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Econotes is a free research publication available on request. It is not a solicitation for business. It is devised and written by Dr. Andrew F. Freris based on 46 years of market experience which included senior positions with GT Capital, Salomon Brothers, Bank of America and BNP Paribas as well as senior academic posts with universities in London and Hong Kong

8/F, 2 Exchange Square, 8 Connaught Place, Central, Hong Kong. Tel: 852 3167 4591, Mob 852 9738 0944
Email: afreris@ecognosisadvisory.com Website: www.ecognosisadvisory.com

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FOREX OUTLOOK : The big ones

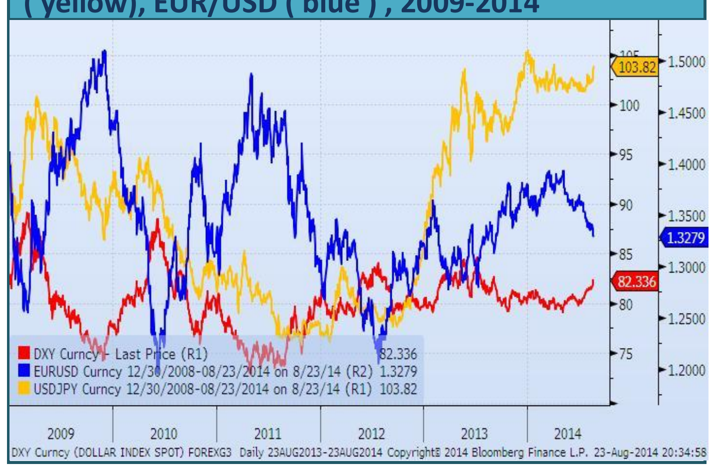
Summary	Investment Conclusions
In this issue of the Econotes we look at some of the G20 currencies especially the JPY, EUR, GBP and AUD. Next week's issue will concentrate on Asians and the week after on some of the more "exotic" forex rates including Latams and Eastern Europeans. There is a common expectation that for the next 12 months the key development will be the strengthening of the USD versus all other currencies. Even if this turns out to be true, the issue of relative strength will also be of importance as well as the trend of interest rate differentials. We also focus on the AUD ,long the darling of carry trades but now under some pressure.	The consensus forecasts to 2Q.15, point to an absolute preference for the GBP up +1.2% from today's price to 1.67 in 2Q.15.Then the next in terms of smaller forecast depreciation, is the EUR, down by -3.0% to 1.28.The JPY expected to fall by -4.8% at today's prices to 109 in 2Q.15 and, lastly, the AUD down by -5.3% to 0.88. Other than the obvious s forex trades, the performance of the Nikkei could benefit by the weaker JPY, although the equities link to the JPY is not that strong as believed.EU equities may benefit from the weaker EUR but the AUD carry positions will be under pressure.

Macro trends: Not at all obvious

The red line in Chart 1 shows the movement of **DXY,** the trade weighted index for the USD. The index consists of a basket of 6 currencies all weighted by their trading importance to the US, and, consisting, in order of weight, of the EUR, JPY, GBP, CAD, SEK and CHF. The underlying argument in our forecast of a stronger USD is, basically, the outperformance of the US economy, plus rising USD interest rates, versus the EU and Japan. Since the bottoming out of the crisis at the end of 2009, the DXY both strengthened and weakened in every single year to 2014 when it entered into a strengthening mode till now. The USD was not in a one way street after the crisis ended and only started to strengthen consistently when the markets took on board the Fed's decision to taper and then to hike. The **EUR**'s steep fall from mid 2011 (blue line in Chart 1) bottomed in 2012 and then strengthened, despite the parlous state of the EU economy. From June 2014 onwards, with a further cut of ECB rates to 0.15% from 0.25%, and with the introduction of selective negative rates, the EUR started to weaken and will likely stay so into 2015.As for the **JPY,** on the weakening of which so much of the Abenomics' expectations for recovery had rested, the path was not straight either.

From the start of the implementation of the fiscal and monetary expansion at the end of 2012, the JPY weakened significantly, with some reversals in mid 2013, but then, for most of 2014 has stayed flat.The JPY performance has been somewhat perverse given the ambivalent trends in the Japanese economy coupled with zero rates,all these being strong arguments for a weaker JPY well into 2015.

Chart 1:Forex, DXY (index red), USD/JPY (yellow), EUR/USD (blue) , 2009-2014



Source: Bloomberg

The yield differentials and forex rates

Chart 2 shows the differentials between the 10Y UST and the 10Y German and JGB bonds. The red line shows the yield of the 10 UST while the yellow and blue lines show, respectively, the differentials to the Japanese and German yields. The trajectory of the UST had not been smooth and after early 2013 the yield had been rising till it peaked at the start of 2014 causing an overall widening in the differentials with both bonds. The almost continuous decline of the German 10Y yields since the middle of 2013, explains the rise in the differentials, whereas the relatively flat performance of the 10Y JGB finds a mirror image in its differential curve to the UST yields. These differentials are bound to rise as neither the BoJ nor the ECB have any plans to hike, while the Fed does and may do so in 2015 thus supporting the USD.

FACTOBOX: A word about the AUD

The fall from grace for the AUD which started at the start of 2013 has been reflecting the fall in the prices of some commodities plus the poorer state of the Ausie economy and the willingness of the RBA to see a weaker AUD. All this, however, belies the official rate at 2.5% with all the likelihood that it will stay there and will not be cut even into 2015 thus giving the AUD the widest carry margin among all major currencies. Even if the Fed starts to hike at 25 bps every three months, it will take 2.5 years to hit the AUD level, by which time the RBA would have hiked again. But then all this leaves out expectations !. Bottom line is not to bury the AUD just yet!

For ease of exposition we left out of the charts the performance of the **GBP ,**whose strength from May 2013 to May 2014 has reflected the market expectations of the BoE hiking rates while the 10Y gilt yields have kept falling since the start of 2014.The ambivalent policy statements and guidance from the BoE did not help, but did not reverse expectations of a rate hike earlier rather than later, possibly even at the end of 2014. This will make the UK one of the first developed economies to break the cycle of super-low interest rates and thus also explains the bullish outlook of the markets towards the GBP. Recent BoE monetary committee votes added to the expectations of an early hike in official rates as did restrictions in bank lending to property and mortgages.

Chart 2: All 10Y, UST (red),UST-JGB (yellow),UST-German bond (blue), 2009-2014

Source: Bloomberg

Investment implications

The summary section at the opening of this note placed the cross-trades in order of 2Q.15 expectation gains, positive for the GBP, then negative for the EUR, the JPY and finally the AUD. in ascending order. Extending the asset argument to equities, USD based portfolios should clearly continue to underweight Japanese shares, a suggestion relatively easy to support given the still negative performance of the Nikkei at -3.3 % YTD in USD terms, and slightly worse at -4.4% YTD in JPY terms. We continue to expect that the EU economy will not be able to support stronger earnings, and that a weaker EUR will be of relative importance to the big exporters, namely Germany, but which continues to be one of the worse EU equity YTD performers. The peripherals (Spain, Portugal and Greece) could benefit from a weaker EUR, but Portugal for now is still too shaky. Greece is too dependent on tourism which, makes it a “one product” export story supported by a weaker EUR, while Spain remains the more diversified export economy, which includes tourism but also the exports of manufactured goods. Hence we stay with our preference for Spanish equities supported by a cheaper EUR and the recovery in Spain, (See Econote No.5).UK equities have been mediocre performers to date (FT100 at +0.50) and higher interest rates are likely to produce initially adverse reactions. Which leaves the US equity market still remaining our top preference.

Andrew Freris (writing completed 25/8/2014)