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IDEA

November 25, 2018 10:00 PM GMT

2019 Global FX Outlook | Global

Top 10 FX Trades

US growth outperformance, driven by fiscal expansion and deregulation, drove global growth de-synchronization and the 2018 USD rally. Now, higher funding costs and fiscal tailwinds subsiding should see this process reverse. Rising capital demand in Northern Asia and Europe should reduce their excess savings, weakening global liquidity conditions and supporting asset volatility. Rising capital scarcity and funding costs should render foreign-financed economies like USD vulnerable to FX weakness while capital exporters like EUR and JPY should rise. USD weakness and cheap valuations should keep EM supported.

1) Short USD vs. EUR, SEK basket

Bullish eurozone inflation and integration outlook while US growth slows

2) Short USD/JPY

Japanese repatriation and a US growth slowdown

3) Short AUD/JPY

Weak household balance sheets, tighter liquidity conditions and repatriation

4) Short AUD, NZD, CAD vs. SEK, NOK basket

Strong European performance contrasts with weak balance sheets

5) Short CHF/JPY

Diverging repatriation support and more European integration

6) Long BRL/MXN

Policy uncertainty and fiscal slippage risks are likely to weigh on MXN

7) Short USD vs. ARS, ZAR, IDR basket

Select high-yielding EM currencies supported by high carry and weaker DXY

8) Short USD/INR

Strong growth, wide real rate differential, weaker oil and high FX carry

9) Short CHF/CZK

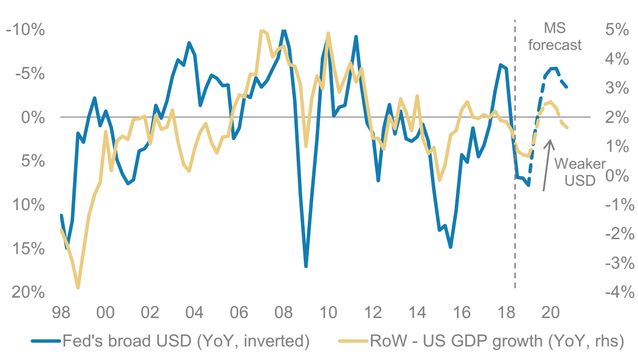
Stronger EUR and EM sees CZK outperform

10) Long SGD/CNH

Effective way to short the CNY NEER basket as China slows down

Click here for our updated economics and strategy forecasts.

Exhibit 1: USD weakness as US growth slows to converge with the RoW



Source: Bloomberg, Haver Analytics, Morgan Stanley Research forecasts; RoW = Rest of the world.

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	1Q19	2Q19	3Q19	4Q19
EUR/USD	1.17	1.20	1.26	1.31
USD/JPY	109	106	104	102
GBP/USD	1.34	1.40	1.45	1.50
USD/CAD	1.33	1.35	1.33	1.32
AUD/USD	0.70	0.67	0.70	0.71
EUR/SEK	10.00	9.90	9.70	9.50
USD/ZAR	13.8	13.5	13.2	13.0
USD/TRY	5.50	5.60	5.70	5.80
USD/RUB	65.0	64.0	63.0	62.0
EUR/PLN	4.35	4.30	4.25	4.20
USD/CNY	7.05	7.03	6.92	6.85
USD/INR	71.0	69.5	68.5	68.0
USD/KRW	1110	1105	1100	1095
USD/MYR	4.20	4.18	4.15	4.12
USD/BRL	3.55	3.85	3.65	3.50
USD/MXN	21.00	21.00	21.00	21.00

Source: Morgan Stanley Research. Note: Forecasts for end-of-period.

Click here for a full list of global currency forecasts

G10 and EM Currency Summaries

Morgan Stanley global currency forecasts

Exhibit 2: FX forecasts – click here for custom forecasts

	Spot	4Q18	1Q19	2Q19	3Q19	4Q19	1Q20	2Q20	3Q20	4Q20
EUR/USD	1.13	1.15	1.17	1.20	1.26	1.31	1.34	1.36	1.37	1.38
USD/JPY	113	112	109	106	104	102	100	98	96	94
GBP/USD	1.28	1.30	1.34	1.40	1.45	1.50	1.54	1.58	1.59	1.60
USD/CHF	1.00	1.00	1.00	0.99	0.97	0.94	0.93	0.93	0.93	0.93
USD/SEK	9.08	8.83	8.55	8.25	7.70	7.25	7.09	7.06	7.08	7.10
USD/NOK	8.59	8.43	8.29	8.00	7.46	7.10	6.94	6.91	6.93	6.96
USD/CAD	1.32	1.31	1.33	1.35	1.33	1.32	1.31	1.30	1.29	1.28
AUD/USD	0.72	0.72	0.70	0.67	0.70	0.71	0.72	0.73	0.74	0.75
NZD/USD	0.68	0.67	0.65	0.62	0.66	0.67	0.68	0.69	0.70	0.71
EUR/JPY	128	129	128	127	131	134	134	133	132	130
EUR/GBP	0.89	0.88	0.87	0.86	0.87	0.87	0.87	0.86	0.86	0.86
EUR/CHF	1.13	1.15	1.17	1.19	1.22	1.23	1.25	1.26	1.27	1.28
EUR/SEK	10.30	10.15	10.00	9.90	9.70	9.50	9.50	9.60	9.70	9.80
EUR/NOK	9.74	9.70	9.70	9.60	9.40	9.30	9.30	9.40	9.50	9.60
USD/CNY	6.95	6.97	7.05	7.03	6.92	6.85	6.81	6.78	6.77	6.75
USD/HKD	7.82	7.80	7.80	7.80	7.80	7.80	7.80	7.80	7.80	7.80
USD/IDR	14544	14700	14400	14200	14100	14000	13900	13800	13700	13600
USD/INR	70.7	72.0	71.0	69.5	68.5	68.0	67.5	67.0	66.5	66.0
USD/KRW	1130	1115	1110	1105	1100	1095	1090	1085	1080	1075
USD/MYR	4.19	4.25	4.20	4.18	4.15	4.12	4.10	4.08	4.05	4.02
USD/PHP	52.5	52.5	52.4	52.3	52.2	52.1	52.0	52.0	52.0	52.0
USD/SGD	1.37	1.37	1.34	1.32	1.29	1.28	1.28	1.27	1.26	1.26
USD/TWD	30.9	30.6	30.4	30.2	30.0	29.8	29.7	29.7	29.6	29.5
USD/THB	33.1	32.8	32.5	32.2	31.8	31.4	31.0	30.5	30.0	30.0
USD/BRL	3.82	3.65	3.55	3.85	3.65	3.50	3.50	3.55	3.60	3.60
USD/MXN	20.37	21.00	21.00	21.00	21.00	21.00	20.75	20.50	20.50	20.50
USD/ARS	36.73	37.00	39.50	41.25	42.50	43.50	44.15	44.75	46.00	42.00
USD/CLP	674	675	660	645	630	620	610	600	590	580
USD/COP	3228	3135	3100	3060	3030	3010	3010	3000	2975	2975
USD/PEN	3.38	3.35	3.32	3.29	3.26	3.23	3.22	3.21	3.20	3.20
USD/ZAR	13.9	14.0	13.8	13.5	13.2	13.0	13.3	13.6	13.9	14.2
USD/TRY	5.29	5.50	5.50	5.60	5.70	5.80	5.90	6.00	6.10	6.20
USD/ILS	3.74	3.65	3.60	3.55	3.50	3.45	3.40	3.40	3.40	3.40
USD/RUB	66.3	66.0	65.0	64.0	63.0	62.0	61.0	60.0	60.0	60.0
EUR/PLN	4.29	4.30	4.35	4.30	4.25	4.20	4.15	4.10	4.10	4.10
EUR/CZK	25.9	25.9	25.5	25.3	25.2	25.0	25.0	24.8	24.5	24.3
EUR/HUF	322	325	330	325	320	315	315	315	315	315
EUR/RON	4.66	4.67	4.70	4.67	4.65	4.60	4.60	4.60	4.60	4.60
DXY Index	97	96	94	92	88	85	84	82	82	81
Fed's Broad USD Index	128	128	127	126	124	122	120	119	119	118

Source: Bloomberg, Morgan Stanley Research forecasts

The year of USD weakness

• **USD is overvalued by about 10-15%:** Assets in the rest of the world (RoW), particularly EM, are cheap relative to USD-denominated assets.

• **Global investors have turned too bearish on Europe:** Investors have divested from European stocks at the same pace as from UK equities.

• **US growth should keep slowing down, which means that global growth again becomes more synchronized:** Rate-sensitive sectors in the US, including housing, continue to slow, and fiscal tailwinds should soon turn into headwinds. Falling oil prices should give a boost to oil-importing economies like in Northern Asia and Europe, but it is a negative to oil producers like the US.

• **Inflows into the US in 2018 have largely been into money market instruments. These are 'low-quality' flows and easily reversed:** Meanwhile, foreign demand for long-term USD-denominated assets, a better barometer of investor sentiment, has been weak. Asset liquidation has not yet translated into FX volatility because investors have shifted funds out of long-term USD assets and into USD money market instruments.

• **Rising money market holdings suggest two important points – liquidation can occur suddenly, and fundamental correlations like interest rate differentials may no longer hold:** The experience of EURUSD in 2017 is a key example, when investors shifted funds into the euro area based on the improving economic and political outlook, while interest rate differentials were largely unchanged.

• **China is turning from a capital exporter to a capital importer:** China ran a current account deficit in 1H18 and its currency reserves have fallen modestly. This means that China is no longer adding to global liquidity, but rather subtracting from it.

• **Japan has been a net seller of foreign bonds this year** and demographic factors suggest that its growth in foreign asset holdings will slow and even start to shrink. Rising volatility in US markets will only accelerate this repatriation process. **We expect rising capital demand in Europe to yield a similar result.**

• **Global liquidity conditions are tightening as economies including China, Japan and Europe are investing less in global financial markets:** Should the euro area's and Japan's current account surpluses shrink, global liquidity conditions would turn even tighter.

• **This process may also push local capital costs higher, moving yield differentials in favor of local currency against USD:** EUR, JPY, SEK and others should slowly see their yield support growing.

• **Hawkish central banks only further this process:** Central bank balance sheet growth is likely to turn negative this year as the Fed's balance sheet shrinking continues, purchases by the BoJ slow further and the ECB's and other G10 central bank balance sheets stop growing.

• **Global savings may have peaked in 2016:** Significant spare capacity and fiscal austerity kept capital demand weak, while savings continued to grow as growth remained sluggish and economic and political uncertainty persisted. US bond yields have risen from their 2016 lows, with rising USD funding costs now weakening the economy.

• **Globalization and supply-oriented policies supported global savings:** Ample global savings and the free movement of capital provided an easy source of financing, fuelling an increase in debt and deficits. This is why current account deficit FX have stayed so supported over recent decades despite the debt build-up.

• **Fiscal contraction has turned into expansion – led by the US:** Populism has been nurtured by growing discontentment with globalization, migration flows and economic inequality.

• **The 'supremacy of supply' may be turning into the 'dominance of demand':** Increasingly expansionary fiscal policy, a reduced pace of globalization and increased domestic investment and consumption come at the expense of savings and capital exports.

• **A retreat in the net savings from Europe, Japan and especially China means that foreign-funded debt will have to pay a higher premium to attract capital.**

• **Risk appetite may have to fall further:** Financial markets, with the help of QE and high global savings, grew far faster than their underlying economies following the financial crisis. Now we may see the reverse.

• **Current account surplus currencies may appreciate as they save less and invest more:** In Japan, we think that the process will be driven by the retiring baby boomers and rising domestic capex. In Europe, it will likely be driven by populism and European integration.

• **EM will have to navigate between rising global capital costs and the falling USD:** The declining USD should boost most EM assets and we are bullish on high yielders.

• **China increasing fiscal and monetary economic support** should boost trade and inherently EM investor confidence. Rebounding Chinese equity markets recovering from valuation lows may act as an EM bellwether for other EM assets.

• **Falling oil prices suggest an income distribution from producers towards consumers** benefiting many major EMs across Asia, Latin America and CEEMEA. This boosts global consumption at the expense of global savings.

• **High-yielding energy-importing countries** should benefit, while energy exporters should lose terms of trade support. INR, ZAR, BRL and IDR are on top our EM high yield recommendation list.

• **EMU integration should see broader European FX support, including Emerging Europe:** PLN and CZK in particular should perform well in that environment

Winter is coming for USD; spring for EUR, JPY and EM

Bottom line: Shifting capital flows will have important market implications. USD and the dollar bloc have benefited from the build-up in net savings from Europe, Japan and China. These savings, well in excess of domestic capital needs, were recycled into foreign financial markets. This process now appears to be shifting. European fiscal policy is moving from austerity to expansionary, Japanese capex is picking up and China is becoming a capital importer to help fuel its fiscal spending. US economic outperformance compared to the rest of the world (RoW), particularly Europe, appears to be reversing, which only furthers this trend. Capital flows reversing mean that FX which have weakened due to capital exports like EUR and JPY should gain while those beneficiaries like USD, AUD, CAD and NZD should weaken. EMFX may outperform due to attractive valuations, high yields and a weaker USD.

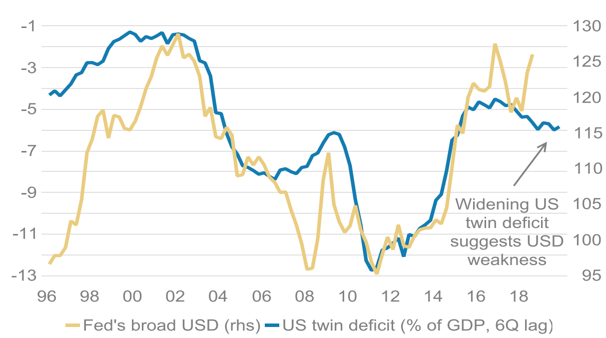
The global savings glut… The US fiscal and current account deficits ('twin deficits') have found easy financing in recent years, thanks to the combination of a persistent savings glut from Northern Asia and accommodative global monetary policies. US capital demand was fairly limited relative to the stock of savings directed therein – US fiscal austerity and household deleveraging meant that much of this inflow was in turn transformed into global USD-denominated liquidity, channelled to EM, where capital demand and rates of return were higher (Exhibit 4).

Exhibit 3: Major FX forecasts: Old versus new

		1Q19	2Q19	3Q19	4Q19
NEW	EUR/USD	1.17	1.20	1.26	1.31
OLD		*1.19*	*1.24*	*1.28*	*1.32*
NEW	USD/JPY	109	106	104	102
OLD		*104*	*100*	*95*	*93*
NEW	GBP/USD	1.34	1.40	1.45	1.50
OLD		*1.34*	*1.39*	*1.44*	*1.50*
NEW	USD/MXN	21.00	21.00	21.00	21.00
OLD		*19.50*	*19.00*	*18.50*	*18.00*
NEW	USD/ZAR	13.8	13.5	13.2	13.0
OLD		*13.3*	*12.8*	*12.4*	*12.1*
NEW	USD/INR	71.0	69.5	68.5	68.0
OLD		*69.1*	*68.5*	*68.0*	*67.5*

Source: Morgan Stanley Research forecasts

Exhibit 4: A widening US twin deficit suggests upcoming USD weakness



Source: Macrobond, Morgan Stanley Research

The 2016/17 EM rally followed by the 2018 EM slump should be viewed in this context. 2018 saw an important reversal in this process, where the combination of deregulation, expansionary fiscal policy and rising capex saw US capital demand rising sufficiently to reverse this flow, with the US absorbing a larger share of global capital at EM's expense, pushing global capital costs higher.

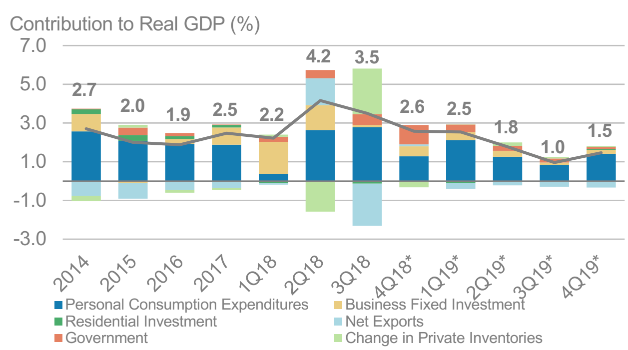
…challenged by pro-cyclical policies: The current late-cycle expansionary fiscal stance echoes US policy in the late 1960s, when rising social and military spending (and resulting wider deficits) sowed the seeds for rising inflation, reduced the attractiveness of USD-denominated assets and ultimately led to the breakdown of the Bretton Woods system.

Indeed, President Johnson's aim of rectifying economic inequality with his 'Great Society' programs bears resemblance to current policy prescriptions aired globally as policy-makers react to the growing discontent with globalization, migration flows, tepid wage growth and high returns on capital.

Falling net capital supply… These new political priorities are not just in the US but globally, and may cause a sea change in global economic policies – away from those favoring saving, production efficiency and the supply side, and towards those favoring investment, consumption maximization and the demand side. Such pro-cyclical policies are perfectly reasonable at a time when global output gaps are wide and the rise in demand can be met with existing supply. When economic capacity is tight, though, a sudden increase in demand can instead strain capital markets and raise prices, leading to financial market volatility and asset underperformance.

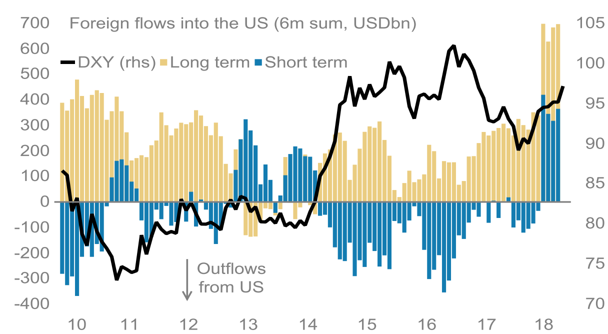
…tightens liquidity conditions and supports volatility: These demand-side policies (which lead to a rise in capital demand) mean that the excess savings that had normally been recycled externally may increasingly be consumed at home. Much of these savings have come from Northern Asia (including Japan) and Europe and a large proportion (70%) of these cross-border capital flows have been deployed in financial markets. This has kept liquidity conditions supportive and volatility low. However, public and private investment spending is likely to rise in these net-saving economies, suggesting that their contributions to global liquidity will fall, rendering liquidity conditions weaker and volatility less suppressed.

Exhibit 5: US economic outlook set to worsen into 2019



Source: Haver Analytics, Morgan Stanley Research; *Morgan Stanley Research forecasts

Exhibit 6: Short-term inflows into the US have increased markedly in 2018



Source: Macrobond, Morgan Stanley Research

USD weakness to come… Higher investment in net-saving economies has also impacted exchange rates. Those economies benefiting from capital imports from net-saving economies saw their current account deficits widen and their currencies appreciate. Indeed, USD is about 10-15% overvalued, in part reflecting these inflows. A slowdown in capital flows into these economies, or even net outflows, suggest that this currency appreciation will reverse.

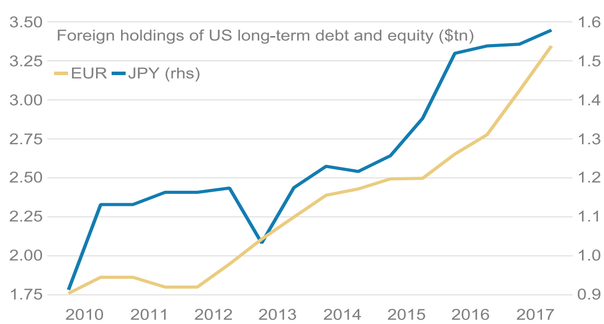
The implication is that those economies which had been reliant on capital imports to finance their deficits – like the US – may find it more difficult to find the necessary capital if external capital demand is rising. A weaker USD would be required to increase domestic savings and provide foreign investors compensation for deploying the increasingly scarce capital in the US.

...as growth slows... This external environment of tightening liquidity conditions comes at a time when the US economic and financial asset outlook worsens. US growth is likely to slow into 2019 as the tailwinds from fiscal stimulus subside and personal consumption slows (Exhibit 5). Corporate revenue growth should slow similarly, while earnings growth is also compressed by narrowing margins due to rising funding costs (as the Fed continues hiking rates), rising wages and rising input costs.

...despite interest rate differentials: USD bulls may argue that attractive US interest rate differentials may keep USD supported. The USD has benefited from inflows into short-term money market instruments as investors take advantage of high US interest rates (Exhibit 6). This has kept USD supported despite the worsening performance and outlook of US assets. However, a shift in allocation into money markets tends to precede FX turning points. Money market investments are easily liquidated and show reduced conviction on the economy in question, and because FX hedging costs are typically linked to high short-term interest rates, these funds tend to be FX-unhedged.

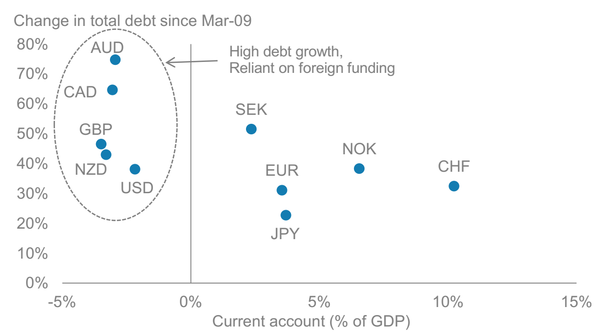
Thus, the shift in assets into money markets should not be seen as USD-bullish but rather as a USD-bearish risk. This is particularly true as US asset volatility looks set to rise as liquidity conditions continue to tighten. The high degree of risk exposure and liquidity in money market instruments suggest that a worsening US outlook can easily translate into USD weakness should external conditions improve in relative terms.

Exhibit 7: EUR and JPY holdings of US long-term debt and equities have increased post-crisis



Source: Macrobond, Morgan Stanley Research

Exhibit 8: Inflows of foreign capital have helped to fuel an increase in debt in Australia, Canada and New Zealand



Source: Macrobond, Morgan Stanley Research

History looks poised to repeat itself: In 1987, the yield differential between the US and Germany was similar to what it is today. The 1985 Plaza Accord, in which DM economies agreed to collectively weaken the overvalued USD, meant that economies like Germany and Japan had to increase domestic demand in order to reduce their excess savings and run tighter monetary policies. This reduced the supply of global liquidity, sending US risk assets sharply lower and causing the Fed to shift from tighter to easier policy. The DXY weakened in response by 12% between October and December 1987, all the more impressive as it had already weakened by 40% over the previous two years.

The year of JPY and EUR strength: The flip side of USD weakness should be EUR and JPY strength. Both Japan and Europe have sent significant amounts of capital into US financial markets, particularly into risk assets (Exhibit 7).

We expect both economies to see capital demand increasing, with private capex in Japan poised to pick up and fiscal expansion in Europe looking more probable, along with central banks turning more hawkish. Improving domestic conditions and capital demand, coupled with a worsening US outlook, should turn 2019 into the year of EUR and JPY.

European FX should perform well... Tailwinds for European FX more broadly look to be rising, with SEK and NOK both likely to outperform EUR and G10 FX more generally. GBP should be buoyed by resolution of a Brexit deal, enabling the BoE to pursue a faster pace of tightening. The exception is CHF, which should stay on the back foot.

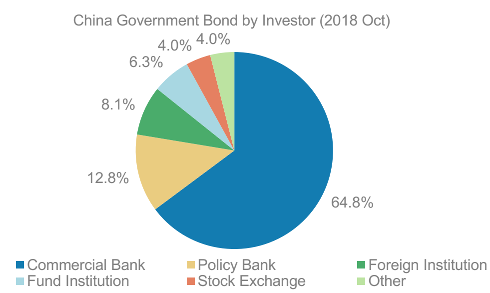
...while the dollar bloc underperforms: USD is not the only currency to benefit from these external capital flows. NZD, CAD and AUD have been buoyed by capital imports, so they will likely see underperformance too. Capital imports over the past 10 years have helped to fuel a build-up in household leverage in these countries, rendering household balance sheets more sensitive to rising global funding costs (Exhibit 8). An increase in domestic savings, buoyed by a weaker currency, should help the longer-term deleveraging process, but also suggests slower consumption and investment growth.

Navigating EM: EMs will have to navigate between fragile risk appetite, rising global capital costs and a weaker USD. In early 2016, DM equity market weakness also paved the way for USD weakness, which in turn enabled EMFX to rally. EM assets were sufficiently attractive from a valuation perspective to attract funds and limit volatility. EM valuations look attractive again today. The USD performance is what matters most for EM assets, and a falling USD driven by a US-centric risk sell-off suggests that EMs with solid fundamentals and attractive carry may benefit.

Exhibit 9: CNY NEER could move lower

Source: Bloomberg, Morgan Stanley Research

Exhibit 10: 65% of Chinese government bonds are owned by domestic commercial banks



Source: CEIC, Morgan Stanley Research

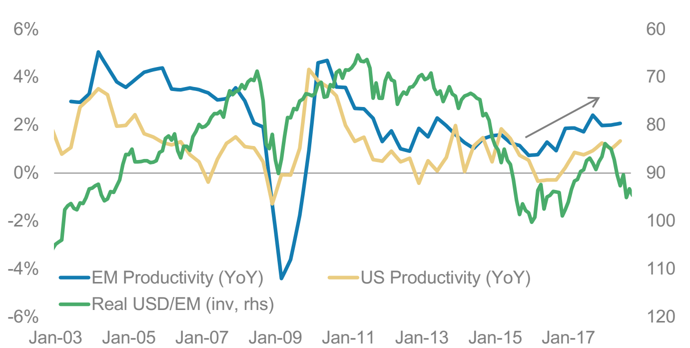
Our colleagues also see a better outlook for EM equities, as more attractive stock valuations and rebalancing global growth likely lead to outperformance relative to the US. As with FX, the equity valuation discount remains wide and in favor of EMs. Another benefit for EM will be a shift in the Fed's rhetoric. We expect the Fed to keep hiking in the short term but for the rate-hiking cycle to take a pause in 2H19. Should additional asset price volatility continue to take the edge off the Fed's hawkish rhetoric then this should increasingly benefit EM both via a weaker USD and easier financing conditions.

Underweight AXJ: China remains a key risk factor for EM, particularly AXJ (Exhibit 9). The build-up in financial sector leverage has meant that monetary policy may have limits to stimulate the economy – an increase in monetary accommodation risks fuelling further leverage at a time when policy-makers are seeking to reduce banking risks. To this end, fiscal stimulus faces similar challenges since roughly two-thirds of government bonds are purchased by the banking sector (Exhibit 10).

Hence, the pace at which China opens up to foreign banks providing RMB lending is important. The Shanghai branch of the PBOC confirming that non-local banks are now lending at a faster pace into China's economy has been constructive news, not only for China, but also the entire EM segment. Going forward, China may need stronger foreign balance sheets to step in, helping to transform RMB base money into long-term bank assets. The internationalization of RMB should be an EM-positive factor. Meanwhile, US-China trade tensions may remain an issue for which the low AXJ yield may not compensate sufficiently. Hence, the AXJ investment thesis looks underwhelming. Within the region, we expect low yielders to underperform and IDR and INR to perform well.

CEEMEA to outperform: The CEEMEA region should do better, lifted by a stronger EUR. We are bullish on ZAR for the year though an early-year wobble cannot be ruled out as we head towards elections and uncertainty over ratings. Following the unexpected SARB rate hike on November 22, the currency is already making good progress. We expect TRY to provide positive total returns but spot USDTRY will likely head higher as inflation differentials weigh and the central bank delivers rate cuts. RUB has good fundamentals and we expect a rally, though sanctions uncertainty is the main risk. **In Latin America,** we are expecting BRL to outperform MXN, though we see a mid-year wobble in response to concerns around the reform outlook. Meanwhile, CLP should be a strong outperformer on account of an improving macro backdrop and a positive copper price outlook.

Exhibit 11: No sign of EM productivity growth dropping yet



Source: Haver Analytics, Morgan Stanley Research

Exhibit 12: FX forecasts: Bull and bear cases

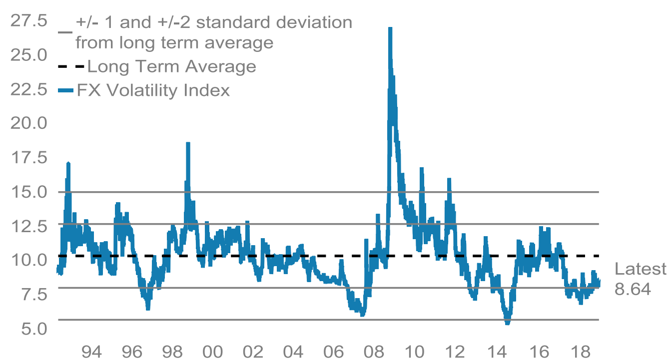
4Q19	Bear	Base	Bull
EURUSD	1.18	1.31	1.38
GBPUSD	1.38	1.50	1.58
USDJPY	97	102	107
AUDUSD	0.65	0.71	0.75
USDINR	64.0	68.0	75.0
USDZAR	12.4	13.0	14.3
USDBRL	3.10	3.50	4.00
USDMXN	20.00	21.00	24.00

Source: Morgan Stanley Research forecasts

FX volatility outlook

We expect higher G10 FX volatility: Equity, bond and FX volatility remain below long-term averages (Exhibit 13). All should rise as tighter global liquidity conditions continue to work their way through markets. G10 FX volatility is cheap versus our forecast targets, versus history and on a cross-asset basis. The options market is skewed towards USD strength (Exhibit 14), making short USD positions attractive, particularly versus EUR and JPY. The ECB ending its QE program and its impact on Bund volatility could be the next catalyst for higher volatility in EUR. In EM, the realized volatility story should be more muted than last year, narrowing the spread between EM- and DM-implied volatility (Exhibit 19). Our spot forecasts are in particular stronger than the forwards in ZAR and INR, making shorter-tenor short vol trades attractive within the EM spectrum.

Exhibit 13: FX volatility is 1 standard deviation below the long-term average



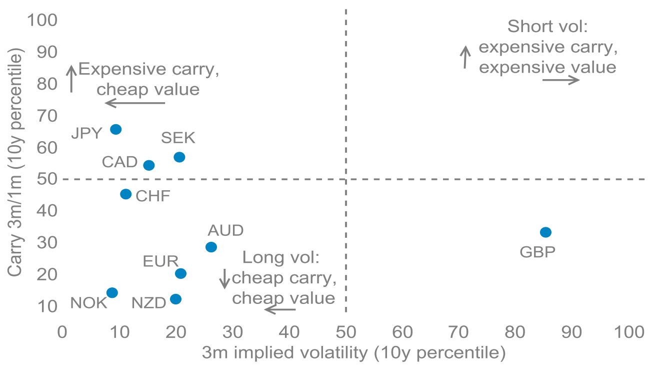
Source: Bloomberg, Macrobond, Morgan Stanley Research

Exhibit 14: Options markets expect USD strength, making it cheaper to sell

Source: Bloomberg, Macrobond, Morgan Stanley Research

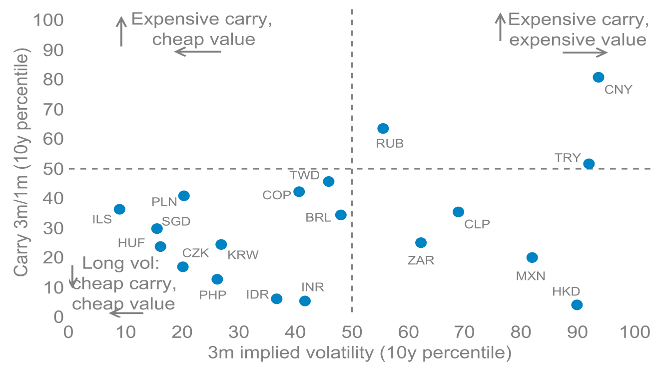
Volatility is low versus history for all G10 currencies apart from GBP (Exhibit 15). To pick trades we have combined the options market valuations with our forecast spot market moves over the coming year. The current low level of implied volatility for NOK and SEK and our expectations for the most appreciation versus the forwards within the G10 make options trades in shorter tenors (3-6 months) attractive. JPY- and EUR-implied volatility is low but we favor trading longer tenors (6-12 months). Within EM, Asia and CEE currencies are in the low-volatility quadrant. Select currencies like ZAR, TRY, MXN, RUB and CNY see high volatility versus history driven by local stories.

Exhibit 15: G10: All apart from GBP are low volatility



Source: Bloomberg, Macrobond, Morgan Stanley Research; Carry is defined as the difference between the 3m implied volatility and the 1m realised volatility of the CCY versus USD.

Exhibit 16: EM: Asia vol is low, ZAR vol is too high



Source: Bloomberg, Macrobond, Morgan Stanley Research; Carry is defined as the difference between the 3m implied volatility and the 1m realised volatility of the CCY versus USD. We use CNY vol to represent CNH as it has a longer history.

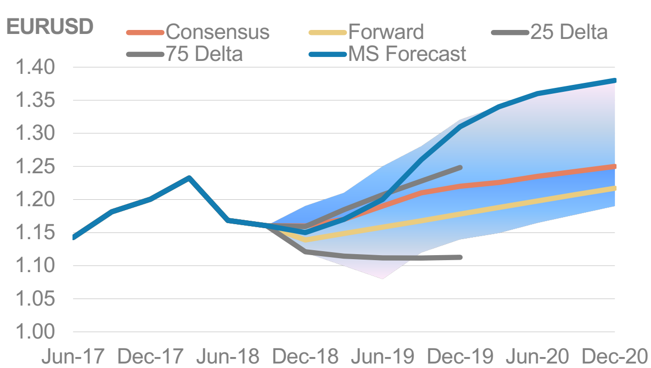
Trade recommendations

- Buy EURUSD 12-month 25 delta call at 1.18%, strike 1.2349.

End-2019 forecast 1.31, forward 1.19, 75 delta strike 1.25.

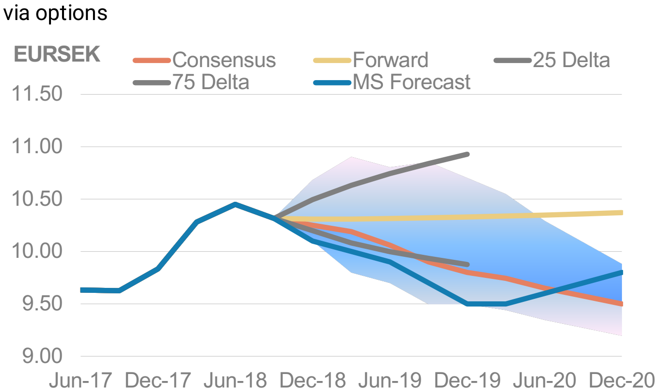
Morgan Stanley's forecast is 11% above the forward and the options market prices less than a 15% probability of reaching this level. The risk reversal is skewed towards EUR weakness, around the average of 2010-16, making the trade more attractive. We choose to trade the 25 delta call but a more out of the money call would also be profitable within our forecast expectations. The risk to the trade is increased uncertainty in the eurozone.

Exhibit 17: EURUSD forecast is 11% above the forward



Source: Bloomberg, Morgan Stanley Research

Exhibit 18: EURSEK forwards are flat for the next year, cheap to sell via options



Source: Bloomberg, Morgan Stanley Research

- Buy EURSEK 3-month ATM put at 1.37%.

End-2019 forecast 9.50, forward 10.33, 25 delta strike 9.83.

March 2019 forecast 10.00, forward 10.31, 25 delta strike 10.04.

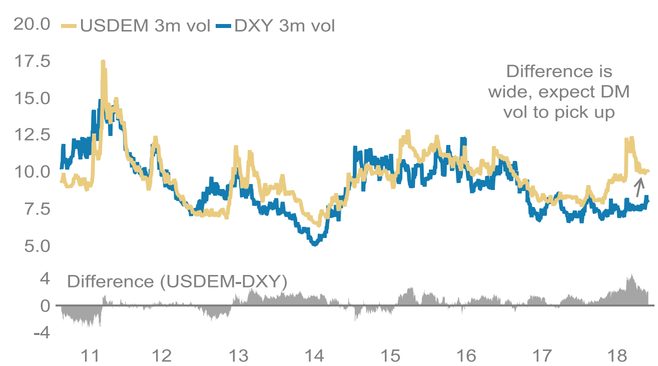
Morgan Stanley's forecast is 8% below the forwards by the end of 2019 and options markets price about a 10% probability of reaching that level. The risk reversal is skewed towards SEK weakness. We have chosen a shorter-tenor option as the curve is relatively flat, so we opt to run a rolling strategy over the coming year. EURSEK implied volatility is in the 30% percentile relative to the last decade. The risk to this trade is an escalation of global trade tensions.

- Buy USDJPY 12-month 40 delta put at 2.31%, strike 106.77.

End-2019 forecast 102.0, forward 108.8, 25 delta strike 102.4.

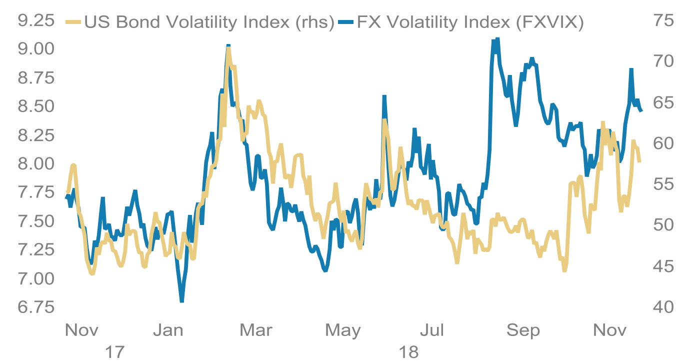
The high US interest rate versus Japan means the FX forward already assumes JPY appreciation versus USD. Morgan Stanley forecasts are for JPY to be 6% stronger than the forwards by the end of 2019. Options market skew (risk reversal) is usually pointing towards JPY strength but it is not extreme and we think that it could move further in that direction as USDJPY downside momentum picks up. The 1y risk reversal has traded at more negative extreme levels than today, meaning that, assuming our forecasts, we would expect a lower risk reversal. The risk to the trade is higher US rates.

Exhibit 19: The EM-DM implied volatility spread should narrow as EM stabilizes and DM picks up



Source: Bloomberg, Macrobond, Morgan Stanley Research

Exhibit 20: FX and bond volatility are linked



Source: Bloomberg, Macrobond, Morgan Stanley Research

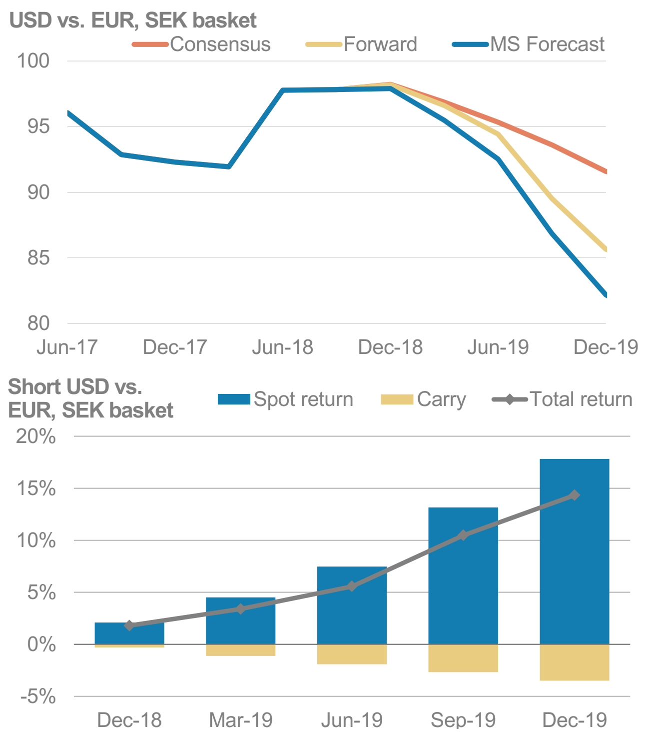
Short USD vs. EUR, SEK basket

Exhibit 21: Short USD vs. EUR, SEK basket: Projected return

	Spot	4Q18	1Q19	2Q19	3Q19	4Q19
EURUSD	*1.13*	1.15	1.17	1.20	1.26	1.31
Spot return		1.4%	3.2%	5.8%	11.1%	15.5%
MS vs consensus		-0.9%	0.0%	0.8%	4.1%	7.4%
USDSEK	*9.08*	8.83	8.55	8.25	7.70	7.25
Spot return		2.8%	5.9%	9.2%	15.2%	20.1%
MS vs consensus		1.5%	2.8%	4.7%	9.3%	11.5%
Short USD vs. EUR, SEK basket						
Spot return		2.1%	4.5%	7.5%	13.2%	17.8%
MS vs consensus		0.3%	1.4%	2.8%	6.7%	9.4%
Carry		-0.3%	-1.1%	-1.9%	-2.7%	-3.5%
Total return		1.8%	3.4%	5.6%	10.5%	14.3%

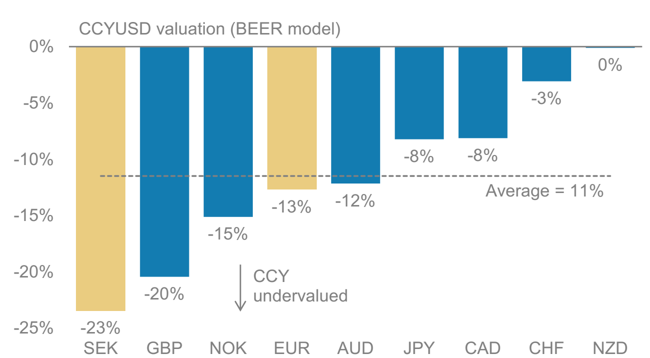
Source: Bloomberg, Morgan Stanley Research forecasts. Returns are relative to spot.

Exhibit 22: Short USD vs. EUR, SEK basket: Returns relative to market consensus and spot



Source: Bloomberg, Morgan Stanley Research forecasts

Exhibit 23: SEK and EUR are undervalued against USD



Source: Haver Analytics, Morgan Stanley Research

We think that USD is set to weaken over 2019 as US risk assets underperform, causing USD outflows, while US growth slows to converge with the RoW, and Fed policy tightening pauses in 2H19. This weakness should be most pronounced against European currencies. EUR should rally on the back of more favorable yield differentials, greater fiscal integration efforts and reduced current account-related outflows. Better eurozone prospects should boost SEK too, particularly given its undervaluation and the Riksbank starting its hiking cycle.

Divergence in flows... Going into 2019, we have a bearish outlook for US equities and credit markets, as rising labor and capital costs weigh on corporate profitability. Investor liquidation of these assets should trigger USD outflows, benefiting EURUSD in particular as eurozone investors are the largest foreign holders of US corporate bonds and equities, with 20% and 4% of the markets, respectively. At the same time, greater EMU fiscal integration efforts should incentivize higher domestic consumption and investment, boosting growth and reducing domestic savings. The resultant fall in the EMU's current account surplus suggests fewer EUR outflows as there are fewer funds to be invested abroad.

...and growth and monetary policy: Beginning in 2Q19, we also see US growth slowing meaningfully to converge to the RoW as the fiscal impulse fades, reducing the attractiveness of US assets and accentuating these USD outflows. The slowdown we forecast is likely to bring Fed rate hikes to a pause and balance sheet normalization to an end in 2H19. This happens as EMU inflation is likely accelerating, prompting the ECB to sound more hawkish gradually to prepare markets for an October rate hike. More hawkish rhetoric from the ECB, coupled with favorable Swedish inflation and growth attainment, should give the Riksbank more room to maneuver and start a hiking cycle in December 2018, pushing yield differentials in favor of EUR and SEK against USD.

Valuations: The Riksbank hiking rates should significantly increase the attractiveness of SEK, which is the most undervalued G10 currency (by 9-24%) based on the Behavioral Equilibrium Exchange Rate (BEER) model and REER relative to 10y average. Similarly, EUR is about 12% undervalued. On the contrary, USD is one of the most overvalued G10 currencies and faces significant downside risk as the US asset outlook weakens.

The key risk to this trade is a sustained rise in US productivity growth, which pushes US real yields and USD higher.

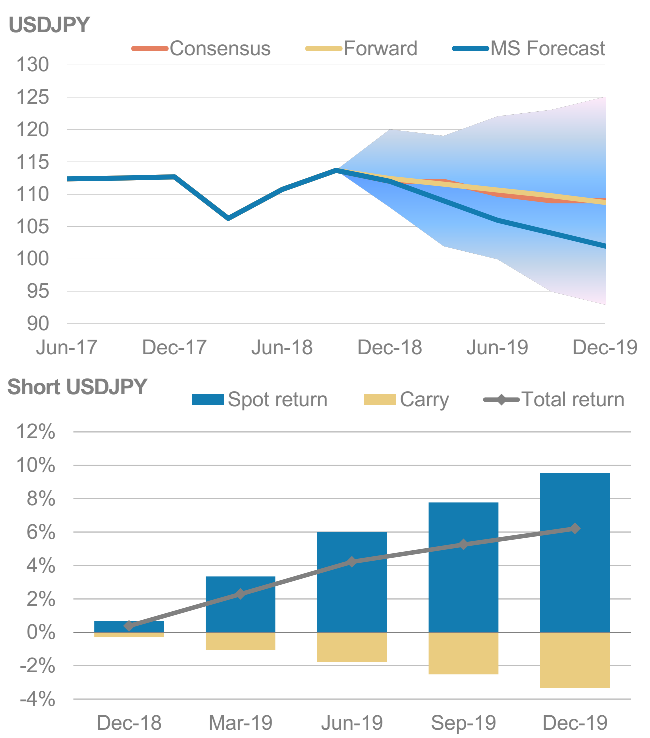
Short USD/JPY

Exhibit 24: Short USD/JPY: Projected return

	Spot	4Q18	1Q19	2Q19	3Q19	4Q19
USDJPY	*113*	112	109	106	104	102
Forward		112	112	111	110	109
Consensus		112	112	110	109	109
MS vs consensus		0.0%	2.7%	3.6%	4.6%	6.4%
Spot return		0.7%	3.3%	6.0%	7.8%	9.6%
Carry		-0.3%	-1.1%	-1.8%	-2.5%	-3.3%
Total return		0.4%	2.3%	4.2%	5.3%	6.2%

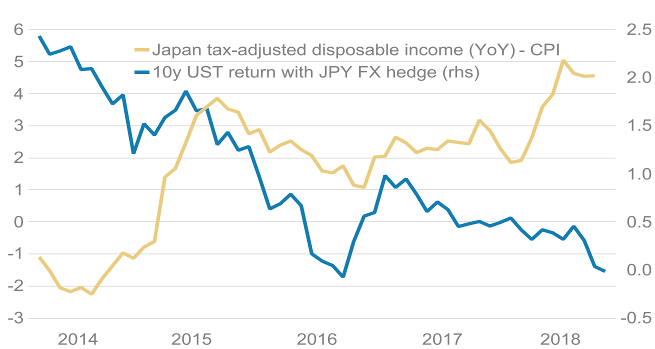
Source: Bloomberg, Morgan Stanley Research forecasts. Returns are relative to spot.

Exhibit 25: Short USD/JPY: Returns relative to market consensus and spot



Source: Bloomberg, Morgan Stanley Research forecasts

Exhibit 26: Leading Japanese indicators are promising while US investments look less attractive



Source: Macrobond, Bloomberg, Morgan Stanley Research

We expect USD/JPY to fall due to stronger growth in Japan, a slowdown in the US and resulting changes in yield differentials.

Japan is becoming a relatively more attractive investment destination… Improved data (Exhibit 26) and higher productivity growth in Japan should increase domestic investment rates and real JGB yields. Upward pressure on JGB yields should help the BoJ to stabilize long-term rates in line with its yield curve control policy and we expect the BoJ to end NIRP in 2019. Stable long-term rates would improve volatility-adjusted domestic returns, bolstering JPY.

…as the US becomes less attractive: A flattening US yield curve reduces Japanese investors' FX-hedged returns to long-term US asset holdings (Exhibit 26). Our economists see evidence of slowing US investment, the fading effects of fiscal stimulus, and tightening global liquidity weighing on US growth. We also see rising inflation (driven by tariffs and higher wages) constraining the Federal Reserve's ability to offset a sharp downturn. Higher inflation would erode real returns on US assets, and a US data slowdown may drive US asset price volatility higher. Both outcomes would incentivize Japanese investors to repatriate assets, driving the USD/JPY exchange rate lower.

Evidence that Japanese holdings in the US have become less sticky: JPY appreciated against USD during previous episodes of US asset volatility, but the exchange rate was relatively stable during US equity market volatility in early October. This observation (and net foreign inflows into US money market funds during recent months) lead us to believe that Japanese investors are liquidating long-term USD holdings and buying short-term (money market) US assets. Such a shift would increase Japanese investors' sensitivity to short-term US interest rates and make their US holdings easier to liquidate. Japanese investors' US holdings are now more prone to repatriation as a result.

Demographic changes should drive Japanese asset repatriation: Japanese pension and life insurance companies are major capital providers to RoW. Pension liabilities and life insurance claims will increase as the Japanese population ages. We expect that Japanese pension and life insurance firms will repatriate assets as liabilities increase, weighing on USD/JPY.

The key risk to the trade is continued US growth outperformance, strengthening USD.

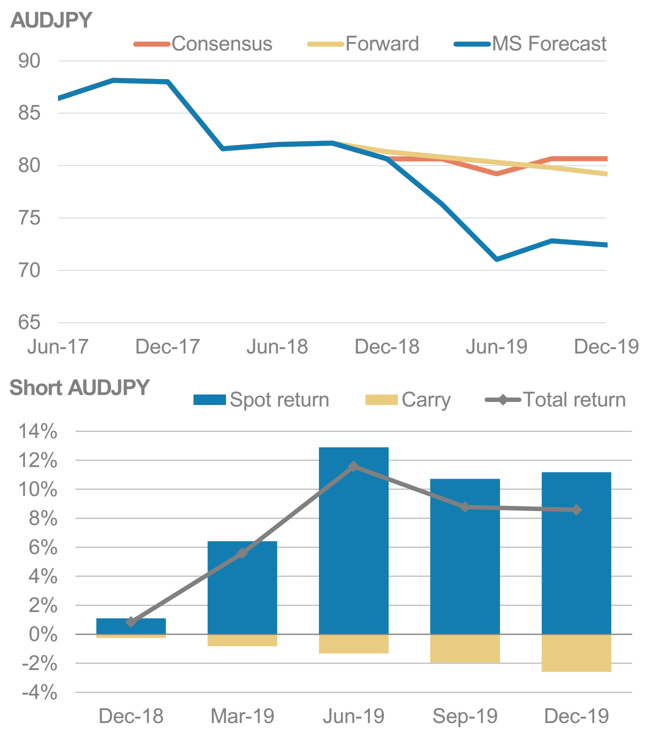
Short AUD/JPY

Exhibit 27: Short AUD/JPY: Projected return

	Spot	4Q18	1Q19	2Q19	3Q19	4Q19
USDJPY	*113*	112	109	106	104	102
AUDUSD	*0.72*	0.72	0.70	0.67	0.70	0.71
AUDJPY	*81.5*	80.6	76.3	71.0	72.8	72.4
Forward		81.3	80.8	80.3	79.8	79.2
Consensus		80.6	80.6	79.2	80.7	80.7
MS vs consensus		0.0%	5.4%	10.3%	9.7%	10.2%
Spot return		1.1%	6.4%	12.9%	10.7%	11.2%
Carry		-0.3%	-0.8%	-1.3%	-1.9%	-2.6%
Total return		0.8%	5.6%	11.6%	8.8%	8.6%

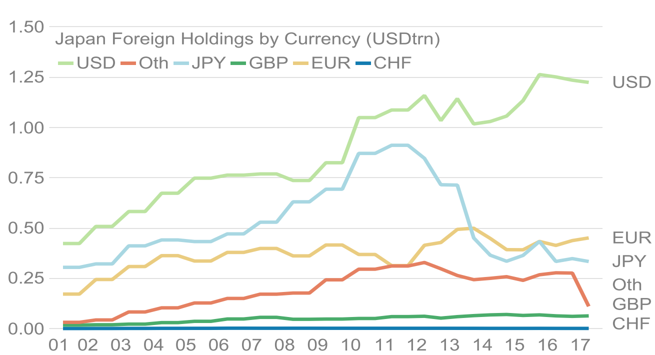
Source: Bloomberg, Morgan Stanley Research forecasts; Returns are relative to spot.

Exhibit 28: Short AUD/JPY: Returns relative to market consensus and spot



Source: Bloomberg, Morgan Stanley Research forecasts

Exhibit 29: Japanese foreign assets predominantly invested in the US



Source: Macrobond, Morgan Stanley Research

AUD/JPY should continue to fall during 2019 as global funding costs continue to rise, market volatility increases and global liquidity conditions tighten, supporting safe haven FX like JPY and weakening highly leveraged, deficit-financed currencies like AUD.

Rising vol and funding costs... 2019 should see rising global funding costs as the Fed continues its policy normalization. Economies with banking sectors reliant on USD wholesale funding costs, including Australia, should see domestic monetary conditions tighten exogenously as banks continue to pass along higher rates to borrowers.

...and worsening liquidity conditions... Meanwhile, further tightening in global liquidity conditions should weigh on currencies of countries reliant on foreign funding. Global liquidity has been supported in recent years by a combination of expanding central bank balance sheets and growth in excess savings from Northern Asia (including Japan) and Europe. Central bank balance sheets are retrenching, and we expect net excess savings deployed into financial markets to fall as these economies increasingly consume their savings domestically.

...should weigh on deficit-financed FX... Australia's current account deficit is financed in part by long-term debt inflows, suggesting that a pullback in global liquidity and net savings may weigh on the currency as it seeks to attract the necessary capital as it becomes increasingly scarce. This is particularly the case as monetary conditions tighten and growth remains challenged amid high household indebtedness, suggesting that investors may be less willing to invest in Australia. Tighter conditions and a weaker outlook help to keep the RBA on hold through 2019.

...and support safe havens like JPY: Conversely, under these conditions, JPY is likely to strengthen as rising market volatility and a worsening US financial and economic outlook increase the incentive for Japanese investors to repatriate their large stock of foreign assets. Japanese investors have increasingly allocated their foreign investments into higher-risk assets like credit, while the bear flattening of the yield curve has resulted in reductions in FX hedging. Higher volatility and a worsening outlook, coupled with improving Japanese domestic fundamentals and the end of NIRP in 2Q19, should incentivize repatriation, leading to broad JPY strength.

The key risk to the trade is that volatility remains subdued, incentivizing further Japanese outflows into foreign assets.

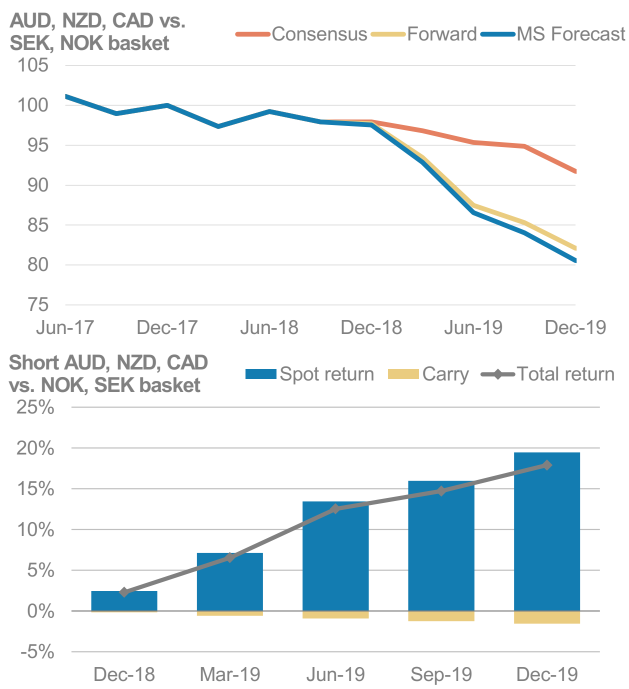
Short AUD, NZD, CAD vs. SEK, NOK basket

Exhibit 30: Short AUD, NZD, CAD vs. SEK, NOK basket: Projected return

	Spot	4Q18	1Q19	2Q19	3Q19	4Q19
AUDUSD	*0.72*	0.72	0.70	0.67	0.70	0.71
NZDUSD	*0.68*	0.67	0.65	0.62	0.66	0.67
USDCAD	*1.32*	1.31	1.33	1.35	1.33	1.32
USDSEK	*9.08*	8.83	8.55	8.25	7.70	7.25
USDNOK	*8.59*	8.43	8.29	8.00	7.46	7.10
Short AUD, NZD, CAD vs. NOK, SEK basket						
Spot return		2.5%	7.1%	13.5%	16.0%	19.5%
MS vs consensus		-1.2%	2.6%	7.8%	9.8%	10.8%
Carry		-0.2%	-0.6%	-0.9%	-1.3%	-1.6%
Total return		2.3%	6.5%	12.5%	14.7%	17.9%

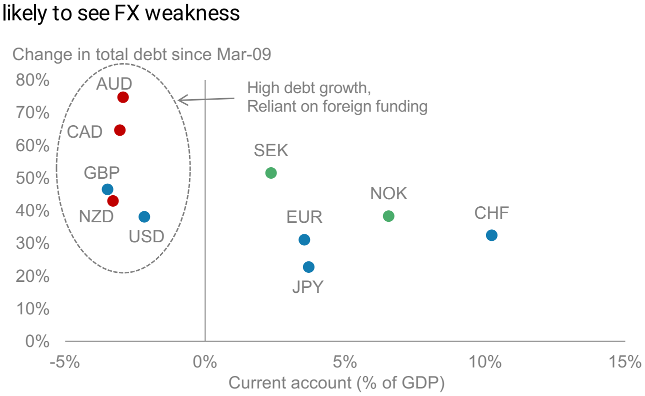
Source: Bloomberg, Morgan Stanley Research forecasts. Returns are relative to spot.

Exhibit 31: Short AUD, NZD, CAD vs. SEK, NOK basket: Returns relative to market consensus and spot



Source: Bloomberg, Morgan Stanley Research forecasts

Exhibit 32: Highly indebted economies reliant on foreign funding likely to see FX weakness



Source: Macrobond, Morgan Stanley Research

NOK and SEK should outperform AUD, NZD and CAD over 2019 as rising market volatility weighs on the dollar bloc while NOK and SEK gain from improving European fundamentals.

Household debt is a shared problem... A common element of these currencies is the high household indebtedness. The post-crisis era of low global funding costs and relative economic outperformance of these economies fuelled their housing booms.

...but relative foreign funding exposures... A key difference, though, is sensitivity to foreign funding and thus volatility. Unlike CAD, AUD and NZD, which rely on foreign inflows to finance their current account deficits, NOK and SEK run current account surpluses and hold significant stocks of foreign assets. In an environment where global asset volatility is likely to rise and global liquidity conditions tighten, current account surplus currencies are likely to outperform amid repatriation flows, while deficit-financed economies may find it more difficult to get foreign financing, leading to FX weakness.

...and relative monetary policy cycles... Meanwhile, Norges Bank and the Riksbank are likely to turn more hawkish compared to the RBA, RBNZ and BoC. Scandinavian monetary policy has tended to follow the ECB, both due to regional linkages and a greater reliance of Scandinavian banks on EUR-denominated wholesale funding. The ECB beginning its tightening cycle in 2019 should lead to similar measures in Scandinavia, bolstering NOK and SEK. However, banks in the dollar bloc are more reliant on USD-denominated wholesale funding, which has meant that domestic monetary conditions have already tightened due to rising USD funding costs. These central banks face headwinds to tightening aggressively under those conditions.

...suggest NOK and SEK outperformance: European FX like NOK and SEK should benefit from improving European economic fundamentals, tighter monetary policy and the prospect of further fiscal integration and expansion. Rising market volatility should keep the dollar bloc weak as their reliance on foreign funding renders them exposed to a pullback in global liquidity conditions. However, beyond 2019, we caution that Norway and Sweden may face conditions similar to those in Australia, Canada and New Zealand in light of their high household indebtedness, suggesting that this trade only performs well in 2019.

The key risk to the trade is that European data soften, weighing on Scandinavian FX.

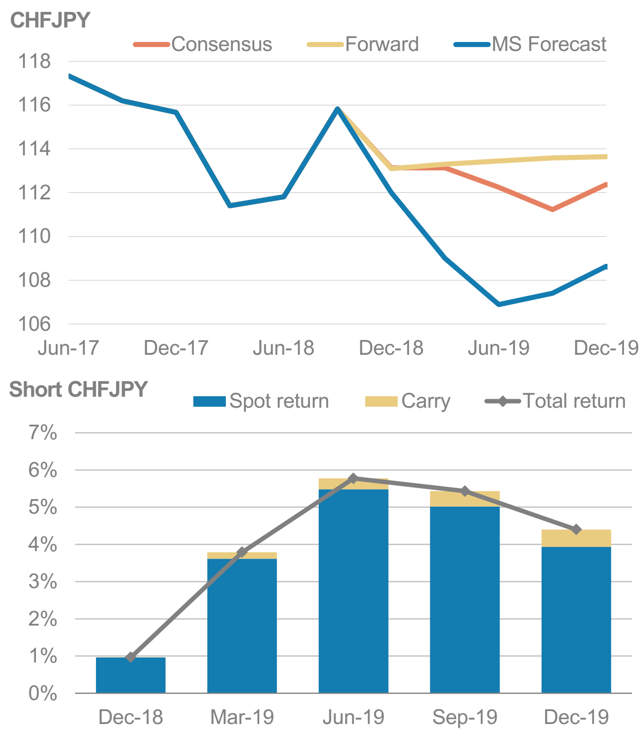
Short CHF/JPY

Exhibit 33: Short CHF/JPY: Projected return

	Spot	4Q18	1Q19	2Q19	3Q19	4Q19
USDJPY	113	112	109	106	104	102
USDCHF	1.00	1.00	1.00	0.99	0.97	0.94
CHFJPY	113	112	109	107	107	109
Forward		113	113	113	114	114
Consensus		113	113	112	111	112
MS vs consensus		1.0%	3.7%	4.8%	3.4%	3.3%
Spot return		1.0%	3.6%	5.5%	5.0%	3.9%
Carry		0.0%	0.2%	0.3%	0.4%	0.5%
Total return		1.0%	3.8%	5.8%	5.4%	4.4%

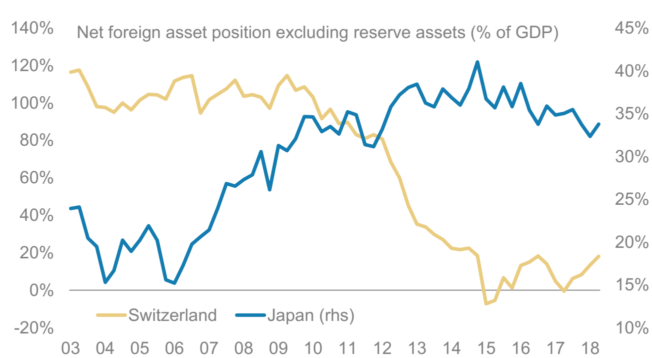
Source: Bloomberg, Morgan Stanley Research forecasts. Returns are relative to spot.

Exhibit 34: Short CHF/JPY: Returns relative to market consensus and spot



Source: Bloomberg, Morgan Stanley Research forecasts

Exhibit 35: Switzerland's repatriation potential has fallen while Japan's has increased



Source: Haver Analytics, Morgan Stanley Research

This trade should perform well in both times of risk-on and risk-off. In times of risk sell-off, particularly if the underperformance is mainly in US assets as we expect, JPY should see more support from repatriation flows than CHF due to differences in foreign asset and FX-hedging positions. More EMU integration efforts while Japan productivity growth picks up, coupled with market expectations for the two central banks' outlook, should also keep CHF/JPY on the back foot.

JPY stands to benefit more than CHF from a US-centric sell-off... In 2019, we expect US risk assets to underperform as asset valuations are high and US growth slows. Between the typical safe-haven currencies JPY and CHF, a US-centric sell-off should support JPY more than CHF, as Japanese investors have more US portfolio assets to liquidate and repatriate than Swiss investors, whose foreign assets are mainly invested in the eurozone.

...as there is more to repatriate: Ignoring the geographical allocation, Switzerland also has fewer foreign assets to repatriate as its foreign asset position is mainly held by the SNB. Excluding reserve assets, Switzerland's foreign asset position has fallen drastically from 97% of GDP (in 2008) to just 18% currently, while Japan's has increased from 26% of GDP to 34% in the same period. Swiss pension funds have also increasingly hedged out their foreign FX exposure while Japanese life insurance companies have done the opposite, implying less CHF strengthening impact from repatriation flows compared to JPY.

Better EMU and Japan outlook: A better EMU fiscal integration outlook strengthening the union should reduce demand for CHF as a hedge against eurozone divorce risks. It should also reduce risk premia on EMU assets, hence increasing yields, attracting capital from Switzerland. With CHF's expensive valuations, this poses notable downside risks for the currency. Conversely, the better Japan productivity growth outlook points towards higher real yields, which should lift the undervalued JPY, in our view.

Monetary policy: We expect the BoJ to move out of negative rates and deliver a 10bp rate hike in April, and the SNB to hike rates only after the ECB, given the SNB's aversion to CHF strength. Markets are not pricing any hikes at the BoJ's April meeting while 12bp of SNB hikes are priced for next year, suggesting that the BoJ is more underpriced and hence more upside potential for JPY.

The risk to this trade is an increase in EMU break-up expectations, strengthening CHF.

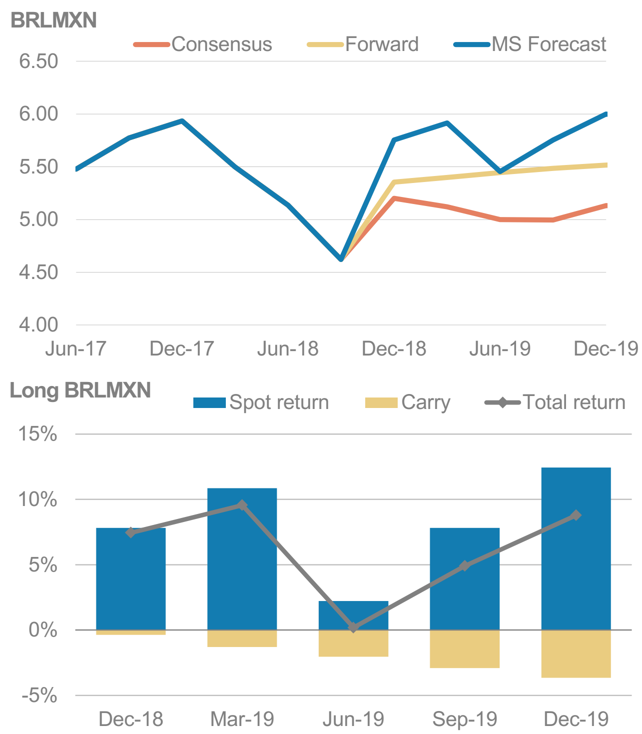
Long BRL/MXN

Exhibit 36: Long BRL/MXN: Projected return

	Spot	4Q18	1Q19	2Q19	3Q19	4Q19
USDBRL	*3.82*	3.65	3.55	3.85	3.65	3.50
USDMXN	*20.37*	21.00	21.00	21.00	21.00	21.00
BRLMXN	*5.34*	5.75	5.92	5.45	5.75	6.00
Forward		5.35	5.40	5.44	5.48	5.52
Consensus		5.20	5.12	5.00	4.99	5.13
MS vs consensus		10.6%	15.5%	9.1%	15.2%	16.9%
Spot return		7.8%	10.9%	2.2%	7.8%	12.4%
Carry		-0.4%	-1.3%	-2.0%	-2.9%	-3.7%
Total return		7.4%	9.6%	0.2%	4.9%	8.8%

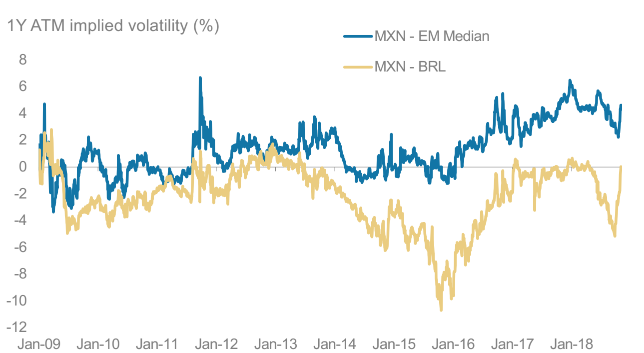
Source: Bloomberg, Morgan Stanley Research forecasts. Returns are relative to spot.

Exhibit 37: Long BRL/MXN: Returns relative to market consensus and spot



Source: Bloomberg, Morgan Stanley Research forecasts

Exhibit 38: MXN vol regime has likely shifted upward relative to its peers



Source: Bloomberg, Morgan Stanley Research

Now that elections are completed in Latin America's two largest economies, focus should shift towards the policies of the new administrations. We see BRL/MXN trending higher in 2019, given our expectation of a divergence in policies between the two countries. We expect Brazil to ultimately implement much-needed pension reforms and Mexico to remain prone to increasing fiscal and policy execution risks.

We see higher volatility in MXN… We remain concerned about potential fiscal slippage over the medium term. In addition, we think that the uncertainty around the airport consultation and its outcome has raised concerns among investors about policy implementation risks in the future. As highlighted in A New Higher Vol Regime: Will Banxico React? (November 9, 2018), we think that greater risks on the policy front (additional consultations, potential unorthodox policies) call for an increased volatility risk premium. This should ultimately weigh on expected risk-adjusted returns and, consequently, on the attractiveness of MXN versus other EM currencies.

…with the new budget as the likely catalyst for underperformance, owing to the airport consultation results and the administration's rhetoric regarding the outcome. On this, we argue that details are ultimately what matter, as even if a balanced budget is presented for 2019, potential concerns about assumptions on growth and/or savings from spending reengineering will likely increase risks. We think that another potential risk to monitor would be the prospects for a USMCA trade deal approval in the US, given the Republicans' loss of the Lower House following the midterm election.

All eyes on pension reform in Brazil: Moving into 2019, we expect markets to focus on incoming President Bolsonaro's ability to pass pension reform, with congressional support and the comprehensiveness of the proposal as the two main factors to watch. While our base case assumes that a less comprehensive pension reform will likely be passed next year, the recent market-friendly cabinet appointments suggest that risks to our USD/BRL forecast are skewed to the downside.

The main risks to this trade include a potential failure of the new government in Brazil to adopt pension reform in 2019 and a more orthodox-than-expected policy path in Mexico.

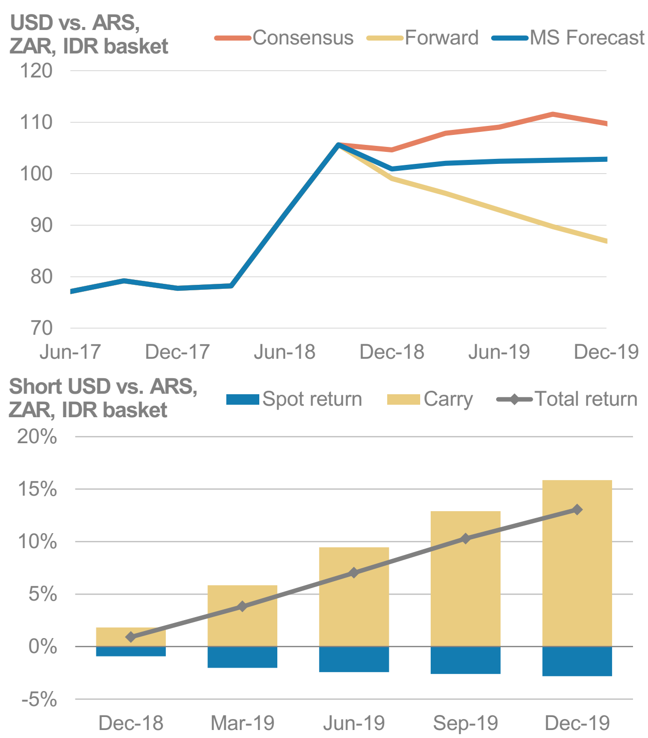
Short USD vs. ARS, ZAR, IDR basket

Exhibit 39: Short USD vs. ARS, ZAR, IDR basket: Projected return

	Spot	4Q18	1Q19	2Q19	3Q19	4Q19
USDARS	*36.73*	37.00	39.50	41.25	42.50	43.50
USDZAR	*13.9*	14.0	13.8	13.5	13.2	13.0
USDIDR	*14544*	14700	14400	14200	14100	14000
Short USD vs. ARS, ZAR, IDR basket						
Spot return		-0.9%	-2.0%	-2.4%	-2.6%	-2.8%
MS vs consensus		3.5%	5.4%	6.1%	7.9%	6.4%
Carry		1.8%	5.8%	9.5%	12.9%	15.9%
Total return		0.9%	3.8%	7.0%	10.3%	13.1%

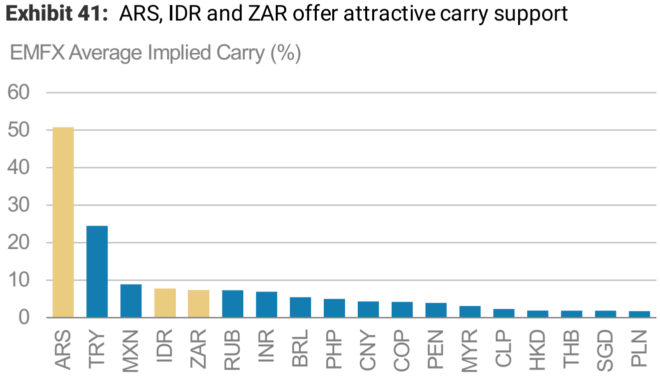
Source: Bloomberg, Morgan Stanley Research forecasts; Returns are relative to spot.

Exhibit 40: Short USD vs. ARS, ZAR, IDR basket: Returns relative to market consensus and spot



Source: Bloomberg, Morgan Stanley Research forecasts

Exhibit 41: ARS, IDR and ZAR offer attractive carry support



Source: Bloomberg, Morgan Stanley Research. Note: The chart shows the average of 3m, 6m and 12m implied carry for each currency.

Given our view that USD could weaken throughout 2019, we select a high-yielding EM currency in each region for attractive carry support.

In Asia, IDR has suffered in 2018 given the broad EM sell-off and investors' focus on Indonesia's twin deficits. However, the authorities have been proactively addressing investors' concerns and reducing Indonesia's vulnerabilities. The government plans to have a smaller fiscal deficit in 2019 (1.8% versus 2% expected). Bank Indonesia (BI) has hiked 150bp so far to increase real rates, announcing measures to curb imports and improve the mechanism of offshore NDF trading. **All these measures should help a recovery in IDR in 2019,** in our view. Positioning in IDR is also lighter, according to our GBI-EM position tracker. While BI is likely to accumulate reserves again should IDR trade too strongly, the current level is still well above the 2016/17 trough.

In CEEMEA, **we believe that ZAR could outperform.** The November budget surprised investors on the downside, given weak growth and sticky expenditure. It also set a low bar for February's budget, where the government could find new measures to reduce the deficit. Investors will focus on the election in 2019, likely welcoming an outcome supporting policy continuation, in our view. Political uncertainty has weighed on business confidence and private sector capex, so an improvement on that front could kick off the investment cycle, a key theme advocated by various private sector companies recently. Lastly, the SARB could remain hawkish, providing an important anchor to ZAR.

In LatAm, **we see ARS as an attractive carry play,** with 3-month implied rates at around 50%, among the highest across EMs. In spot terms, we think that USD/ARS should remain fairly close to the lower bound of the sliding intervention band, implying a mild depreciation (~10%) into end-2019 versus the very attractive carry it offers. Full support from the IMF has helped to reduce the risk premium in local assets, and we expect it to continue declining, as external vulnerabilities are reduced and the economy exits recession territory, with policy continuity after the 2019 election as our base case. Given ARS's cheapness in PPP terms and our expectation of a weaker USD, the peso should be able to navigate 2019 in an orderly fashion, providing an attractive carry boost.

The key risks to this trade include a larger-than-expected reserve accumulation program by BI, a less hawkish SARB and a policy shift following the 2019 presidential elections in Argentina.

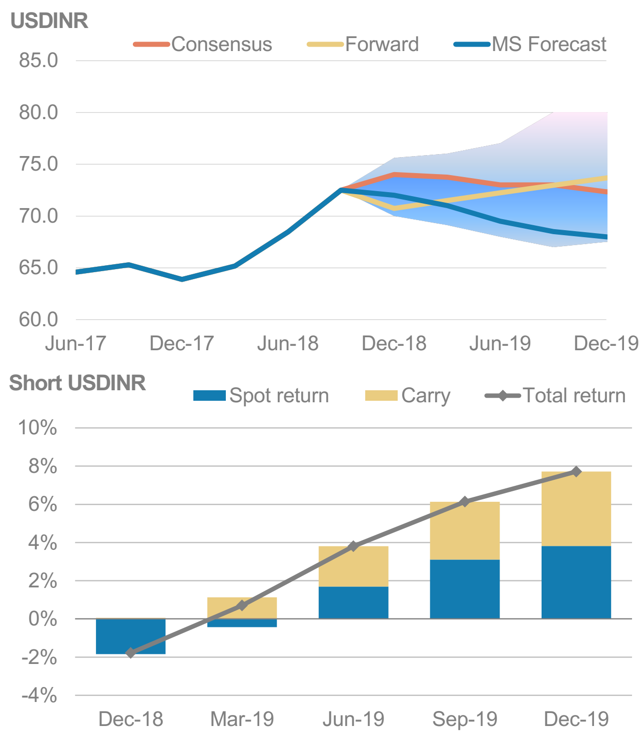
Short USD/INR

Exhibit 42: Short USD/INR: Projected return

	Spot	4Q18	1Q19	2Q19	3Q19	4Q19
USDINR	*70.7*	72.0	71.0	69.5	68.5	68.0
Forward		70.7	71.5	72.2	73.0	73.7
Consensus		74.0	73.8	73.0	73.0	72.4
MS vs consensus		2.7%	3.7%	4.8%	6.2%	6.0%
Spot return		-1.8%	-0.4%	1.7%	3.1%	3.8%
Carry		0.1%	1.1%	2.1%	3.0%	3.9%
Total return		-1.8%	0.7%	3.8%	6.1%	7.7%

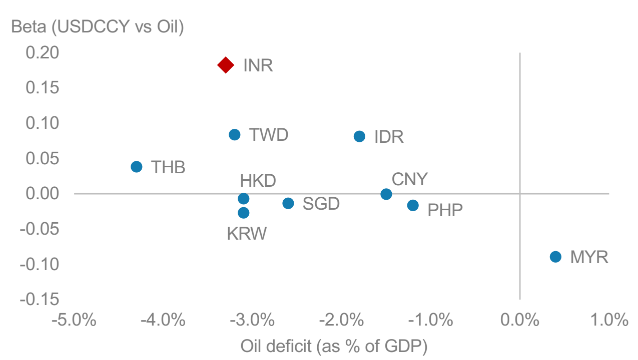
Source: Bloomberg, Morgan Stanley Research forecasts. Returns are relative to spot.

Exhibit 43: Short USD/INR: Returns relative to market consensus and spot



Source: Bloomberg, Morgan Stanley Research forecasts

Exhibit 44: We expect those currencies with high oil dependency to benefit from the sell-off in Brent



Source: Bloomberg, Morgan Stanley Research

Despite expecting EM Asia to underperform the overall EM complex, we highlight select local stories we expect to generate alpha against regional peers. In the region, we think that India offers the best growth potential and we expect USD/INR to reach 68 (down ~4% from current levels) by end-2019.

Strong local growth profile with wide real rates differential: As our four-factor model shows, the relative growth differential is the single most important variable in explaining the performance of FX crosses against USD. Our economists currently expect India to exhibit the strongest growth profile among major economies and throughout Asia, growing at 7.6%Y in 2019. The RBI is the only Asian central bank our economists expect to hike in tandem with the Fed (50bp in 1H19) and hence our expectation is for Indian real rates to remain wide and INR to outperform.

Weaker oil: As explained by our commodities strategists, the bull case for crude oil prices has become increasingly fragile and risks are increasingly skewed to lower oil prices. Among AXJ economies, India has one of the highest oil deficits (see here for more details) and INR exhibits the greatest sensitivity to changes in oil prices. As such, in 2019, we no longer see oil as the dominating theme for INR as it was in 3Q18.

Attractive carry, along with decent capital gains potential: Reflective of the high interest rate environment, FX carry on short USD/INR positions is attractive and is the second-highest in the region. Despite IDR having better carry, we think that USD/INR has more downside potential now that oil prices have stabilized. Historically, we have not seen many episodes of sharp downward movement in USD/IDR due to BI accumulating reserves during periods of inflows. As a result, the decent FX carry, combined with better prospects for capital gains, leads us to believe that INR will outperform IDR on a relative basis.

Risks: The main risks to the INR outlook are: i) An unexpected increase in oil prices and a deterioration in India's current account position; ii) Increased fiscal expenditure prior to the Indian national election in April-May 2019; and iii) Higher US rates leading to a narrowing in real rate differentials and larger outflows.

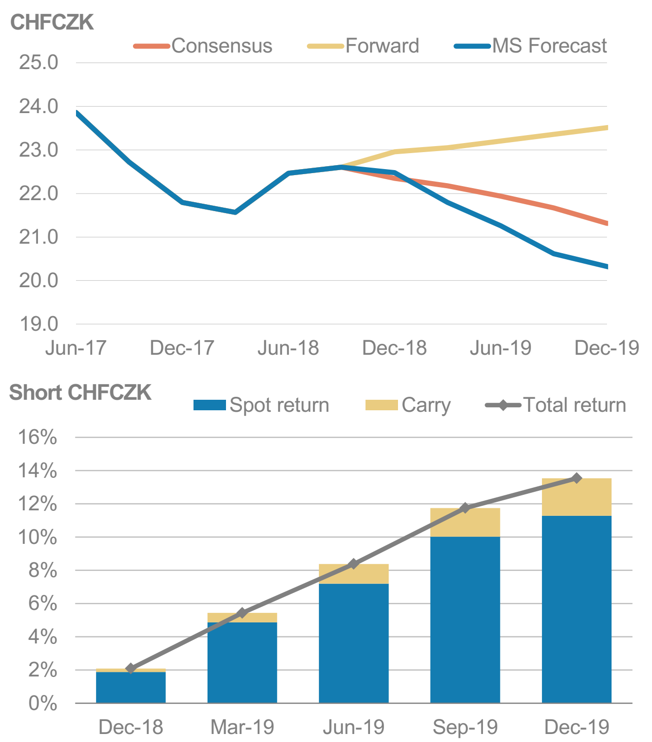
Short CHF/CZK

Exhibit 45: Short CHF/CZK: Expected return

	Spot	4Q18	1Q19	2Q19	3Q19	4Q19
EURCZK	*25.9*	25.9	25.5	25.3	25.2	25.0
EURCHF	*1.13*	1.15	1.17	1.19	1.22	1.23
CHFCZK	*22.9*	22.5	21.8	21.3	20.6	20.3
Forward		23.0	23.0	23.2	23.4	23.5
Consensus		22.3	22.2	21.9	21.7	21.3
MS vs consensus		-0.6%	1.7%	3.1%	4.9%	4.6%
Spot return		1.9%	4.9%	7.2%	10.0%	11.3%
Carry		0.2%	0.6%	1.2%	1.7%	2.3%
Total return		2.1%	5.4%	8.4%	11.7%	13.5%

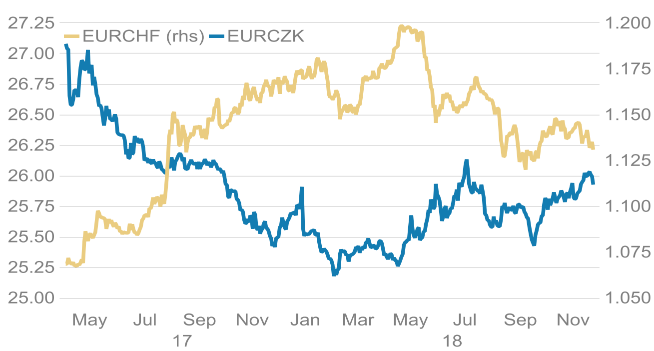
Source: Bloomberg, Morgan Stanley Research forecasts. Returns are relative to spot.

Exhibit 46: Short CHF/CZK: Returns relative to market consensus and spot



Source: Bloomberg, Morgan Stanley Research forecasts

Exhibit 47: CZK outperformance coming



Source: Bloomberg, Morgan Stanley Research

Our currency forecasts project outperformance of CZK versus CHF for 2019.

Good capital gains: Since the EUR/CZK floor gave way in early 2017, EUR/CZK and EUR/CHF have been inversely correlated, for the most part at least. So, our forecast for EUR/CHF to head higher over 2019 to 1.23 and EUR/CZK to head down to 25.0 by the end of the year looks consistent with past dynamics. This forecast suggests that CHF/CZK will be trading at 20.3 by end-2019, compared to 22.9 now.

Reduced safe haven demand: Given our expectation for greater eurozone reform and outperformance of European risk assets, relative to the US at least, there should be less demand for CHF given reduced repatriation/safe-haven demand.

Stronger EUR and better EM: Investors often ask why CZK has not appreciated over 2018, despite a hawkish central bank and a number of rate hikes delivered. Our answer is pretty simple: EUR/USD declined and performance of EM assets in general has been very poor. Most EUR/CEE crosses move inversely to EUR/USD, so when the latter declines EUR/CZK has tended to move up. For 2019 we expect to see the opposite trend – we see EUR/USD rising strongly and a better performance for EM assets.

More rate hikes: Our macro forecasts also see more hikes from the CNB next year (+75bp) compared to the consensus and marginally higher inflation. Although this tightening has not been particularly helpful for CZK this year, as the broader backdrop changes we think rate hikes will give CZK an extra boost.

Positive carry: The 12-month yield on CZK forwards is 1.3% compared to -0.84% on CHF, giving a carry of over 2% and a realized annualized volatility of around 7.5%. While we think there will be other EMs that deliver better total returns than CZK, this relative value trade is relatively low volatility and plays on a European recovery theme.

The main risks to this trade are that European growth surprises to the downside and the CNB turns more dovish.

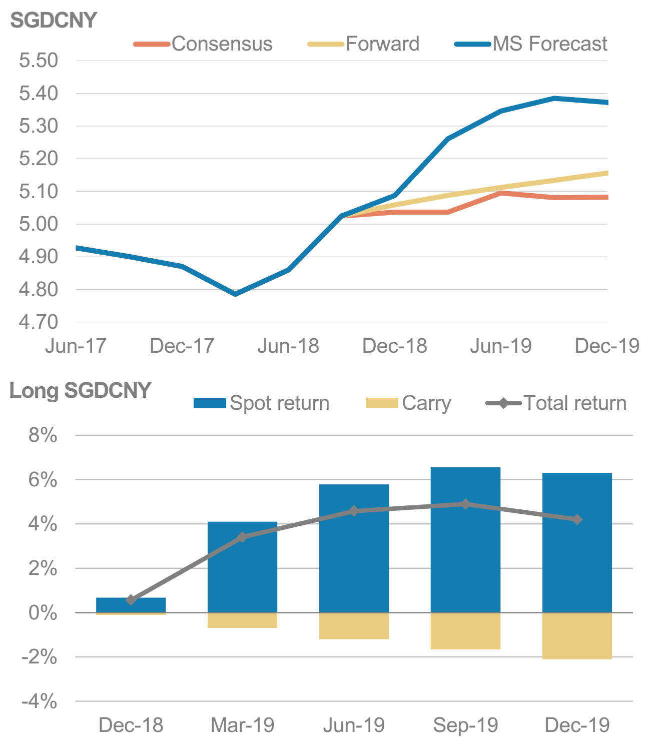
Long SGD/CNH

Exhibit 48: Long SGD/CNH: Projected return

	Spot	4Q18	1Q19	2Q19	3Q19	4Q19
USDSGD	*1.37*	1.37	1.34	1.32	1.29	1.28
USDCNY	*6.95*	6.97	7.05	7.03	6.92	6.85
SGDCNY	*5.05*	5.09	5.26	5.35	5.39	5.37
Forward		5.06	5.09	5.11	5.13	5.16
Consensus		5.04	5.04	5.10	5.08	5.08
MS vs consensus		1.0%	4.5%	4.9%	6.0%	5.7%
Spot return		-0.7%	-4.1%	-5.8%	-6.6%	-6.3%
Carry		1.2%	7.5%	10.4%	11.5%	10.5%
Total return		0.6%	3.4%	4.6%	4.9%	4.2%

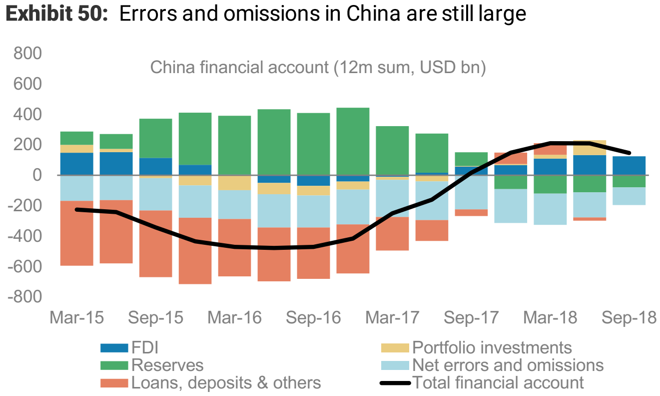
Source: Bloomberg, Morgan Stanley Research forecasts; Returns are relative to spot.

Exhibit 49: Long SGD/CNH: Returns relative to market consensus and spot



Source: Bloomberg, Morgan Stanley Research

Exhibit 50: Errors and omissions in China are still large



Source: Haver Analytics, Morgan Stanley Research

CNY is expensive from a capital account perspective: From a current account perspective, CNY doesn't seem to be overvalued as China's current account surplus has shrunk from 4% in 2010 to flat in 2018 and China is likely to run a 0.3% deficit in 2019, according to our economist. However, from a capital account perspective, CNY could be seen as expensive because China continues to have large errors and omissions, in the range of US$170-200 billion a year. Errors and omissions are the items that are not captured by any of the official channels, hence suggesting constant capital outflows.

A weaker CNY NEER helps... CNY NEER has experienced four regimes in the past three years: 10% gradual depreciation before mid-2016, stable between mid-2016 and mid-2017, 7% gradual appreciation between mid-2017 and mid-2018 and 5% one-off depreciation in mid-2018. Clearly, the PBOC manages CNY NEER similar to how the MAS manages SGD NEER, but with much greater flexibility. A lower CNY NEER could help to support exports and growth and alleviate the pressure on capital outflows, in our view.

...but its stability is also important: However, we also believe that the PBOC would like to have a relative stable currency to attract capital inflows. In order to fund the current account deficit and open its domestic equity and fixed income markets to foreign investors, it is in China's interest for the CNY NEER to not depreciate too fast.

What the PBOC could do: Hence, we believe that the PBOC could keep USD/CNY stable when USD is weak but let USD/CNY trade higher should USD be strong. In other words, the PBOC would refrain from using the countercyclical factor should DXY march higher, a pattern we have observed in October.

Meanwhile, we expect SGD to trade well, given our bearish view on DXY and 1% steepening in S$NEER guided by the MAS.

Risks to the trade could come from a reduction in trade uncertainty and an acceleration in China's growth, which warrants a strong CNY NEER.

G10 Currency Summaries

USD -5% Bearish	We anticipate broad USD weakness against much of the G10 and EM. Global liquidity has been increasingly concentrated in the US over 2018, a classic late-cycle symptom, but we believe that rising market volatility, a worsening US economic and asset outlook and rising capital demand abroad suggest that funds will increasingly leave the US. The Fed pausing on policy tightening in 2H19 should also weaken USD. USD weakness should be most pronounced against large exporters of capital such as EUR and JPY, and related currencies like SEK.
EUR +16% Bullish	We remain long-term bullish on EUR and EUR crosses. We expect European growth to rebound and core inflation to pick up, which should enable the ECB to keep normalizing policy, narrowing interest rate differentials. Political momentum should continue shifting towards fiscal expansion and integration. Rising domestic consumption and investment, coupled with a worsening US outlook, suggests that excess eurozone savings, for so long deployed in US capital markets, may increasingly stay at home.
JPY +10% Bullish	JPY should rally over 2019. Rising FX hedging costs have meant that Japanese foreign asset holdings have become both increasingly FX-unhedged and in riskier assets. In our view, high risk exposure amid a worsening US asset outlook and rising volatility contrasts with an improving Japan macro outlook and rising capital demand, increasing the incentive for repatriation. The BoJ moving out of negative interest rates in 2Q19 should bolster JPY too.
GBP +17% Bullish	In our base case of an eventual soft Brexit outcome, keeping cross-border production chains in place, GBP should rally, driven by its cheap valuation. The removal of Brexit uncertainty should also boost investment as pent-up demand is executed, increasing capital demand and yields, in turn supporting GBP. Rising domestic inflationary pressures allowing the BoE to hike rates twice next year and start QE unwind in 4Q19 should also boost UK yields and GBP, as this is not priced in by the markets.
CHF -9% Bearish	EURCHF should rally in 2019 as a better EMU integration outlook reduces demand for CHF as a hedge against eurozone break-up risks. It may also incentivize Swiss investors to deploy funds in higher-yielding EUR assets. Switzerland's smaller foreign asset position also implies less support for CHF from repatriation flows. The European Parliament elections and SNB rate hike, which we expect to come only after the ECB, may introduce modest CHF strength but only temporarily as the SNB stays cautious.
CAD 0% Bearish	USDCAD should stay supported amid a worsening Canadian economic outlook. The BoC hiking rates in response to capacity constraints and rising inflation should further weigh on consumption as highly levered households face higher debt-service costs. As we see it, Canada's reliance on portfolio inflows to finance its current account deficit suggests that it is vulnerable to tightening external liquidity conditions.
AUD -2% Bearish	AUD should see weakness into 2019. Increasing scarcity of funds globally suggests that AUD needs to weaken to attract foreign capital to fund its current account deficit. Domestic growth challenges remain due to high household leverage and a slowing housing market weighing on consumption, which should keep the RBA on hold through 2019 compared to central bank policy normalization in the rest of G10, pushing rate differentials against AUD.
NZD -1% Bearish	Tightening global liquidity conditions should keep NZD under pressure. With the RBNZ expected to stay relatively dovish in 1H19, keeping New Zealand yields depressed, the currency likely needs to weaken to attract increasingly scarce foreign capital to fund its current account deficit. In our view, in 2H19, when the RBNZ starts preparing markets for a rate hike, NZD may receive a boost, particularly in an environment of a weak USD.
SEK +8% Bullish	SEK should be the best-performing G10 currency in 2019. We expect the Riksbank to start its hiking cycle in December 2018, earlier than markets are pricing. Favorable domestic inflation and growth attainment, as well as ECB normalization, should keep Riksbank rate expectations high. Higher SEK yields should lift the currency, which is one of the most undervalued within G10. Sweden's record-high foreign asset position provides cushion for the currency in an environment of tightening liquidity conditions.
NOK +5% Bullish	NOK should be supported by continued rate hikes from Norges Bank. With Norwegian growth and inflation expected to hold up well, and households unlikely to delever significantly over the next 1-2 years, we see Norges Bank delivering two rate hikes in 2019, more than current market pricing. NOK performance is closely tied to house prices and oil prices, both of which have already undergone significant corrections, pointing to upside risks.

Percentage moves represent 4Q19 forecasts relative to spot (rounded to nearest %) for currency against USD, except for CHF, SEK and NOK, which are against EUR, and the USD which is the Fed's Broad TWI.

EM currency summaries

CZK +6% Bullish	We think that CZK will rebound in 2019, after a fairly lackluster 2018. Rate hikes did not give the intended boost thanks to EM and weak sentiment towards EUR-linked currencies. This should change next year as a rising EUR, more rate hikes and better EM sentiment lead to a stronger performance from CZK.
HUF +3% Neutral	We think that HUF will underperform CEE peers next year. Continued dovishness from the central bank as the ECB prepares to hike will put the spotlight on HUF. We expect HUF weakness in the first half of the year followed by recovery.
ILS +4% Neutral	We think that ILS will rally in line with EUR. We expect real GDP growth to remain solid at 3.3%Y next year and the balance of payments remains in good shape. Falling rate differentials with the US have not been detrimental to ILS performance recently thanks to the solid external position, and we expect this to remain the case.
PLN +5% Bullish	We think PLN will have a good year in 2019. Growth might slow but should still be solid. A rising EUR and better EM performance should help sentiment towards CEE FX and PLN should be a beneficiary. Low inflation should mean the NBP's dovish stance does not affect the currency in the same way as in Hungary, yet ECB tightening may raise the stakes.
RUB +11% Bullish	We see gains for RUB over 2019. High yields, good balance of payments and prudent monetary and fiscal policy should be supportive of the currency. Still, the tail risk of sanctions remains an ever-present threat for investors and we suspect appetite for sovereign bond exposure will be lower as a result. We expect gains, but the range of outcomes is quite wide.
TRY +10% Neutral	TRY is one of the few currencies where we expect weakness in spot terms against USD, though high carry should ensure total returns stay positive. We think TRY could buck the broader USD trend thanks to high inflation differentials that will put pressure on the real exchange rate should we see nominal appreciation. Meanwhile, rate cuts and other growth-supporting measures are a risk for the currency. Although the total return is high, we see large risks around the forecast and hence have a neutral stance.
ZAR +11% Bullish	We are bullish on ZAR for 2019. We expect growth to recover and the currency retains a high beta to USD weakness. With carry, total returns would be attractive. With the budget and elections some distance in the future, and positioning relatively light, we think that ZAR will end 2018 and start next year on a strong footing.
ARS +20% Bullish	Full support from the IMF has helped to reduce the risk premium in local assets, and we expect it to continue declining in 2019, as external vulnerabilities are reduced and the economy exits recession territory, with policy continuity after the 2019 election as our base case. Given ARS's cheapness in PPP terms and our expectation of a weaker USD, it should be able to navigate 2019 in an orderly fashion, while also providing significantly high carry relative to other EM currencies.
BRL +11% Neutral	Despite the recent rally, we see further room for BRL to strengthen in an environment where USD trends down and valuations are far from stretched. However, we see the currency running out of steam and correcting lower in 2Q19 as the reform discussion intensifies in Congress. For this reason we keep our stance neutral, though 2H19 could deliver strong returns should appropriate reforms be passed.
CLP +8% Bullish	Chile's fundamental story remains attractive and supportive for CLP. Moreover, we expect the government to make progress on its reform agenda next year, including on tax and pension reforms, which should help to support business confidence and drive further investment. The 2019 outlook for copper remains positive, according to our metals strategist, which should provide further support for CLP, in addition to our expectation of a weaker USD.
COP +8% Bearish	While Colombia's better external position has helped to decrease asset price sensitivity to global shocks, the country remains heavily dependent on oil revenues. With risks for oil tilted to the downside, and inexpensive carry, COP looks vulnerable relative to its LatAm peers. Moreover, Colombia requires a comprehensive fiscal reform to maintain its investment grade credit rating. While a tax reform proposal has already been introduced in Congress, it is likely that it will not be approved in its current form, given resistance from a majority of parties. Our base case is that a more watered-down version of this reform will be eventually passed in Congress, but noise around the approval process could weigh further on the peso.

MXN +4% Bearish	We remain concerned about potential fiscal slippage over the medium term. In addition, we think that the uncertainty around the airport consultation and its outcome has raised concerns among investors about policy implementation risks in the future. In our view, greater risks on the policy front (additional consultations, potential unorthodox policies) call for an increased volatility risk premium. This should ultimately weigh on expected risk-adjusted returns and, consequently, on the attractiveness of MXN versus other EM currencies.
PEN +6% Neutral	We remain neutral on PEN into 2019, despite a weaker USD, as regular FX interventions by BCRP limit any potential upside. Loose monetary conditions with improving investment but little to no inflation should keep monetary policy anchored. We note that the new administration has started to put forth objectives on improving investment, increasing tax revenues and boosting growth, but progress has been slow, given significant political polarization.
CNY +2% Bearish	We think that CNY could strengthen against USD should DXY stay weak, but CNY is likely to weaken in basket terms in 2019 as a weaker currency could support exports and growth. The currency is expensive from a capital account perspective as errors and omissions, which could mean capital outflows, remain large. However, rapid depreciation is unlikely given the importance of capital inflows and given that the lower CNY NEER can lend support to exports and growth.
INR +8% Bullish	Eased inflation pressure and falling oil prices, as our commodities strategists projected, suggest an INR recovery. Our economists expect strong growth in India compared to its regional peers and pencil in 50bp of hikes by the RBI in 2019. With rate differentials against the US remaining high and given our DXY weakness view, we are bullish on INR and recommend a short USD/INR position.
IDR +9% Bullish	With BI's proactive policy hikes since May 2018 to increase real rates and reduce IDR vulnerability, we're bullish on IDR given the attractive carry. In addition, with our bearish view on DXY and with UST continuing to rally, funding pressure on Indonesia's current account deficit can be released. The potential inflows to bonds and equity, on which our equity strategists are overweight, could support IDR.
KRW +1% Bearish	Our equity strategists see an aggressive KOSPI rally as less likely, meaning that KRW would still remain pressured, given the high foreign participation in the Korean equity market. Coupled with the macroprudential tightening measures, which could weigh further on property markets, a slowing global economy and softer Chinese domestic demand, this does not bode well for Korea's economy.
MYR +3% Bearish	With BNM likely to stay on hold and our economists expecting economic moderation for Malaysia, we remain bearish on MYR. Our risk premium model suggests that MYR is currently overvalued and that its risk premium is low, suggesting further underperformance should GBI-EM investors continue to leave the bond market, given the concerns about market liquidity.
SGD +6% Neutral	We think that the MAS is likely to continue its current appreciation slope for S$NEER, suggesting a stronger SGD. According to our MS SGD NEER model and the BIS trade weights, the US and China are the two most weighted countries. Thus, as we expect DXY weakness and a lower CNY NEER, USDSGD could outperform its regional peers. In addition, our economists expect Singapore GDP to continue to stay at a healthy level.
THB +4% Neutral	Given Thailand's better economic fundamentals and current account surplus, we see THB as relatively stable in the medium term. The lingering US-China trade tensions may be beneficial for Thailand while the expectation of a slowing global economy could weigh on THB. Our economists expect the BoT to hike 25bp by the end of this year and stay on hold in 2019. We expect THB to outperform Asia low yielders but underperform high yielders.
PHP +3% Bearish	We are bearish on PHP due to structural issues that remain unresolved. Our economists see the Philippines' economic overheating problem as likely to persist and the BSP would need more rate hikes to curb macro-instability. However, further interest rates hikes would mean more downside risks for growth, weighing on PHP in the longer term.
TWD 0% Neutral	The softer China domestic demand and lingering US-China trade tensions could pressure TWD, despite Taiwan's current account surplus and the economy holding up fine. However, with our equity strategists' neutral stance on the Taiwanese stock market and the low-volatility characteristic of TWD, the currency is likely to stay relatively stable. In addition, our economists expect the CBC to stay on hold in 2019, suggesting that material TWD appreciation is unlikely.

Percentage moves represent total return relative to spot (rounded to nearest %) by 4Q19 for currency against USD, except for CZK, HUF and PLN which are against EUR.

FX forecasts: Old vs. new

Exhibit 51: G10 FX forecasts: Old vs. new

		Spot	4Q18	1Q19	2Q19	3Q19	4Q19
NEW	**EUR/USD**	**1.13**	**1.15**	**1.17**	**1.20**	**1.26**	**1.31**
OLD			*1.15*	*1.19*	*1.24*	*1.28*	*1.32*
NEW	**USD/JPY**	**113**	**112**	**109**	**106**	**104**	**102**
OLD			*108*	*104*	*100*	*95*	*93*
NEW	**GBP/USD**	**1.28**	**1.30**	**1.34**	**1.40**	**1.45**	**1.50**
OLD			*1.30*	*1.34*	*1.39*	*1.44*	*1.50*
NEW	**EUR/CHF**	**1.13**	**1.15**	**1.17**	**1.19**	**1.22**	**1.23**
OLD			*1.14*	*1.16*	*1.18*	*1.19*	*1.20*
NEW	**EUR/SEK**	**10.30**	**10.15**	**10.00**	**9.90**	**9.70**	**9.50**
OLD			*10.50*	*10.30*	*10.00*	*9.70*	*9.50*
NEW	**EUR/NOK**	**9.74**	**9.70**	**9.70**	**9.60**	**9.40**	**9.30**
OLD			*9.50*	*9.30*	*9.10*	*8.90*	*8.80*
NEW	**AUD/USD**	**0.72**	**0.72**	**0.70**	**0.67**	**0.70**	**0.71**
OLD			*0.67*	*0.69*	*0.71*	*0.73*	*0.73*
NEW	**NZD/USD**	**0.68**	**0.67**	**0.65**	**0.62**	**0.66**	**0.67**
OLD			*0.66*	*0.68*	*0.70*	*0.70*	*0.70*
NEW	**USD/CAD**	**1.32**	**1.31**	**1.33**	**1.35**	**1.33**	**1.32**
OLD			*1.37*	*1.34*	*1.33*	*1.32*	*1.31*
NEW	**DXY Index**	**97**	**96**	**94**	**92**	**88**	**85**
OLD			*96*	*93*	*89*	*86*	*84*
NEW	**Fed Broad USD**	**128**	**128**	**127**	**126**	**124**	**122**
OLD			*124*	*121*	*119*	*116*	*114*

Source: Morgan Stanley Research forecasts. Old forecasts were last updated on June 21, 2018. USD/JPY forecasts were updated on September 20, 2018.

Exhibit 52: Latin America FX forecasts: Old vs. new

		Spot	4Q18	1Q19	2Q19	3Q19	4Q19
NEW	**USD/BRL**	**3.82**	**3.65**	**3.55**	**3.85**	**3.65**	**3.50**
OLD			*3.90*	*3.75*	*3.75*	*3.75*	*3.40*
NEW	**USD/MXN**	**20.37**	**21.00**	**21.00**	**21.00**	**21.00**	**21.00**
OLD			*20.00*	*19.50*	*19.00*	*18.50*	*18.00*
NEW	**USD/ARS**	**36.73**	**37.00**	**39.50**	**41.25**	**42.50**	**43.50**
OLD			*44.00*	*45.00*	*46.00*	*47.00*	*48.00*
NEW	**USD/CLP**	**674**	**675**	**660**	**645**	**630**	**620**
OLD			*630*	*610*	*585*	*560*	*555*
NEW	**USD/COP**	**3228**	**3135**	**3100**	**3060**	**3030**	**3010**
OLD			*3000*	*2840*	*2750*	*2750*	*2740*
NEW	**USD/PEN**	**3.38**	**3.35**	**3.32**	**3.29**	**3.26**	**3.23**
OLD			*3.26*	*3.23*	*3.22*	*3.20*	*3.15*

Source: Morgan Stanley Research forecasts. Old forecasts were last updated on June 21, 2018. USD/MXN forecasts were updated on July 18, 2018. USD/ARS forecasts were updated on September 6, 2018.

Exhibit 53: CEEMEA FX forecasts: Old vs. new

		Spot	4Q18	1Q19	2Q19	3Q19	4Q19
NEW	**USD/ZAR**	**13.9**	**14.0**	**13.8**	**13.5**	**13.2**	**13.0**
OLD			13.70	13.30	12.80	12.40	12.10
NEW	**USD/TRY**	**5.29**	**5.50**	**5.50**	**5.60**	**5.70**	**5.80**
OLD			5.05	5.00	4.95	4.90	4.85
NEW	**USD/ILS**	**3.74**	**3.65**	**3.60**	**3.55**	**3.50**	**3.45**
OLD			3.60	3.50	3.45	3.40	3.40
NEW	**USD/RUB**	**66.3**	**66.0**	**65.0**	**64.0**	**63.0**	**62.0**
OLD			64.0	62.0	61.0	60.5	60.0
NEW	**EUR/PLN**	**4.29**	**4.30**	**4.35**	**4.30**	**4.25**	**4.20**
OLD			4.30	4.25	4.20	4.15	4.10
NEW	**EUR/CZK**	**25.9**	**25.9**	**25.5**	**25.3**	**25.2**	**25.0**
OLD			25.75	25.50	25.25	25.00	24.75
NEW	**EUR/HUF**	**322**	**325**	**330**	**325**	**320**	**315**
OLD			325	320	315	315	315
NEW	**EUR/RON**	**4.66**	**4.67**	**4.70**	**4.67**	**4.65**	**4.60**
OLD			4.67	4.65	4.60	4.60	4.60

Source: Morgan Stanley Research forecasts. Old forecasts were last updated on June 21, 2018. USD/TRY forecasts were updated on June 28, 2018.

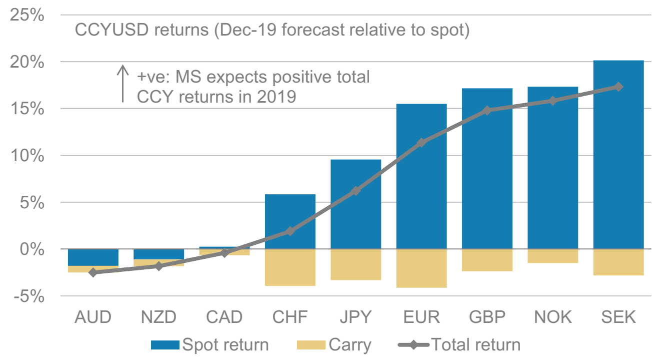
Exhibit 54: Asia FX forecasts: Old vs. new

		Spot	4Q18	1Q19	2Q19	3Q19	4Q19
NEW	**USD/CNY**	**6.94**	**6.97**	**7.05**	**7.03**	**6.92**	**6.85**
OLD			*6.60*	*6.47*	*6.40*	*6.32*	*6.25*
NEW	**USD/HKD**	**7.82**	**7.80**	**7.80**	**7.80**	**7.80**	**7.80**
OLD			*7.80*	*7.80*	*7.80*	*7.80*	*7.80*
NEW	**USD/IDR**	**14522**	**14700**	**14400**	**14200**	**14100**	**14000**
OLD			*14207*	*14095*	*13984*	*13874*	*13778*
NEW	**USD/INR**	**70.5**	**72.0**	**71.0**	**69.5**	**68.5**	**68.0**
OLD			*70.0*	*69.1*	*68.5*	*68.0*	*67.5*
NEW	**USD/KRW**	**1132**	**1115**	**1110**	**1105**	**1100**	**1095**
OLD			*1142*	*1119*	*1102*	*1085*	*1067*
NEW	**USD/MYR**	**4.19**	**4.25**	**4.20**	**4.18**	**4.15**	**4.12**
OLD			*4.28*	*4.21*	*4.15*	*4.10*	*4.02*
NEW	**USD/PHP**	**52.4**	**52.5**	**52.4**	**52.3**	**52.2**	**52.1**
OLD			*54.8*	*54.4*	*54.0*	*53.6*	*53.3*
NEW	**USD/SGD**	**1.37**	**1.37**	**1.34**	**1.32**	**1.29**	**1.28**
OLD			*1.37*	*1.35*	*1.33*	*1.31*	*1.30*
NEW	**USD/TWD**	**30.9**	**30.6**	**30.4**	**30.2**	**30.0**	**29.8**
OLD			*30.8*	*30.4*	*30.1*	*29.7*	*29.4*
NEW	**USD/THB**	**33.1**	**32.8**	**32.5**	**32.2**	**31.8**	**31.4**
OLD			*33.1*	*32.7*	*32.2*	*31.8*	*31.4*

Source: Morgan Stanley Research forecasts. Old forecasts were last updated on June 21, 2018.

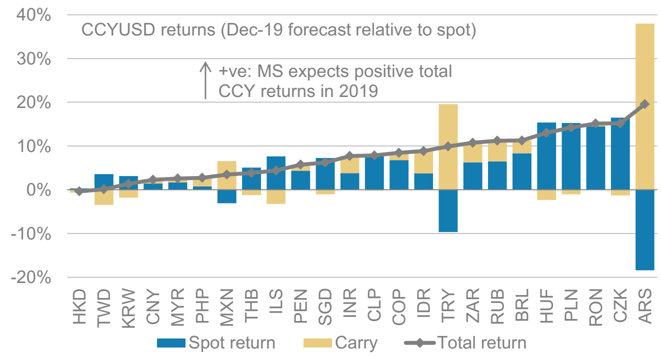
Forecasts vs. the market

Exhibit 55: G10: Total returns over 2019



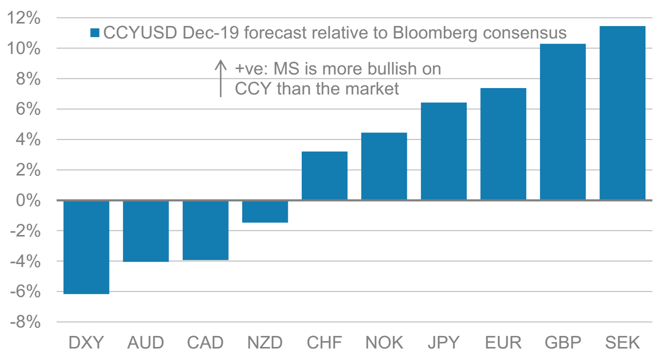
Source: Bloomberg, Morgan Stanley Research

Exhibit 56: EM: Total returns over 2019



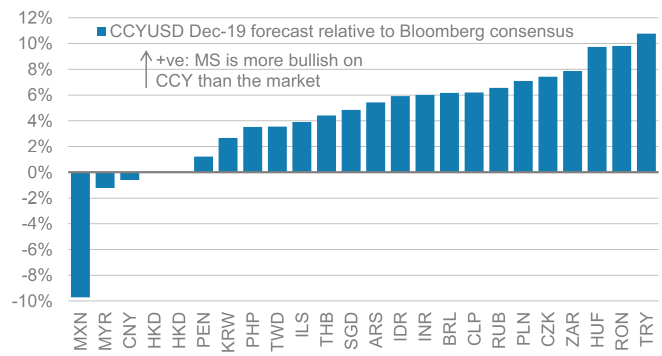
Source: Bloomberg, Morgan Stanley Research

Exhibit 57: G10: FX forecasts vs. consensus



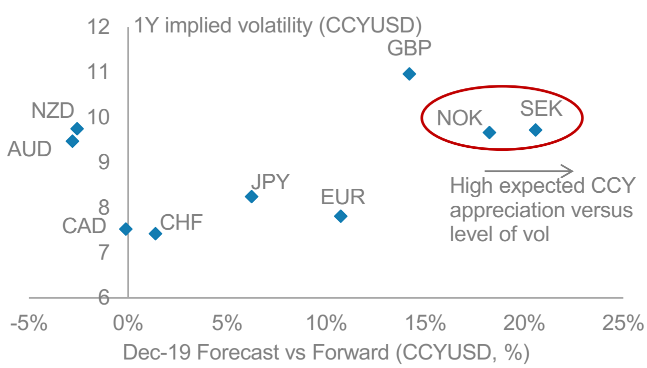
Source: Bloomberg, Morgan Stanley Research

Exhibit 58: EM: FX forecasts vs. consensus



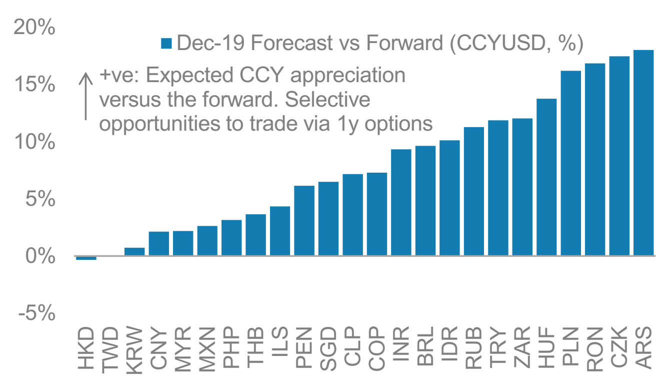
Source: Bloomberg, Morgan Stanley Research

Exhibit 59: G10: Forecasts versus forwards and implied volatility



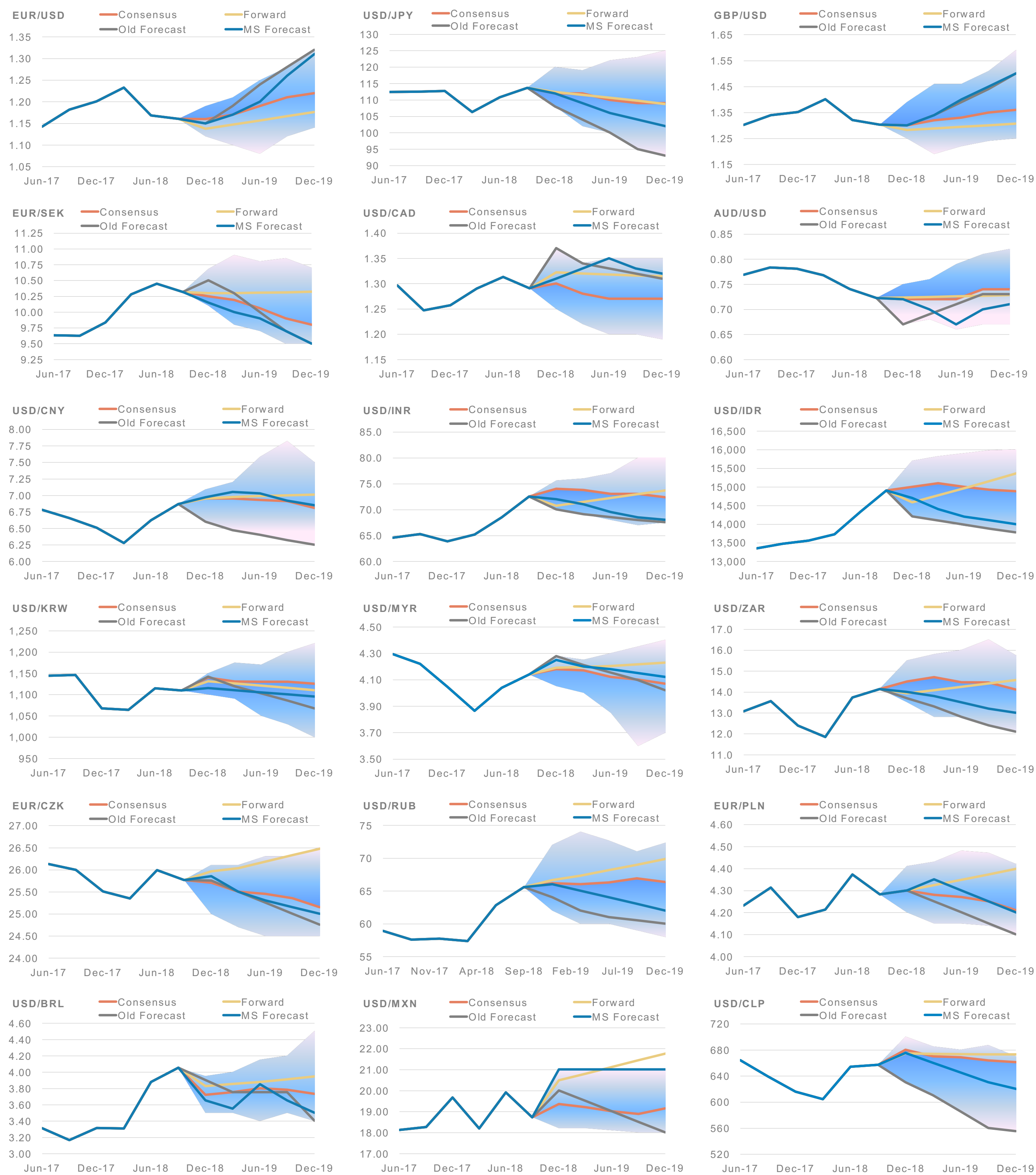
Source: Bloomberg, Morgan Stanley Research

Exhibit 60: EM: Forecasts versus forwards



Source: Bloomberg, Morgan Stanley Research

Exhibit 61: FX forecasts relative to market



Source: Bloomberg, Morgan Stanley Research forecasts; shaded area is the range of market forecasts.

Monetary policy forecasts

Exhibit 62: Monetary policy rate forecasts

	4Q18	1Q19	2Q19	3Q19	4Q19	1Q20	2Q20	3Q20	4Q20
US	2.375	2.625	2.875	2.875	2.875	3.125	3.375	3.625	3.875
Euro Area	-0.40	-0.40	-0.40	-0.40	-0.25	0.00	0.00	0.25	0.25
Japan	-0.10	-0.10	0.00	0.00	0.00	0.00	0.00	0.00	0.00
United Kingdom	0.75	0.75	1.00	1.00	1.25	1.25	1.50	1.75	2.00
Canada	1.75	2.00	2.25	2.50	2.50	2.75	3.00	3.00	3.00
Norway	0.75	1.00	1.00	1.25	1.25	1.50	1.50	1.75	2.00
Sweden	-0.25	-0.25	-0.25	0.00	0.00	0.25	0.25	0.50	0.75
Australia	1.50	1.50	1.50	1.50	1.50	1.75	2.00	2.00	2.00
New Zealand	1.75	1.75	1.75	1.75	2.00	2.25	2.50	2.75	2.75
Russia	7.75	8.00	8.00	8.00	8.00	7.75	7.75	7.75	7.75
Poland	1.50	1.50	1.50	1.50	1.50	1.75	1.75	2.00	2.00
Czech Republic	1.75	2.00	2.25	2.50	2.50	2.75	2.75	2.75	2.75
Hungary	0.90	0.90	0.90	0.90	1.00	1.25	1.25	1.50	1.50
Romania	2.50	2.50	2.75	2.75	3.00	3.00	3.25	3.25	3.50
Turkey	24.00	24.00	22.00	20.00	19.00	19.00	19.00	18.00	18.00
Israel	0.10	0.25	0.25	0.25	0.25	0.25	0.50	0.50	0.50
South Africa	6.75	7.00	7.00	7.00	7.00	7.00	7.00	7.25	7.50
Nigeria	14.00	15.00	15.00	15.00	14.50	14.00	14.00	14.00	14.00
Saudi Arabia	3.00	3.25	3.50	3.50	3.50	3.75	4.00	4.25	4.50
China	2.60	2.60	2.60	2.60	2.60	2.60	2.60	2.60	2.60
India	6.50	6.75	7.00	7.00	7.00	7.25	7.50	7.50	7.50
Hong Kong	2.75	3.00	3.25	3.25	3.25	3.50	3.75	4.00	4.25
S. Korea	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75
Taiwan	1.375	1.375	1.375	1.375	1.375	1.375	1.375	1.375	1.375
Indonesia	6.00	6.00	6.00	6.00	6.00	6.25	6.25	6.25	6.25
Malaysia	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25
Thailand	1.75	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00
Philippines	5.25	5.25	5.25	5.25	5.25	5.25	5.25	5.25	5.25
Brazil	6.50	6.50	6.50	6.50	7.50	8.50	9.00	9.00	9.00
Mexico	8.25	8.25	8.25	8.00	7.50	7.50	7.50	7.50	7.50
Chile	2.75	3.25	3.50	3.50	3.50	3.75	4.00	4.00	4.00
Peru	2.75	2.75	2.75	2.75	2.75	2.75	2.75	2.75	3.25
Colombia	4.25	4.75	5.25	5.50	5.50	5.50	5.50	5.50	5.50
Argentina	60.00	57.00	51.00	44.50	41.00	37.00	30.00	26.00	24.00

Source: Morgan Stanley Economics forecasts

2019 central bank calendar

Exhibit 63: G10 central bank rates decisions in 2019

Central Bank Monetary Policy Decision Calendar: 2019	Fed	ECB	BoJ	BoE	BoC	RBA	RBNZ	Norges	Riksbank	SNB
January	30	24	23*		9*			24		
February				7*		5*	13*		13*	
March	20*	7*	15	21	6	5	27	21*		21*
April		10	25*		24*	2			25*	
May	1			2*	29	7*	8*	9		
June	19*	6*	20	20		4	26	20*		13*
July	31	25	30*		10*	2			2*	
August				1*		6*	7*	15		
September	18*	12*	19	19	4	3	25	19*		19*
October	30	24	31*		30*	1		24		
November				7*		5*	13*			
December	11*	12*	19	19	4	3		19*		12*

Date of policy decision announcement, local time. *Forecast update (RBA release 3 days later). Compiled by Morgan Stanley FX Strategy Morgan Stanley | RESEARCH

Source: Central Bank Websites, Morgan Stanley Research. Note that the Riksbank has not announced its full calendar of meetings for the year.

Exhibit 64: Select EM central bank rates decisions in 2019

Central Bank Monetary Policy Decision Calendar: 2019	BoK	BI	BoT	BCB	Banxico	SARB	CNB	CBT	CBR	NBH	NBP
January						17				29	9
February			6	6			7		8	26	6
March			20	20		28	28		22	26	6
April									26	30	3
May			8	8		23	2			28	15
June			19	19			26		14	25	5
July				31		18			26	23	3
August			7				1			27	
September			18	18		19	25		6	24	11
October				30					25	22	2
November			6			21	7			19	6
December			18	11			19		13	17	4

Date of policy decision announcement, local time. Empty columns mean the central bank has not released a 2019 calendar yet. Morgan Stanley | RESEARCH

Source: Central Bank Websites, Morgan Stanley Research. Note that empty columns signify a central bank that hasn't released its 2018 calendar yet. We will update this table as soon the information is available.

Appendix: Performance of last year's trades

The following table provides an overview of the 10 trades recommended in last year's Outlook report.

Exhibit 65: Performance of top trades for 2018

	Trade	Spot 27-Nov-17	Spot 23-Nov-18	Spot return	Carry	Total return
Long	**USDCAD**	1.28	1.32	3.6%	0.4%	4.0%
Long	**EURNOK**	9.70	9.74	0.4%	-1.2%	-0.8%
Short	**CHFJPY**	113	113	0.1%	0.6%	0.7%
Short	**USDJPY**	111	113	-1.6%	-2.2%	-3.8%
Long	**EUR vs. AUD, NZD basket**			-1.3%	-2.7%	-4.0%
	EURAUD	1.56	1.57	0.2%	-2.5%	-2.3%
	EURNZD	1.72	1.67	-2.9%	-2.8%	-5.7%
Long	**CLPMXN**	2.90	3.01	3.9%	-4.9%	-1.0%
Long	**PLNHUF**	73.94	75.12	1.6%	1.8%	3.4%
Short	**USDMYR**	4.11	4.19	-1.9%	0.8%	-1.1%
Short	**AUD vs. KRW, TWD basket**			1.8%	-1.4%	0.4%
	AUDKRW	830.14	818.41	1.4%	-0.4%	1.0%
	AUDTWD	22.82	22.34	2.1%	-2.4%	-0.3%
Long	**IDRPHP**	0.3727	0.3609	-3.2%	1.6%	-1.6%
Total				0.3%	-0.7%	-0.4%

Source: Bloomberg, Morgan Stanley Research forecasts. The above represents indicative performance of trade ideas from our 2018 Outlook. The table represents hypothetical, not actual, investments. The total return includes spot and carry returns, but does not take into account transaction fees and other costs. Carry is calculated using forwards. Past performance is no guarantee of future results. FX Performance Data Package, contains complete performance statistics.

Exhibit 66: History of recommendations for buy EURUSD 12-month 25 delta call

Instrument	Maturity	Trade	Entry Date	Entry Level	Exit Date	Exit Level	Target/ Objective	Stop/Re-assess	Size of Trade or Unit/Notional	CUSIP / ISIN / BLOOMBERG	Gross P&L BP	Gross P&L US$K
Eurostoxx Index	12m	Long Eurostoxx (FX-hedged)	6-Apr-18	3405.70	15-Jun-18					SX5E Index		
EUR/USD 12M Forward	12m	Long Eurostoxx (FX-hedged)	6-Apr-18	1.26	15-Jun-18					EUR12M Curncy		

Source: Morgan Stanley Research

Exhibit 67: History of recommendations for buy USDJPY 12-month 40 delta put

Instrument	Maturity	Trade	Entry Date	Entry Level	Exit Date	Exit Level	Target/ Objective	Stop/Re-assess	Size of Trade or Unit/Notional	CUSIP/ISIN/ BLOOMBERG	Gross P&L BP	Gross P&L US$K
USD/JPY	12m	Buy USD/JPY 1yr 40D puts	4-Jun-18	0.02	15-Oct-18					USDJPY Curncy		

Source: Morgan Stanley Research

Definition of terms

Buy/Long: The analyst expects the total or excess return (depending on the nature of the recommendation) of the instrument or issuer that is the subject of the investment recommendation to be positive over the relevant time period.

Sell/Short: The analyst expects the total or excess return (depending on the nature of the recommendation) of the instrument or issuer that is the subject of the investment recommendation to be negative over the relevant time period.

Selling protection or Buying Risk: The analyst expects that the price of protection against the event occurring will decrease over the relevant time period.

Buying protection or Selling Risk: The analyst expects the price of protection against the event occurring will increase over the relevant time period.

Pay: The analyst expects that over the specified time period the variable rate underlying the swap agreement that is the subject of the investment recommendation will increase.

Receive: The analyst expects that over the specified time period the variable rate underlying the swap agreement that is the subject of the investment recommendation will decrease.

Unless otherwise specified, the time frame for recommendations included in the Morgan Stanley Fixed Income Research reports is 1 - 3 months and the price of financial instruments mentioned in the recommendation is as at the date and time of publication of the recommendation.

When more than one issuer or instrument is included in a recommendation, analyst expects one part of the trade to outperform the other trade or combination of other trades included in the recommendation on a relative basis.

For important disclosures related to the proportion of all investment recommendations over the past 12 months that fit each of the categories defined above, and the proportion of issuers corresponding to each of those categories to which Morgan Stanley has supplied material services, please see the Morgan Stanley disclosure at https://ny.matrix.ms.com/eqr/article/webapp/a5cdea6a-d95a-11e8-9388-71fc4ae660a6?ch=rpint&sch=ar

Strategy Risk Factors

Buying calls or call spreads: Investors who buy call options risk loss of the entire premium paid if the underlying security finishes below the strike price at expiration. Investors who buy call spreads (buy a call and sell a further OTM call) also have a maximum loss of the entire up-front premium paid. The maximum gain from buying call spreads is the difference between the strike prices, less the upfront premium paid.

Buying puts or put spreads: Investors who buy put options risk loss of the entire premium paid if the underlying security finishes above the strike price at expiration. Investors who buy put spreads (buy a put and sell a further OTM put) also have a maximum loss of the upfront premium paid. The maximum gain from buying put spreads is the difference between the strike prices, less the upfront premium paid.

Selling calls: Investors who sell covered calls (own the underlying security and sell a call) risk limiting their upside to the strike price plus the upfront premium received and may have their security called away if the security price exceeds the strike price of the short call. Additionally, the investor has full downside exposure that is only partially offset by the upfront premium taken in. Investors short naked calls (i.e. sold calls but don't hold underlying security) risk unlimited losses of security price less strike price. Investors who sell naked call spreads (i.e. sell a call and buy a farther out-of-the-money call with no underlying security position) have a maximum loss of the difference between the long call strike and the short call strike, less the upfront premium taken in, if the underlying security finishes above the long call strike at expiration. The maximum gain is the upfront premium taken in, if the security finishes below the short call strike at expiration.

Selling puts: Put sellers commit to buying the underlying security at the strike price in the event the security falls below the strike price. The maximum loss is the full strike price less the premium received for selling the put. Put sellers who are also long a lower dollar-strike put face a maximum loss of the difference between the long and short put strikes less the options premium received.

Buying strangles: The maximum loss is the entire premium paid (put + call), if the security finishes between the put strike and the call strike at expiration.

Selling strangles or straddles: Investors who are long a security and short a strangle or straddle risk capping their upside in the security to the strike price of the call that is sold plus the upfront premium received. Additionally, if the security trades below the strike price of the short put, the investor risks losing the difference between the strike price and the security price (less the value of the premium received) on the short put and will also experience losses in the security position if he owns shares. The maximum potential loss is the full value of the strike price (less the value of the premium received) plus losses on the long security position. Investors who are short naked strangles or straddles have unlimited potential loss since if the security trades above the call strike price, the investor risks losing the difference between the strike price and the security price (less the value of the premium received) on the short call. Additionally, they are obligated to buy the security at the put strike price (less upfront premium received) if the security finishes below the put strike price at expiration. Strangle/straddle sellers risk assignment on short put positions that become in the money. Additionally, they risk having stock called away from short call positions that become in the money.

Options Disclaimer

Options are not for everyone. Before engaging in the purchasing or writing of options, investors should understand the nature and extent of their rights and obligations and be aware of the risks involved, including the risks pertaining to the business and financial condition of the issuer and the underlying stock. A secondary market may not exist for these securities. For customers of Morgan Stanley & Co. Incorporated who are purchasing or writing exchange-traded options, your attention is called to the publication “Characteristics and Risks of Standardized Options;” in particular, the statement entitled “Risks of Option Writers.” That publication, which you should have read and understood prior to investing in options, can be viewed on the Web at the following address: http://www.optionsclearing.com/about/publications/character-risks.jsp. Spreading may also entail substantial commissions, because it involves at least twice the number of contracts as a long or short position and because spreads are almost invariably closed out prior to expiration. Potential investors should be advised that the tax treatment applicable to spread transactions should be carefully reviewed prior to entering into any transaction. Also, it should be pointed out that while the investor who engages in spread transactions may be reducing risk, he is also reducing his profit potential. The risk/ reward ratio, hence, is an important consideration.

The risk of exercise in a spread position is the same as that in a short position. Certain investors may be able to anticipate exercise and execute a "rollover" transaction. However, should exercise occur, it would clearly mark the end of the spread position and thereby change the risk/reward ratio. Due to early assignments of the short side of the spread, what appears to be a limited risk spread may have more risk than initially perceived. An investor with a spread position in index options that is assigned an exercise is at risk for any adverse movement in the current level between the time the settlement value is determined on the date when the exercise notice is filed with OCC and the time when such investor sells or exercises the long leg of the spread. Other multiple-option strategies involving cash settled options, including combinations and straddles, present similar risk.

Important information: Examples within are indicative only, please call your local Morgan Stanley Sales representative for current levels.

By selling an option, the seller receives a premium from the option purchaser, and the purchase receives the right to exercise the option at the strike price. If the option purchaser elects to exercise the option, the option seller is obligated to deliver/purchase the underlying shares to/from the option buyer at the strike price. If the option seller does not own the underlying security while maintaining the short option position (naked), the option seller is exposed to unlimited market risk.

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Multi-legged strategies are only effective if all components of a suggested trade are implemented.

Investors in long option strategies are at risk of losing all of their option premiums. Investors in short option strategies are at risk of unlimited losses.

There are special risks associated with uncovered option writing which expose the investor to potentially significant loss. Therefore, this type of strategy may not be suitable for all customers approved for options transactions. The potential loss of uncovered call writing is unlimited. The writer of an uncovered call is in an extremely risky position, and may incur large losses if the value of the underlying instrument increases above the exercise price.

As with writing uncovered calls, the risk of writing uncovered put options is substantial. The writer of an uncovered put option bears a risk of loss if the value of the underlying instrument declines below the exercise price. Such loss could be substantial if there is a significant decline in the value of the underlying instrument.

Uncovered option writing is thus suitable only for the knowledgeable investor who understands the risks, has the financial capacity and willingness to incur potentially substantial losses, and has sufficient liquid assets to meet applicable margin requirements. In this regard, if the value of the underlying instrument moves against an uncovered writer’s options position, the investor’s broker may request significant additional margin payments. If an investor does not make such margin payments, the broker may liquidate stock or options positions in the investor’s account, with little or no prior notice in accordance with the investor’s margin agreement.

For combination writing, where the investor writes both a put and a call on the same underlying instrument, the potential risk is unlimited.

If a secondary market in options were to become unavailable, investors could not engage in closing transactions, and an option writer would remain obligated until expiration or assignment.

The writer of an American-style option is subject to being assigned an exercise at any time after he has written the option until the option expires. By contrast, the writer of a European-style option is subject to exercise assignment only during the exercise period.

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