose to 12.2% from 12.0% confounding hopes that the worst of the labour market deterioration might be over. Furthermore, sales and spending data in Germany and France (the two largest economies in the Eurozone) registered negative readings for September after already soft outturns in August.

EUR/USD reverses sharply



Source: Bloomberg, Emirates NBD Research

As we have long retained a forecast for the ECB to cut interest rates further, to 0.25% from 0.50% currently, we would not be hugely surprised if this were to happen in the coming week. Markets certainly see this possibility, but they have been disappointed before. Other options would be to resort to unconventional measures such as issuing more LTROs, or setting negative deposit rates, but it might be strange to do these when conventional measures have not been fully exhausted. Finally the ECB may just signal its intention to 'wait and see' giving it time to evaluate new forecasts for growth and inflation due next month. Needless to say the EUR is likely to at least remain pressured until the ECB meeting on Thursday, especially with data from the Eurozone expected to remain sluggish.

The US moves out of the spotlight for once

In contrast to the weak Eurozone data, the US printed fairly encouraging data at the end of last week, with the ISM manufacturing index actually rising to 56.4 in October from 56.3, defying expectations of a slowdown. This is a strong reading consistent with growth of close to 3.0% in Q4, with the data appearing to suggest that the US manufacturing sector was little affected by the government shutdown last month. Another regional survey in Chicago rose to 65.9 in October from 55.7, for the largest monthly gain in thirty years. Coming after the Fed already appeared less dovish than expected last week, the markets appear to be reassessing expectations of a week ago that the QE tapering might not begin until March 2014. We think this reappraisal is sensible, as it is still clearly too early to properly assess the impact of the government shutdown on the broader economy, or of the ongoing fiscal policy uncertainty with fiscal deadlines again looming in early 2014.

….despite payrolls and growth data due this week

USD/JPY's recent losses have reflected the broad weakness of the USD driven by fears that the Fed will postpone tapering QE for an extended period of time. In terms of Japan's own economic fundamentals nothing much has changed, however, to alter the need to maintain the easing that is underway in order that the 2.0% inflation target is met. This week the Bank of Japan will meet and will release its semi-annual 'Outlook for Economic Activity and Prices'. It is likely that the BOJ will remain optimistic about meeting its inflation target, but it may still require more monetary policy stimulus measures to ensure this. This should enable USD/JPY to find a floor close to current levels around 97.0.

USD/JPY awaits more BOJ stimulus

Elsewhere this week, there will be focus on the Indian RBI, on the New Zealand RBNZ and on the Central Bank of Egypt which all have monetary policy meetings to consider. Last week the Bank of Canada removed its tightening bias, and the Governor of the RBNZ hinted at intervention to soften the NZD even as it maintains an intention to tighten monetary policy. The RBA's governor Stevens will also be speaking in the week ahead, with his comments about the AUD likely to be closely watched in the light of its recent strength. In this respect Chinese economic data will also be of interest in coming days for signs as to whether Q3's economic stabilization looks likely to continue, which in the process could help to underpin resource exporting currencies like the AUD.

Caution merited on GBP

GBP lost ground as the USD recovered last week, but it recovered against the EUR as the greater surprises were negative Eurozone ones. The UK is not without its own problems still, however. Although there has been a clear upshift in the economy as reflected in a Q3 quarterly growth rate of 0.8%, the sustainability of this recovery is still open to question. Our view is the recovery is disjointed, with strength seen in some aspects of domestic demand (housing) but weakness still prevalent in others, and with the external trade deficit still severe. And even in terms of the positive data, our suspicion is that the survey data contained in the PMI indices overstates the true level of expansion, and will have to go a lot further to drive unemployment down. The PMI series for manufacturing, construction and services are all undoubtedly expanding strongly, but other surveys have been much less encouraging, including from the CBI where output and sales surveys have been weak.

It is worth remembering that the PMI indices have often overstated UK recoveries in the past, most notably in 2010 when they failed to translate into a sustainable recovery in GDP growth. So we would be cautious about over interpreting the current signals, especially in the context of a still weak labour market which is what the Bank of England is really looking at. This week the BoE's MPC meeting is widely expected to announce unchanged policy, which would leave the repo rate at its historic low of 0.5% (in place since March 2009) and the QE total at GBP 375 billion. No statement is likely, as is usual after no-change decisions, which should mean that it is a relative non-event for markets. We continue to see GBP as likely to outperform the EUR over coming months, but think that the markets have become too optimistic about GBP/USD and see it slipping back towards 1.55 over the coming year.

Swiss inflation and the RBA complete the week

Two other events stand out in the coming week as likely to be influential for currencies. First the RBA will be meeting to set monetary policy in Australia. We expect the RBA to maintain its dovish bias for now, supported by the slowing in Q3 CPI to a 2.2% y/y rate, versus a 2.4% y/y rate in the prior quarter. The RBA also releases its monetary policy statement on Thursday, which will provide additional insights into the Bank's perspective. In terms of both of these events the markets will be on the lookout for more verbal intervention from Governor Stevens, following his warnings last week that 'at some point in the future the AUD will be materially lower than it is today'.

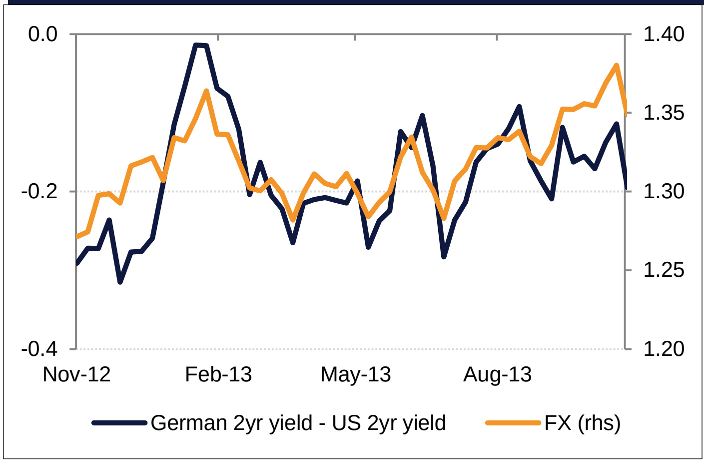
Finally in Switzerland the focus will be on Swiss inflation data. An unchanged reading of -0.1% y/y should keep the focus on what more can be done to ignite inflation in Switzerland, with suspicions the EUR/CHF cap could be raised from 1.20 never far away.

FX Forecasts - Major						Forwards		
	Spot 1.11	1M	3M	6M	12M	3M	6M	12M
EUR / USD	1.3487	1.34	1.31	1.27	1.20	1.3489	1.3492	1.3500
USD /JPY	98.67	100.0	103.0	107.0	110.0	98.61	98.55	98.36
USD / CHF	0.9123	0.93	0.95	0.98	1.04	0.9116	0.9108	0.9087
GBP / USD	1.5921	1.60	1.57	1.56	1.55	1.5910	1.5899	1.5875
AUD / USD	0.9438	0.92	0.90	0.88	0.85	0.9381	0.9326	0.9210
USD / CAD	1.0420	1.05	1.06	1.07	1.10	1.0444	1.0468	1.0517
EUR / GBP	0.8469	0.84	0.83	0.81	0.78	0.8476	0.8484	0.8501
EUR / JPY	133.08	134	134.9	135.9	132.0	133.08	133.08	133.08
EUR / CHF	1.2305	1.25	1.24	1.25	1.26	1.2297	1.2289	1.2268
FX Forecasts - Emerging						**Forwards**		
	Spot 1.11	1M	3M	6M	12M	3M	6M	12M
USD / SAR*	3.7503	3.75	3.75	3.75	3.75	3.7506	3.7510	3.7520
USD / AED*	3.6730	3.67	3.67	3.67	3.67	3.6727	3.6728	3.6725
USD / KWD	0.2826	0.282	0.285	0.282	0.28	0.2881	0.2904	0.2990
USD / OMR*	0.3850	0.38	0.38	0.38	0.38	0.3847	0.3842	0.3838
USD / BHD*	0.3770	0.376	0.376	0.376	0.376	0.3797	0.3817	0.3854
USD / QAR*	3.6402	3.64	3.64	3.64	3.64	3.6447	3.6482	3.6556
USD / INR	61.7300	62.00	61.00	59.00	57.00	61.7458	61.7593	61.7822
USD / CNY	6.0992	6.15	6.15	6.20	6.20	426.4392	475.8492	617.0992

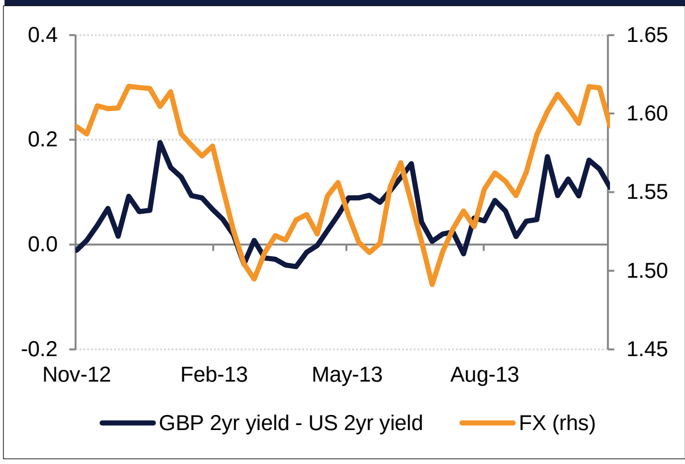
**Denotes USD peg*
Source: Bloomberg, Emirates NBD Research

Major Currency Pairs and Interest Rates

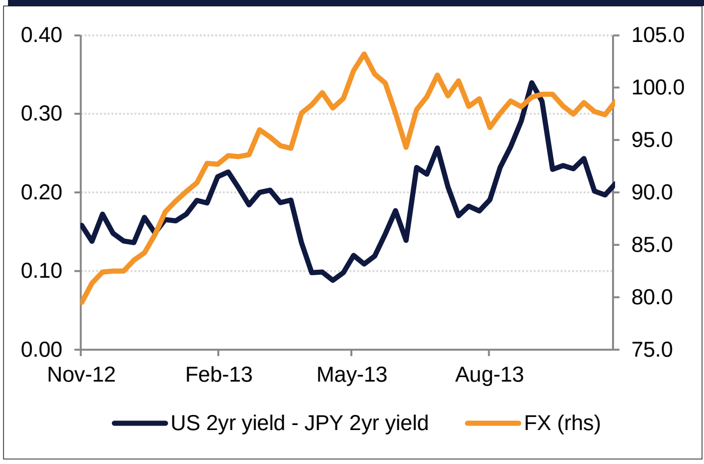
Interest Rate Differentials - EUR



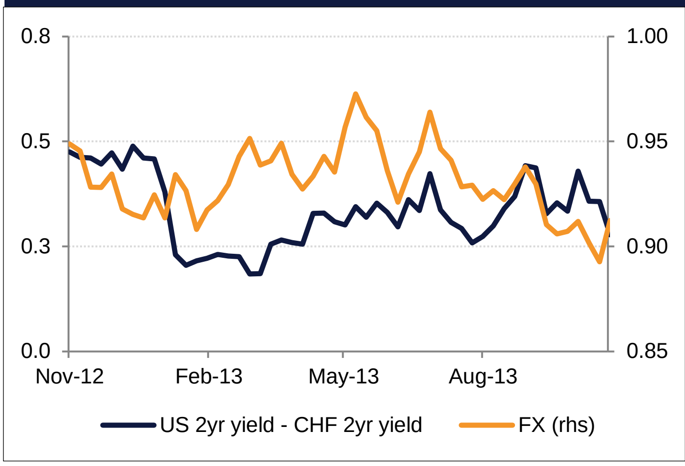
Interest Rate Differentials - GBP



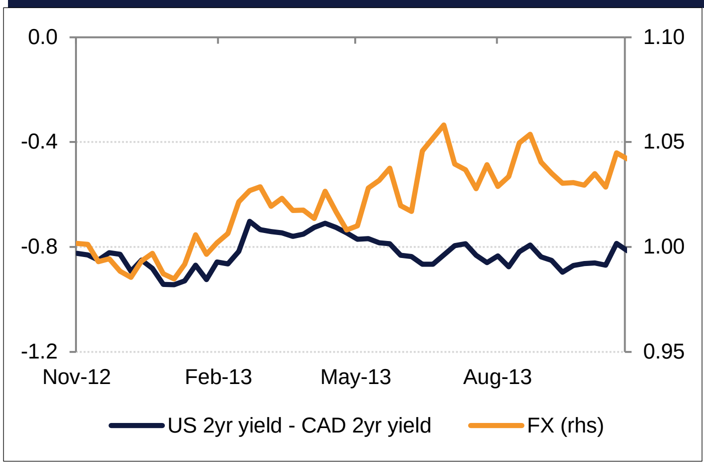
Interest Rate Differentials –JPY



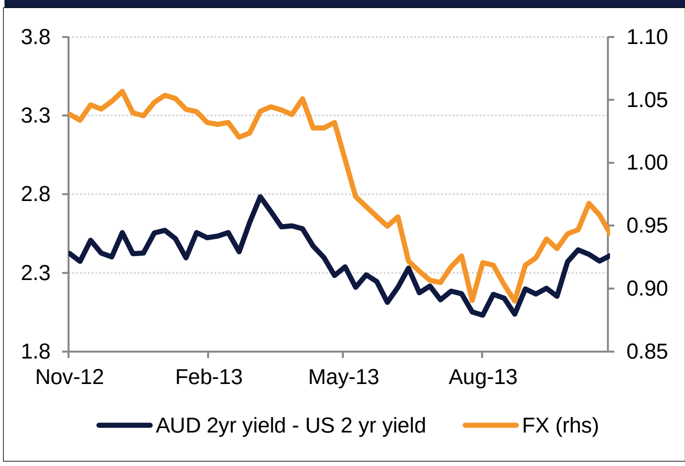
Interest Rate Differentials - CHF



Interest Rate Differentials - CAD



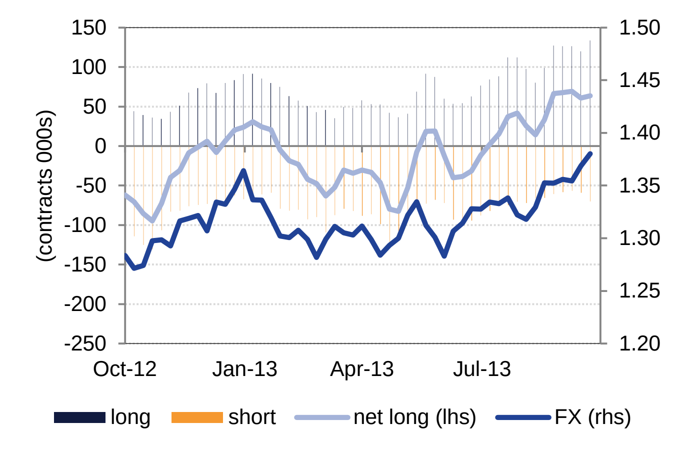
Interest Rate Differentials - AUD



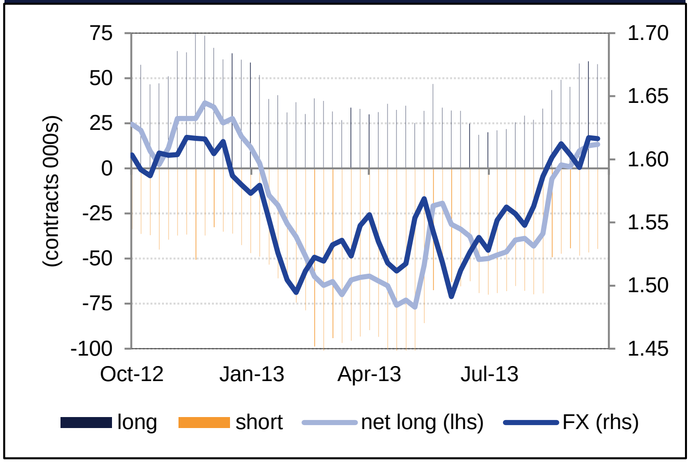
Source: Bloomberg, Emirates NBD Research

Major Currency Positions*

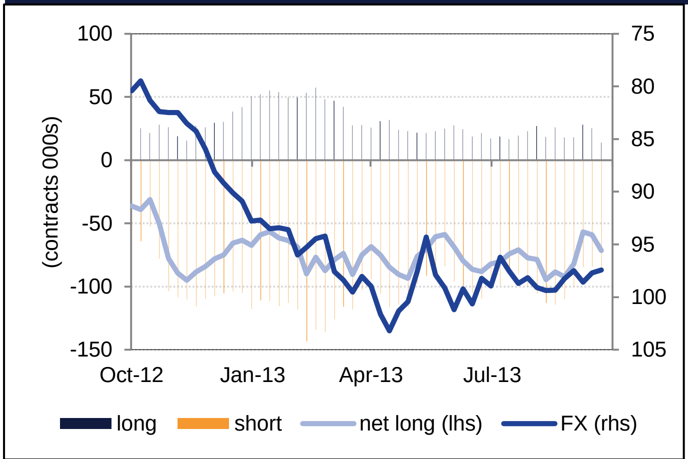
CFTC – Speculative Positions - EUR



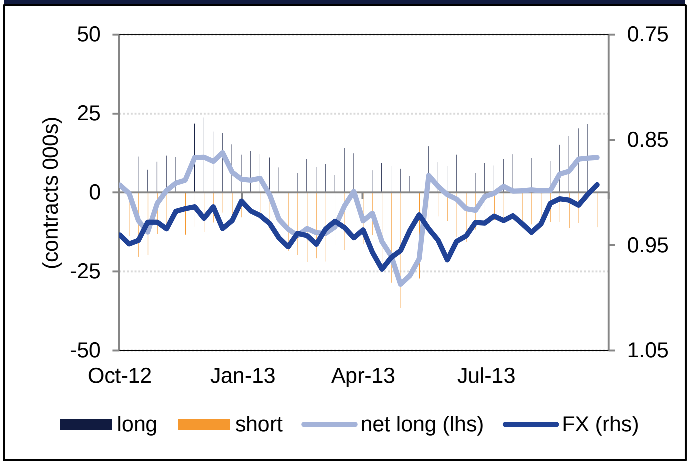
CFTC – Speculative Positions - GBP



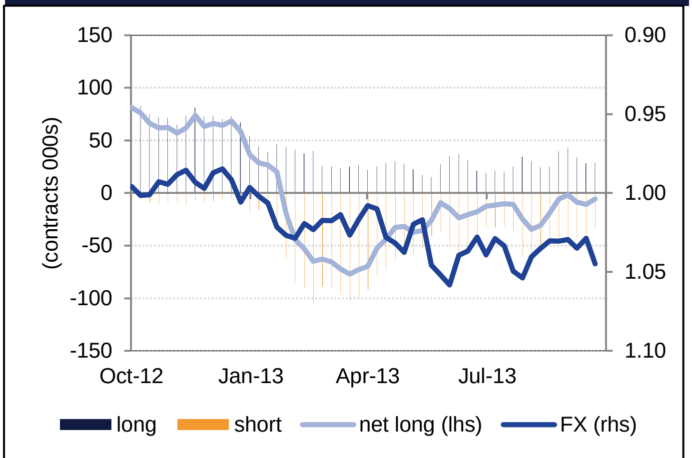
CFTC – Speculative Positions - JPY



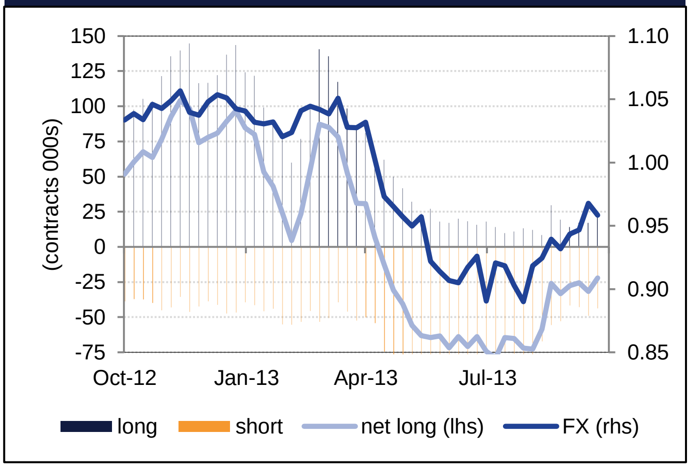
CFTC – Speculative Positions - CHF



CFTC – Speculative Positions - CAD



CFTC – Speculative Positions - AUD



Source: Bloomberg, Emirates NBD Research
**Data as of 1 November , 2013*

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