G10 FX Outlook: GBP & USD are the Stars
FX Themes

USD: Tapering should support a stronger USD against the other lower yielding G10 currencies. Long USD positioning has not fully recovered, which provides scope for upside despite for consensus for USD strength.

EUR: Further ECB policy easing is increasingly likely and we forecast a further rate cut in early 2014. EUR will suffer from this while current account support is also fading. We forecast 1.23 EURUSD by end-2014.

Asia: Growth in the region to remain robust, but Fed tapering expectation to impact USD vs Asia. Asian currencies may struggle in 2014.

JPY: USDJPY to rise as the BoJ remains committed to very loose policy, in contrast to a Fed that is heading towards the exit. Domestic investors to continue to be crowded out of the JGB market and allocating funds abroad. We forecast 118 USDJPY by end-2014.

GBP: The recovering in UK economy to continue to underpin the GBP. Market positioning is extreme long but it remains cheap vs long-term valuation. We forecast 0.78 EURGBP by end-2014.

CHF: EURCHF to rally as global growth recovers, but further ECB easing will provide a headwind. As the Swiss begin to recycle large current account surplus we forecast a gentle rise to 1.25 EURCHF by end-2014.

AUD, NZD, CAD: Pockets of EM resilience + local growth will be enough to shield commodity currencies strong as Chinese growth remains robust. AUD & NZD now appear undervalued.

NOK, SEK: Scandinavian currencies appear oversold currently, in particular the NOK should recover against the SEK in 2014.
We expect USD to gain broadly in 2014

Sharper USD gains are due in 2014 especially vs EUR, JPY & CHF

Forecast percentage change vs. USD from 01-Jan-2014 to end 2014

Source: Ecowin Reuters, BNP Paribas
Our basecase is in line with the agenda laid out by the Fed.
US & UK move to the top of the pack

Comparison of major countries PMI readings (Manufacturing)

US and the UK outpace the rest, eurozone and China lag

Source: Ecowin Reuters, Bloomberg, BNP Paribas
US yields hit new highs recently

Fed QE has kept yields subdued despite improving data...but yields are starting to relink.

Source: US Federal Reserve, BNP Paribas
The USD continues to take its lead from US yield.

The USD continues to take its lead from yields. USD is now lagging the yield pick-up.
USD is set to rise against the low-yielders

2Y Sovereign Benchmark yields (bp)

EUR & GBP yields rise in tandem with USD, but JPY & CHF stay low

Source: Ecowin Reuters, BNP Paribas
Largest FX market positions are long GBP & short CAD, JPY

CAD shorts have overtaken AUD & JPY, while GBP is the largest long positioning
FX participants shift to a net long USD exposure

FX investors generally establish USD shorts during QE. But the more data contingent nature of QE3 has made markets less comfortable funding in USDs.

BNP Paribas Estimate of FX Market Positioning for USD

Methodology
- Client Exposure – Internal sales desks’ estimate of FX investor exposure
- IMM – The Commitment of Traders (CFTC) is a widely used proxy for US-based hedge-fund/CTA activity.
- Risk reversals – Risk reversals indicate the relative price of calls relative to puts, and thus incorporate a option “market sentiment” function.
- Beta – Decomposition of the BTOP managed currency index.
- BNPP Trending Indicator. - A technical measure of the strength of a currencies momentum.

The overall currency score is then calculated as the equally weighted sum of the components

Source: Ecowin Reuters, BNP Paribas
Overall FX positioning is low

Total G10 positions

Positions typically build in Oct. and Nov.

Seasonal analysis shows that October and November are when FX positioning is usually highest

Source: Ecowin Reuters, BNP Paribas
Dislocation between market views and positioning

Market consensus is bullish USD, but investors have only started to put on the position

Source: Ecowin Reuters, BNP Paribas
US TIC capital flow data broken down by asset type

Inflows into US Treasuries and Agency debt have returned
EUR strength is starting to wane: EURUSD is set to fall
EURUSD has now diverged from interest rate spreads

EURUSD vs. 2-yr euro–US swap spread

US fiscal stress has pushed EURUSD way beyond fundamentals

Source: Ecowin Reuters, BNP Paribas
The sharp undershoot in inflation increases prospects for ECB easing. We forecast a refi rate cut in December.

Source: Ecowin, Reuters, BNP Paribas
Support from the current account is fading

C/A surplus appears to have peaked

Periphery has driven the deterioration

Source: Ecowin Reuters, BNP Paribas

Eurozone current account suggest greater EUR vulnerability
Portfolio flow data show the EUR surplus is being recycled more efficiently now

Source: Ecowin, Reuters, BNP Paribas
Market Positioning remains Long EUR

EUR Market Positioning

The market remains long EUR despite dovish ECB rhetoric.

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Source: BNP Paribas

BNP Paribas FX Positioning Analysis

Trending Indicator  FX Funds  Risk Reversals  IMM  Clients

January 2014
EURUSD trades very close to its fair value

**BNP Paribas FEER for EURUSD**

BNPP FEER (Fundamental Equilibrium Exchange Rate) is the value of an exchange rate when an economy is operating with an internal balance (i.e. output in line with potential output, full employment and inflation in line with central bank’s target) and a sustainable current account balance.

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**EURUSD FEER is estimated at 1.32, so EURUSD is not overvalued despite Fed QE3**
Our STEER model signals EURUSD is trading above fair value

**BNP Paribas STEER™* fair value model EURUSD**

*BNPP STEERs are regression based short-term fair-values based on relationships between exchange rates, interest rate markets, equity markets and commodity markets.

![Graph showing EURUSD trades inside its corridor]

Source: BNP Paribas
Relaxation in Eurozone stress normalizes euro basis

Spanish 5 Year CDS vs Euro Basis 5 year swap

Euro basis normalization creates opportunities for some corporates
JPY to be driven higher by “Abenomics.”
The BOJ undertakes a dramatic increase in policy

Japanese monetary base projections (JPY trillions)

The policy shift under Governor Kuroda is dramatic
USDJPY is highly correlated to Nikkei 225

The close link between Japanese equities and the JPY is policy driven by “Abenomics”
JPY short exposure had fallen to just -16...

BNP Paribas FX Positioning Analysis (JPY)

Source: BNP Paribas

BNP Paribas JPY positioning indicator signals that investors’ short JPY exposure is the smallest this year.
...but domestic investors are not yet short JPY

Japanese investors’ net purchases of foreign assets

Japanese investors have turned net long JPY over Q1. Most of this is driven by repatriation.

Source: Ecowin Reuters, BNP Paribas
Evidence has yet to emerge of large-scale JPY outflows but the net inflows are falling.
USDJPY long-term fair value is now 74

BNP Paribas FEER for USDJPY

BNP Paribas FEER (Fundamental Equilibrium Exchange Rate) is the value of an exchange rate when an economy is operating with an internal balance (i.e. output in line with potential output, full employment and inflation in line with central bank’s target) and a sustainable current account balance.

Our estimate of long-term fair value (BNP Paribas FEER) continues to fall and now stands at 74

Source: BNP Paribas
GBP: Economic recovery to provide ongoing support
Recovery in UK Data is Different This Time

Economic data is finally strong enough for the output gap to start to narrow
We favour EURGBP downside

UK growing much faster than eurozone

EURGBP shorts far from extreme level

We expect the GBP to recover against the EUR, targeting 0.81 EURGBP
EURGBP is significantly above long-term fair value estimates

BNP Paribas FEER for EURGBP

BNPP FEER (Fundamental Equilibrium Exchange Rate) is the value of an exchange rate when an economy is operating with an internal balance (i.e. output in line with potential output, full employment and inflation in line with central bank’s target) and a sustainable current account balance.

EURGBP overvalued on longer term valuation estimates and has plenty of scope to decline

Source: BNP Paribas
EURGBP tracking real yield differentials instead

EURGBP vs. 5 year yield spreads

Source: Ecowin Reuters, BNP Paribas

Real rates maybe a better indicator as central bank policy is now impacting FX through the inflation expectations channel.
Easing of eurozone stress now suggests durable Swiss Franc reversal
Easing of eurozone stress key for durable Swiss Franc reversal

EURCHF vs. Weighted Peripheral Spreads

Source: Ecowin Reuters, BNP Paribas

Easing eurozone stress now signals EURCHF upside
Swiss investment outflows

Financial account moves from inflow to outflow

Total net financial inflows peaked in Q2 2012 at the same time eurozone stress peaked. Outflows are now taking off.

Source: Ecowin Reuters, BNP Paribas
Easing of Eurozone stress key for durable Swiss Franc reversal

EURCHF v. 2-year swap spread

CHF appears extremely overvalued vs relative interest rates

Source: Ecowin Reuters, BNP Paribas
EURCHF is undervalued relative to its long term fair value

**BNP Paribas FEER for EURCHF**

BNPP FEER (Fundamental Equilibrium Exchange Rate) is the value of an exchange rate when an economy is operating with an internal balance (i.e. output in line with potential output, full employment and inflation in line with central bank’s target) and a sustainable current account balance.

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**EURCHF trades significantly below its FEER of 1.40**

*Source: BNP Paribas*
Market positioned neutral CHF

Market positioning has turned long CHF for the first time since the floor was introduced

Source: BNP Paribas
Commodity currencies; A surprisingly positive outlook
Fed tapering has been negative for commodity currencies

Source: Ecowin Reuters, BNP Paribas

Expectations of Fed tapering is negative for the commodity currencies
AUDUSD not trading rich vs commodity prices

AUDUSD vs. AUD exporter commodity prices

Source: Ecowin Reuters, BNP Paribas

AUDUSD is not trading that rich against underlying export commodity prices
Australian commodity prices stable in 2013

AUD commodity prices relatively stable

AUD commodity prices have stabilised in 2013, at odds with notion of a severe terms of trade shock

Source: Reuters Ecowin, BNP Paribas
China now providing positive signal

AUD NEER vs. Hang Seng China Enterprises index

Chinese stocks signals AUD upside

Source: Ecowin Reuters, BNP Paribas
We believe that BNP Paribas FEER is more useful than PPP and indicates that AUDUSD is not overvalued.
Scandinavia; Appreciation but NOK outperforms
Norwegian inflation pressures have increased in recent months

Norwegian CPI-ATE (% y/y)

Inflation pressures have increased in recent months

Source: Ecowin Reuters, BNP Paribas

Inflation has picked up in Norway in recent months
Interest rate differentials suggest scope for EURNOK decline

NOK is trading far weaker than signalled by the rates market

Source: Ecowin Reuters, BNP Paribas
NOK appears undervalued relative to oil prices.

NOK has weakened relative to oil prices. Our commodity strategists target Brent at $115 per barrel.

Source: Ecowin Reuters, BNP Paribas
Our STEER model signals EURSEK is undervalued

BNP Paribas STEER™* fair value model EURSEK

BNPP STEERs are regression based short-term fair-values based on relationships between exchange rates, interest rate markets, equity markets and commodity markets.

EURSEK appears undervalued according to STEER

Source: BNP Paribas
Short-term rates are the principal driver of EURSEK

We believe the Riksbank will hike rates at least 12 months ahead of the ECB. The downward trend will continue.

Source: Ecowin Reuters, BNP Paribas
EURSEK is strongly linked to the EZ business cycle

German IFO Expectations vs EURSEK deviation from 12 month average

Source: Ecowin Reuters, BNP Paribas

SEK should appreciate as the EZ business cycle improves
Top FX Trade Ideas for 2014

1. **Short EURUSD – target 1.25**
   One of our strongest themes for 2014 is the widening of US short-term yield spreads versus those in the eurozone. This widening trend should produce a sharp fall in EURUSD despite the recent market focus on the zone’s robust current account surplus.

2. **Long USDJPY – target 118**
   As the USD rebounds in 2014, we forecast it to make its largest gains against the currencies with the loosest monetary policy. The BoJ is likely to ensure that policy is loosest in Japan and that JGB yields remain low.

3. **Long NAFTA basket: Long USD, MXN and CAD vs short CHF and JPY**
   The improvement in US growth will boost economic activity in Canada and Mexico, providing support to the CAD and MXN. Meanwhile, the ultra-low yielding CHF and JPY remain our funding currencies of choice.

4. **Short EURGBP – target 0.78**
   The UK economy should continue to grow strongly in 2014 causing markets to price in higher yields, especially relative to the eurozone. In addition, the GBP remains very cheap according to our longer-term BNP Paribas FEER model.

5. **Long NOKSEK – target 1.1460**
   Macroeconomic favour Norway over Sweden in 2014. Both the Norges Bank and the Riksbank are likely to keep interest rates on hold throughout most or all of 2014, but we except a strong Norwegian economy to support a rebound in NOKSEK.
Top FX Trade Ideas for 2014

6. Position for taper stress via GBPUSD put spreads and FVAs
We recommend going long forward volatility in a carry-efficient manner, to position for an intensification of stress related to Fed tapering.

7. Long GBPSEK targeting 11.20 – Play the relative housing cycle
We think a number of currencies like GBP, NZD, NOK and SEK are being increasingly driven by trends in their housing markets. The UK housing market is growing at a fast pace, in contrast in Sweden the housing market is slowing modestly.

8. Positioning for limited upside in EURCHF
To position for modest upside in EURCHF, while exploiting expensive topside vols relative to higher delta topside and the SNB’s floor at 1.20 EURCHF, we propose entering long EURCHF spot and selling a 12m 2x1 1.26/1.3125 ratio call spread

The relative pricing of rate hike expectations between the RBA and the RBNZ appears extreme. 125bp of rate hikes from the RBNZ are expected by mid-2014. In contrast, there is scope for RBA rate expectation to rebound.

10. Prepare for ECB QE via long EUR forward vols
To position for a weaker EUR we favour purchasing forward volatility in EUR crosses taking advantage of very low base vols in the entire EUR complex, coupled with flat curves, resulting in a very mild decay profile for the entire EUR complex.
### Forecasts

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#### Others

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<th>Q2 '15</th>
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*End Quarter
How to Access our Research

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