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May 29, 2014

Currencies

Global

Outlook

FX Pulse

EUR: Whatever It Takes

The yield puzzle. Global bond yields are near record lows, even as equity markets remain near all-time highs. Central bank accommodation has kept pressure on yields. While the market anticipates tighter policy from the Fed and BoE, it also expects increased accommodation from the ECB and BoJ to support global liquidity.

Deflation depresses currencies. Global deflation concerns have kept pressure on bond yields. Disinflation concerns are particularly heightened in Europe and have led to expectations for aggressive ECB easing at the upcoming meeting, driving EUR weaker. CHF and SEK have also underperformed as markets anticipate central banks will keep policy loose for longer due to disinflation, contrasting with the Fed and BoE, which are set to tighten policy.

JPY thrives. We like shorting currencies with high deflation risks against JPY in particular, and hold our short CHF/JPY trade this week. Lower bond yields reduce the incentive for Japanese investors to send money overseas into foreign bonds. This has put pressure on JGB yields, in a market where liquidity is already tight. Indeed, the BoJ recently announced a shift in its purchases, focusing more on the front end of the curve, given tight liquidity in the longer end. This too should be JPY supportive, as it limits the scope for future BoJ action.

In This Week's Edition

With the ECB meeting rapidly approaching, we discuss the path for the EUR going forward. We believe the ECB intends to cap EUR strength and will use any tools necessary. We expect a refi rate and depo rate cut at the next meeting, but we would not rule out further measures if these fail to stem EUR appreciation. With asymmetric risks for the currency, we would sell EUR on any disappointment at the upcoming ECB meeting.

Disinflation also persists in Sweden and has kept anticipation for future Riksbank easing high. We explore the factors behind low Swedish inflation and find that disinflation could continue to be a risk for some time. So long as deflation remains a concern, SEK will remain sold.

See page 12 for more details. Changes in stops/targets in bold italics.

MS Major Currency Forecasts

	2Q14	3Q14	4Q14	1Q15
EUR/USD	1.41	1.37	1.33	1.27
USD/JPY	100	104	108	110
GBP/USD	1.65	1.64	1.63	1.60
USD/CHF	0.87	0.91	0.94	1.00
USD/CAD	1.14	1.16	1.18	1.19
AUD/USD	0.88	0.86	0.85	0.83
NZD/USD	0.81	0.79	0.77	0.76
EUR/JPY	141	142	144	140
EUR/GBP	0.85	0.84	0.82	0.79
EUR/CHF	1.22	1.24	1.25	1.27
EUR/SEK	9.25	9.35	9.25	9.20
EUR/NOK	8.40	8.45	8.50	8.60

Note: Forecasts for end-of-period. G10 forecasts updated March 17, 2014

FX Overview

Hans Redeker, James Lord

- The USD has started to rally, despite US back-end bond yields hitting new cycle lows.
- US data releases suggest the US economy is gathering momentum. More data strength is in store.
- After a brief period of consolidation, the RMB has weakened again.
- Carry traders watch the RMB as an indication of the evolution of DM bond yields.
- However, a falling RMB does not necessarily translate into higher Chinese FX reserves and related DM bond buying, depressing DM bond yields.
- Rising DM bond yields combined with a supply-driven rebound in the US economy should mark the end of the EM-supportive carry trade.
- We will watch Korea export data this weekend to gauge whether support for EM currencies could come from improving fundamentals and not just falling global volatility.
- The EM central bank reaction function to market stability should increasingly drive relative performance.
- We remain bullish on PLN and HUF, though rate differentials are increasingly supporting the PLN.

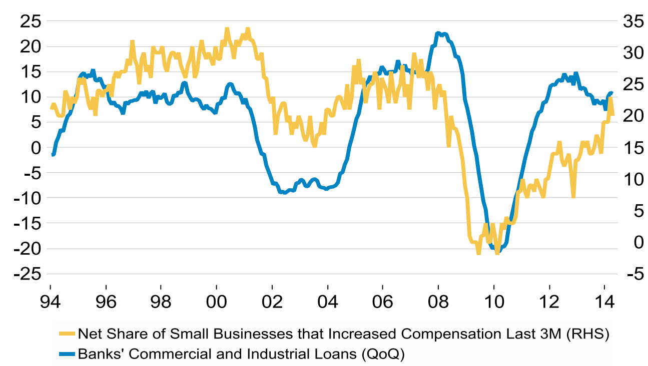
USD Rallies as US Economy Rebounds

The USD is set to rally, supported by higher US front-end rates (see *US Interest Rate Strategy Brief: Set Up for the Summer, Sell the Front End (27 May 2014)*). Not only have US data come in on the strong side of expectations, but the quality of US growth has also improved with the supply side of the US economy picking up. Capital spending holds the key for long-term USD performance, as rising capital demand will affect the US rate market.

There are a number of indications that the supply side of the US economy is improving. First, SMEs have increased demand for loans. SMEs are generally not listed and therefore not involved in raising debt to fund equity buyback programs, suggesting the demanded funding will be used for business investment. Second, SMEs have begun to pay higher wages, suggesting that the US labour market might be tighter than generally assumed. SME hiring has picked up, which in the context of rising loan demand is the strongest indicator yet that the 'monetisation' of the US capital stock has finally come to a standstill. Third, M&A activity has picked up, suggesting US companies are returning to growth-oriented strategies.

Exhibit 1

US SMEs Report Higher Wages and Rising Loan Demand



Source: Macrobond, Morgan Stanley Research

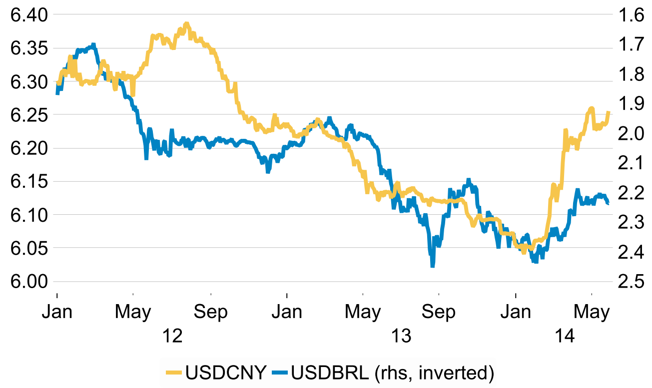
While US 2-year rates trade near the three-month average, long-end US bond yields have declined further, despite the release of stronger US data. Low back-end bond yields cannot be explained by inflation rates either, as both core US PPI and CPI have rebounded over recent months. While EM starting to export deflation via declining real effective exchange rates may have decreased the inflation risk premiums in the US bond market, this argument looks artificial in light of actual US inflation data beating market expectations. Reserve managers buying DM sovereign bonds may provide a better explanation.

The Weak RMB and Its Side Effects

After a brief period of consolidation, the RMB has weakened again. Exhibit 2 shows the relationship between the RMB and the carry trade. When the RMB ended a period of appreciation in January, carry traders saw daylight again. Contrary to previous assumptions, the weakening of the RMB was not predominantly driven by private-sector flows. Instead, it was official flows driving the RMB lower. Consequently, the PBoC experienced the strongest historical increase in its FX reserves in Q1. Initially Chinese reserve managers accumulated USD cash, and with cash providing no yield, they started buying into DM bond markets, putting their emphasis on increasing US sovereign bond holdings. The subsequent decline of US bond yields increased the relative attractiveness of high yielding assets, revitalising the carry trade.

Exhibit 2

USD/RMB Inverse Relationship to USD/BRL



Source: Macrobond, Morgan Stanley Research

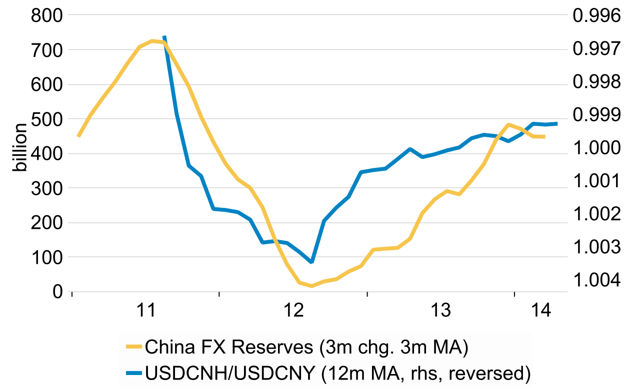
The inverse relationship between USD/RMB and USD/BRL is obvious. When the RMB started to weaken in January, it set the starting point of a pronounced rally among high-yielding currencies. We have chosen the BRL as a proxy for the general carry trade, as Brazil offers high nominal yield but has reported weakening fundamentals. It is the yield differential keeping fundamentally challenged currencies, such as the BRL, supported for now. But with the RMB weakening again, does this mean the carry trade will receive another shot in the arm? The answer is 'yes' if RMB weakening comes alongside another increase in FX reserves. The answer is 'no' if the next round of RMB weakening is driven by private-sector outflows.

What Can We Learn from RMB Flows?

The question is how to get ahead of the crowd in interpreting reserve-related flows into the bond market and the impact on FX. Again, it will make a fundamental difference if the RMB decline is accompanied by rising Chinese currency reserves, which would point towards the carry trade remaining attractive, or the alternative scenario of currency reserve growth coming to standstill, suggesting DM bond markets will lose important support.

Exhibit 3

RMB Onshore – Offshore Spread vs. Reserve Accumulation



Source: Macrobond, Morgan Stanley Research

The spread between onshore and offshore RMB should provide market participants with some important insights concerning China's reserve accumulation. When offshore RMB trades at an increasing spread to onshore RMB, China's FX reserves tend to decline. We have illustrated this relationship in Exhibit 3. A slower pace of reserve allocation or even a decline of reserves could have a meaningful impact on bond yields. Remember, when US bond yields undershot US nominal GDP growth in the middle part of the last decade, Fed Chair Greenspan explained this 'conundrum' buy the glut of Asian savings.

Conundrum or Intervention?

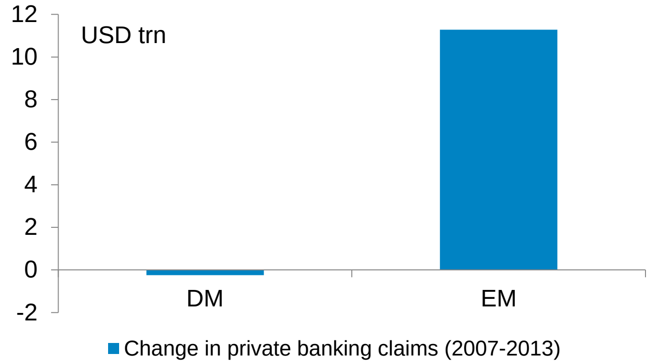
Falling bonds yields accompanied by rising equity prices are often the result of central bank intervention. During the last decade, Asian central banks in particular shifted funds into DM sovereign bond markets. At this time, it was DM central banks buying domestic sovereign bonds in the context of their QE operations. In both cases bond yields decoupled from equity markets. Once again, we make a similar observation, seeing bond yields declining while equity markets trade at or near historical highs. Reserve managers buying DM sovereign bonds might explain the current divergent performance of yield and share prices within the DM world.

With bond yields trading well below their equilibrium, there is always danger of a sharp snapback, which would increase volatility within many asset classes, including FX. Equity markets report thin trading volumes despite breaking higher, which is not a sign of strength, while bond market sentiment has hit a bullish extreme. Unlike equity and FX volatility, which does not necessarily spread into other asset classes, rising bond volatility will be felt globally. Leverage, which has reached new extremes globally, may even increase this effect. Short CHF/JPY should benefit if volatility rises (see our May 22 *FX Pulse: Vol AWOL*).

US Yields Matter

Exhibit 4 compares the change of leverage in the US with the developments in EM from 2008 until 2013. EM has leveraged up at times of low global funding costs, often channelling funds into low-return investments such as housing. Moreover, EM corporates often used their subsidiaries in DM countries to raise hard-currency loans. The USD value of EM hard-currency liability position is now larger than before the EM crisis of the mid-1990s, leaving EM vulnerable to rising global funding costs and rising hard currencies.

Exhibit 4
EM Leverage Build-up



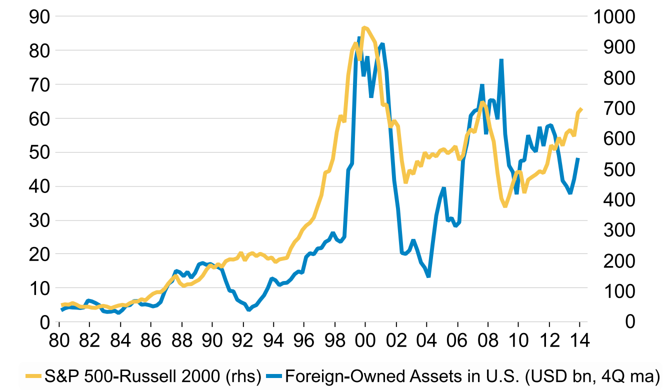
Source: Haver Analytics, Morgan Stanley Research

FDI US Inflows in the Wings?

Interestingly, when EM markets sold off in the mid-1990s, DM asset markets continued to rally. Investors repatriating funds back into the US supported local US liquidity conditions. This liquidity looked for domestic investment opportunity, sparking an M&A boom in the US. The US became a long-term investment destination. Now as the supply side of the US economy improves, we have to look for early signs that the US is entering a similar constellation comparable to the experience made from 1995 to 2000. Within those five years, the USD TWI gained 45%. Markets tend to provide early indications when changes take place.

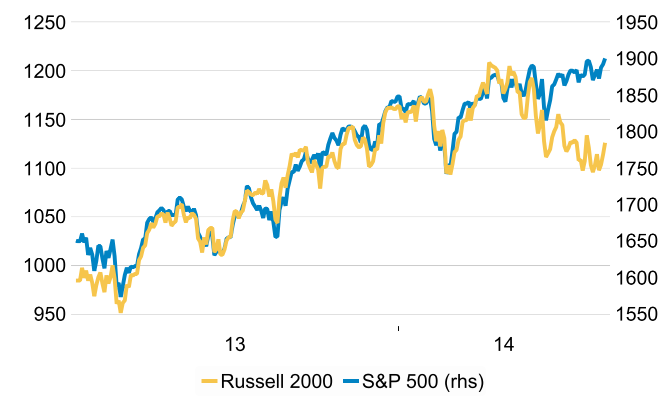
Exhibit 5 shows the spread between the normalised index levels of the S&P 500 and the broader Russell index, comparing it to the evolution of FDI flows into the US. When the spread widened in 1995, FDI inflows started to accelerate, staying strong until the bursting of the tech bubble in March 2000. Exhibit 6 shows the S&P 500 and the Russell 2000 diverging again. It seems to be time to get long USDs again.

Exhibit 5
FDI Flows into the US Set to increase



Source: Macrobond, Morgan Stanley Research

Exhibit 6
The Equity Signal



Source: Macrobond, Morgan Stanley Research

Will Korea Exports Continue to Grow?

Prospects for improved exports and greater productivity-enhancing reforms have been key variables for us to monitor when thinking about the sustainability of the EM rally. Falling levels of global volatility can only take the EM bulls so far, with fundamentals catching up sooner or later.

For us, a continued global economic recovery can help to sustain an EM currency rally if it translates into stronger export growth for EM economies. As such, Korea's May trade data to be released over the coming weekend (June 1st) will be an important indicator to judge the strength of the broader

EM export recovery. As the Exhibit 7 shows, Korean exports move very closely with the level of exports for the rest of EM. The chart includes only those EM economies that have released data for April, but we exclude China given questions over data quality. The chart shows that over the past year, export growth has been very lacklustre, with Korea marginally outperforming. A drop back in export growth for Korea in May would be disappointing, raising questions for us about the longer-term outlook for EM currencies.

Exhibit 7

Gradual Pick-up in Exports, Korea Rising

Source: Macrobond, Morgan Stanley Research

Low Volatility, Policy Divergence & Selectivity

While weak exports would cast something of a shadow over EM in the medium term, continued low levels of global volatility and core market yields will likely maintain stability for EM as long as there is no deterioration in other macro variables.

With global disinflationary forces, dovish central bank policy, and continued purchases of USTs from EM reserve managers, it is difficult to envisage the kind of pressure on EM currencies that we saw throughout much of 2013. We expect broadly sideways trading in emerging markets for the short term, though with differentiation likely to remain a strong theme.

One of the variables through which we expect relative performance to be determined is central bank reaction functions to currency strength and broader market stability. One of the factors that helped to turn markets around earlier this year was the aggressive action taken by several EM central banks to protect their currencies in the face of external risks. Now those pressures are less acute, as a continued defensive position by EM central banks helped to maintain a strong rally. Now we see growing evidence that central banks are starting to back away with Turkey's central bank cutting, South Africa maintaining rates and a number of central banks leaning against FX strength with intervention policy. This is likely to take some of the steam out of the recent rally, and also provide a variable for relative performance.

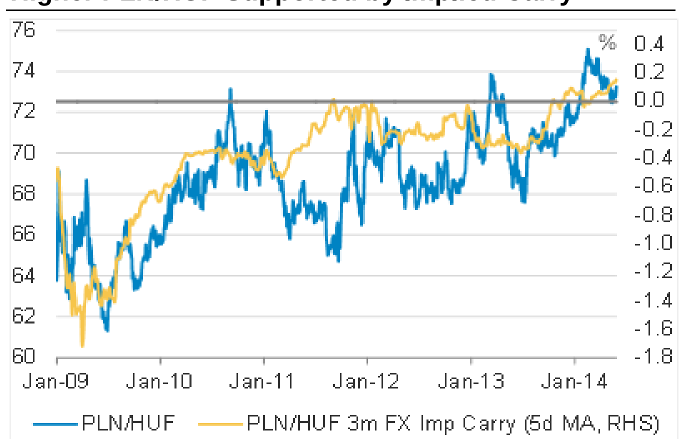
Rate Differentials Supporting PLN/HUF

Some divergences in CEE performance have become apparent over the last few days. Most notably PLN/HUF has resumed the uptrend that has been in place for several years. While both PLN and HUF have rallied against the EUR, which we expect to continue, and potential divergences in monetary policy may more heavily influence relative value between the two currencies. This year we have seen PLN offer a greater yield than HUF on a sustained basis (using 3m FX forward contracts) for the first time since 2002.

Poland's central bank has kept its policy rate on hold at 2.50% since July 2013, while Hungary has reduced its policy rate by 185bp to 2.40% over this period, and following this week's MPC meeting has kept the door open to further rate cuts (see *Hungary Economics: When Inflation Trumps Everything Else*, May 27, 2014). This has not had a great impact on HUF performance versus the EUR given building expectations for ECB easing next week; however, it has contributed to some HUF underperformance versus PLN. Should the NBP continue to keep policy rates on hold and the NBH continue cutting, as our economists expect, we could see rate differentials continue to provide technical support for PLN/HUF over the coming months. Note that we still forecast both currencies to continue to make gains versus the EUR.

Exhibit 8

Higher PLN/HUF Supported by Implied Carry



Source: Macrobond, Morgan Stanley Research

EUR: Asymmetric Risk Profile

Calvin Tse and Evan Brown

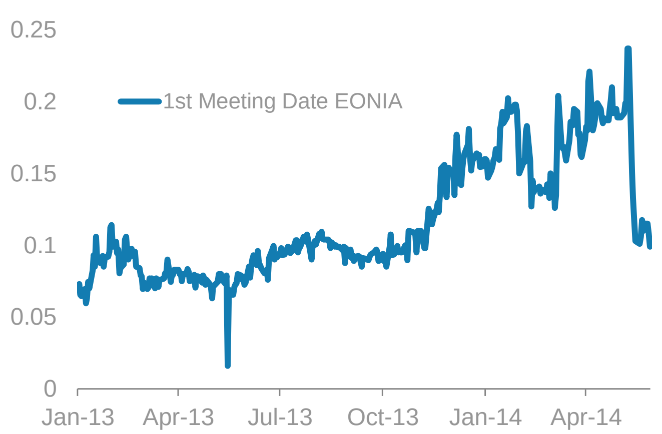
- The risk-reward favors short EUR over the medium term now that Draghi has made EUR strength the de facto trigger for further easing.
- While rate cuts may technically be priced in for next week, liquidity measures designed to bring down EONIA are not. There is potential for Draghi to surprise and bring EUR lower.
- Second-round effects related to FX hedging and the signaling impact of eliminating a zero-bound are also not priced in.
- Should the ECB exhaust domestic easing measures and fail to arrest deflationary pressures, we think foreign bond buying is a possibility.

Volatility into the ECB

After the last ECB rate decision, where President Draghi made a strong EUR the de-facto trigger for further easing, we suggested that this was the start of the medium-term EUR bear market (see *Why We're Selling EUR Now*, May 19, 2014). Admittedly, with monetary easing expectations increasing significantly into the ECB next week (Exhibit 1), there is likely to be plenty of two-way EUR price action around the event. But short-term volatility aside, we still believe that the EUR is set to trade gradually lower over the medium term, even if Draghi doesn't 'deliver on all policy levers next Thursday.

Exhibit 1

June Rate Cut Priced; But Not Liquidity Measures…

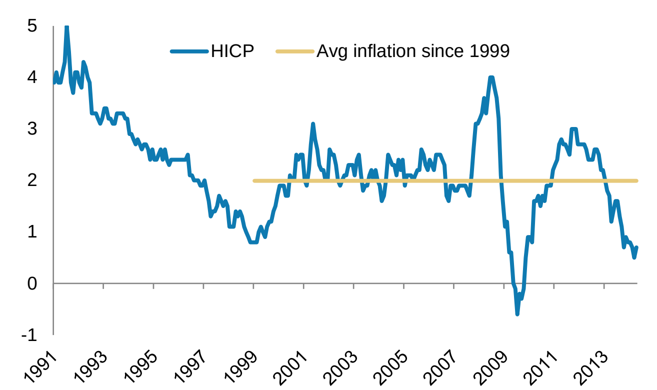


Source: Bloomberg, Morgan Stanley Research

To be sure, we've highlighted in the past that the actual impact on the EUR via negative deposits rates is a bit ambiguous (see *EUR: Zero and Below*, May 30, 2013). A few things are different now. Inflation has continued to fall (Exhibit 2), inflation expectations stand at risk of debasing and Draghi has explicitly linked currency strength to deflationary risk. Draghi has been able to build a 'consensus of concern' around EUR strength, bringing even the most hawkish members of the ECB on board for unconventional policies. Indeed, discussion of negative deposit rates and an unsterilized SMP program is now commonplace in ECB communication. In mustering consensus, Draghi has sent a powerful message to the market that the ECB is not a reactive institution and that if one policy isn't enough, more will come. And just as he pledged in July 2012 to do "whatever it takes" to save the eurozone from fragmentation, we believe that he will now do whatever it takes to prevent the EUR from materially strengthening further.

Exhibit 2

Eurozone Inflation is Worryingly Low

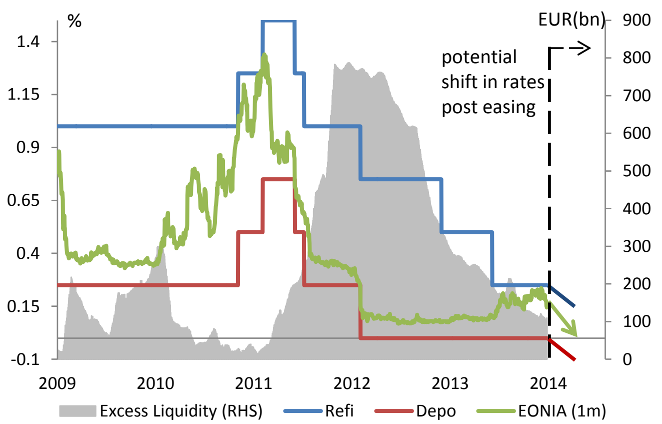


Source: Bloomberg, Morgan Stanley Research

What's In the Price?

Expectations going into the next rate decision are that the ECB moves the entire rates corridor down by 10-15bps. This is reflected in June EONIA, which is trading around these levels. That said, we do not think the market has priced in full liquidity measures that would push EONIA lower and closer to the deposit rate (Exhibit 3). These measures include but are not limited to another LTRO, leaving the SMP programme unsterilized, and lowering reserve requirements. If these measures were priced in, EONIA would more likely trade just above zero (historically in periods of high excess liquidity, EONIA trades roughly 10bps higher than the deposit rate). Thus to the extent Draghi announces liquidity measures, there is room for EUR to decline further immediately after the meeting.

Exhibit 3
EONIA Has Room to Trade Lower



Source: Bloomberg, Morgan Stanley Research

The second-round effects are also meaningful, though difficult to gauge whether they are appropriately priced in. By this we mean the potential for increased FX hedging of existing foreign asset holdings, particularly equities. We have talked at length about how much the EUR has been supported by foreign inflows; now, the asymmetric risk profile to EUR and increased cost effectiveness of FX hedging implies plenty of room for significant hedging on these holdings going forward. Direct outflows from European money markets are possible as well (see *FX Pulse: EUR: What Does the Flow Say?* May 15, 2014).

Moreover, there is a meaningful signal to the market of eliminating the so-called zero-bound, which may not be fully appreciated. Pushing rates into negative territory would lead investors to question how far it can move lower. This psychological impact and commitment to do more is quite powerful, we think. Should inflation remain at low levels, we do not rule out Draghi using much more aggressive measures in the months ahead. Full-scale quantitative easing (*see What if the ECB did QE?,* May 12, 2014), or even FX intervention are possibilities.

Why Not Buy Foreign Bonds?

Indeed, one measure that has not been discussed publicly by the ECB is the possibility of foreign bond buying. We think the ECB can and would buy foreign bonds as long as it has exhausted all domestic-focused policies in order to achieve its price stability mandate. Such a program would qualify as FX intervention, which is (1) legal under Article 109 of the European Treaty and (2) the sole responsibility of the ECB.[1] Indeed, the ECB spearheaded a coordinated intervention in the fall of 2000, to support the fledgling EUR. The ECB also joined the G7 in selling JPY following the Fukushima nuclear disaster in 2011.

While the ECB has not officially intervened to *weaken* the EUR, we think the barriers are far from insurmountable. Now that Draghi has referenced the strong EUR as a key risk to the ECB's price stability objective, he can use FX intervention as a means to achieve this mandate, rather than explicitly targeting a EUR level as a policy target.

As long as the policy is communicated in terms of the ECB's primary objective and the ECB has exhausted domestic policy tools, we would not expect significant pushback from the international community. Indeed, should Draghi follow through and take deposit rates negative next week, the ECB will be the only major central bank to have done so; the Fed, BoJ and BoE have been reluctant to take such a step.

The IMF deemed the 'SNB's'heavy nonsterilized purchases of foreign exchange' as successful in a recent paper[2], signaling an openness to such policies in the absence of an alternative. In Switzerland, the key domestic constraint was a limited domestic bond market. In Europe, the constraints are either legal (restrictions on financing sovereigns) or technical (issues with the size and regulatory marking of the ABS market). Should a domestic QE program prove unsatisfactory in arresting deflationary pressures, the international community would have to decide between European foreign bond purchases or the risk of deflation in one of the world's largest economies. We think ultimately they'd side with intervention. At the most recent IMF meetings, even Japanese Finance Minister Aso emphasized the dangers of deflation in Europe.

Given Draghi's renewed focus on the level of the currency, we believe that the EUR will trade with an asymmetric risk profile going forward, with EURUSD in the high 1.30s likely to cap gains. We have a 1.32 target on our short EURUSD recommendation (see Strategic FX Portfolio, page 12).

[1] Bundesbank Monthly Report January 2001
[2] http://www.imf.org/external/pubs/ft/sdn/2014/sdn1403.pdf

EUR: Endless Possibilities

Ian Stannard, Dara Blume

- We look at a variety of potential ECB scenarios, though do not view this as a comprehensive list of outcomes.
- We give estimates of where EUR would trade under these scenarios, though we highlight that these are very rough approximations. We see EURUSD heading towards 1.34-1.32 under most scenarios.

Anticipating the exact impact of the ECB meeting on the EUR is extremely difficult given the array of potential policy options available. The transmission channel of potential policy measures is also unclear in several cases, adding to the complexity of the analysis. Moreover, the reaction of asset markets and the lending behavior of the banks need to be taken into account, especially when it comes to the more medium-term outlook for the EUR. Indeed, we would suggest that the potential for a positive asset market reaction to ECB easing and the continued cautious (overseas) lending behavior of banks due to regulation implies some constraint when it comes to EUR bearish projections. While most of the easing measures under consideration by the ECB will likely have an initial negative impact on the EUR, the precise nature of the policy action taken is likely to have a bearing on the extent and duration of downward pressure on the EUR. Here we attempt to gauge the extent of the impact on the EUR under several potential scenarios. These scenarios are only a few of the possibilities; for a more comprehensive list see our European economists' piece, *EuroTower Insights: Policy Options the ECB Ponders*, 29 May 2014. In addition, these estimates are just that, and are purely approximations that can be used for the rough scale of moves we would expect. The outcome will be very much influenced by the details released on the day, and how market conditions develop between the time of writing and the ECB meeting itself.

Market expectations for policy action are heightened, with a series of measures now anticipated at the June meeting. This increases the potential volatility over the announcement itself. In the assessment we make here we assume market expectations are for a refi and deposit rate cut, possibly alongside some liquidity measures. While the EUR has already weakened since the last ECB meeting in anticipation of policy action, we see failure to meet the basic market expectations of a refi and depo rate cut as the only scenario where the EUR is likely to rebound beyond the initial volatility of the announcement. In the table below we list the extent of EUR decline we envisage under various, but not comprehensive, scenarios, with EURUSD heading lower into the 1.34-1.32 area the most likely outcome, we believe. We also believe that the central bank could maintain a dovish tone, maintaining anticipation of potential further easing, and keeping the EUR under pressure even if just the minimum of measures is delivered.

Outright QE, large scale purchases of assets, is likely to have the most negative impact on the EUR, in our view, and is the only scenario were we would anticipate a sub-1.30 reading for EURUSD, even if there were a positive asset market reaction.

Exhibit 1

ECB – Possible Policy Actions at a Glance

Policy instrument	Morgan Stanley View	Potential FX impact	Approximate EURUSD Level
Refi rate cut	Expecting 15bp cut in June to anchor EONIA near zero	This would be less than the market expects, and would drive a rally in EUR.	1.37
+Depo rate cut	Expecting 15bp in June to fend off EUR strength	This would lead to one-off EUR weakness, but is unlikely to drive sustained depreciation.	1.34
+Forward guidance	Some forward guidance already in place; hurdles for explicit numerical linked targets is high	If door perceived to be credibly open for future action, could prompt markets to price in further easing.	1.32
+Targeted liquidity measures	Targeted LTRO to boost SME lending possible	This would weaken EUR, as we expect it would increase the monetary base. However, positive impact on equities would limit EUR decline.	1.32
+Broad liquidity measures	General LTRO possible, but hurdle high. Measures to increase excess liquidity possible as well.	A general increase in the monetary base, without the targeted economic impact, would drive EUR lower.	1.30
+QE – large-scale asset purchases	Very high hurdle, would only be based on significant changes to medium-term inflation outlook (deflation)	Very unlikely, but the most bearish EUR outcome, though it would not lead to a sustained decline.	1.28

Source: Morgan Stanley Research. Note the table is cumulative, i.e., each row includes the action of the rows above it.

SEK: Disinflationary Decline

Hans Redeker, Dara Blume

- Inflationary pressures in Sweden have been puzzlingly low, keeping the possibility for further rate cuts open.
- This has added to pressure on SEK.
- We examine the causes of disinflationary pressures in Sweden, and find that some of these are likely to persist.
- As long as inflationary pressures in Sweden remain low or even in decline, the market is likely to price in a probability of further Riksbank easing, weighing on SEK.

Over the past few months, SEK has traded very much in line with anticipation of rate changes and central bank policy. Certainly, there are a number of factors, ranging from risk appetite to euro area politics, which influence SEK. However, recently, the focus has been on the Riksbank and the 'will they/won't they' question of further easing. In this context, inflation prints have been key for SEK, and are likely to remain as long as further cuts continue to be a risk.

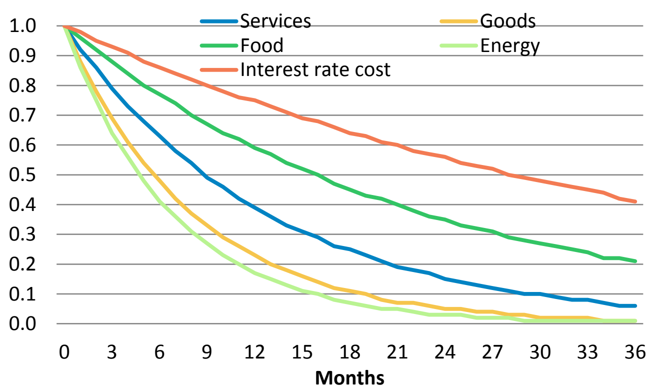
Indeed, Swedish inflation has been puzzlingly low, even as growth has picked up somewhat. The Riksbank's own models suggest that, given current levels of labor costs and producer imports, inflation is lower than one would expect.[1] We identify four factors that have put downward pressure on Swedish inflation, two of which could persist for some time, supporting our view for SEK weakness for the next few months as disinflationary pressures remain. Perhaps the resulting SEK weakness could be enough to raise import prices, which would in the end drive the pick-up in inflation the Riksbank has long anticipated. For us, the bottom line is that with rates at 75bp, the central bank has scope to cut. Therefore, as long as inflation remains low in Sweden, markets are likely to price in some probability of a cut, keeping pressure on SEK.

Persistent Disinflationary Pressures

Somewhat ironically, one of the key downward pressures on inflationary pressures in Sweden stems from its high levels of household debt. Because the household sector has such high levels of mortgage debt, mortgage interest costs make up about 5% of Swedish CPI. With many of these fixed mortgages, low interest costs are likely to add persistent pressure to inflation. Indeed, the Riksbank found in its February monetary policy report that it can take up to 30 months just for the impact of interest rate costs to halve their impact on inflation (see Exhibit 1). With mortgage interest rate costs in negative territory for only 20 months, there is certainly scope for deflationary pressures from this source to persist, weighing on SEK.

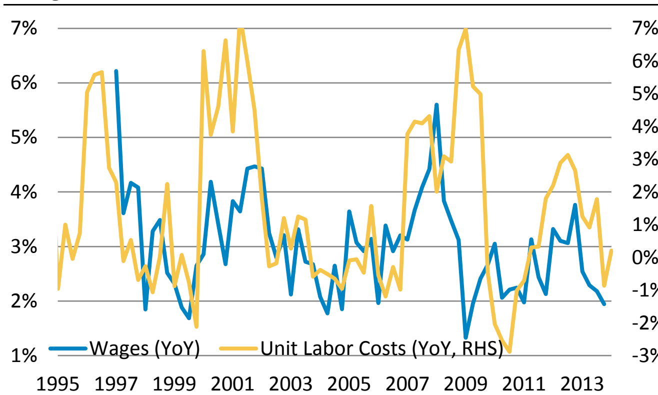
In addition, all else equal, in order for interest costs to rise, the repo rate would need to be lifted. However, as long as inflation is low, the Riksbank has pledged to keep rates on hold – even the more hawkish Riksbank members have agreed to this. This creates a 'chicken and the egg' problem, whereby an external shock would be needed to move either variable. All else equal, this should keep pressure on SEK in the absence of such a development.

Exhibit 1
Share of Price Shock that Persists in Inflation



Source: Riksbank, Morgan Stanley Research

Exhibit 2
Wages and Unit Labour Costs Muted



Source: Haver Analytics, Morgan Stanley Research

[1]See *Monetary Policy Report February 2014*, pg 43.

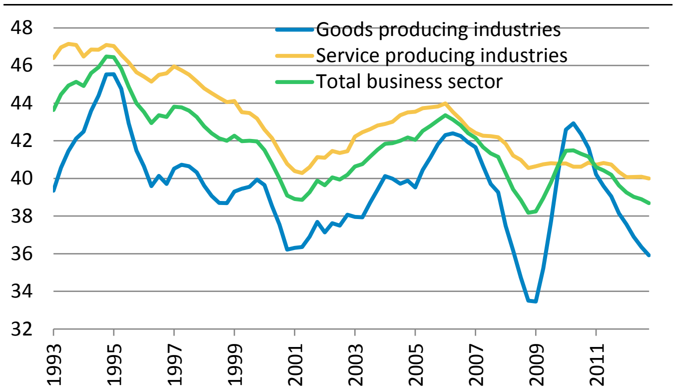
Another disinflationary pressure that is unlikely to fade soon is wages. Wage pressures have been minimal, and there are no large-scale bargaining rounds expected until 2016. The Riksbank expects wage growth to pick up to about 3% in 2014, the average rate of growth since 2013. However, with no future negotiations on the cards, and with unit labor costs still at relatively low levels (see Exhibit 2), a pick-up in inflation is unlikely to come from this front, keeping the Riksbank dovish, and adding pressure to SEK.

Where Are the Upside Risks

Despite low unit labor costs, companies have not increased their profit shares, as they have not passed on higher costs to the consumer (see Exhibit 3). This is perhaps the most puzzling aspect of low Swedish inflation. Domestic demand in Sweden is relatively robust, growth has held up despite weakness in the euro area, but nonetheless, companies have not passed on higher costs to consumers. This suggests a lower level of confidence, as seen in the latest manufacturing NIER survey. It also highlights the low level of capacity utilization in Swedish non-durable consumer goods. Nonetheless, strong domestic demand could drive companies to pass on cost increases to customers. This is one of the areas where upside pressure in inflation could stem from, and we will watch for any signs that this is beginning, as this would pose a risk to our short SEK view.

Exhibit 3

Profit Shares in the Business Sector



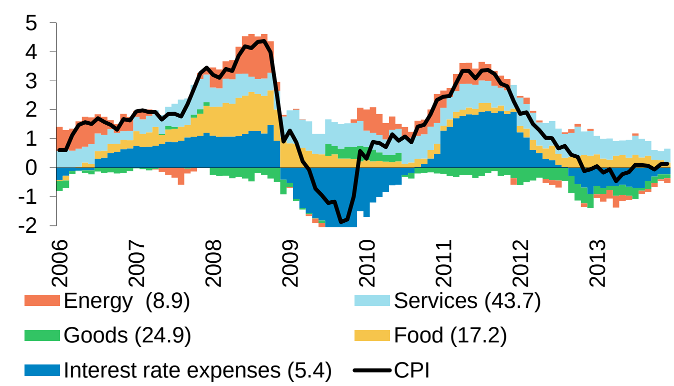
Source: Riksbank, Morgan Stanley Research

The other upside risk to CPI, in our view, would be a pick-up in energy or food prices. These are two of the more volatile components in inflation (as seen in Exhibit 1) and together comprise just over 25% of the total reading (see Exhibit 4). That said, if prices were to rise purely because of a one-off pick-up in energy or food prices, the central bank could well look through this, unless it believed that it could feed through into a larger pick-up in prices. As a result, in terms of the currency impact, we would be tempted to fade any SEK strength off the back of increases in inflation due to one-off energy or food price increases.

Swedish inflation is unlikely to pick up quickly, in our view. Two of the four main factors behind low inflation are likely to persist for some time, and the Riksbank is likely to look through a third. As a result, pressure on SEK due to disinflationary risks and the anticipation of a potential Riksbank response could persist for some time.

Exhibit 4

Contribution to CPI Growth

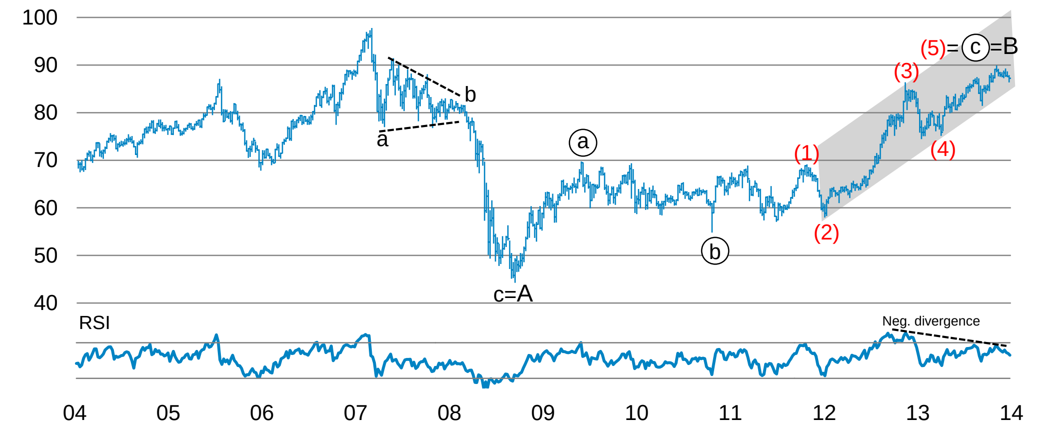


Source: Riksbank, Morgan Stanley Research; Numbers in brackets represent % contribution to total CPI

Technical Chart of the Week – NZD/JPY

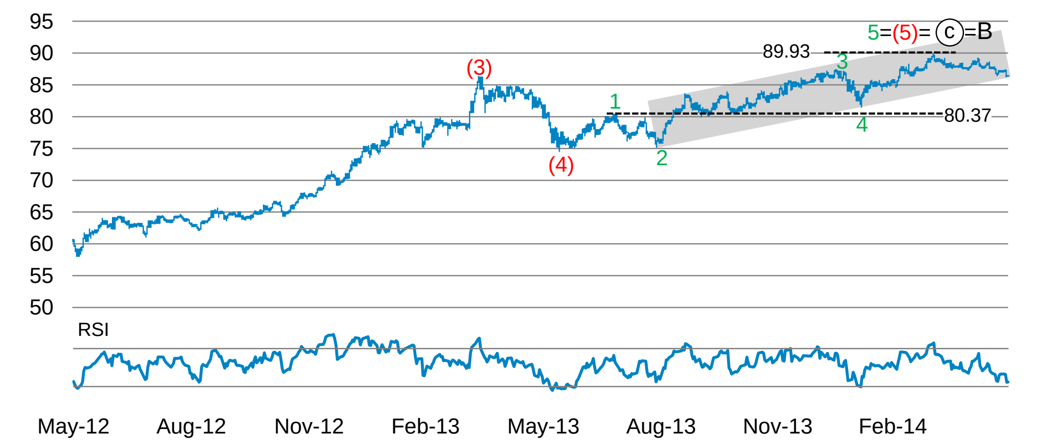
Sheena Shah

10-year NZD/JPY Chart



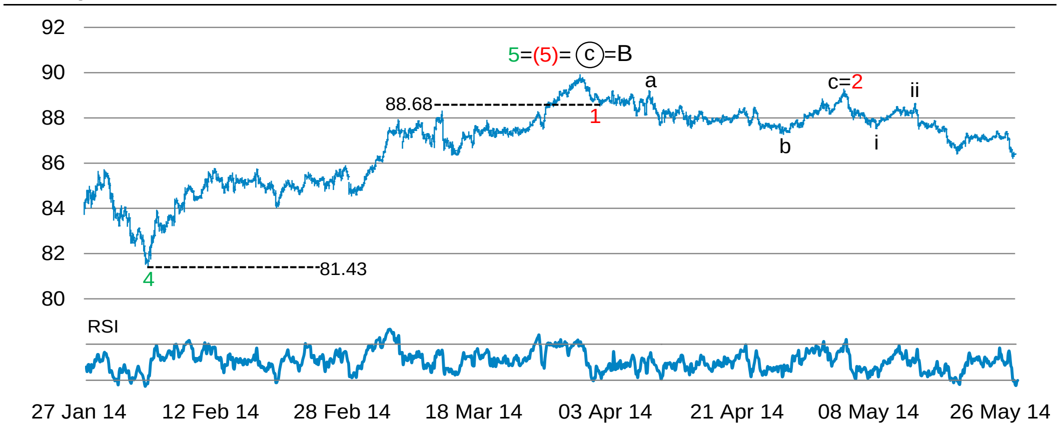
We are bearish on NZD/JPY as we believe it has topped out at the 0.8993 level, completing a a 5-wave structure. The observation of negative divergence from the 14-day RSI also gives a bearish signal for the currency pair. Over the longer term we would expect a correction of the 5-wave structure.

2-year NZD/JPY Chart



NZD/JPY has completed a 5-wave structure starting from a low of 74.46 in May-2013. We expect NZD/JPY to initially retrace to 61.8% of the (5)th wave at 80.37. A move below here would give further bearish signals. Initial bearish signals would come from a move below the bottom end of the trend channel at 85.97.

90-day NZD/JPY Chart



In the near term, NZD/JPY is in the iiird sub-wave, part of a 3rd larger wave, both suggesting that NZD/JPY should head lower. The risk is a move above the 1st wave bottom at 88.68, where we would reconsider the bearish strategy.

For a description of the Elliott Wave Theory see: *Trading Technicals – The Elliott Wave Method*, January 10, 2014.
Source: Bloomberg, Morgan Stanley Research

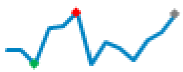
G10 Currency Summary

Dara Blume, Sheena Shah

Click here for interactive currency pages: Morgan Stanley Matrix

USD

0.9%



Front End Rates Support USD — **Bullish** — *Watch: Personal Spending, PCE, ISM, Non Farm Payrolls*

We expect the USD to rally, supported by higher US front-end rates. Not only has US data come in on the strong side of expectations, but the quality of US growth has also improved with the supply side of the US economy picking up. Capital spending holds the key for long-term USD performance, as rising capital demand will affect the US rate market. For longer term economic strength we look at the increasing demand for loans from small businesses and expected increased FDI.

EUR

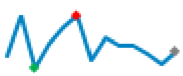
-1.3%

All Eyes on the ECB — **Bearish** — *Watch: Manufacturing PMI, CPI estimate, ECB Rates Decision*

The major event for EUR next week will be the ECB rates decision and press conference. The risk-reward favors short EUR over the medium term now that Draghi has made EUR the de facto trigger for further easing. While rate cuts may technically be priced in for next week, liquidity measures designed to bring down EONIA are not. There is potential for Draghi to surprise and bring EUR lower. We like to sell EUR especially on the crosses such as EURJPY and EURGBP.

JPY

0.2%

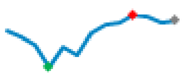


BoJ Moves Down the Yield Curve — **Bullish** — *Watch: Employment, CPI, Construction Orders, Leading Index*

We remain bearish on USDJPY. Declining JGB liquidity makes it difficult for the BoJ to carry out its QE operations. The BoJ has now announced that it will increase its bond purchases in the short end of the curve, which in our view is bullish for the JPY, as it suggests less aggressive easing. We like to also sell CHF/JPY that would do well in a rising volatility environment. This week we will be watching the CPI release, expected to be strong from the rise in sales tax.

GBP

0.5%

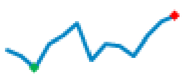


Re-Pricing a Hike? — **Bullish** — *Watch: Mortgage Approvals, PMI, BoE Decision; Trade*

We believe GBP could see continued support after some correction over recent days. Data in the UK remain strong, and are likely to offer continued support to the currency. At the same time, some members of the MPC have become more vocal regarding their views on spare capacity and the timing of the first rate hike. This creates potential for markets to bring forward the pricing of the first hike, which should add support to GBP.

CHF

1.8%

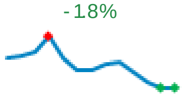


CHF Weak Even with Dovish ECB — **Bearish** — *Watch: KoF, PMI, SNB FX Reserves, CPI, Industrial Output*

We believe CHF will remain sold, even if the ECB eases further. Though markets expect a pickup in inflation in Switzerland, overall inflationary pressures remain low, and are likely to keep the SNB easy for some time to come. We expect that the market will not test the SNB, but note that if it did, the central bank has room to respond with further tools. As a result, we see an asymmetric risk profile for CHF and remain short.

CAD

-1.8%

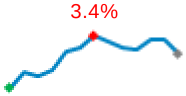


Upward Trend Set to Resume — **Bearish** — *Watch: GDP, Trade, BoC Decision, Employment*

We believe USDCAD is now set for its next leg up. Positioning has turned more neutral, while momentum has reached a bullish extreme. This sets up a technical environment where CAD could see weakness. What's more, two year US yields have started to rise, which should further the interest rate differential between the US and Canada, boosting USDCAD further.

AUD

3.4%

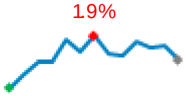


Strong Domestic Conditions — **Neutral** — *Watch: Building Approvals, Trade Balance, RBA, GDP*

In the near term we see some upside risks for AUD. AUDUSD rebounded following the upward revision to Australia's capex forecasts and the rebound in the new home sales for April. We still remain bearish on AUD over the longer term, however for now, strong Australian domestic conditions and China seeking AAA sovereign investments will likely keep AUD supported. In particular we like buying AUDNZD.

NZD

1.9%

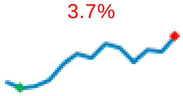


Dairy Prices in Focus — **Bearish** — *Watch: M3, Terms of Trade, Commodity Price, House Prices*

We remain bearish on NZD. This week we saw that New Zealand's milk prices were slightly better than expected but have fallen 30% since March. The reduction in GDP expected from the fall in prices is around 1.1%. There are also risks coming from the RBNZ talking down the strength of the currency. We remain bearish on NZD for fundamental and technical reasons. We like to sell against AUD. This week we will be watching the commodity prices, and their effect on terms of trade.

SEK

3.7%

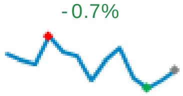


Persistent Disinflationary Pressures — **Bearish** — *Watch: GDP, PMI, Industrial Production*

We maintain our bearish SEK view over the medium term, and believe that disinflationary pressures will continue to weigh on the currency. Sweden's low inflation is something of a puzzle given strong growth. However, examining some of the contributing factors, we believe there is a relatively high risk that inflation in Sweden remains low for some time, keeping the central bank dovish, and weighing on SEK.

NOK

-0.7%



Near-Term Upside Risks — **Bullish** — *Watch: PMI, Unemployment rate, Industrial production*

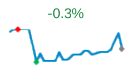
We believe NOK could see upside over coming weeks. Recent data has been robust, inflation remains near target, and the central bank is firmly on hold. At the same time, Norwegian equity markets have been outperforming, which is also likely to bolster the currency. Over the medium term, we are concerned that structural issues and a lack of competitiveness could weigh on NOK, but this should not drive NOK weakness over the next few months.

Charts show 1M performance against USD, as normally quoted and DXY for USD. Click on any currency for a reference webpage on Matrix.

EM Currency Summary

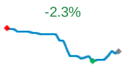
Kritika Kashyap (AXJ), Meena Bassily (CEEMEA), Felipe Hernandez (LatAm)

CNY **Bearish**



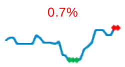
Following the CNY band widening, we think risks are skewed to the upside for USD/CNY on the back of recent soft China macro data and increasing tail risks from the ongoing deleveraging in the Chinese economy. We prefer to express this view through long-dated CNH put options.

INR **Neutral**



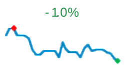
INR continues to trade well and we expect further gains in the short term, driven by portfolio flows – particularly into the equity market. The RBI will likely smooth the trend. Longer-term prospects will hinge more on the success of reform efforts.

IDR **Neutral**



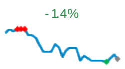
We remain neutral as much of the impact is waning from factors such as the narrowing of Indonesia's current account and Jokowi's announcement as the PDI-P presidential candidate. Scope for the current account to narrow further has decreased. However, high carry makes IDR a difficult short.

KRW **Bullish**



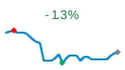
Korea's GDP and trade numbers point to economic recovery. At the same time, the BoK has allowed USD/KRW to break below 1048, which opens the door for more downside, in our view. Korean bonds continue to see inflows from reserve diversification, while inflows into equities have also returned.

MYR **Neutral**



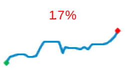
Recent data have been positive, showing strong IP growth and trade improvement. Malaysia, being a net oil exporter, is also likely to outperform regional peers if oil prices rise. However, in the near term, USD/MYR continues to be driven by the broader sentiment on China and the global economy.

PHP **Bullish**



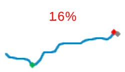
The Philippines' strong fundamentals, incoming foreign investor flows in local equities and the BSP turning to a more hawkish bias support the peso. That said, the currency remains susceptible to the broader risk sentiment on EM and Asian currencies.

THB **Bearish**



Continued political uncertainty is likely to remain a drag on GDP growth and exports. Thailand is also exposed to funding risks, given its weak current account cushion, and FDI flows that supported THB through last year have taken a hit since November. We remain most bearish on THB in the region.

CZK **Neutral**

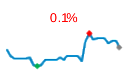


EUR/CZK remains stable, trading around 1.5% above the CNB's stated floor at 27. We expect it would take a large shift in data – and particularly inflation – for these dynamics to change.

HUF **Bullish**

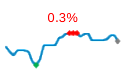
The National Bank of Hungary has resumed its cutting cycle, and our economists look for another 40bp worth of cuts over coming months. Despite this continued easing the currency remains resilient against the EUR given the continued decline in inflation and the increased risk of ECB meeting next week. We stay constructive on HUF.

ILS **Neutral**



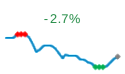
The Bank of Israel has kept rates on hold despite recently lower than expected inflation and some modest weakness in data. In the absence of further dovish policy or greater concern with exchange rate strength we expect underlying balance of payment dynamics to support a modest appreciation of ILS.

PLN **Bullish**



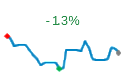
Regional disinflation risks have driven a rally in Polish rates and resulted in further inflow into Poland's debt market helping support the zloty. In addition the risk of further dovish ECB action should help keep downward pressure in place on EUR/PLN. We think PLN strength also reflects improving fundamentals.

RUB **Bearish**



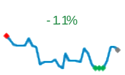
The RUB relief rally has lost momentum with the reduced risk of sanctions having already been priced into the exchange rate in our view. We therefore see more value in positioning for the medium-term weakening trend of the RUB – that is driven by weakness in capital flows and growth – to resume,

TRY **Bearish**



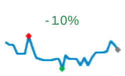
USD/TRY has failed to move convincingly below the 200 day MA, and we think risk-reward in chasing the cross lower from current levels has diminished. Most importantly the CBT's more dovish stance makes the currency more vulnerable to any interruption to the currently stable external environment.

ZAR **Bearish**



With elections passed, focus is turning back to fundamentals, and this week's disappointing growth reading for Q1 highlights some of the supply-side issues in the economy which are impacting key export sectors such as mining. In addition weak growth reduces the chance of imminent rate hikes. We recommend buying MXN/ZAR.

BRL **Bearish**

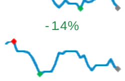


Amid low volatility, BRL continues benefiting from high carry and increasing hopes for regime change, with short term upside now limited by the BCB unwinding FX swaps and less favourable technical factors. We still look for sharp depreciation ahead of the October elections, as the low-growth/high-inflation balance and higher interest rates weigh on weak fiscal accounts and the highly leveraged private sector.

CLP **Neutral**

Higher inflation moderates forecasts for rate cuts and supports CLP in the short term. However, lower growth and downside risks from copper prices and demand from China continue to weigh on CLP.

COP **Neutral**

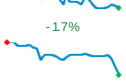


Higher interest rates, recovering activity and foreign investment support COP. Officials maintain a weakening bias with increasing intervention – and risks for more intervention are likely to build a strong floor near 1900.

MXN **Bullish**

We maintain our constructive medium-term outlook and see scope for further appreciation, as reforms boost growth and attract new capital inflows. High beta characteristics still imply short term exposure to global risks.

PEN **Neutral**



Central bank intervention limits volatility in both directions, but lower commodity prices and weaker external demand imply eroding PEN valuations, as an adjustment weaker seems necessary.

Charts show 1M performance against USD, as normally quoted