Deutsche Bank
Markets Research

Global

Foreign Exchange
FX Spot

Date
22 September 2014

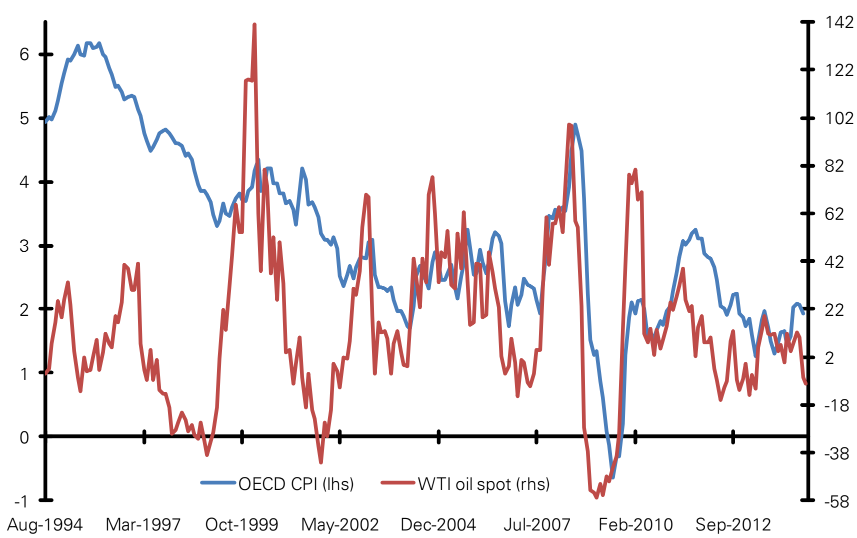
Alan Ruskin
Macro strategist
(+1) 212 250-8646
alan.ruskin@db.com

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.

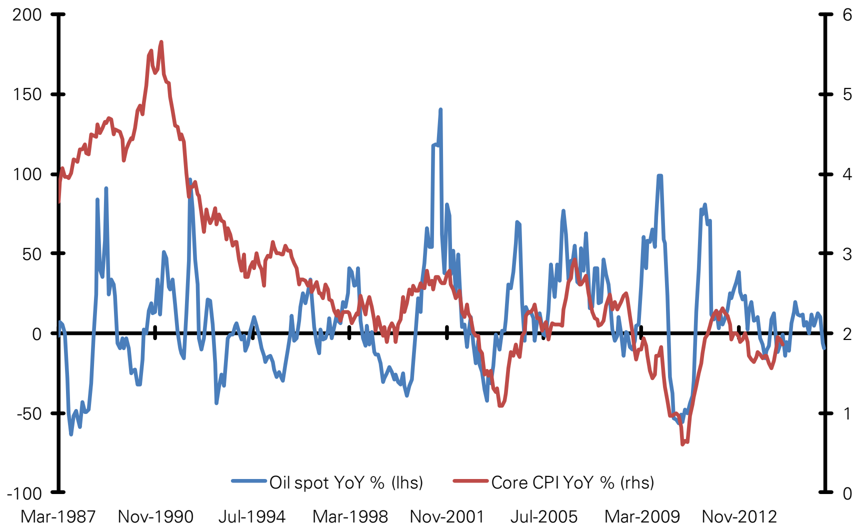
Figure 1: OECD CPI versus WTI oil spot (YoY % changes)



Source: Deutsche Bank, EcoWin

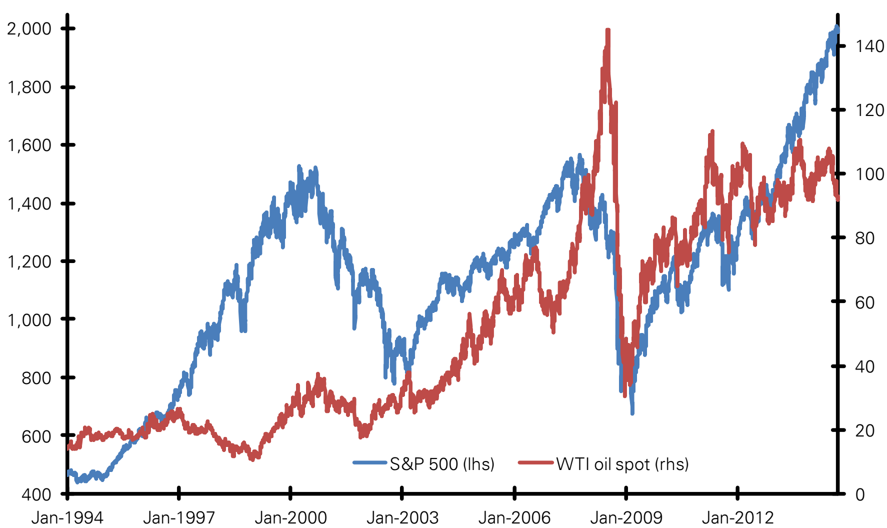
The last time we had similar circumstances with subdued commodity prices relative to equities was 1996-1999 when Asia was having problems, and the pay-off from reduced commodity price pressures was a Federal Reserve that could remain easier for longer. This was a key factor behind the frothy asset prices 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:

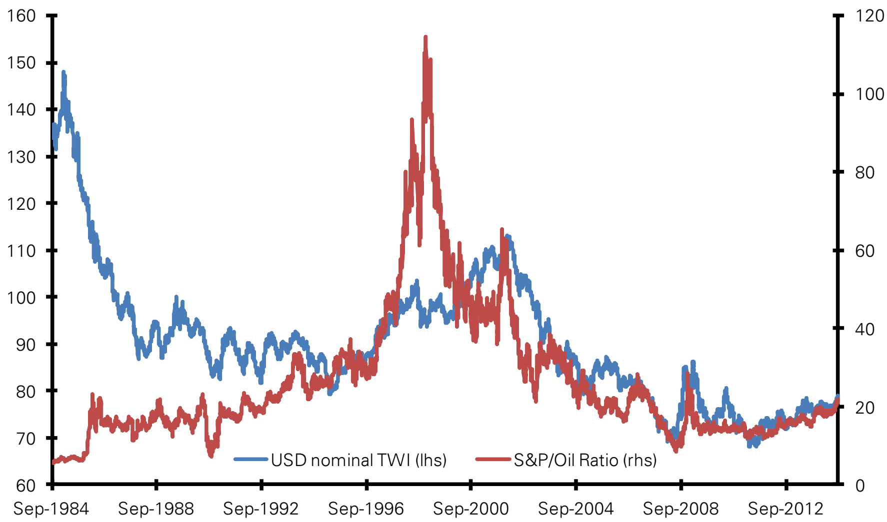
1. It will encourage unorthodox easing measures in the likes of the EUR area and Japan that will stand in contrast to a slower Fed tightening cycle.

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

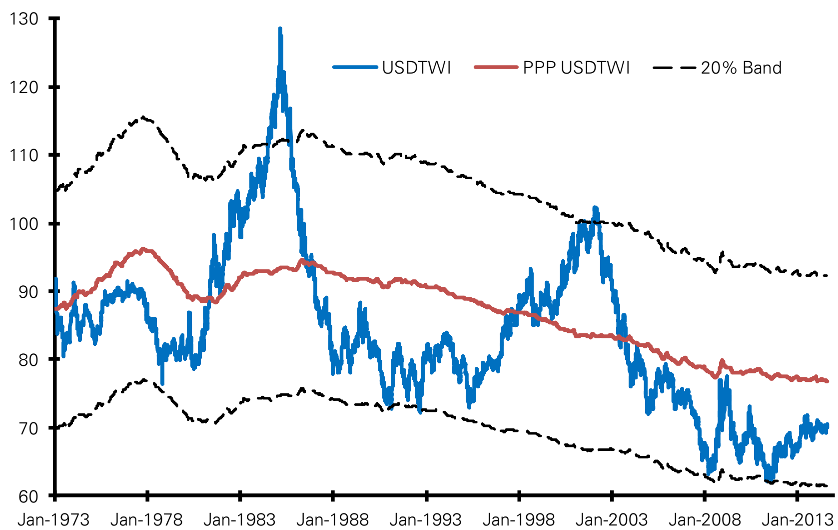
	Count	Median QoQ % change USD TWI
Weak real GDP growth - Decelerating/low inflation	22	0.432
Weak real GDP growth - Accelerating/high inflation	18	-1.742
Strong real GDP growth - Decelerating/low inflation	20	1.339
Strong real GDP growth - Accelerating/high inflation	20	0.616

**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

Important Disclosures

Additional information available upon request

For disclosures pertaining to recommendations or estimates made on securities other than the primary subject of this research, please see the most recently published company report or visit our global disclosure look-up page on our website at http://gm.db.com/ger/disclosure/DisclosureDirectory.eqsr

Analyst Certification

The views expressed in this report accurately reflect the personal views of the undersigned lead analyst(s). In addition, the undersigned lead analyst(s) has not and will not receive any compensation for providing a specific recommendation or view in this report. Alan Ruskin

Regulatory Disclosures

1. Important Additional Conflict Disclosures

Aside from within this report, important conflict disclosures can also be found at https://gm.db.com/equities under the "Disclosures Lookup" and "Legal" tabs. Investors are strongly encouraged to review this information before investing.

2. Short-Term Trade Ideas

Deutsche Bank equity research analysts sometimes have shorter-term trade ideas (known as SOLAR ideas) that are consistent or inconsistent with Deutsche Bank's existing longer term ratings. These trade ideas can be found at the SOLAR link at http://gm.db.com.

3. Country-Specific Disclosures

Australia and New Zealand: This research, and any access to it, is intended only for "wholesale clients" within the meaning of the Australian Corporations Act and New Zealand Financial Advisors Act respectively.
Brazil: The views expressed above accurately reflect personal views of the authors about the subject company(ies) and its(their) securities, including in relation to Deutsche Bank. The compensation of the equity research analyst(s) is indirectly affected by revenues deriving from the business and financial transactions of Deutsche Bank. In cases where at least one Brazil based analyst (identified by a phone number starting with +55 country code) has taken part in the preparation of this research report, the Brazil based analyst whose name appears first assumes primary responsibility for its content from a Brazilian regulatory perspective and for its compliance with CVM Instruction # 483.
EU countries: Disclosures relating to our obligations under MiFiD can be found at http://www.globalmarkets.db.com/riskdisclosures.
Japan: Disclosures under the Financial Instruments and Exchange Law: Company name - Deutsche Securities Inc. Registration number - Registered as a financial instruments dealer by the Head of the Kanto Local Finance Bureau (Kinsho) No. 117. Member of associations: JSDA, Type II Financial Instruments Firms Association, The Financial Futures Association of Japan, Japan Investment Advisers Association. This report is not meant to solicit the purchase of specific financial instruments or related services. We may charge commissions and fees for certain categories of investment advice, products and services. Recommended investment strategies, products and services carry the risk of losses to principal and other losses as a result of changes in market and/or economic trends, and/or fluctuations in market value. Before deciding on the purchase of financial products and/or services, customers should carefully read the relevant disclosures, prospectuses and other documentation. "Moody's", "Standard & Poor's", and "Fitch" mentioned in this report are not registered credit rating agencies in Japan unless "Japan" or "Nippon" is specifically designated in the name of the entity.
Malaysia: Deutsche Bank AG and/or its affiliate(s) may maintain positions in the securities referred to herein and may from time to time offer those securities for purchase or may have an interest to purchase such securities. Deutsche Bank may engage in transactions in a manner inconsistent with the views discussed herein.
Qatar: Deutsche Bank AG in the Qatar Financial Centre (registered no. 00032) is regulated by the Qatar Financial Centre Regulatory Authority. Deutsche Bank AG - QFC Branch may only undertake the financial services activities that fall within the scope of its existing QFCRA license. Principal place of business in the QFC: Qatar Financial Centre, Tower, West Bay, Level 5, PO Box 14928, Doha, Qatar. This information has been distributed by Deutsche Bank AG. Related financial products or services are only available to Business Customers, as defined by the Qatar Financial Centre Regulatory Authority.
Russia: This information, interpretation and opinions submitted herein are not in the context of, and do not constitute, any appraisal or evaluation activity requiring a license in the Russian Federation.
Kingdom of Saudi Arabia: Deutsche Securities Saudi Arabia LLC Company, (registered no. 07073-37) is regulated by the Capital Market Authority. Deutsche Securities Saudi Arabia may only undertake the financial services activities that fall within the scope of its existing CMA license. Principal place of business in Saudi Arabia: King Fahad Road, Al Olaya District, P.O. Box 301809, Faisaliah Tower - 17th Floor, 11372 Riyadh, Saudi Arabia.
United Arab Emirates: Deutsche Bank AG in the Dubai International Financial Centre (registered no. 00045) is regulated by the Dubai Financial Services Authority. Deutsche Bank AG - DIFC Branch may only undertake the financial services activities that fall within the scope of its existing DFSA license. Principal place of business in the DIFC: Dubai International Financial Centre, The Gate Village, Building 5, PO Box 504902, Dubai, U.A.E. This information has been distributed by Deutsche Bank AG. Related financial products or services are only available to Professional Clients, as defined by the Dubai Financial Services Authority.

Risks to Fixed Income Positions

Macroeconomic fluctuations often account for most of the risks associated with exposures to instruments that promise to pay fixed or variable interest rates. For an investor that is long fixed rate instruments (thus receiving these cash flows), increases in interest rates naturally lift the discount factors applied to the expected cash flows and thus cause a loss. The longer the maturity of a certain cash flow and the higher the move in the discount factor, the higher will be the loss. Upside surprises in inflation, fiscal funding needs, and FX depreciation rates are among the most common adverse macroeconomic shocks to receivers. But counterparty exposure, issuer creditworthiness, client segmentation, regulation (including changes in assets holding limits for different types of investors), changes in tax policies, currency convertibility (which may constrain currency conversion, repatriation of profits and/or the liquidation of positions), and settlement issues related to local clearing houses are also important risk factors to be considered. The sensitivity of fixed income instruments to macroeconomic shocks may be mitigated by indexing the contracted cash flows to inflation, to FX depreciation, or to specified interest rates - these are common in emerging markets. It is important to note that the index fixings may -- by construction -- lag or mis-measure the actual move in the underlying variables they are intended to track. The choice of the proper fixing (or metric) is particularly important in swaps markets, where floating coupon rates (i.e., coupons indexed to a typically short-dated interest rate reference index) are exchanged for fixed coupons. It is also important to acknowledge that funding in a currency that differs from the currency in which the coupons to be received are denominated carries FX risk. Naturally, options on swaps (swaptions) also bear the risks typical to options in addition to the risks related to rates movements.

David Folkerts-Landau
Group Chief Economist
Member of the Group Executive Committee

Guy Ashton
Global Chief Operating Officer
Research

Marcel Cassard
Global Head
FICC Research & Global Macro Economics

Richard Smith and Steve Pollard
Co-Global Heads
Equity Research

Michael Spencer
Regional Head
Asia Pacific Research

Ralf Hoffmann
Regional Head
Deutsche Bank Research, Germany

Andreas Neubauer
Regional Head
Equity Research, Germany

Steve Pollard
Regional Head
Americas Research

International Locations

Deutsche Bank AG
Deutsche Bank Place
Level 16
Corner of Hunter & Phillip Streets
Sydney, NSW 2000
Australia
Tel: (61) 2 8258 1234

Deutsche Bank AG
Große Gallusstraße 10-14
60272 Frankfurt am Main
Germany
Tel: (49) 69 910 00

Deutsche Bank AG
Filiale Hongkong
International Commerce Centre,
1 Austin Road West,Kowloon,
Hong Kong
Tel: (852) 2203 8888

Deutsche Securities Inc.
2-11-1 Nagatacho
Sanno Park Tower
Chiyoda-ku, Tokyo 100-6171
Japan
Tel: (81) 3 5156 6770

Deutsche Bank AG London
1 Great Winchester Street
London EC2N 2EQ
United Kingdom
Tel: (44) 20 7545 8000

Deutsche Bank Securities Inc.
60 Wall Street
New York, NY 10005
United States of America
Tel: (1) 212 250 2500

Global Disclaimer