Introduction

Calendar year 2016 has come in with a burst of volatility. The MSCI World equity index is down 8% and the CRB commodity index is down 9%. Global interest rates have plummeted. In FX, commodity currencies have tumbled, while JPY has surged higher. A popular USD index is up 1.4% in just two weeks of trading.

Global markets appear to be pricing in a rising and relatively high probability of a global recession. Based on various monthly economic indicators, it does appear that the global economy has slowed slightly, but there is nothing in the data (yet) to confirm all of the recession fear. Markets need to react early and they could be right, but they tend to price in three recessions for every one that actually occurs.

This century has already seen a number of episodes of panic that reverse almost as quickly as they appeared. We expect that the current episode will prove to be another in the annals of premature panics. From what we can tell, financial market liquidity is exceptionally thin, which has caused an exaggerated response to a barely noticeable ‘soft patch’ in economic data. But under that soft patch, we have China and the US continuing to grow at roughly the pace of the past four years as Europe and Japan gently accelerate.

Our core scenario is a recuperation of market confidence over the next 2-4 months. If that occurs, we think the Fed will continue to hike rates. With the way that markets have moved to price out further rate hikes in 2016, pricing them back in should be positive for the USD. Based on that scenario, we are still looking for 3-5% of additional USD appreciation over the next few months.

We openly acknowledge that we could be overly optimistic. If we are wrong and the global situation really is more dire than the data currently shows, then the USD should rally for a different reason: full-fledged panic. The difference between the two USD rallies is that a global recession USD rally has EUR & JPY holding steady or gaining a bit while emerging currencies sell off. A Fed-on USD rally has EUR and JPY selling off aggressively while emerging currencies get steamrolled. That is the scenario we favor. We are particularly bullish on USDJPY at present levels. We expect it to return to 123 over the next three months. We acknowledge an alternative path to that level. If risk appetite deteriorates substantially further, the BoJ could ease policy at either its January or March meeting. Further ECB easing looks unlikely for now, but it also cannot be entirely ruled out—particularly if EURUSD continues to move higher.

The Canadian dollar and commodity cousins AUD and NZD are down 5% on the year already. We look for further declines as their central banks cut rates and the market goes back to pricing in Fed rate hikes. These currencies would fall even more aggressively under a global recession scenario, so we see decent value is shorting them at present levels—even if they are at or near decade lows.

For local market currencies, the China watch continues. We don’t expect China to shift its FX policy in a major way. We are only looking for about 2% in additional RMB depreciation. But if RMB weakness proves to be more pronounced, most other local market currencies will follow RMB lower.

There will undoubtedly be other major factors that end up influencing FX markets this quarter. No single document can adequately explore all the intricacies of markets as complex as FX. We readily admit that we are only scratching the surface in this report. Our style, which is ‘presentation’ rather than ‘textbook’ leaves many risk scenarios and other points under-discussed. We would be delighted to discuss them with you and your team. Please contact your BMO representative to arrange a conference call or meeting.

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# Economics Team’s economic forecasts

## Economic Forecast Summary for January 15, 2016

BMO Capital Markets Economic Research

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<td>Q2</td>
<td>Q3</td>
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Section 1: Global macro factors
Global economic growth appears to be decelerating slightly

- We estimate that world GDP growth slowed by about 3 tenths to 2.4% YoY. If so, this would slow the rolling 4Q average by a tenth to 2.3% YoY. Q4 data is unavailable (except for China) but growth appears likely to have been somewhat slower than Q3. However, Q4 should not be anywhere near a contraction.

- Most of the global angst is focused on China, but there is increasing market chatter of a global recession.

- Monthly composite PMI data shows that China’s producer sentiment regarding output slowed in 2015 (relative to the 2013 and 2014 average). The data also shows Dec-15 as considerably slower than the year’s average.

- The UK shows a similar deceleration trend as China. The US didn’t show any meaningful difference between 2015 and the previous two years, but it did show a deceleration in December.

- The same PMI data suggests that the Eurozone and Japan are accelerating.
Global commodity prices are tanking—especially energy and base metals

- Brent crude fell 36% in 2015 and is down another 23% in the first two weeks of 2016. Brent has reached a new low since 2003. The global supply glut and fears that it won’t clear have the oil industry in a panic.

- Gold fell -10% in 2015 but is up 2.7% in the first two weeks of 2016. The gold decline of 2015 roughly matches the USD move, so that gold was roughly flat in a non-USD currency basket in 2015.

- Industrial metals haven’t fared much better than oil. The Bloomberg industrial metals index fell 27% in 2015 and is down another 6% thus far in 2016.

- The Bloomberg agricultural commodity index fell 16% in 2015 and is down another 1% thus far in 2016. That performance is substantially better than energy and base metals, but lags precious metals just slightly.
Global interest rates are declining rapidly—particularly in Canada

- Despite the Fed’s first rate hike in 9 years, the US’s 5Y swap rate fell 3bps in 2015 and is down a shocking 36 bps in the first two weeks of 2016
- CAD 5Y swap rates fell 59bps in 2015 and are down another 35bps in 2016, so the rate reduction has been far more severe than for AUD, which has seen the equivalent rate fall 5bps in 2015 and 26bps in 2016
- GBP rates have fallen the most thus far in 2016 (-37bps) but they rose 14bps in 2015, so the YoY change is small
- EUR and JPY-denominated 5Y swap rates don’t have much room to fall. EUR 5Y swaps are down 10 bps in 2016, while JPY swaps are down 3bps
- The convergence in swap rates (towards the bottom) is a benefit to EUR & JPY relative to AUD & CAD
Global equity markets are under pressure

MSCI World (in USD) daily and YTD returns

2015 and 2016 YTD returns for MSCI country indices

- MSCI World rose 0.2% in 2015 in local currency terms, but fell 4.3% in USD terms. Thus far in 2016, MSCI World local is down 8.4%, while MSCI World USD is down 8.7%.

- The sharp decline of early 2016 is about the same magnitude as the decline in August-September of 2015. However, daily volatility is lower this time around—it’s just that a run of negative days has made it ‘feel’ worse. Eight of ten days have been negative thus far in 2016.

- Japan and the Eurozone are the currency zones that showed positive returns in 2015, presumably with a big assist from QE. Thus far in 2016, QE isn’t helping those two equity markets. They are underperforming, presumably because their currencies are appreciating, which undercuts profitability.

- Latin American equities quietly took a worse beating than Chinese equities in 2015. Thus far in 2016, China is showing the worst returns, but LatAm’s are still bad, despite the boost that should come from currency weakness.
Section 2: FX returns, volatility, volumes & positions
Returns and carry of G20 currencies showed a massive divergence in Q4

**Q4 spot returns (against USD)**

- AUD: 3.7%
- CAD: -3.9%
- CHF: -2.9%
- EUR: -2.9%
- GBP: -2.9%
- JPY: -0.3%
- NOK: -3.8%
- NZD: 6.5%
- SEK: -5.5%
- USD: 0.0%
- BRL: -0.3%
- CNH: -3.2%
- INR: -0.9%
- KRW: 0.9%
- MXN: -1.7%
- PLN: -3.2%
- RUB: -10.4%
- TRY: -11.0%
- ZAR: -15.0%

**3M annualized carry (against USD) as of 14-Jan**

- AUD: 1.7%
- CAD: -0.1%
- CHF: -1.5%
- EUR: -1.0%
- GBP: -0.1%
- JPY: -1.0%
- NOK: 0.4%
- NZD: 2.2%
- SEK: -1.1%
- USD: 0.0%
- BRL: 11.7%
- CNH: 7.0%
- INR: 5.5%
- KRW: 0.9%
- MXN: 2.5%
- PLN: 0.8%
- RUB: 10.0%
- TRY: 10.3%
- ZAR: 6.8%

- In G10, NZD was the biggest winner in Q4, while SEK was the biggest loser.
- In Local Markets, ZAR was the biggest loser in Q4, while TRY was the biggest winner.
- Carry remains unattractive for buy and hold strategies in G10 space. Even the highest carry cross (long NZD/CHF) offers only 3.7% annualized carry.
- Among LM currencies, several offer carry over 10%, which will make them magnets when risk appetite improves.
Realized volatility and Implied volatility of various currencies

**Q4 Realized Volatility of Daily Returns**

- AUD: 10.9%
- CAD: 7.7%
- CHF: 9.9%
- EUR: 11.0%
- GBP: 7.8%
- JPY: 6.4%
- NOK: 12.4%
- NZD: 12.2%
- SEK: 10.0%
- USD: 0.0%
- BRL: 21.4%
- CNH: 4.0%
- INR: 5.0%
- KRW: 9.3%
- MXN: 9.7%
- PLN: 10.2%
- RUB: 13.4%
- TRY: 13.4%
- ZAR: 20.3%

**3M Implied Vol vs USD as of 14-Jan (atmf, mid)**

- AUD: 12.9%
- CAD: 11.1%
- CHF: 10.0%
- EUR: 10.2%
- GBP: 8.7%
- JPY: 10.3%
- NOK: 12.5%
- NZD: 14.3%
- SEK: 10.8%
- USD: 0.0%
- BRL: 19.4%
- CNH: 9.1%
- INR: 7.4%
- KRW: 12.2%
- MXN: 13.5%
- PLN: 12.0%
- RUB: 20.9%
- TRY: 14.2%
- ZAR: 20.8%

- NOK and NZD had the highest realized volatility (using daily closes) among G10 currencies in Q4 while BRL and ZAR hold that distinction for local market currencies.
- In addition to NOK, realized volatility measured high for other European currencies too. EURUSD and USDSEK realized volatility was above 10.0%, while for USDCHF it was 9.9%. Realized volatility was exceptionally low for USDJPY. Realized volatility was roughly in line with historical norms for local market currencies.
- The options market is pricing in slightly higher implied volatility for Q1 2016 than Q4 realized volatility.
FX volume fell sharply in Q4

- EBS volume fell off a cliff in Q4; it was down 35% YoY. Over the past ten years, the average QoQ drop in volume for Q4 is 6% but for 2015, the drop was 14%. The EBS platform is the most used platform for pairs including EURUSD, USDJPY, GBPUSD and EURGBP.
- The Reuters platform is the most used platform for pairs including USDCAD, AUDUSD, NZDUSD and USDMXN.
- The Reuters Platform (including FXAll & Matching) had Q4 volume down 21% YoY. Q4 volume was down 13% QoQ vs a normal Q4 decline of 10%. For the entirety of 2015, Reuters volume was down 6% YoY.
- The decline in FX volume is much steeper than the stagnation in global trade would suggest. Investors appear to be abandoning foreign markets. They also appear to be abandoning the FX category.
FX manager returns were soft in 2015 but are encouraging in early 2016

- BTOP FX investors (who tend to be trend followers) had a solid quarter in Q4, gaining 1.05% for the quarter to end the year with a 1.73% return.
- BTOP members lost 0.40% on the trickiest day of Q4 (ECB decision day 03-Dec) but made up for it with strong gains in the last 3 weeks of December.
- Parker-Blacktree investors (mostly quantitative macro systems users) lost 0.51% in Q4, which brought their return for calendar 2015 down to a loss of 2.26%.
- Parker-Blacktree members lost 0.83% on 03-Dec but also made back that particular loss later in December.
- Weak performance is presumably pushing investment capital away from the FX category. However, the good news is that both indices have started 2016 with gains in the vicinity of 1% in just 2 weeks of trading.
Over the course of 2015, the general pattern in the BTOP generally followed the pattern of Bloomberg’s liquidity-weighted USD index, which suggests that long-USD was generally the prevailing position.

Starting in late October, BBDXY took off but BTOP stayed stagnant until mid December, which suggests BTOP investors didn’t have the long-USD trade on in size. But over the last three weeks, BTOP has gained 2.6% while BBDXY gained 2.1%. This suggests BTOP investors were well positioned for risk off on crosses like AUDJPY.

As noted on page 15, the Parker Blacktree lost ground in 2015. It’s general pattern often followed the pattern of BBDXY, but not always. This allows use of an alternative way of gauging their positions in the US dollar. This is done by charting a rolling 1-month beta of the Parker Blacktree index regressed on BBDXY. The beta analysis suggests that Parker Blacktree managers have been building long-USD positions over the past 2 months.
IMM leveraged funds have historically light FX positions

15-January snapshot of IMM ‘leveraged funds’

- Positioning is generally light across the board.
- Short-GBP, at 69% of the record for that side, is the only position that looks even slightly large.
- Short-EUR and short-JPY were substantial positions in November, but now they are at just 54% and 32% of their respective records.
- CAD has almost nothing on the long side and a moderate short side that is at 43% of its record.
- The position in USD against the aggregate of the other currencies has been trimmed substantially from what it was in late November when the market was focused on the December FOMC. It stands at 46% of the record established in January 2015.
FX reserves are shrinking as managers continue to shift away from EUR

- China’s FX reserves (now reported monthly) fell 5.2% in Q4 to USD 3,330bn. BRITM (Brazil, Russia, India, Turkey, Mexico) reserves (reported weekly) fell 0.8% in Q4 of 2015 to the equivalent of USD 993bn.

- Data for Q4 isn’t yet available, but global FX reserves fell by 2.2% QoQ in Q3 of 2015, according to the IMF’s COFER data (on 146 countries). Reserves are now $780bn (6.5%) below their peak in Q2 of 2014.

- The IMF gives data of the composition of an ‘allocated’ pool are reported by currency. As of Q3, with partial inclusion of China’s allocation data, allocated FX reserves are composed as follows: USD 64.0%, EUR 20.3%, GBP 4.7%, JPY 3.8%, CAD 1.9%, AUD 1.8%, CHF 0.3%, ‘Other’ 3.2%.

- The USD weight rose by 2 tenths while the EUR weight fell by 2 tenths. Other weights remained roughly constant. However, the steady weights of AUD and CAD in a quarter when they fell 9.6% and 8.2%, respectively, suggests reserve managers bought those two currencies. EUR gained 0.1% but its weight fell, which suggests that reserve managers sold EUR fairly aggressively.
Section 3: USD factors and outlook
USD index long-run wave analysis shows bull phase at least half done

Federal Reserve’s broad real trade-weighted dollar index since Bretton Woods

- The USD is 6% ABOVE its post Bretton Woods average.
- The USD has had about 2¾ cycles in 43 years of floating rates; USD rallies have lasted 6-7 years.
- The bottom of the last cycle was 53 months ago and since then the USD has risen 25%.
US twin deficits have stopped improving and the USD has almost caught up

The ‘Twin Sin Score’ computed by summing the US deficits improved dramatically 2012-2013.

Past turns in the Sin Score have preceded turns in the USD by 1-4 years.

The USD is 3-6% weaker than the historical relationship with the twin sin fundamental says it should be.

The twin sin score for Q2 of -4.8% was the best since Q1 2002 but it deteriorated to -4.9% in Q3.

The trend of improvement in the twin sin score has flattened out so substantial improvement looks questionable.

The twin deficits seem critically intertwined with energy prices and the 2016 election; oil lower for longer deters US production and current account improvement while gridlock seems to be the best setup for the fiscal account.
The USD ‘smiled’ again in Q4

Dollar ‘smile’ theory posits that the USD rallies in periods when markets are frightened (due to safe haven attraction) and in periods when markets are extremely optimistic about the economy (because that they think the Fed will hike soon). Smile theory basically combines risk-on/risk-off with Fed-on/Fed-off explanations of USD index dynamics.

Under smile theory, the USD has negative performance in ‘goldilocks’ periods when markets foresee moderate economic growth that isn’t so weak as to trigger concern about a recession but also isn’t strong enough to trigger Fed tightening.

Bloomberg’s liquidity-weighted USD index gained 1.7% in Q4 to bring the 2015 return to 9.0%. BBXY is already up 1.4% in 2016. The Fed’s broad USD index gained 1.8% in Q4 and 10.5% for 2015. It’s up 2.1% in 2016.

In general, USD behaviour in Q4 conformed to smile theory in Q4 and continues to do so in early 2016.
Dots say one hike per quarter for 2016-2017 but markets price one hike per year

Implied Fed Funds rates from December futures

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<td>Dec 2017</td>
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<tr>
<td>Dec 2018</td>
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FOMC ‘dots’ from the December meeting

- The mean of the 2016 year-end ‘dots’ is 1.29%, which implies 92bps of tightening in 2016. Markets never had 3-4 Fed hikes priced in for 2016. At their highest, they had a little more than 2 hikes priced in. Today there is 1 hike priced in for November or December.

- The mean of the 2017 year-end dots is 2.41%, which would imply that FOMC members were contemplating 4-5 hikes in calendar 2017. The money market only prices in a little more than 1 additional hike in 2017.

- A divergence between the dots and market prices has been there for years, but the current divergence is wider than it has ever been. Markets would be stunned by a rate hike in March and they would be surprised by 2 hikes per year over the next two years. If hikes get priced back in, the USD should continue to rise.
USD to move 3-5% higher in H1 of 2016 and then begin to reverse

- We expect the broad USD to rise about 2% on a 3M horizon and 4% on a 6M horizon
- We expect market sentiment to at least partially recover and the Fed to hike at least once in H1 of 2016
- We expect the USD to peak roughly during the summer and then begin to show signs of reversal
- Once the Fed has hiked 2-3 times, the shock value wears off and other factors become the USD drivers
- The ‘twin sin’ fundamental has already topped out and it leads the USD by 1-4 years
- Elections are negative for current account deficit currencies due to event risk alone, but as the Nov-16 election lines up right now, it appears unlikely to inspire foreign investor confidence
Section 4: USDCAD outlook
• We expect USDCAD to rise to 1.47 on a 1M horizon and 1.49 on a 3M horizon. We expect that to be the peak.

• We think that the BoC will cut its base rate one more time to 0.25%. We expect the Fed to hike at least once in H1 and hike 2-3 times in 2016. The end result will be a 50-100bp yield advantage for the USD by the end of 2016.

• Oil is the other factor that has been so crucial for CAD. We expect oil prices to stabilize around $30/bbl (for WTI) over the next several months before rebounding above $40 by late in the year.

• The nightmare scenario that gets USDCAD back to its 1.62 high from 2002 is oil remaining in the $20s (or lower) for the entirety of the year—prompting the BoC to cut its base rate to zero while the Fed hikes a couple of times.

• The scenario that drives USDCAD back to 1.35 is no BoC cut and a rebound in oil to $50/bbl.
Looking at the longer term and moves greater than 5%, USDCAD almost always follows the USD index—at least in direction. Magnitudes of deviation don’t match as closely as direction, but there has been a general mapping in this century.

The Fed’s broad real USD index is 5% above average, but USDCAD is running about 18% above its post Bretton Woods average. So USDCAD is running an order of magnitude ahead of the USD index.

BoC rate cuts represent the first reason why USDCAD is ahead. The oil price crash is presumably reason #2.

Key issues: (1) US rate moves influence CAD about the same as other currencies UNLESS the BoC is doing the opposite; (2) commodities tend to move with the USD cycle which feeds back to CAD via BoC monetary policy.
USDCAD and a few more of its most correlated ‘factors’
The 3M OIS interest rate differential has the tightest relationship with USDCAD over the past 6 months.

The price of West Texas Crude is only slightly behind in its ability to predict USDCAD 1 day out of sample.

Interest rate (navy blue) and commodity (medium blue) factors have been more predictive than risk appetite factors (orange) over the past few months.

Like spot, fair value from our rotating financial factor model has been accelerated higher over the past six weeks on the back of the interest rate differential moving sharply in the USD’s favour and the collapse in oil.

From our model’s perspective, the USDCAD move isn’t an overshoot—it maps almost perfectly with movements in other related financial variables.
Section 5: RMB outlook
RMB – at the center of risk aversion

• We expect USDCNY and USDCNH to trade at 6.70 and 6.73 respectively in 3M. PBoC’s recent weakening of the CNY mid-rate indicates a preference to let market forces do their work as the economy and capital flows adjust.

• Chinese policy makers are tinkering with a number of policy levers to 1) control the pace of RMB depreciation and capital outflows, 2) provide the appropriate level of stimulus to the domestic economy, 3) regulate the build-up of new leverage, 4) rebalance the economy towards consumption & services, 5) engage in social reform.

• These policy levers have turned China’s economy into a great experiment. China is not purely interested in providing palliatives to smooth the economic transition, so the great experiment will continue to act as a brake on global risk appetite and RMB inflows. China is aiming for structural changes and a sustainable growth pattern.

• PBoC began to set the USDCNY mid-rate sharply above the predicted levels of our models in late December and early January. The trade-weighted CNY dropped below its December 2014 base level in January (right chart).
RMB – efforts to engineer a soft landing require a higher risk premium

- At the time of the Global Financial Crisis, China had a lower debt ratio and higher growth potential than the rest of the world along with net capital inflows. Now China has a higher debt ratio, lower growth potential and net outflows.

- PBoC’s loose policy settings are supporting growth by encouraging additional leverage and reducing credit spreads, but China’s growth potential is slowing. Fiscal policy is also set to be relaxed in 2016.

- PBoC-induced improvements in bank lending growth, credit spreads, real estate and financial intermediation require a higher risk premium in the RMB (left chart).

- The trend in the basic balance will provide a cap on the CNY given how strong the currency still is in trade-weighted terms (right chart). However, the basic balance surplus will prevent an extreme fall in the CNY.

- Officials will cap RMB weakness and outflows to avoid self-fulfilling vicious cycles and tighter onshore conditions.
Section 6: FX majors outlooks
• We expect EURUSD to trade at 1.07 in 3M. Sluggish domestic growth, fragile global conditions, the rise of populism and the migration crisis will entrench the ECB in easing mode barring a significant uptick in inflation.

• Fragile market conditions and periods of risk-off will provide support to the euro throughout H1, but both of those factors will also result in a very dovish ECB. The ECB’s 2016 baseline assumption for EURUSD is 1.09.

• Capital markets union is in its infancy stages so the scarcity of assets is forcing the yields on sovereign bonds into negative territory. New debt issuance is also low by historical standards (right chart).

• Eurozone excess liquidity should reach €800 billion in H1, and cross currency basis swaps indicate a surfeit of euros. The December QE extension and the ECB’s new reinvestment programme will add an additional €680 billion in new liquidity to the Eurosystem by 2019.
The nominal goods trade surplus was flat in the 11 months through November. In volume terms, exports fell 2% in the 10 months through October, while imports rose 3%. On a cumulative basis, net exports subtracted from real GDP in the first three quarters of 2015 (right chart). Reserve managers were persistent EUR sellers in 2015.

Gross purchases of foreign assets by Eurozone residents tapered off after China’s August devaluation, but debt and FDI outflows were persistent throughout 2015 and will likely remain so for the foreseeable future (left chart).

An improving economy will keep some capital onshore in 2016, but the ECB will use the weak EUR to prevent growth from being too lopsided away from net exports. The Eurozone does not need another big debt binge.

The annual growth rate of new foreign orders of industrial goods dropped off sharply in H2 2015. Weak productivity growth and investment in fixed capital will continue to cap economic growth potential.
GBP – Carney’s opportunity

GBPUSD outlook

- We expect GBPUSD to trade at 1.42 in 3M, followed by a rebound to 1.50 in 12M. The origins of the December-January pound decline can be traced back to Mark Carney’s dovish interview with the FT on December 15th.

- BoE rhetoric leaned into the phase of USD strength that began in the wake of the December Fed rate hike and the shift in the likely timing of the EU referendum to June/July. Global investors were overweight the pound at the end of 2015, meaning the timing of Carney’s rhetoric was impeccable (right chart).

- Risk-off conditions at the start of 2016 have caused further complications for the pound. A strong USD and a strong euro have prevented the GBP from rebounding.

- Consumer credit growth is strong and household debt-to-income is relatively high amongst developed economies. These factors and a wide current account deficit will continue to insert a risk premium into UK rates and a risk discount into the pound.
GBP – a more balanced profile than market price action suggests

**UK select external position data**

- The current account deficit stabilised during Q3 2015. Better economic conditions in the Eurozone have caused an improvement in the UK’s income deficit. The recent GBP depreciation has pushed the currency in the opposite direction to the one implied by Q3 current account data (left chart).

- Over the four quarters through Q3 2015, UK banks repaid a total of £180 billion in foreign loans. The UK’s refinancing risks are well below the average of the previous 15 years. Inbound FDI & portfolio investment have taken the place of those loans and both are subject to lower refinancing risks.

- UK service sector output grew roughly in-line with its long-run average in 2015, and some aspects of credit growth took off (right chart). Fundamentals favour a targeted tightening of macro prudential policy and a small rate hike in 2016. UK consumer confidence is near a 15-year high.

- A higher base rate should help bank profitability and be less damaging than imposing higher capital requirements.
JPY – poised to rebound on a return of risk-on or (if not) a BoJ policy ease

- We expect USDJPY to return to 123 on a 3M horizon either because risk appetite partially recovers or (if it doesn’t) the BoJ eases policy again.
- We expect USDJPY to continue higher to 127 on a 1Y horizon. For the USD index, we have a small reversal lower in Q4, but for USDJPY we don’t. Improving risk appetite should be positive for USDJPY.
- Warnings of the potential for further policy easing have taken on a slightly stronger tone over the past few weeks, but the BoJ won’t completely signal an easing move because they want it to have an impact on the day it happens. We’d put the probability of an ease around 50% for 29-Jan. The most likely ease is an increase in asset purchases, but a move to negative rates is a possibility.
- Cheap oil is a huge benefit to Japan. It hasn’t yet, but it should stoke consumption at some point.
JPY – improving external accounts but deteriorating demographics

- Japan’s trade balance went negative the month of the earthquake/tsunami/nuclear disaster. But improvement became evident by mid 2014 due to a weaker JPY. Then energy prices collapsed, which greatly reduced the value of imports. December data is still pending, but it looks like Japan’s trade balance for 2015 was almost flat.

- Japan had heavy outbound FDI for the 2011 to 2014 period, but that was beginning to wane prior to the oil crash and should wane further now that Japan can access cheap energy for industry.

- With US interest rates rising, a positive basic balance looks to be restored.

- But permanently escaping deflation and reducing the large stock of government debt may prove difficult with the work force declining in absolute terms and Japanese society aging rapidly.
Section 7: G5-10 outlooks
AUD – headed a bit lower still due to China, commodity and divergence pressures

- We expect AUDUSD to drop to 0.66 in 3 months and then 0.65 in 6 months before rebounding slightly to 0.66 at the end of 2017.
- AUD is the most China-linked G10 currency and is therefore used as a China proxy—particularly for those who want to get long of China risk (because AUD offers carry).
- AUDUSD is also driven by a combination of interest rate differentials and commodity prices.
- We expect the RBA to ease policy in either February or March and then again at some point July – September.
- We expect commodity prices to touch bottom soon and then rebound a bit in Q4. This should help stabilize AUDUSD even as AUD’s interest rate premium narrows due to Fed hiking and RBA easing.
CHF – the SNB is still holding back an avalanche

**USDCHF outlook**

- We expect USDCHF to trade at 1.01 in 3M and 1.02 in 6M, followed by an appreciation of the franc back to 0.99 in 12M. The BoP is still a big headache for the SNB. This is partly due to the positive impact of merchanting activities on the current account and an excess of domestic savings over investment.

- The C/A surplus stood at CHF23bn in Q3, while the offsetting combined deficit on portfolio investment, FDI and other investment was just CHF8bn. CHF would have appreciated in Q1-Q3 without SNB intervention (right chart).

- Portfolio investment and FDI outflows picked up after the Jan-2015 CHF revaluation, but the 4Q total combined balance on the current account, portfolio investment and FDI has been positive since Q3 2009.

- The trade-weighted CHF appreciated in Q3 & Q4 as global equities fell, but it has been curiously flat during January’s turbulence (SNB intervention). Broad money supply and credit growth were strong again in H2 2015. The threat of imbalances means a Fed rate hike pause or a big ECB QE add would tie the SNB’s hands again.
NOK – Crude realities collide with structural ills

USDNOK outlook

- We expect USDNOK to trade at 9.15 in 3M followed by a rebound in the NOK during H2 2016 as oil prices stabilise. However, USDNOK is likely to remain well above its long-run average (6.60) beyond year-end.
- Weak energy prices will see drillers look for innovative ways to lower their costs and streamline their operations. However, this process will be slow, with oil & gas investment spending growth set to contract again in 2016.
- Fiscal policy may have to be tightened in the short run to prevent transfers from the Pension Fund (which cover the non-oil budget deficit) from fuelling bubbles. Norges Bank monetary policy will remain looser for longer.
- A medium-term risk premium will remain embedded in the NOK due to high drilling costs, the development of alternative energy sources, slower EM growth and a record inflation-adjusted non-energy trade deficit.
- Brent crude oil is back to its 60-year average. In real terms, the trade surplus is also mean-reverting (right chart).
NZD – likely to face one more leg down before a late-year recovery

- We look for NZDUSD to return to around 0.64 on a 3M horizon and then drop to 0.62 in 6M as the RBNZ eases again. We look for a recovery back to 0.64 on a 12M horizon as commodities begin to rebound and the US election steers investors away from the USD.

- The RBNZ has backed off from earlier aggressiveness but still does its best to steer NZD lower. As it evaluates exchange rates, the RBNZ looks at AUDNZD as much as NZDUSD.

- NZDUSD looks a little overvalued relative to its 2Y interest rate differential right now.

- NZ exports agricultural commodities to China, so NZD has some China sensitivity, but not as much as AUD.

- As a pure importer of oil, New Zealand’s balance of payments benefits from the dramatic decline in oil prices.
SEK – an ERM-II currency in all but name

**USDSEK outlook**

- We expect USDSEK to trade at 8.80 in 3M and 8.80 in 6M, followed by a modest SEK rebound to 8.58 in 12M. At the expense of domestic imbalances, loose Riksbank policy helped growth accelerate in H2 2015. Substantial net portfolio & direct investment outflows will continue to weigh on the SEK during risk-on periods in financial markets.

- Merchanting activities and net investment income inflows are boosting the current account surplus, but this masks the underlying competitiveness issues facing goods trade (right chart).

- Riksbank officials can now intervene directly in the FX market at any time and in any direction. The Riksbank is drifting away from using the benchmark rate to manage inflation towards an FX management regime.

- If EURSEK were inside of ERM-II with +/- 2.25% trading limits and a central parity rate equal to its long-run average, the Riksbank would be aiming to keep EURSEK at around 9.30 with 9.50 and 9.10 as the upper and lower ends of the band. That was the EURSEK range for Q4 and we expect it to continue to be the range.
Section 8: Select local market currencies
BRL – On the verge of stabilizing as core flows turn positive

• We look for the USDBRL to remain above 4.00 for the several months. Our 3M view is 4.15, while our 6M view is 4.10. Our 1Y view is 4.00.

• Although political scandals are a part of the story, Brazil’s troubles tie back to commodity prices. The weakness in commodity prices has caused Brazil to run large twin deficits. However, even as commodities continue to fall, Brazil’s current account deficit has begun to recover. This has led to a tiny core flows surplus.

• Brazil has a long history of excessive exchange rate swings. The move from 2.00 to 4.00 over the past three years is just one example. Once commercial flows get momentum rolling in a particular direction, it snowballs. Olympics-related tourism inflows should bolster the budding core flows surplus and turn momentum by the end of the year.

• BRL has the highest carry in the G20, so once carry traders sense that it has stabilized, they will short USDBRL.
INR – EM catch-up risks have risen

• We expect USDINR to trade at 71 in 3M. The RBI will have little choice but to let the INR weaken as China and the rest of Asia devalue a bit further.

• The INR has enjoyed a long-run of exceptionally low volatility and relative outperformance. H2 2015 saw steady INR inflows and a rise in RBI FX reserves. Net exports declined thanks to weak external conditions and strong domestic demand in India. The RBI needs the INR to weaken to help prevent net exports from falling too far.

• 2015 saw the improvement in the merchandise trade deficit decelerate. Foreign debt and deposit inflows rose while urban consumers increased their borrowing. A slower pace of RBI easing in H1 2016 will contribute to a reduction in net capital inflows before stabilisation sets in around mid-year.

• India’s economic outperformance will keep the RBI cautious on 1) further rate cuts and 2) INR intervention sales. A further rise in relative prices will harm India’s competitiveness as the rest of Asia devalues (right chart).
We expect USDKRW to trade at 1,235 in 3M, followed by a small reversal to 1,224 in 12M. The large trade surplus suggests Korea does not have a major competitiveness problem, but it does have the dual threats of a weaker RMB and additional BoJ easing to consider.

The KRW fell vs both CNY and JPY in 2015. However, it outperformed the ADXY and the trade-weighted index is about 8% above its early-2010 level (right chart). In January, the BoK downgraded its 2016 CPI and GDP forecasts. National security threats and the weak RMB will keep the BoK preemptive ahead of April elections.

Real exports subtracted from growth in 2015 through end-Q3. The total volume of net exports fell to its lowest level since H1 2012 in Q3. The BoK will therefore want to ensure that USDKRW keeps pace with USDCNY.

Net portfolio and foreign direct investment outflows will continue to offset the current account surplus, and the KRW is on track to become a viable alternative to the JPY as a funding currency once risk appetite rebounds.
MXN – punished by oil but priming for an eventual reversal

- We expect USDMXN to rise to 18.60 in 3M and 18.90 in 6M. However, when the USD turns, the turn in USDMXN should be relatively sharp. We expect a reversal to 17.80 on a 1Y horizon.

- USDMXN is the most liquid emerging market currency, which means it is the fastest to sell off when markets grow averse to risk for reasons such as a Fed hike or an equity market crash.

- Oil is not a major component of Mexico’s export basket. The auto sector dwarfs it. But the problem with low oil is that Pemex provides almost half the Mexican government’s revenues. Mexico ends up being forced to tighten fiscal policy due to cheap oil.

- Banxico raised its base rate right after the Fed did and continues to operate intervention auctions. Further FX depreciation is unwelcome.

- MXN is on the cheap side of PPP. We would put PPP fair value in the 14.00 – 15.00 range.
RUB – set to stabilise when oil stops falling

**USDRUB outlook**

- We expect USDRUB to trade at 85 in 3M. The latest phase of the oil bear market has been less severe for the ruble because Russia’s external position has had time to adjust and banks have been recapitalised. CBR’s reserve bleed has therefore subsided, but RUB remains the second most-volatile currency after BRL.

- USD-denominated external debt issued by the government and banks will continue to mature over the first three quarters of 2016, but redemptions will average $18bln/quarter vs $52bln in the 3 quarters through Q1 2015.

- Linear regression models with the USD-RUB 10yr sovereign rate differential and 5-year CDS as independent variables indicate that RUB is undervalued vs the USD and in broad trade-weighted terms (right chart).

- Excluding exports of oil, oil products and gas, the quarterly goods trade balance rose to a surplus of $8bln in Q4, which was the best reading for that series since Q3 2010. The CRB is likely to cut rates quickly as soon as it is clear that oil prices have stabilised. Capital flows into the ruble should pick up moderately thereafter.
TRY – inching back to stability but still vulnerable

- We expect USDTRY to trade at 3.19 in 3M. Turkey continues to hemorrhage portfolio flows, so vulnerable forms of external financing could dry up quickly given a bad set of circumstances (right chart). The failure of annual CPI to stabilise in H2 2015 leaves room for 1 or 2 rate hikes in H1 2016.

- Turkey’s FX reserves dropped by nearly 5% in the 6 weeks through January 8th indicating that the central bank is probably intervening to support the TRY. Given that intervention, a major geopolitical setback in the Mid-East or a sharp deterioration in global growth could hit the TRY particularly hard.

- President Erdogan’s firm grasp on government should keep political risks in the background while low energy prices and restrictive monetary policy support Turkey’s external position.

- However, the central bank is walking a fine line between the scenario where rate hikes can support the currency and the scenario where rate hikes send the lira sharply lower due to fears of a growth relapse.
ZAR – the black swan currency

USDZAR outlook

- We expect USDZAR to rise to 18.10 in 3M. South Africa had 3 finance ministers in less than a week during December’s political crisis.

- The current FX market environment is very unfavourable for twin deficit currencies. The ZAR’s twin deficit is currently around 8% of GDP. The external position improved slightly in early-2015 but then partially reversed (right chart). Low competitiveness in the resource and non-resource sectors hinder prolonged improvement.

- South Africa is best by risks. The bulk of South Africa’s external financing needs will be met by non-FDI flows, which are subject to higher rollover risks. Inflation developments prevent SARB policy from supporting growth. Fiscal policy is constrained by the rising debt-to-GDP ratio and elevated government bond yields.

- At least one of the big 3 ratings agencies has South Africa just one notch above junk. A downgrade to junk would be a serious blow. One low-probability upside risk for ZAR would be an ANC rebellion to depose Jacob Zuma.
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