Short EUR/USD

Thesis: A new wave of COVID cases spreading rapidly throughout the EU will yield volatility and uncertainty in commodities and local equities as countries impose additional restrictions and even lockdowns. As a result of increasing risk-off sentiment, Eurozone investors will move towards safer and more secure investments abroad, such as the dollar and 10-YR US Treasuries, resulting in EUR depreciation and USD appreciation.

Coronavirus

Cases have rapidly increased throughout Europe, leading to partial or full lockdowns and increasing restrictions. Elsewhere, such as France, new daily cases have lagged behind, but show beginning signs of a new wave. Even countries with high vaccination rates have seen significant increases in infections, indicating that this new wave could be a sub-variant which proves more resistant to existing vaccines and/or other treatments. In Eastern Europe, the spike began much earlier and provides some indicator of the potential duration: for example, in Romania and Bulgaria, which are emerging out of the latest wave, infections peaked 6-8 weeks after the surge began and are taking a comparable amount of time to draw back down. More developed Western healthcare infrastructure might draw down this timeframe.

Economic strength

Industrial production in the EU continues to be weighed down by high energy commodity prices. The introduction of new COVID lockdowns and restrictions should also depress the economic recovery via weaker sentiment, affirming the dovish ECB stance. On the other hand, a robust US recovery will continue to support USD in the near-term, especially since Fed will likely accelerate tapering in December.

Risk-off sentiment

As recovery in equity markets in Europe grind to a halt and movements in commodities such as energies are disrupted due to renewed COVID uncertainties, Eurozone investors will continue to reposition towards safe-haven assets such as the dollar and dollar-denominated risk-off assets such as US Treasuries. As these investors ramp up their purchases of dollar-denominated assets, EUR will continue to depreciate in relation to the USD.

Year-end drop in euro-dollar basis

Inflated Eurozone bank balance sheets ahead of year-end resolution fees has led to shortages of German and French bills which supports a cheaper price for paying swap premium and purchasing US Treasury bills than purchasing and holding local bills. This will continue to weigh on euro-dollar basis, keeping it low. Heightened global risk sentiment can also depress euro-dollar basis in the near-future.

Risks
Restrictive measures could be less economically stressful than those during initial lockdowns depending on the approaches taken by national governments – though the impact on consumer confidence should still support a negative view. Additional treatments including the approval of Pfizer and Merck antiviral pills and research into the possibility of a new strain could also impact the speed with which EU overcomes the current wave.

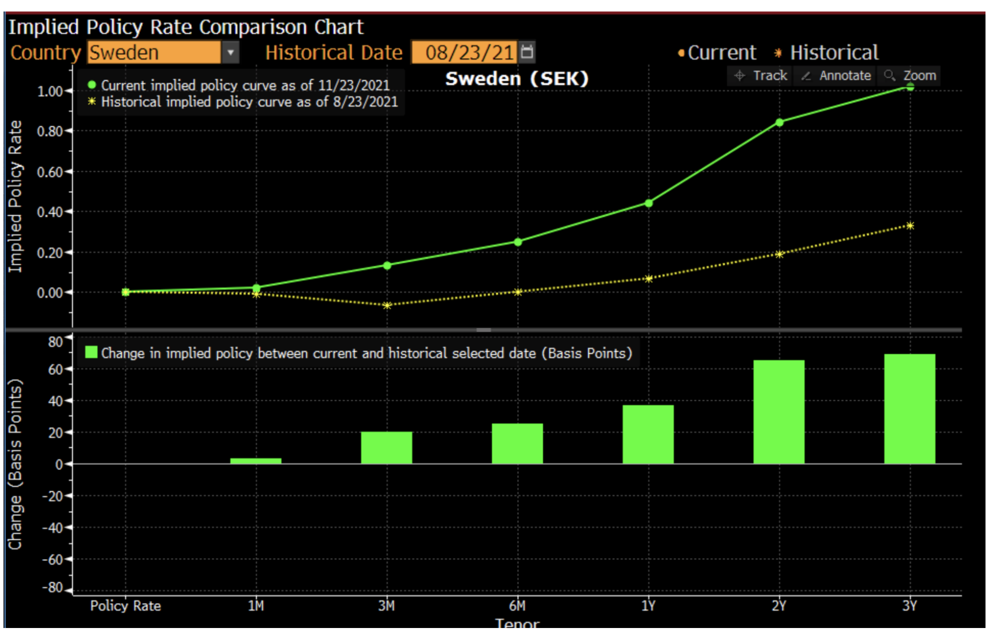
Conclusion: The impact of the current COVID wave on the relative attractiveness of safe-haven US financial assets and interest rates against their EU counterparts will support the USD in relation to the EUR for the following several weeks until Eurozone countries overcome the spike in cases. Developments on antiviral pill approval and European infections will indicate the duration of the current thesis.

Long USD/SEK

Thesis: As was the case with EUR recently, the market has been pricing in excessive rate hikes as soon as next year while the Riksbank has remained very dovish. Inflation data fails to confirm the presence of systemic inflationary pressures within Sweden, and I expect the Riksbank to double down on its dovish stance when it meets next week. Additionally, since so much of the Swedish economy relies on trade with the EU, the current spike in COVID infections and the reimposition of lockdown in many member states will slow down economic recovery and weaken the SEK – as well as reinforcing the Riksbank's dovish case.

CB policy

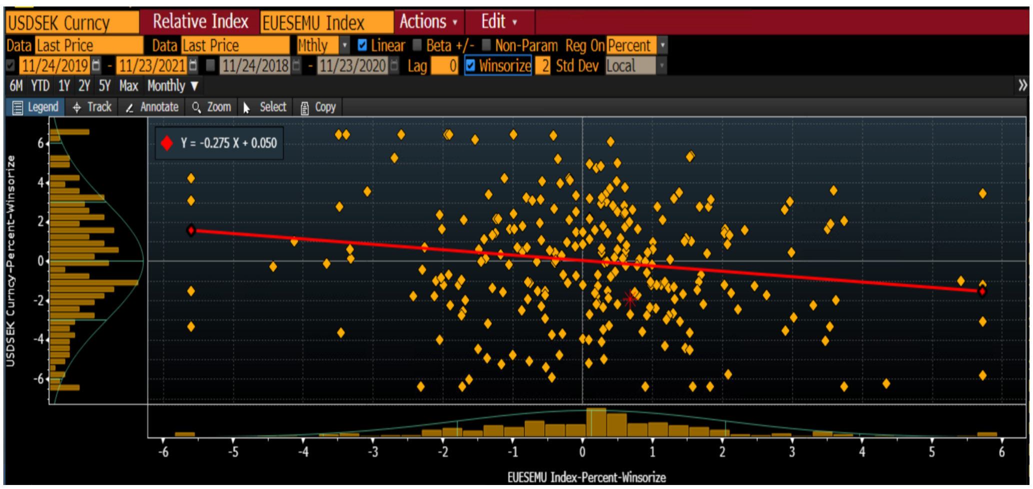
Over the past several months, the market has priced in increasingly hawkish Riksbank rate hikes despite dovish messages from the central bank. CPIF, the adjusted CPI that the Riksbank uses to guide monetary policy decisions, hit 3.1% YoY last month from 2.8% YoY due to broad-based increases in non-electricity energy prices, food and non-alcoholic beverages, and recreational and culture services and goods. However, the CPIF-EX (excluding energy) rose only 0.3pps to 1.8% YoY, which remains well within the central bank's 2% inflation target. Broad-based non-energy increases can be attributed to the recent lifting of COVID restrictions – which are unlikely to be reimposed due to Sweden's very low daily cases and effective pandemic management policies – rather than the systematisation of inflationary pressures. CPI data affirms the Riksbank's view of energy inflation as transitory and sort of lines up with their view of no hikes until 2024, though this timeframe may be a bit too dovish. At the same time, markets are pricing in hikes as soon as next year. I expect that the market will react negatively to the Riksbank meeting next week, where they will affirm existing dovish sentiments in contrast to EM CBs and other major CBs like the Fed and BoE.



Swedish MIPR (now v. 2M ago)

Trade with EU

The vast majority of Sweden's trade occurs with continental Europe, which accounts for nearly 82% of imports and 71% of exports with Sweden. 68% of Swedish imports originate from the EU and 52% of Swedish exports are sent to the EU. This is according to the latest yearly data from the OEC. With the Eurozone facing a spike in COVID infections and renewed lockdowns in many member nations, EU sentiment will drop significantly, resulting in lower import and export figures for Sweden. Additionally, since much of the trade relies on finished goods, slowing industrial production in the Eurozone should continue to weigh down on trade. Due to the Swedish economy's reliance on its trade with the EU, the SEK can be expected to perform worse until the EU re-emerges out of sentiment-sapping lockdowns/restrictions and slowdowns in industrial production.



Y = USD-SEK X-RATE	
X = European Commission Economic S	
Linear Beta	Range 1
Raw BETA	-0.275
Adjusted BETA	0.150
ALPHA (Intercept)	0.050
R^2 (Correlation^2)	0.031
R (Correlation)	-0.175
Std Dev of Error	2.976
Std Error of ALPHA	0.185
Std Error of BETA	0.096
t-Test	-2.860
Significance	0.005
Last T-Value	-0.604
Last P-Value	0.273
Number of Points	261
Last Spread	110.01
Last Ratio	0.072

β of USDSEK to EU Commission's Economic Sentiment Index

Strong dollar

The dollar has been strengthening recently due to a resilient economic recovery in comparison to other G-10 paired with high inflation figures that suggest tapering and rate hikes in the near future. Tapering has already begun and discussions by figures in regional and national Fed offices have indicated an acceleration of tapering this December. The dollar should remain supported by these factors in the near-term.

DXY Index, USD strength to a basket of CCYs

Risks

Strong economic data on the labour market and domestic consumer and producer sentiment indicate a strong Swedish economy. Upward wage pressures could emerge, though even in this case increasing wages are unlikely to cause systemic inflation or a strong reaction by the Riksbank. Long-term inflation expectations remain anchored at the Riksbank target. Slower EU economies should place a break on excessive Swedish economic growth.

In the short-run, SEK strength depends on the Riksbank's announcements in its upcoming meeting next week; it is very unlikely to present a timeframe that aligns with the market's hawkishness, but even an acceleration of the current timeframe (which is a bit overly-optimistic) might confirm that sentiment and result in a failure to reprice dovishly.

Conclusion: Excessive rate hikes expected by the market should be repriced closer to the Riskbank's plan following a dovish meeting next week. SEK strength should be weighed down by worse trade with the EU over the next month or so until the COVID wave in the Eurozone slows. Finally, the trade will be supported by a strong USD in the near-term.