

# FX Crossroads

21 March 2007

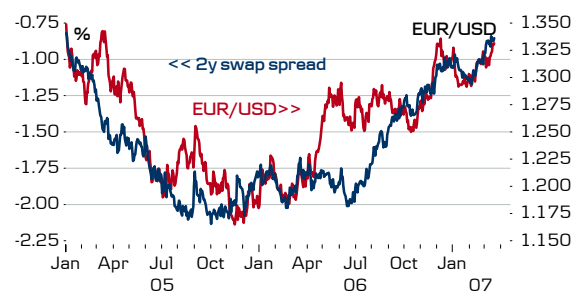
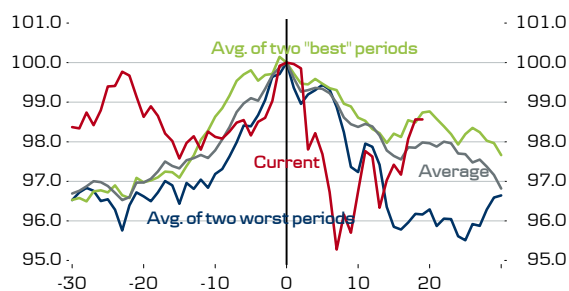
## Carry crisis over, USD still struggles

### Summary and conclusions

- The Shanghai stock index has now erased all the losses from late February and our G10 carry index is showing a modest loss during March of just 1.5%. Superficially speaking, it would appear that the “carry crisis” is over and done with. We continue to treat the current period as a financial correction rather than the beginning of a fundamental crisis. Accordingly, we expect the yen to weaken again. The biggest risk to this view – and to our call for a stronger dollar – lies with the risk of a hard landing in the US. We continue to look for a rebound in the US economy, but acknowledge that data has taken a turn for the worse recently.
- As expected, the Swiss National Bank hiked rates by 25bps to 2.25% last week, and the accompanying statement confirmed us in our view that the SNB will deliver one additional hike before going on hold. Combined with our view on the ECB and current market pricing, relative interest rates are not set to move in favour of CHF any time soon – and we stick to our call of EUR/CHF at 1.62 in the coming months. The joker in the pack remains renewed flare-ups in global risk aversion, which should benefit the CHF – but we still do not expect the more fundamental turn in the currency markets that could bring a sustained drop in EUR/CHF

Carry performance makes a strong comeback...

...but the dollar struggles on “hard landing” worries



# Global: Carry crisis over, USD still struggles

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## Float like a Chinese butterfly, sting like a Kiwi

The Shanghai stock index has now erased all the losses from February 28, AUS/USD has reached a new high for this cycle, NZD/JPY is back in range, and our G10 carry index is showing a modest loss during March of just 1.5%. Superficially speaking, it would appear that the “carry crisis” is over and done with.



The panic that hit global financial markets towards the end of February was real enough. Yet, our stance has been and remains that this is a financial correction rather than a fundamental crisis. The global economy is strong (“strongest in my lifetime” says Hank Paulson, US Sec Tres), inflation is low and policy rates are below neutral. There is little to indicate that a global recession is imminent. Our biggest concern right now is a hard landing in the US, but our economics team is confident that the US economy will bounce back in the coming months. If this proves to be correct, the global economy will continue to hum along in 2007. This note summarises what we now know about carry performance and position unwinding since the end of February. We also consider the arguments in favour of a stronger yen as well as a weaker dollar. Our views are:

### Carry unwinding pauses

First, unwinding of speculative carry positions appears to have paused after a substantial correction in the first week of March. Markets are left net short of JPY and CHF and long of EUR, GBP and

AUD, but the recent performance of AUD and NZD has been strong, and it will take but a modest rise from here to erase the entire drawdown to carry strategies during March. Unless markets hit another bump on the road, we are tempted to look for continued carry performance, taking into careful consideration that financial volatility remains somewhat elevated.

### JPY drivers are fading

Second, there were valid, local arguments in favour of JPY strength building since late 2006, including a rise in JPY volatility, relative interest rates and a reversal of capital outflows. But money market forward rates have now fallen back below pre-hike levels and we see little risk that BOJ will tighten again until late in 2007. The central bank has acknowledged this week that deflation may re-appear during spring. The net capital inflow during January and February was unexpectedly strong, but is unlikely to emerge as a secular trend as long as Japan faces a structural portfolio shift from JPY deposits to riskier assets. As implied volatility fades, the outlook for the yen will deteriorate once more.

### USD still struggles

Third, the rise in EUR/USD lately owes little to the global setting but a lot to renewed fears of a hard landing in the US. The subprime crisis as well as a drop in both orders and investments combined with a hawkish ECB has triggered a decline in relative US rates as well as a weaker dollar. **We remain of the view that a cyclical rotation in favour of the US in 2007 will lead to a drop in EUR/USD towards 1.25.** However, we also acknowledge that such a move appears somewhat premature until market perceptions about the outlook for the US economy changes for the better. This probably requires not only that the housing scare fades, but also that a more benign outlook for US industry emerges.

Incidentally, a hard US landing is likely to be highly negative not just for the dollar but also for FX carry positions due to a rise in market volatility. While the dollar could well strengthen once the global economy stalls, such a reaction will depend upon

actions by the Fed to stimulate the economy, which may be delayed due to inflation concerns (think May 2006). Since the yen is now an anti-cyclical currency in the extreme, increased fears of a global hard landing appear to be perhaps the biggest risk to our negative view on the yen.

Overall, while hard-landing concerns should not be dismissed easily, current market pricing for fed funds futures does seem a little excessive and we see value in being short EUR/USD from here. A move above the 2006 highs (1.3370) seems unlikely barring a further deterioration in the economy that we do not foresee.

We also recommend staying short yen, despite the risk of a short-term, technical setback. Whereas the fiscal year-end effect on the yen during March is insignificant, the seasonal pattern in favour of JPY depreciation in April is not. We also recommend modest shorts in CHF (see the next article).

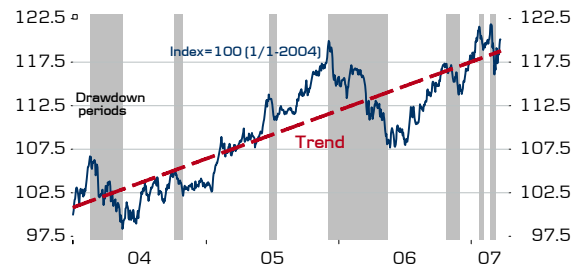
We generally have a bullish take on both AUD and NZD but look for a correction lower in the near-term. Australian rate markets are now pricing in a further rate hike with high probability and it seems that there is little mileage from this argument going forward. In New Zealand, implied 3m rates are now flirting with 8.0%. Further, historically, the 0.80 area in AUD/USD has been hard to break on a sustained basis. We continue to see more downside in USD/CAD, though a fall depends crucially on a stronger USD as well.

GBP is likely to be range-bound, floating with MPC expectations. We expect BOE to deliver at least one final rate hike in this cycle, which may offer some support relative to EUR. Technically, a break below 0.6770 would target 0.6690, whereas a break above 0.6820 would signal a deeper correction to the upside.

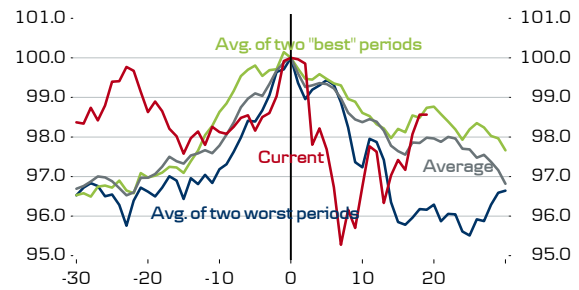
The latest rise in EUR/NOK seems to be driven by position squaring rather than fundamental arguments and we look for a move below 8.10 again. Place stops around 8.2125. In contrast, we favour the upside in EUR/SEK, targeting 9.37 with stops at 9.26.

## 1: Carry update

**Chart 1: G10 carry performance – long AUD, GBP, NZD vs JPY, CHF, SEK.**



**Chart 2: G10 carry performance now on par with two "best" drawdowns since 2004**

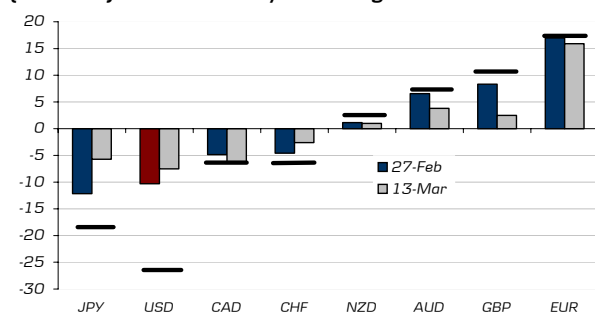


**Chart 3: NZD/JPY back in range**

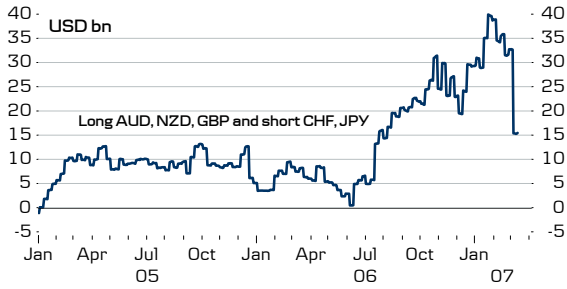


## 2: Position update

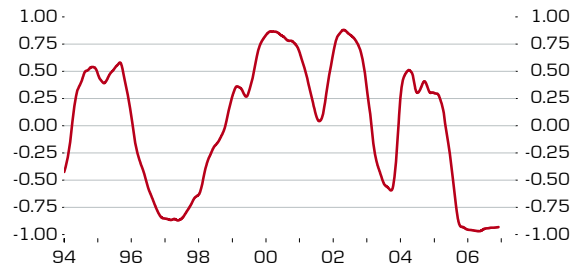
**Chart 4: Change in non-commercial IMM positions (USD bn) – AUD+ GBP/JPY longs reduced**



**Chart 5: Non-commercial carry positions reduced sharply during March**

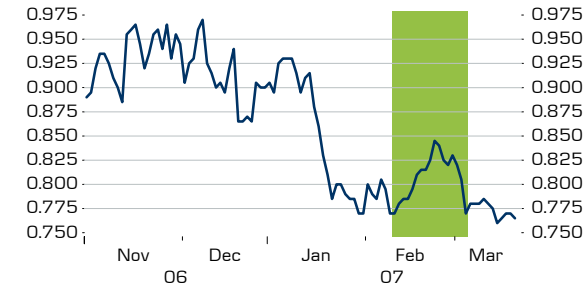


**Chart 8: JPY correlation with OECD industrial production – strong global growth is bearish for JPY**



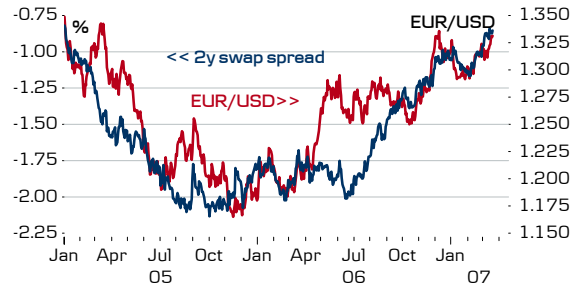
3: JPY – rates, flows and correlations

**Chart 6: JPY SEP-07 3m rates now below pre-hike levels**

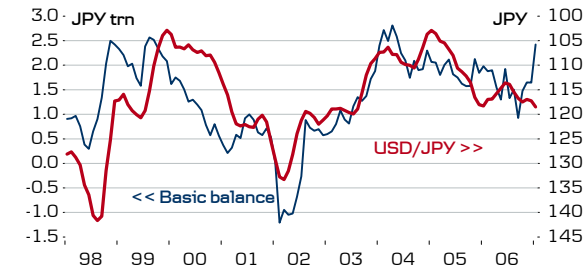


4: USD – rate expectations seem excessive but the economy continues to struggle

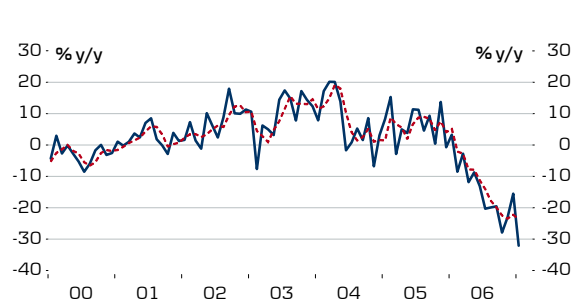
**Chart 9: EUR/USD and 2-year swap spread – USD weakness consistent with rate expectations**



**Chart 7: JPY capital flows improves sharply in 2007 as Japanese investors net sell foreign bonds**

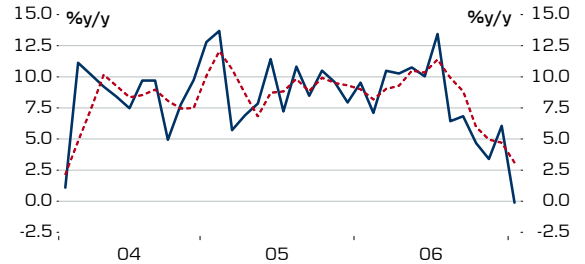


**Chart 10: Average of US housing starts and new home sales still falling sharply**



Note: basic balance is sum of foreign trade, net FDI and net portfolio flows

**Chart 11: Durable goods orders slowing sharply**



# CHF: SNB's bark is worse than its bite

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## SNB talks tough – but likely to prove a case of all talk and little action

The Swiss National Bank (SNB) hiked rates by 25bp last week, bringing the midpoint of the target range for the 3-month libor to 2.25%. The hike in itself was widely anticipated and thus should not have had much of a market impact. Hence, the market reaction there was (FRA's up a few bps, EUR/CHF dipping below 1.61 from 1.612) must have derived from a perception that the SNB was flexing its muscles in the accompanying Monetary Policy Assessment (MPA). But while this may have been the case on the surface, we believe that the message from the SNB was in fact, on deeper reflection, somewhat softer than previously.

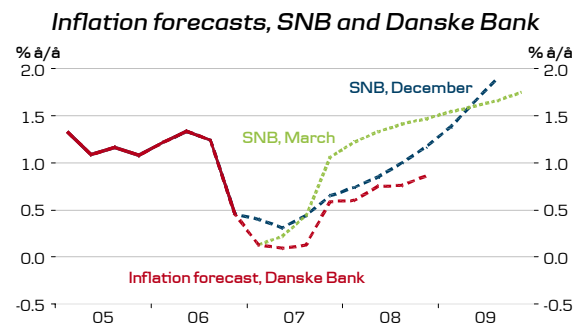
The MPA thus did not give us reason to alter our expectation that the SNB will deliver one final hike of 25bp in June before going on hold. With the ECB set to deliver at least as much – and the SNB hike more than fully priced and the ECB one not yet so – relative interest rates will not move in favour of the swissie for the foreseeable future. Combined with our expectation that the recent carry unwinding is temporary, we still see EUR/CHF at 1.62 in the coming months.

### Inflation is not the problem

The SNB's evaluation of the economy was unchanged from its last meeting, as it continues to expect solid growth of around 2% in 2007 (albeit down from 2.7% in 2006). One possible reason for the hawkish interpretation of the SNB assessment may have been the fact that the inflation forecast was revised somewhat higher in H2 2007/H1 2008 – up from 0.4% to 0.5% for 2007 and from 0.9% to 1.4% for 2008. The change was rather surprising, considering that the SNB's December forecast has overshoot the mark during the first couple of months of 2007 and, furthermore, that the new forecast is made on the basis of a higher monetary policy rate. According to the SNB, the inflation forecast is mainly revised higher due to the weak CHF, which "has partially neutralised the impact of the last increase in the interest rate". The SNB thus repeats its warning that the weak CHF

may influence the inflation outlook adversely, but also states that, so far, "the exchange rate has had no notable effect on inflation" – and that there is "a great deal of uncertainty, however, regarding the extent and the duration of this effect".<sup>1</sup>

In general, the SNB comes across as somewhat uncertain on the inflation outlook. It sees a chance that inflation could turn out lower than it expects due to structural developments in the economy, while, on the other hand, it sees a risk that a weak CHF could drive inflation higher. Crucially, however, inflation in 2009 is now expected to show a flatter trajectory than previously and is expected to end 2009 at about 1.75% – still safely below the 2% inflation target (see chart below).



As the SNB assumes a constant monetary policy rate, an additional hike in June will move the forecast lower (all else being equal) and bring the SNB very close to the "flat forecast" that it has said will signal the end of the monetary policy tightening. Furthermore, while the SNB in previous MPAs has stated that it would "further pursue its path of monetary policy normalisation", it this time adds a not entirely innocent "probably" – again a signal that a peak in rates is perhaps not that far off.

In our view, the SNB is currently facing a policy dilemma. Deep down in their central-banking hearts, they should know that inflation is simply not an issue at the moment. But at the same time, they are genuinely worried about the possible inflationary ef-

<sup>1</sup> The warnings against the follies of the carry trade and the risks of betting on a weak Swiss franc are also repeated (although in more moderate language than the good Dr. Roth has used in recent newspaper interviews).

fects of a weak CHF. Hence, further monetary restraint may not be needed – but if the SNB says so, the weakening CHF may prompt the need, and vice versa. In this environment, the SNB would not want to signal that a peak in rates is near, although they may secretly harbour such thoughts.

Bottom line, the MPA does not change our view that the SNB will deliver an additional 25bp hike in June before going on hold. We thus see no chance of the SNB closing the rate gap vis-à-vis the ECB any time soon – and with the June hike from the SNB already fully priced and the one from the ECB not so, relative rates should not support the CHF in the coming months. This leaves renewed flare-ups in global risk aversion as the only possible catalyst for a stronger CHF in the short run.

#### Keeping up with the Joneses – or the ECB?

The main risk to our SNB call – if not our CHF call – appears to be the ECB. With the SNB genuinely worried by the weakness of the CHF, additional tightening by the ECB beyond the June hike could prompt the SNB to tighten again – not from some ill-conceived idea of having to keep up with ones peers, but because further monetary restraint in the euro area is just the recipe for a weaker CHF. Hence, if the ECB moves beyond 4% during H2 2007, the SNB may have to follow suit just to stop EUR/CHF moving higher from these already elevated levels.

#### If not a safe haven then a sheltered bay at least

We have previously discussed how the Swiss franc's safe haven status appears to have diminished somewhat in recent years – but this is not the same as saying that the CHF should not benefit in times of trouble, as the events of the past couple of weeks have also shown.

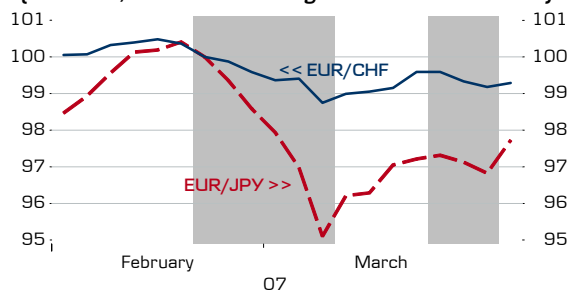
We continue to treat the latest sub-par carry performance as a correction rather than the start of a new trend (c.f. the first article in this week's FXC), and we are thus not looking for the CHF to receive much further support from that front.

Having said that, the CHF does have all the characteristics that should allow it to benefit from a sustained rise in risk aversion. By any measure, it is undervalued: our PPP estimate for EUR/CHF stands at 1.45 (more than 10% below spot), CHF currently trades at the upper end of historical

ranges and, in effective terms, it currently trades 5% below its historical average. Furthermore, while the recent carry drawdown has shaken out some of the CHF shorts, non-commercial positioning still shows substantial net CHF shorts.

Given this backdrop, it is actually rather surprising that the CHF has not benefited more in recent weeks. While the JPY strengthened by 5.3% against the EUR during the first global sell-off event in late February/early March (defined as periods when the US equity markets sold off), EUR/CHF only dropped by approx 1.5%.

**EUR/CHF and EUR/JPY during recent turmoil**  
(Indexed, shaded area = global sell-off events)



Hence, while continued turmoil in the financial markets should benefit CHF, the potential gains appear smaller than we previously have assumed.

#### May you live in interesting times

Summing up, the outcome of the latest SNB meeting has not altered our view that the SNB will deliver one additional hike before going on hold. Combined with our view on the ECB and current market pricing, relative interest rates are not set to move in favour of CHF any time soon – and we stick to our call of EUR/CHF at 1.62 in the coming months. The joker in the pack remains renewed flare-ups in global risk aversion, which should benefit the CHF – but we still do not expect the more fundamental turn in the currency markets that could bring a sustained drop in EUR/CHF.

Finally, it is worth noting that following more than a year of largely predictable policy decisions, uncertainty about rate decisions will begin to increasingly creep in – and domestic data should thus have an ever greater effect on the CHF in the months ahead after having been more or less completely ignored for some time.

# G10 portfolio model<sup>2</sup>

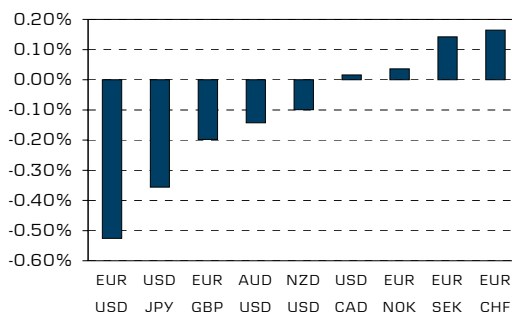
## Highlights

- Our model portfolio gained 31bp last week. We gained from being long EUR/CHF, USD/JPY, USD/CAD and NZD/USD, but lost on being short EUR/NOK.
- This week we are once again adding to overall risk in the portfolio and raising line utilisation from 76% to 90%.
- Our core positions are short EUR/USD (15% up from 4% last week), long USD/JPY (essentially unchanged at 13%), long EUR/CHF (16% down from 27%), short EUR/NOK (19% vs. 17%) and short USD/CAD (10% up from 5%). For the third week in a row we are taking no risk in EUR/SEK. We have turned our long position in NZD/USD to a short and gone from neutral to short in AUD/USD due to a risk of a correction after recent strong performance.

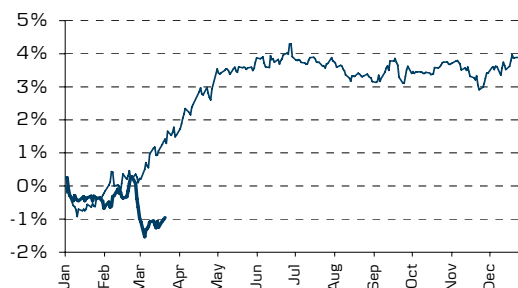
## Portfolio composition and performance

	Portfolio weights	1-week return	4-week return	YTD 2007 return
EUR/CHF	16%	0.13%	-0.07%	0.16%
EUR/GBP	-5%	-0.02%	-0.06%	-0.20%
EUR/NOK	-19%	-0.13%	-0.11%	0.04%
EUR/SEK	0%	0.00%	-0.03%	0.14%
AUD/USD	-8%	0.00%	-0.06%	-0.14%
USD/CAD	-10%	0.06%	-0.01%	0.02%
EUR/USD	-15%	-0.03%	-0.10%	-0.53%
USD/JPY	13%	0.14%	-0.60%	-0.36%
NZD/USD	-4%	0.16%	0.03%	-0.10%
Return		0.31%	-1.02%	-0.96%
Volatility		0.33%	0.94%	1.26%
Information ratio		0.96	-1.09	-0.76

## YTD return for individual currency pairs



## Total return



<sup>2</sup> Our portfolio model is a qualitative overlay model based on a Black-Litterman setup. For further details please see "FX Crossroads: Introducing the Danske Bank portfolio model, October 3, 2006"

## Directional trades

	Date	Start	Now	Target	Stop	P/L (incl carry)
<b>Open</b>						
No open trades at the moment						
<b>Recently closed</b>						
Buy NOK/CZK	25/01/07	3.42	3.5	3.550	3.45	2.46
Buy USD/JPY	20/02/07	119.95	118.5	123.000	118.5	-1.10
Sell AUD/NZD	14/02/07	1.1312	1.1312	1.100	1.1312	0.06
Buy NZD/JPY	06/03/07	79.29	79.29	82.500	79.29	0.02
<b>P/L 2007</b>	<b>4.63%</b>	<b>Open</b>	<b>0.00%</b>	<b>Closed</b>	<b>4.63%</b>	
<b># of trades *</b>	<b>65</b>					
<b>- average net gain</b>	<b>0.27%</b>					
<b>- batting average</b>	<b>0.52</b>					

\* Since 17 November 2005

\*\* Stop moved to entry level on 7 March 2007

## Central bank overview

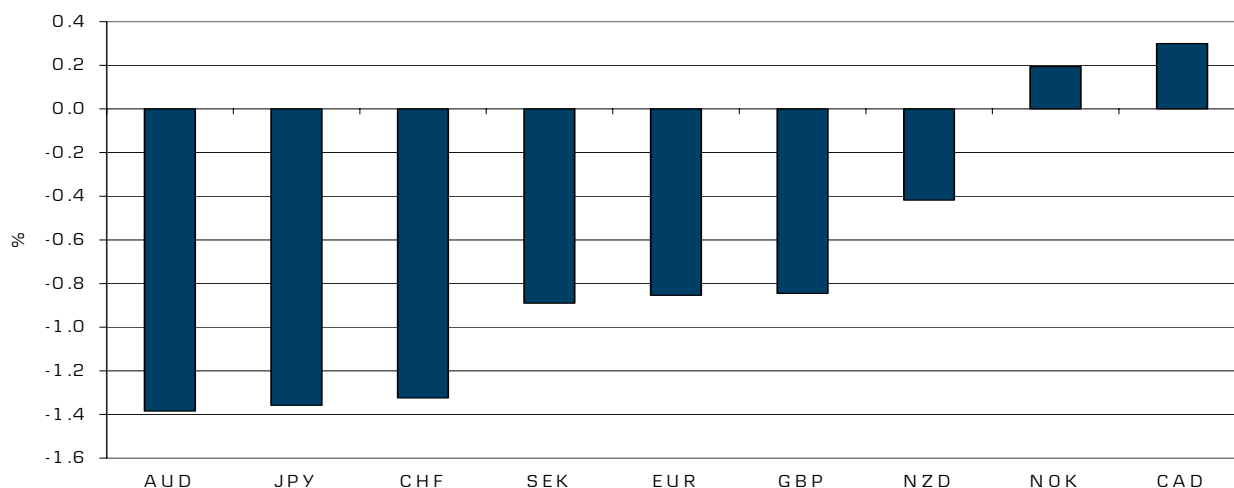
Country	Official interest rate	Policy rate	Next decision*	Last change
United States	Federal funds rate	5.25	21 Mar (unch)	29 Jun 06 (+25bp)
Euroland	Minimum bid rate	3.75	12 Apr (unch)	8 Mar (+25bp)
Japan	Overnight call rate	0.50	10 Apr (unch)	21 Feb (+25bp)
United Kingdom	Base rate	5.25	5 April (unch)	11 Jan (+25bp)
Switzerland	3-month Libor	2.25	14 Jun (+25bp)	15 Mar (+25bp)
Canada	Overnight rate	4.25	24 April (unch)	25 May (+25bp)
Australia	Cash rate	6.25	4 April (unch)	7 Nov (+25bp)
New Zealand	Cash rate	7.50	26 April (unch)	7 Mar (+25bp)
Sweden	Repo rate	3.25	30 Mar (unch)	15 Feb (+25bp)
Norway	Sight deposit rate	4.00	25 Apr (unch)	15 Mar (+25bp)

\* Expected decision in brackets

## Exchange rate forecasts

	Spot	Forecast				Forecast vs forward outright, %			
		+1m	+3m	+6m	+12m	+1m	+3m	+6m	+12m
<b>Exchange rates vs EUR</b>									
USD	1.33	1.32	1.30	1.25	1.25	-0.9	-2.6	-6.7	-7.1
JPY	156.74	157	156	156	156	0.5	0.3	1.3	3.0
GBP	0.679	0.680	0.685	0.685	0.690	0.0	0.5	0.1	0.1
CHF	1.61	1.62	1.62	1.62	1.60	0.5	0.7	1.1	0.6
DKK	7.45	7.46	7.46	7.46	7.46	0.1	0.1	0.1	0.0
NOK	8.18	8.05	7.90	7.80	7.80	-1.7	-3.6	-5.0	-5.4
SEK	9.30	9.30	9.20	9.10	9.00	0.0	-1.0	-1.9	-2.8
PLN	3.87	3.95	4.05	4.05	4.05	1.9	4.5	4.4	4.2
CZK	27.93	28.40	28.40	28.50	28.50	1.8	2.1	2.8	3.4
HUF	248	260	260	260	260	4.7	4.0	3.2	1.5
TRY	1.85	1.90	1.95	2.00	2.10	1.3	1.5	0.5	-1.7
<b>Exchange rates vs USD</b>									
JPY	117.9	119	120	125	125	1.4	3.0	8.4	10.4
GBP	1.96	1.94	1.90	1.82	1.81	-0.8	-3.0	-6.7	-7.0
CHF	1.21	1.23	1.25	1.30	1.28	1.3	3.4	8.2	8.0
DKK	5.60	5.65	5.74	5.97	5.97	1.0	2.8	7.1	7.5
NOK	6.15	6.10	6.08	6.24	6.24	-0.8	-1.0	1.8	1.8
SEK	7.00	7.05	7.08	7.28	7.20	0.9	1.7	5.0	4.4
CAD	1.16	1.16	1.16	1.14	1.14	0.1	0.3	-1.2	-0.8
AUD	0.80	0.79	0.79	0.75	0.72	-1.4	-1.2	-5.8	-8.8
NZD	0.70	0.70	0.70	0.68	0.62	-0.4	0.0	-2.2	-9.2
ZAR	7.34	7.30	7.30	7.30	7.20	-0.9	-1.6	-2.6	-6.1
BRL	2.07	2.18	2.18	2.22	2.25	4.7	3.8	4.3	3.2
MXN	11.09	11.10	11.10	11.00	11.00	0.0	-0.4	-1.9	-3.2
CNY	7.74	7.71	7.64	7.55	7.35	0.2	0.4	0.7	0.8

Expected change in USD vs forwards, 1 m



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