05 November 2015

Strategy

What US investors think and how we differ

- **US investors expect the Fed to hike and the ECB to enact aggressive easing in December. We expect the ECB to very aggressive in December by cutting rates, expanding QE and providing strong forward guidance.**
- **US investors expect EUR/USD to fall sharply near-term. We believe that it will be 'sell the rumour, buy the fact' when the Fed hikes/the ECB eases. Moreover, we expect EUR/USD to rise sharply in 2016 on valuations and a closing European output gap.**
- **US investors are bullish on short-duration euro FI periphery, particularly Italy and Spain, but more cautious on Portugal. We remain bullish on 10Y Portugal despite current political jitters.**
- **US investors think that Swedish inflation will rise and that the SEK is cheap. We are of the view that the Riksbank is still too positive on CPIF and that the currency is not that cheap. We like the 5Y SGB while EUR/SEK remains stuck in a 9.30-9.60 range.**
- **US investors are bearish on Norway but think the currency is looking increasingly cheap. We expect a spike in EUR/NOK into year-end but see significant potential in long-dated bearish EUR/NOK structures if it spikes to 9.60-9.80.**

What US investors think

During the week of 26-30 October, FICC research was on the road in the US, talking with around 20 leverage and real money clients. Below, we outline US investors' key market views and where we differ.

The Fed. US investors think that the Fed will hike rates in December. They think that a stabilisation in China and ECB easing will convince the Fed to hike as long as equities and US job creation do not collapse. In addition, US investors are bullish on the US economy where recent negative factors from net exports and inventories will fade, in their view. At the September meeting, the FOMC did not raise interest rates. We believe this was because of (1) China concerns and (2) the USD. The Chinese economy is stabilising as recent monetary and fiscal stimuli feed through to the economy. Moreover, while the USD is strengthening versus the EUR, it has recently been stable versus CNY, CAD and MXN, which together account for nearly three times the size of the EUR in the Fed's trade-weighted USD index (see Chart 1). Hence, so far the USD is not a hindrance to Fed hikes. Our current call is that the Fed will hike in January, when it will be more certain about the pick-up in growth. However, it is a close call whether it will be December or January. Still, for markets it may not matter much – we elaborate further on this below.

Chart 1: Fed's trade-weighted USD index – not a hindrance to Fed hikes

Currency weights, top five countries	
China	21.29
Euro area	16.38
Canada	12.66
Mexico	11.87
Japan	6.90

Source: Federal Reserve Board, Danske Bank Markets

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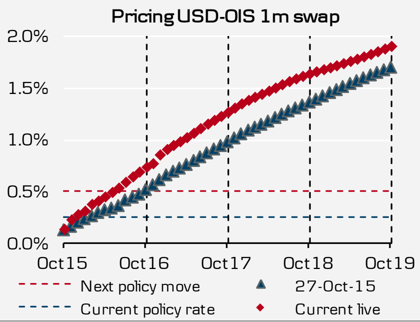
The ECB. All investors me met believe that the ECB will be aggressive in December by, at the very least, cutting the deposit rate by 10bp and expanding the QE program. We expect the ECB to cut the deposit rate by 10bp, extend QE purchases by three months to December 2016 and expand the monthly purchases to EUR75bn (see Chart 3). In addition, we believe the ECB will signal that rates could still go even lower. (See *ECB Research – ECB cutting through the lower bound – Danish experiences, 4 November 2015*). Our view is that Draghi will be forced to surprise as he is keen to drive the EUR lower. On balance, our expectations for the ECB are still slightly above market expectations but it is a moving target.

Chart 2: Markets increasingly pricing in Fed hike for December



Source: Danske Bank Markets

Chart 3: The ECB considers a whole menu of easing measures

Instrument	Change	Market reaction
QE program	Extend QE purchases by three months	The open-endedness of the QE program implies this would not be a big surprise
	Expand QE purchases to EUR75bn p/m	Signals the ECB is committed to fighting low inflation and supports inflation expectations
	Expand eligible assets to include corporate bonds	The market is already pricing in a high chance of the ECB buying corporate bonds
Policy rates	Cut the deposit rate by 10bp	The October meeting strengthened the aggressive pricing of further rate cuts
	Strengthen forward guidance on policy rates	No signal of a new lower bound would imply continued pricing in of further rate cuts

Source: Eurostat, Danske Bank Markets

The euro. US investors we met think that EUR/USD will fall sharply into Fed hike/ECB easing on relative interest rates. Targets range from 0.95-1.05 over 1-3M. We agree that the USD will strengthen into ECB easing and the first Fed hike, with EUR/USD likely to undershoot our 3M forecasts at 1.08, possibly testing the multi-year low from March at 1.0458. However, it would be 'sell the rumour, buy the fact', in our view, as it has been over the recent Fed hiking cycles. The longer-term trajectory for EUR/USD is higher as the 'natural' flow in EUR/USD is the buying of EUR given the euro zone's large trade surplus and the likely closing of the eurozone's output gap in 2017. Our MEVA estimate for EUR/USD is 1.28 and our 12M forecast is 1.20 (see Chart 4). This is clearly very non-consensus and contrasts sharply with US investors' view that the EUR will 'fall forever'.

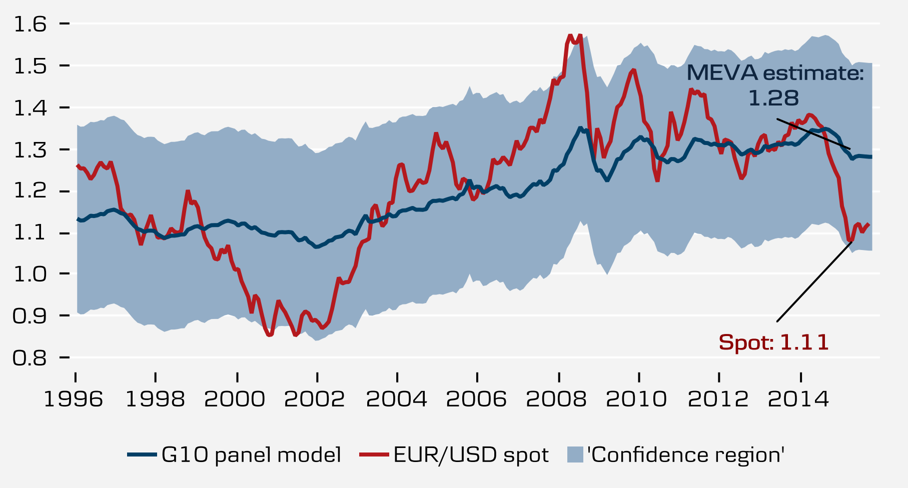
Euro Fixed Income. US investors are positive on selective periphery bond markets, in particular Italy and Spain in the shorter tenors but are more cautious on Portugal given the politics. They expect the periphery FI to have less room to rally than in Q4 14/Q1 15 given lower yield levels and the lesson from Q2, where it was key to 'getting out' at the right time. Some investors think that break-even inflation in Europe has room to rise as well in Sweden – more on this below. We continue to recommend being long 10Y Portugal given the support from the ECB for periphery bonds despite the possibility that political uncertainty could well continue ahead of the 9 November and 10 November parliamentary discussions. We also stick to our long 15Y Spain versus Italy.

Sweden. US investors think that inflation will rise faster in coming months and are bullish on SEK. In addition, they think that there are troubles ahead for the Swedish economy as the housing market is on fire while rates are negative. In our view, inflation will rise in Sweden over the coming months but the Riksbank remains too optimistic on the upcoming wage negotiations and thereby on CPIF later in 2016 (see Chart 5 and see our recent piece *Research – Waging war: Riksbank fighting on two fronts: Inflation and competiveness*). We continue to believe that the Riksbank will cut interest rates by 10bp in December, which is neither priced in by the market nor is it the viewpoint of US investors. US investors think that the SEK is very cheap. We agree that the SEK is a little cheap but much less so than many believe. Our MEVA estimate for EUR/SEK is 9.15. We continue to believe that EUR/SEK is stuck in a 9.30-9.60 range where the central bank is likely to cut rates by 10bp in December.

Norway. US investors are bearish on Norway as they think there will be a hit to domestic demand and property prices from the hit to the oil industry and jobs. Many US investors do not understand Norges Bank's (NB) focus on weakening the exchange rate given that a large proportion of Norway's exports are oil-related goods and fish products where they believe a weaker exchange rate does not help much (see Chart 6). We disagree here given that a weaker exchange rate is an important part of transforming the economy. Unit labour costs in Norway have risen dramatically over the past 20 years, up roughly 35% compared with its major trading partners measured in common currency. A weaker exchange rate would improve Norway's competiveness despite the fact that a large proportion of its exports are settled in USD.

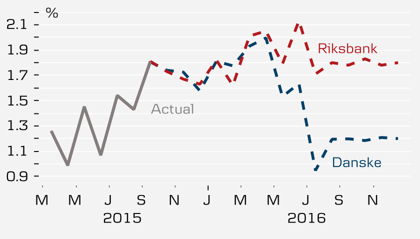
Near term, we expect EUR/NOK to spike higher as markets are likely to price in a 50% probability of a December rate cut, and as the NOK is normally vulnerable at year-end when liquidity tends to worsen. Medium term, we believe there is a lot of value in being short EUR/NOK if we get a spike up to 9.60-9.80 towards year-end, which is also the view of US investors.

Chart 4: Mind the gap – our MEVA points to EUR/USD at 1.28



Source: Eviews, Macrobond Financial, Danske Bank Markets

Chart 5: Riksbank remains too positive on CPIF in 2016



Source: Macrobond Financial, Danske Bank Markets

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