Global FX Strategy
QE to Pressure Euro and Yen

FX

Global

Weaker euro and yen to reflect aggressive policy

In light of the continued decline in oil prices, and the corresponding rise in disinflationary headwinds, we now expect many at-risk G10 central banks to accelerate their efforts to stabilise price expectations. The Bank of Japan has already acted decisively and pre-emptively, and the ECB will likely be next: UBS now expects broad-based quantitative easing to be launched in Q1 2015 (see *Macro-Strategy Key Issue – ECB: Falling oil prices spell broader QE*, 3rd December). The currency is the most effective way for asset purchases to take effect, so we lower our three-month targets for the yen and euro against the dollar to USDJPY 124, from 118, and EURUSD 1.23, from 1.25. We also mark to market our one-month USDJPY forecast to 120 (from 115 previously).

Commodity currencies under the spotlight

With the oil market now looking over-supplied in the medium term, UBS expects Brent and WTI to trade at $65/bbl and $60/bbl respectively by end-Q1, from $100/bbl and $95/bbl. Demand issues will also weigh on commodities, materially affecting the terms of trade for commodity currencies. Among major currencies, CAD and NOK are particularly exposed to lower oil prices, as expectations for capital expenditures will also face material downward revision. We expect this to particularly affect krone given the risks of policy follow-through in Norway, and we revise our one-month EURNOK forecast to 8.90, from 8.50, and our three-month forecast to 8.75, from 8.25.

UBS FX Strategy Forecast Table

	Spot	1m		Previous	3m		Previous
EURUSD	1.2537	**1.23**	=	1.23	**1.23**	↓	1.25
USDJPY	109.35	**120**	↑	115	**124**	↑	118
EURJPY	137.09	**148**	↑	141	**153**	↑	148
GBPUSD	1.5972	**1.60**	=	1.60	**1.60**	↓	1.62
EURGBP	0.78495	**0.77**	=	0.77	**0.77**	=	0.77
EURCHF	1.21148	**1.21**	=	1.21	**1.22**	=	1.22
USDCHF	0.9663	**0.98**	=	0.98	**0.99**	↑	0.98
EURSEK	9.0822	**9.40**	=	9.40	**9.40**	=	9.40
EURNOK	8.1619	**8.90**	↑	8.50	**8.75**	↑	8.25
NOKSEK	1.1128	**1.06**	↓	1.11	**1.07**	↓	1.14
AUDUSD	0.8731	**0.84**	=	0.84	**0.83**	=	0.83
NZDUSD	0.7794	**0.76**	=	0.76	**0.73**	=	0.73
AUDNZD	1.1202	**1.11**	=	1.11	**1.14**	=	1.14
USDCAD	1.122	**1.14**	=	1.14	**1.15**	=	1.15

Source: UBS FX Strategy, spot correct as of December 3rd

Any references to options in this document refer to over-the-counter options

Weaker euro expected, but caution necessary

One of the most direct and effective forms of monetary transmission through quantitative easing is through the currency. We have seen the 'announcement effect' time and time again in various markets, though the sustainability of weakness is open to question as the full effect of balance sheet expansion can be priced in relatively swiftly. Much depends on the ability of monetary policy to generate portfolio rotation into risk, especially into overseas assets – as the BoJ's latest efforts are clearly trying to encourage. In the Eurozone's case, recycling core surpluses into zone-wide investment is undoubtedly favoured, but by definition there will be less of a currency effect. In addition, we believe an expansionary ECB has to a large extent been priced into the euro. The 'balance sheet to currency' relationship is dubious in itself, but in relative terms the Fed (even with tapering) has actually been quite more active compared to its counterpart in Frankfurt, but the euro has been trading at a discount since the ECB strengthened its easing bias and reached the zero bound through the second half of this year. As stated above, unless the Eurozone chooses to recycle its current account surplus overseas, it is difficult to see a materially weaker euro *driven by the ECB alone*. As such, we shift our three month forecast in EURUSD to 1.23 (from 1.25) on the back of the QE 'launch effect', while future price action will depend on the design and scale of the programme, in addition to external factors. Our longer-term bias in favour of the dollar remains linked to our views on the Fed's normalisation cycle and domestically-driven US recovery, which remains unchanged despite risks of a stronger pass-through effect on prices as the policy differentials versus the US continue to widen. We now target EURUSD at 1.15 and 1.10 (from 1.20 and 1.15) at end-2015 and end-2016, respectively.

The same lines of thinking apply to USDJPY forecasts. In last updated we noted how the Bank of Japan had 'made its mark' with a surprise expansion in quantitative and qualitative easing. While the surprise decision by Prime Minister Abe to suspend the second round of the consumption tax hike and to call new elections represents a minor risk factor, we still believe the portfolio reallocation effects will be material and Ministry of Finance data is already showing a sharp rise in outflows, suggesting there is strong domestic credibility of the current mix of policy measures. In addition, there should be no further doubts with respect to the BoJ's resolve and we believe there is a chance of *additional stimulus* in mid- to late-2015 (see *Japan Economic Comment: Post-general election political/economic highlights*, December 1st) as the BoJ's current inflation targets appear out of reach. Recent commentary by Fed vice-Chairman Fischer suggests the FOMC will be at ease with this approach. The upside limits to USDJPY depend far more on the level at which input price (and price expectations) far exceed those of outputs – very unlikely in the medium term given the ongoing downward pressure on energy and commodity prices. On the other hand, should USDJPY increase but attributed to Fed-driven dollar strength, this would be seen as a form of 'healthy' decline in the JPY with a strong external demand component, which the BoJ would embrace.

We leave our CHF and GBP forecasts against the euro unchanged. The SNB has likely already entered markets to defend the floor and additional measures are possible should there be a strong need to 'follow' any form of ECB expansion. The amounts involved so far are probably not enough to encourage any 'diversification' trade for now, though we will reassess if Eurozone QE does generate greater balance sheet expansion for the SNB as well. Overall, current price action suggests very limited appetite by markets to challenge the floor and the comprehensive rejection of the Gold Initiative on November 30th removes additional tail risk related to uncertainties over policy execution. For sterling, we continue to see risks of a short-term data-driven recovery in policy expectations in the coming year but the currency itself will largely react to adjustments in rates markets. However, we would sell into any GBPUSD move above 1.60 and we would maintain a defensive stance heading into Q2 next year as the UK's political uncertainties come to the fore (see *FX Perspectives: FX Outlook 2015*, November 17th).

Within the risk currencies, the CAD and NOK are most affected by the current decline in crude prices. For now we leave our USDCAD forecasts unchanged as the currency has been reflecting a dovish BoC bias for some time, while valuations have reached levels where the non-energy sector of the economy may start to recover some competitiveness losses and help the labour market heal. In contrast, the risks of a major revision in the Norwegian growth outlook by the central bank are rising. Capital expenditure will likely face sharp revisions to the downside and the latest regional network report from Norges Bank reports the oil supplier industry is expecting a 'further decline in output' over the next six months. While we would not rule out exceptional fiscal expansion, it is safe to assume that the country's output gap will have to widen beyond current accepted levels, and this will give the central bank some scope to ease policy via rate cuts. However, given the stabilisers in place for the wider economy complementing accommodation, the adjustment to growth and output is likely to be more modest compared to other commodity producers. As such, after a possible policy-induced overshoot in EURNOK (new target 8.90 in 1m), we still favour a gradual recovery in the krone and ECB QE will likely pressure euro crosses where there is a non-negligible interest rate gap. Our EURSEK forecasts remain unchanged; the policy direction in Sweden remains accommodative and escalating political instability is an additional risk. The Riksbank's response to ECB QE will be a major test for Stockholm in 2015 as Sweden's inflation outlook is arguably more precarious than the Eurozone's, and quantitative measures cannot be ruled out (see *FX Outlook 2015,* 17th November).

We keep our bearish outlook on AUD and NZD, not only in anticipation of an extension to the broad US dollar rally, but also because domestic drivers are still chipping away at both currencies' defences. Iron prices continue to sink, in part due to the surge in Australia's export supply, and in part because of faltering Chinese demand. Adding to the Australian dollar's predicament, portfolio inflows that had propped up the currency in recent years are dwindling fast – latest data released this week show bond inflows during Q3 2014 slowed to levels not seen in almost 6 years. Meanwhile, the RBNZ appears to have suspended its tightening campaign well ahead of schedule as local inflationary pressure subsides. The failure of milk prices to rebound so far is also cause for concern. The RBNZ's blast of FX intervention to weaken the currency in August was not repeated in September or October, but that is unlikely to change the picture much, although it suggests future currency weakness will be more gradual than we witnessed earlier this year.

Forecast Scorecard Update (accurate as of December 3rd 08:20 GMT)

	Spot	1m Forecast	3m Forecast	3m Option Delta	3m Skew Z-score	1y rate pricing (bp)	Valuations Z-Score
EURUSD	1.2361	1.23	1.23	45.90	-3.620	-50.52	0.3399
USDJPY	119.27	120	124	24.30	2.297	53.22	0.6883
EURJPY	147.44	148	153	23.50	1.466	2.7	1.3431
GBPUSD	1.5626	1.60	1.60	23.15	-0.655	-16.02	-0.0951
EURGBP	0.79108	0.77	0.77	21.00	-0.386	-34.5	0.3852
EURCHF	1.20343	1.21	1.22	22.15	-0.936	2.74	-0.9241
USDCHF	0.9735	0.98	0.99	35.70	2.113	53.26	-1.0003
EURSEK	9.2793	9.40	9.40	35.60	2.184	-2.38	1.3150
EURNOK	8.677	8.90	8.75	30.50	3.056	28.67	0.3230
NOKSEK	1.0694	1.06	1.07	45.00	-2.776	-31.05	1.4183
AUDUSD	0.8402	0.84	0.83	44.15	-1.501	-62.42	1.1940
NZDUSD	0.7781	0.76	0.73	19.50	-1.226	-30.85	1.6292
AUDNZD	1.0799	1.11	1.14	8.30	-1.988	-31.57	-0.2921
USDCAD	1.139	1.14	1.15	41.20	1.096	38.07	-0.4607

Forecast Change	New forecast not aggressive	Strongly -ve skew, upside f/c bias	Strongly +ve IRD, upside f/c bias	Strongly Undervalued, +ve f/c bias
No Forecast Change	New forecast aggressive	Strongly +ve skew, downside f/c bias	Strongly -ve IRD, downside f/c bias	Strongly Overvalued, -ve f/c bias

Source: UBS FX Strategy, Bloomberg OVML pricing

Like our November forecast update, our three month targets – with the exception of AUDNZD – remain relatively defensive. A slight shift higher in implied volatility in the euro would likely push several of our three-month forecasts above the 25 delta threshold. In part this is due to our view that policy-related discounts remain largely in the price so scope for additional spot movement is limited. Even our USDJPY three month target will begin to look conservative if the rotation flows manage to maintain their current momentum. Our most aggressive view at present is AUDNZD, standing at 8.3 delta for our three moth target of 1.15. Although the view may take somewhat more time than expected to materialise, we remain comfortable with this view in light of the ongoing deterioration in New Zealand's terms of trade and especially the need for further valuation convergence.

Options positioning measured by the Z-score in three-month 25-delta risk-reversal skew has adjusted significantly for many currency pairs since our November update. Firstly, EURUSD has collapsed from -1.4 to -3.6, again underscoring our view that the market is heavily positioned for quantitative easing by the ECB in the form of EUR downside and the pullback could be fierce if there is disappointment in any form. USDJPY's Z-score has also jumped from 0.70 to 2.30, suggesting that the market is now also pricing in additional easing and/or outflows from Japan, though we would not define these levels as 'extreme yet'. EURNOK is in a similar position to EURUSD with a skew Z-score of 3.1, but it was already near 3.0 in November so markets appear to consolidating around the view that Norges will need to ease. In contrast, EURCHF's skew Z-score has normalised to -0.9 from -3.4 in November, even as intervention has been realised, indicating a preference not to challenge the credibility of the floor. The result of the Gold Initiative may have also contributed to the removal of some positions favouring downside.

Interest rate expectations and differentials remain largely unchanged, though the antipodeans have seen further erosion in their supposed rate advantages. AUDUSD rate differentials are expected to fall by over 60bp over one year (from 40bp) and NZDUSD pricing is up to -31bp (from -16bp). In part this reflects strengthening in current policy expectations but also rising concern over the global demand outlook for commodities. In contrast, the market continues to see more limited disinflationary impulse in the US and as long as the Fed and data releases do not challenge this view, we expect rate pricing will continue to move in the dollar's favour. REER valuation Z-scores are largely unchanged from the previous update, though we would note that the BIS REER figures for October do not incorporate price action since the latest increase in QQE.