

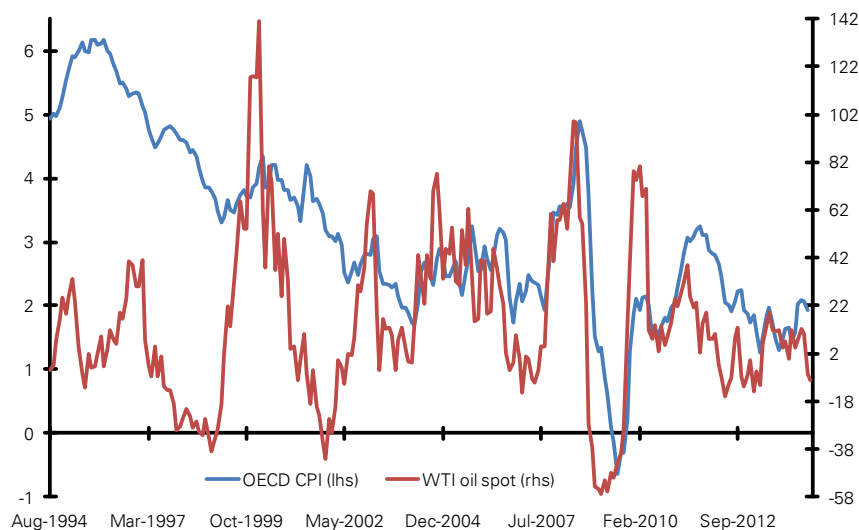


## FX Daily

# Why the USD will shine in a low inflation world

Foreign exchange participants should expect a world in which US growth is relatively solid, but inflation trends remain subdued. A new ingredient in the softer inflation story is low oil prices and its dominant influence in a world where inflation trends are subdued. In the last 10 years, WTI oil prices led US CPI headline inflation rates by 1 month with an exceptionally strong correlation of 80% using y/y% data. The relationship is very similar for oil and OECD CPI inflation. Oil prices also slowly filter into higher core US CPI inflation with a peak 18 month lead time, and a still strong correlation of 47% in the past 10 years.

Figure 1: OECD CPI versus WTI oil spot (YoY % changes)

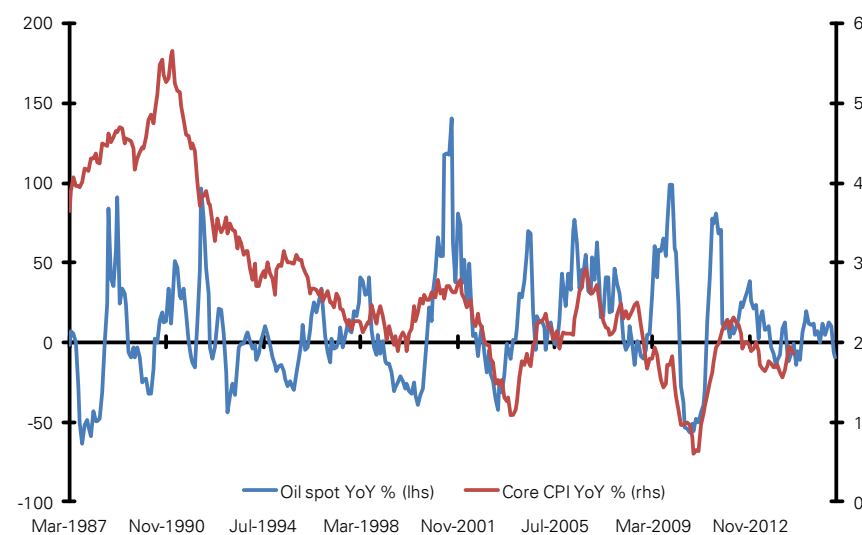


Source: Deutsche Bank, EcoWin

The last time we had similar circumstances with subdued commodity prices relative to equities was 1996-1999 when Asia was having problems, and the pay-off from reduced commodity price pressures was a Federal Reserve that could remain easier for longer. This was a key factor behind the frothy asset prices of the time. Strong asset prices were associated with the strong FDI and equity inflows into the US that were key factors behind the stronger USD.

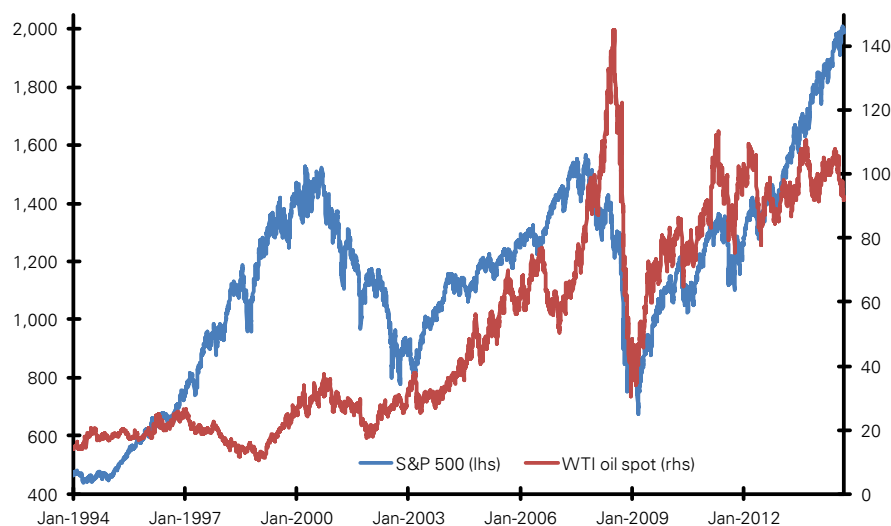


Figure 2: WTI oil spot (18m forward) versus US core CPI (YoY % change)



Source: Deutsche Bank, EcoWin

Figure 3: S&P 500 versus WTI oil spot (USD)



Source: Deutsche Bank, EcoWin

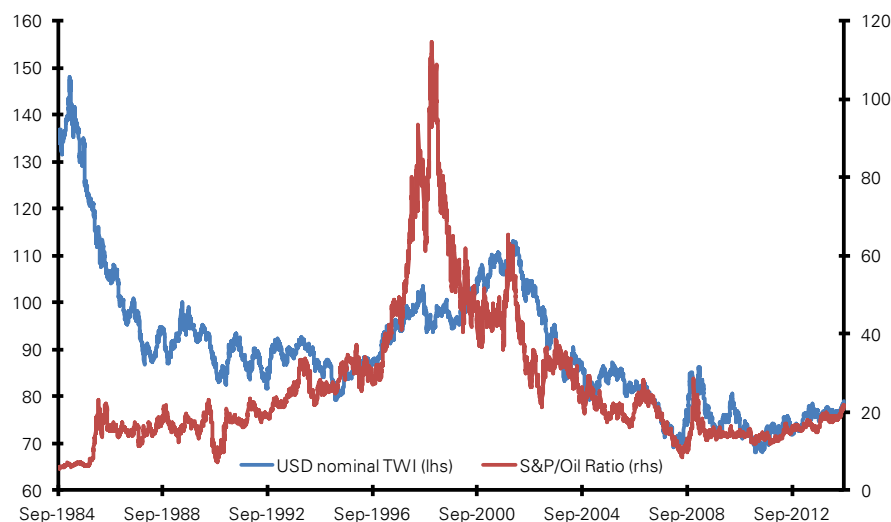
In the current circumstances, subdued global inflation is likely to be positive for different reasons including:

1. It will encourage unorthodox easing measures in the likes of the EUR area and Japan that will stand in contrast to a slower Fed tightening cycle.
2. Similarly the more Central Banks like the ECB and BOJ are faced with a deflation threat, the more likely they are to encourage a weaker currency through less than subtle verbal 'intervention'.
3. Lower commodity prices are strongly correlated with positive terms of trade shocks for the US;



4. Strong rates of return for equities, notably versus commodities, have also been associated with USD strength over the last 20 years, partly because of the terms of trade shock as per above, and partly because asset inflation supports growth and ultimately prompts tighter Fed policy.

Figure 4: USD nominal TWI vs S&P 500 – WTI oil spot ratio



Source: Deutsche Bank, EcoWin

5. Similarly in the current cycle, the risk positive impact of lower energy prices will result in the JPY and EUR (and CHF) acting as ongoing financing vehicles, also consistent with a positive US equities – USD correlation.

The Table below shows 4 states of the world and shows how in the past 20 years the USD has traded best in a strong growth, low or decelerating inflation world; and the USD trades worst in quarters of weak growth and accelerating or high inflation.

Figure 5: USD TWI median response to different states of the world

	Count	Median QoQ % change USD TWI
Weak real GDP growth - Decelerating/low inflation	22	0.432
Weak real GDP growth - Accelerating/high inflation	18	-1.742
Strong real GDP growth - Decelerating/low inflation	20	1.339
Strong real GDP growth - Accelerating/high inflation	20	0.616

\*Strong real GDP growth: Real GDP QoQ % 2 quarter average above 10 year average

\*Weak real GDP growth: Real GDP QoQ % 2 quarter average below 10 year average

\*Accelerating/high inflation: Core CPI MoM 4m average above 12m average or core CPI YoY % above 3.5% YoY

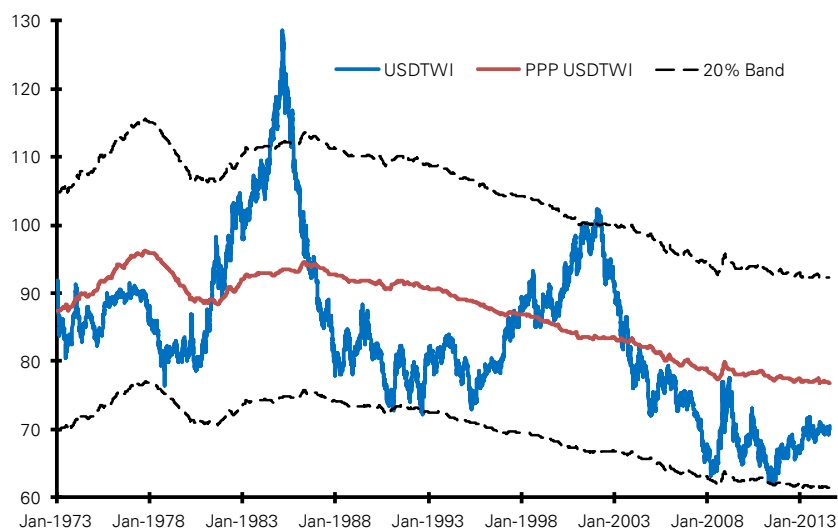
\*Decelerating/low inflation: Core CPI MoM 4m average below 12m average or core CPI YoY % below 1.5% YoY

Source: Deutsche Bank, EcoWin, Bloomberg Finance LP



The experience over the coming year should further validate the experience of the data set above, with EUR/USD seen tracking to 1.25 by year-end and 1.18 by the end of 2015, and USD/JPY showing even more scope for depreciating this year, targeting Y112 and then Y120 at the end of 2014 and 2015 respectively.

Figure 6: USD TWI valuation



Source: Deutsche Bank



# Appendix 1

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