



# Currency Strategy

## Cyclical drivers dominate political risks

January 2017

# Currency Strategy in a new format

## CYCLICAL DRIVERS DOMINATE POLITICAL RISKS

SEB Currency Strategy report has been published since 2007. In 2012 we broaden the ranking methodology to incorporate SEB FX Scorecard which ranks currencies according to 10 different categories each with an individual weight depending on what we think governs the FX market outlook currently. The ranking methodology has worked well with a positive result over the past 4-5 years. Lately (post Brexit) it has become evident that the policy influence of governments and central banks on markets make a standardised ranking methodology more challenging to use given these “market distortions”. We still use the FX Scorecard for analysing the long-term outlook for currencies but we will also look deeper into currency specific factors for the 3-6 month outlook (i.e. not using the exact same weights/factors for ranking the currencies). Over time with less political/central bank influence in markets we think the FX Scorecard approach will be very functional again.

## SUMMARY FX MARKET OUTLOOK

Global growth is recovering and the business cycle upturn is synchronized. The political outlook is more uncertain following the inauguration of the Trump administration but increasing political risk premia does not outweigh the positives from rising business barometers, inflation and inflation expectations yet. Hence in the coming 3-6 months we expect growth-sensitive currencies such as commodity currencies to do well including selected EM currencies. USD is overvalued and market is very long dollar. Near-term we expect the greenback to weaken, but looking deeper into 2017 we are of the opinion that EUR/USD remains a sell on rallies towards 1.10. EUR/SEK will trade below 9.00 should Riksbank hike in Dec-17 as SEB predicts.

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# FX Forecasts

FX forecasts	SEB					Fwd 12m	Consensus*
	25-Jan	3m	6m	12m	2y		
EUR/USD	1.07	1.10	1.06	1.03	1.08	1.10	1.05
EUR/JPY	122	127	124	124	134	122	123
EUR/GBP	0.86	0.89	0.88	0.87	0.83	0.86	0.85
EUR/CHF	1.07	1.06	1.04	1.03	1.06	1.07	1.10
EUR/SEK	9.50	9.40	9.30	8.95	8.80	9.48	9.20
EUR/NOK	8.95	8.85	8.75	8.50	8.40	9.09	8.75
EUR/DKK	7.44	7.44	7.44	7.44	7.44	7.42	7.45
USD/RUB	59.2	60.5	61.0	63.5	70.0	63.3	61.2
USD/JPY	114	115	117	120	124	111	117
GBP/USD	1.25	1.24	1.20	1.18	1.30	1.27	1.24
USD/CAD	1.32	1.30	1.29	1.26	1.22	1.31	1.36
USD/CHF	1.00	0.96	0.98	1.00	0.98	0.98	1.05
AUD/USD	0.75	0.76	0.77	0.78	0.74	0.75	0.72
NZD/USD	0.72	0.73	0.75	0.77	0.74	0.72	0.68
USD/SEK	8.85	8.55	8.77	8.69	8.15	8.66	8.76
GBP/SEK	11.09	10.60	10.53	10.25	10.59	10.97	10.86
JPY/SEK	7.78	7.43	7.50	7.24	6.57	7.77	7.49
CHF/SEK	8.85	8.87	8.94	8.69	8.30	8.87	8.36
NOK/SEK	1.06	1.06	1.06	1.05	1.05	1.04	1.05
USD/NOK	8.34	8.05	8.25	8.25	7.78	8.30	8.33
USD/CNY	6.88	6.70	6.80	7.05	6.80	6.90	7.15

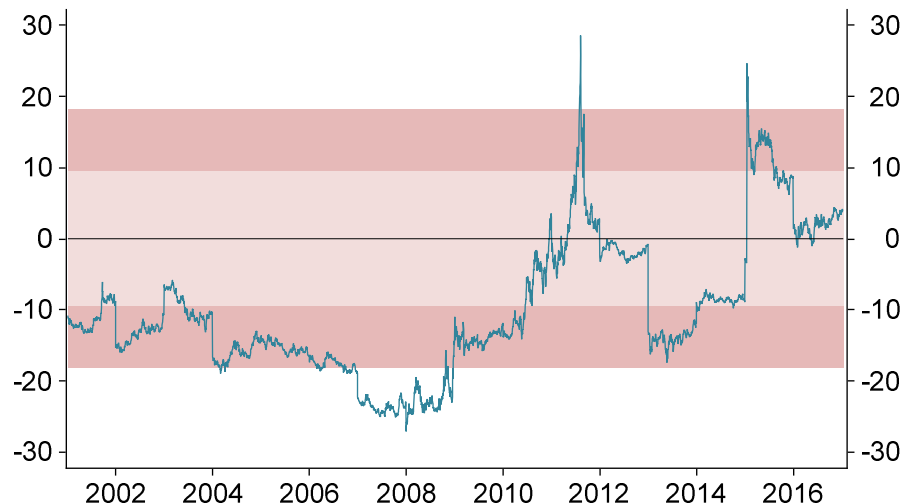
\*Bloomberg survey FX forecasts.

# How to trade it?

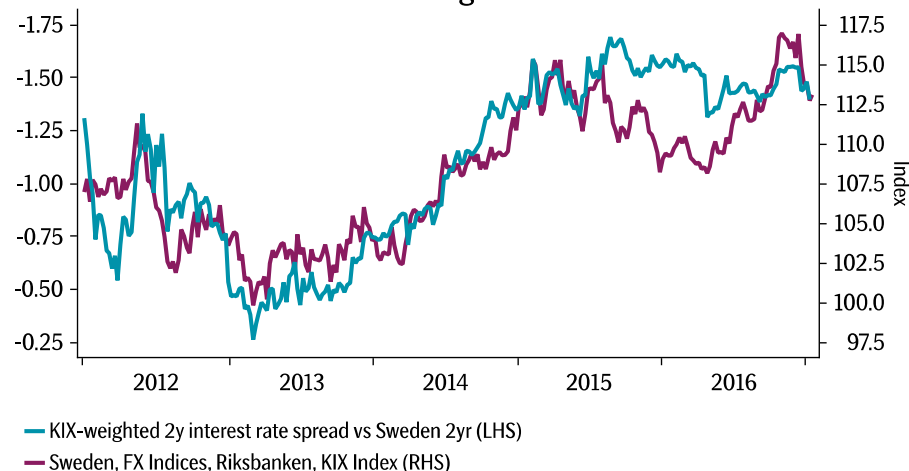
## OUR TRADE IDEAS

- **Sell EUR/CHF targeting 1.04.** FX Reserves keep rising and we expect the SNB to gradually allow the franc to appreciate.
- **Sell EUR/SEK on rallies to 9.60.** We expect EUR/SEK to be range-bound in the coming months (9.30-9.60), a test below 9.00 is expected as Riksbank hike rates dec-17.
- **Sell EUR/NOK through options.** The Norwegian krone has been surprisingly weak despite recovering growth, elevated Norges Bank NOK-purchases (NOK 1bn/day) and a relatively high oil price. We expect a grind lower in spot, the main risk is a further quick fall in inflation in addition to the already broad-based bullish NOK expectations/positioning.
- **Sell USD/CAD, target 1.25.** Although the Canadian economy has some way left (according to BoC) before reaching full capacity utilisation we think the undervalued currency has more room for appreciation. As an alternative we would look at short AUD/CAD.
- **Sell EUR/NZD.** Our love/hate relationship with the kiwi continues. The currency is grossly overvalued but the economy is so strong that the RBNZ can/must overlook the low rate of inflation. FX markets are in a state of Carry and the euro will continue to suffer as a result.
- **Be long EUR/GBP vol.** The Brexit process will provide the market with opportunities to be long Gamma.

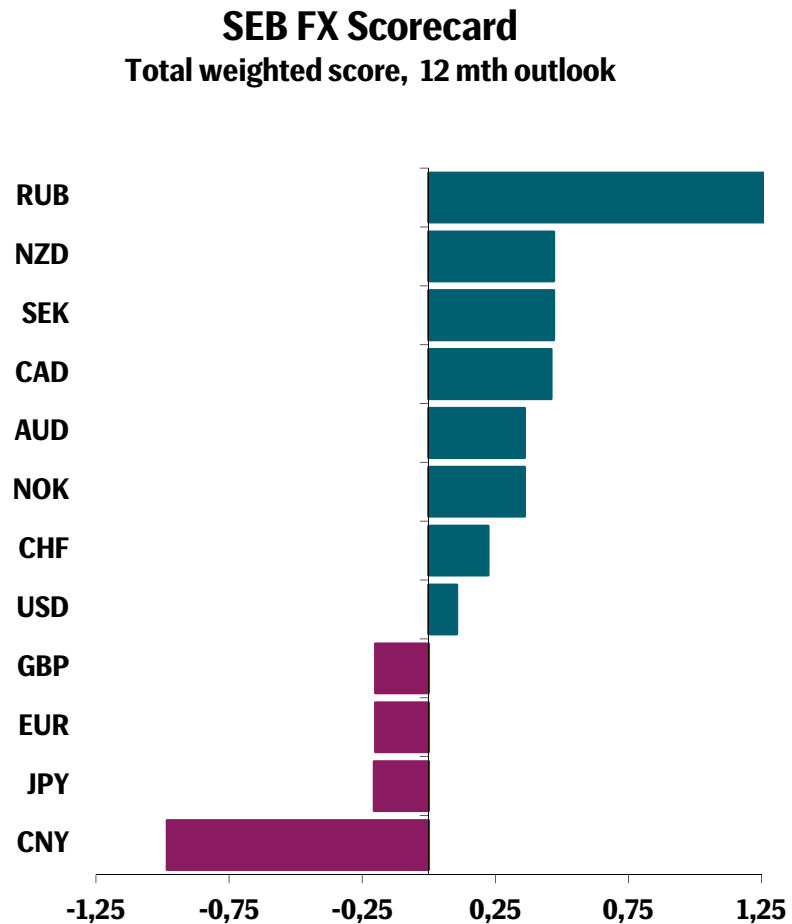
SEB valuation model: Swiss franc is not overvalued



KIX trading "in-line" with KIX-weighted interest rate spread  
Riksbank rate hike would strengthen SEK back to 107-110 area



# Currency overview



Themes	Pages
USD	6-7
EUR	8-9
JPY	10-11
GBP	12-13
CAD	14-15
AUD	16-17
NZD	18-19
CHF	20-21
SEK	22-23
NOK	24-25
RUB	26-27
CNY	28-29

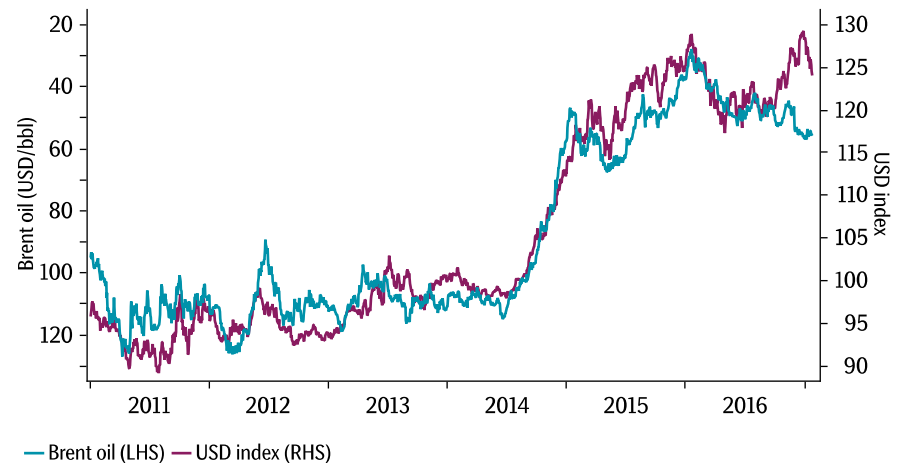
# US dollar: Market too optimistic on Trump

**UNCERTAIN DOLLAR STRENGTH.** Prior to the election our view was that a Trump victory would be dollar positive. Indeed, by now it seems like much of it is already discounted which makes the dollar vulnerable. We expect the USD to retreat in coming months before strong growth, fiscal policy and additional Fed rate hikes pulls EUR/USD towards 1.03.

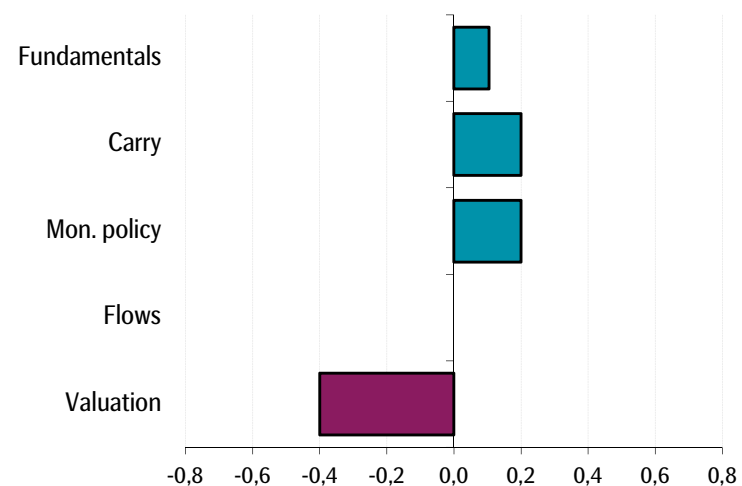
**SHORT-TERM:** Long USD probably is a broad consensus bet which is confirmed by speculative positioning. In recent weeks turbulence around the new president has been substantial and approval rates are at historical lows. Soon the new president has to move from talk to action. The ability to succeed is uncertain given how controversial he is and discontent with his policy is clearly a downside risk for the dollar. Moreover there is a rising concern the new president will abandon the 'strong dollar policy' after he has expressed that dollar strength is negative for US competitiveness.

**LONG-TERM:** Growth related indicators have improved since summer and despite stronger sentiment after the Trump win this probably reflects actual underlying strength in the US economy. We are slightly more optimistic on US growth this year and it is not only related to fiscal policy expansion. Fed policy is likely to remain supportive for the dollar as the Fed gradually tightens policy. This year we see two hikes by the Fed. However, policy tightening could accelerate as a consequence of Trump policy. The Fed could, however, start to partly replace rate hikes by shrinking its balance sheet. This would clearly reduce the support for the USD from monetary policy tightening. The USD seems long-term overvalued but the stretch is not large enough to weaken the USD.

The USD and oil - divorced, but not because of Trump

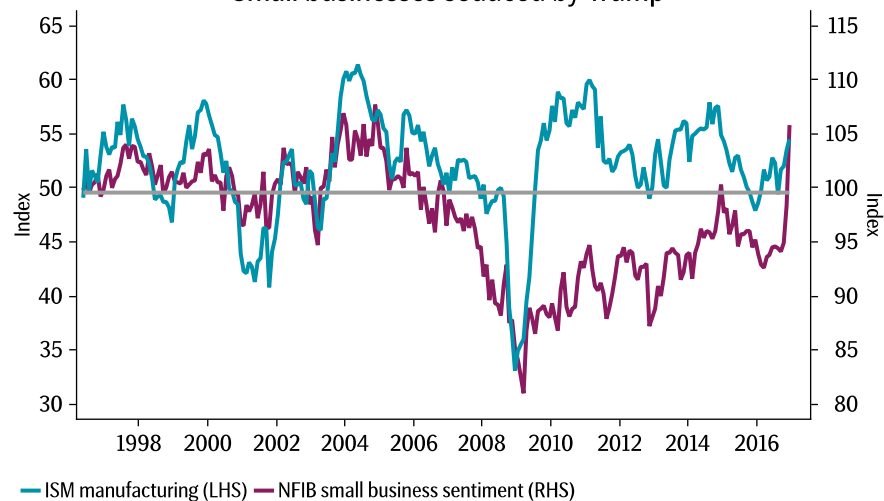


USD Weighted score: 0.1

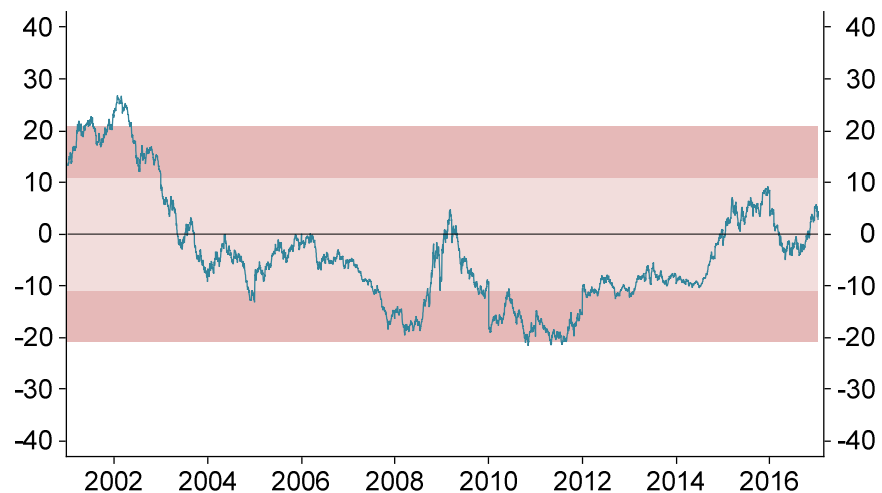


# US dollar: Strong growth but overvalued

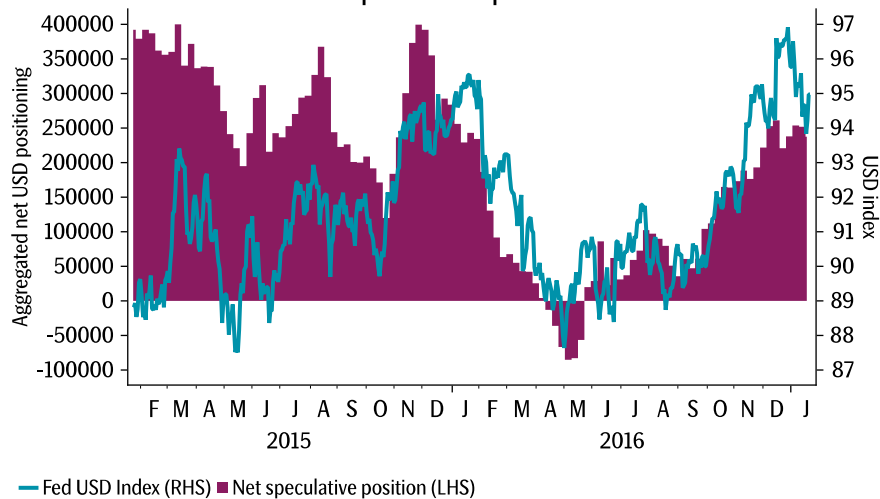
Small businesses seduced by Trump



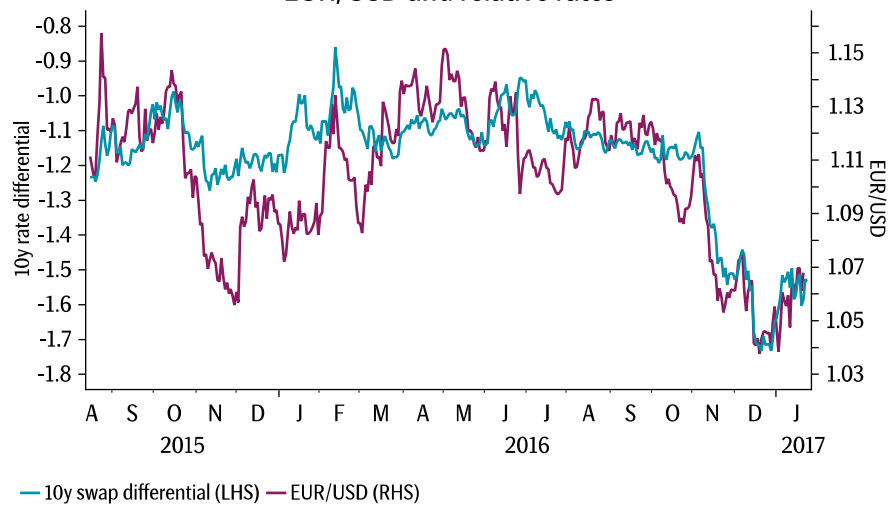
SEBEER USD Index



USD speculative positions



EUR/USD and relative rates



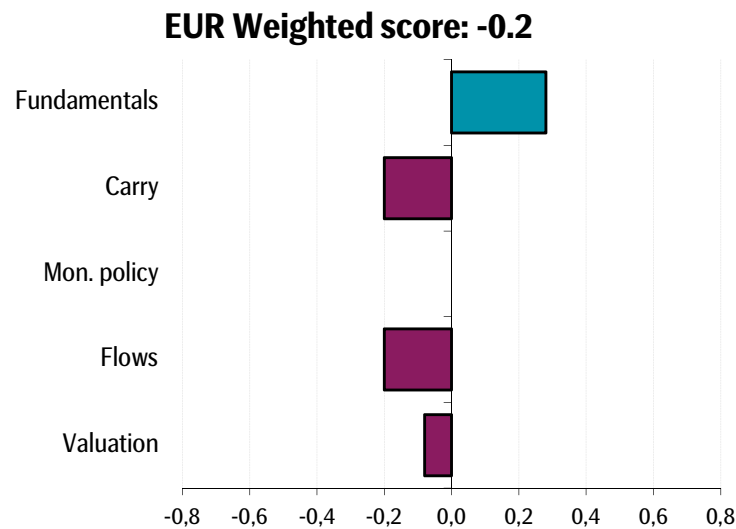
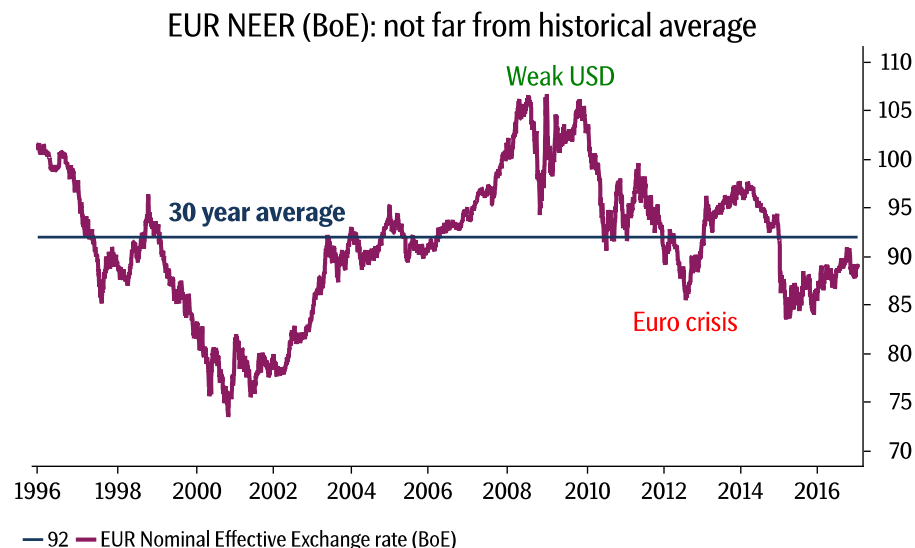


# The euro: low expectations to give some support

**EURO NOT READY FOR A SUSTAINABLE RALLY.** The outlook for the euro remains negative, consensus projects EUR/USD to trade lower near parity during H1 2017. We agree but the market is also clearly positioned for a weak euro -> we expect **EUR/USD to rally short-term** up towards 1.10 as USD-positioning looks stretched. EUR/USD remains a sell on rallies.

**SHORT-TERM:** Economic growth is recovering and the euro area is expanding just above trend. Unemployment is falling and inflation is slowly rising. We think it likely ECB will continue its QE-program throughout 2017 but that Mr Draghi may well taper current pace of purchases further (currently EUR 60bn/month from April). **The policy divergence vs a hiking Federal Reserve remains a relevant (negative) driver for the euro in the coming year.** QE policy has likely contributed to make global reserve managers cut the fixed income holding of the euro-zone (large net bond outflows 2015/16), in-turn boosting already large imbalances in the Target 2 system. Furthermore, the current account development (increasing surpluses) is driven almost exclusively by German exports (hence not that strong a supportive euro factor). These factors show that **large internal euro-zone imbalances and problems still exist.** Political elections in 2017 risks boosting already elevated risk premia in the euro-zone furthermore.

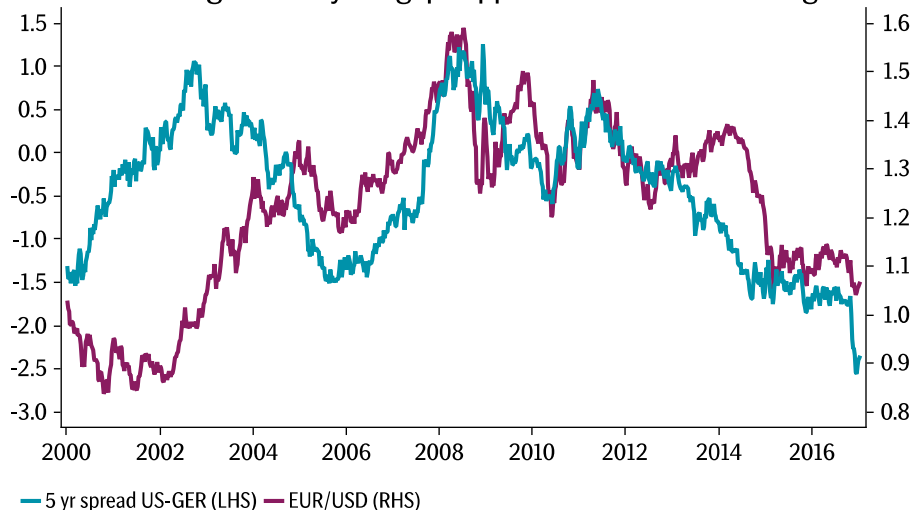
**LONG-TERM:** The institutional crisis and imbalances that the euro-zone finds itself in, motivates a weak euro for long. Appetite on European assets will be low and foreign capital likely to seek to hedge their euro exposures. We expect the euro trade-weighted currency to be a funding currency of choice in 2017.



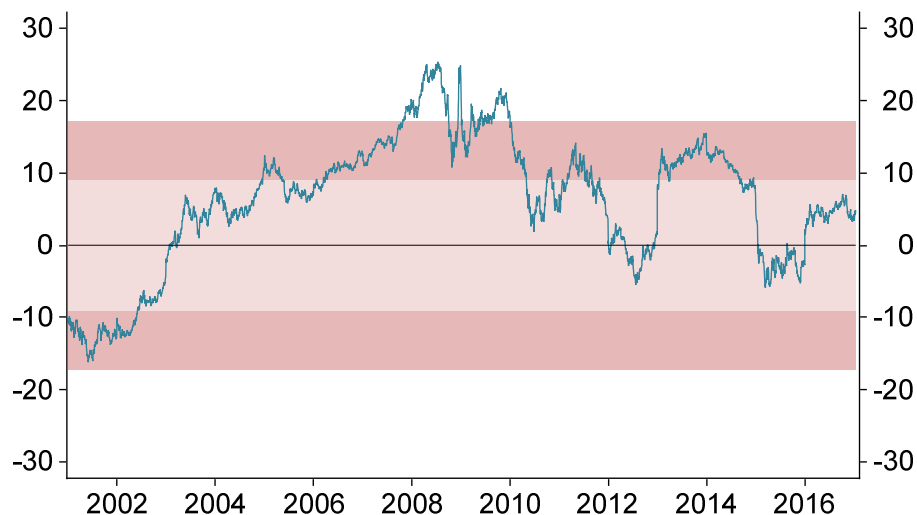


# The euro: policy divergence remains negative

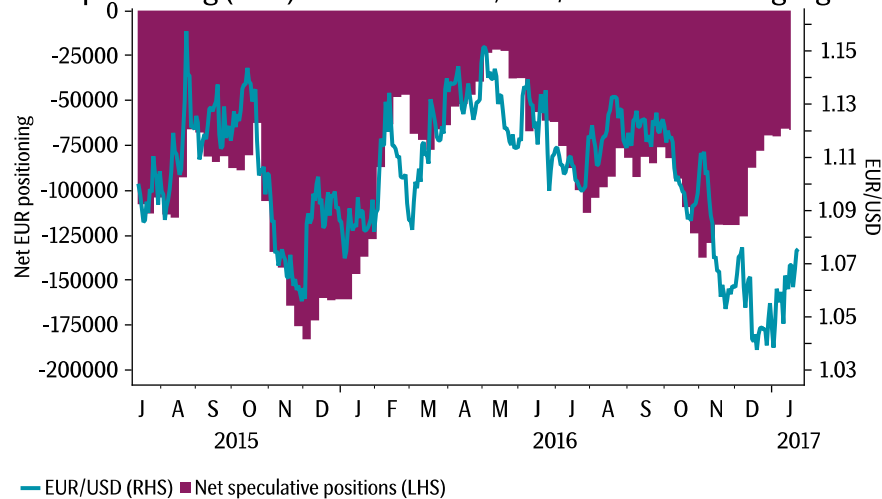
Record-large US-EU yield gap supports a weak euro for longer



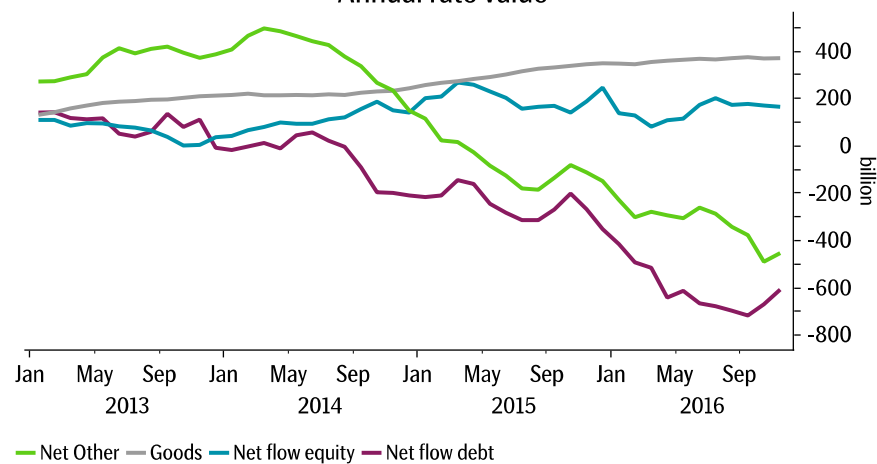
SEBEER EUR Index



EUR positioning (IMM): Shorts reduced, EUR/USD not following higher



Euro-19, BoP components: Large debt outflows  
Annual rate value



# Japanese yen: new weaker range established

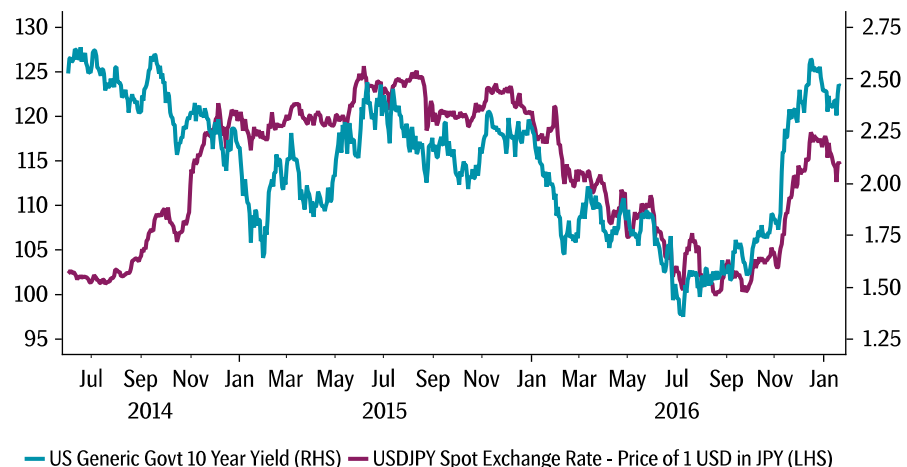
**WE EXPECT JPY TO REMAIN WEAK.** We think JPY will continue to weaken in 2017 as US rates remain high. JPY will trade in the 110-120 range in 2017 compared to the 100-110 range in 2016. European political events can push JPY below 110. However, **they should be good buying opportunities.**

**SHORT-TERM:** The economy will stay stagnant around 0.5% in 2017 from 0.5% in 2016. We expect some stabilization in consumption since the VAT hike scheduled for April 2017 has been delayed until Oct 2019. Capex is slowly recovering with business confidence returning also in reaction to delay in VAT hike. Recovery in domestic demand should reduce the current account surplus.

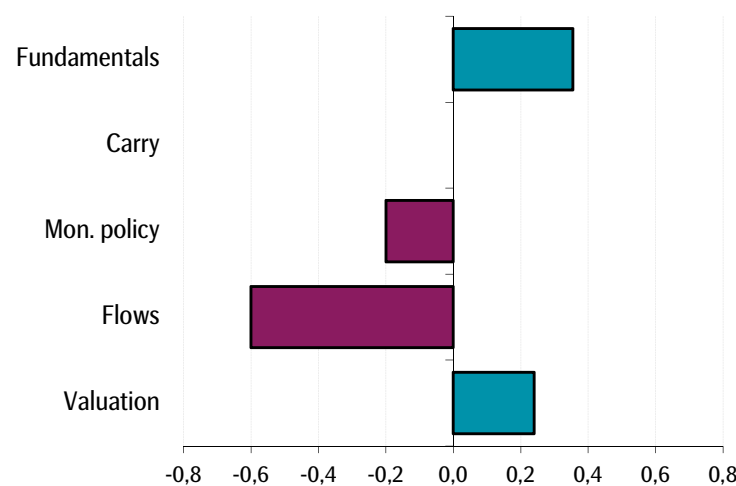
Japan's issue is that the economic recovery is too slow for inflation pressures to rise and hit Bank of Japan's 2% inflation target in 2017. **BoJ's new policy of Yield Curve Control** is highly beneficial when global interest rates are rising since Japan's rates are kept constant and the wider spread weakens JPY and loosens policy further. This will help the Japanese economy into 2017 and capital outflow **will continue to keep JPY weak.**

**LONG-TERM:** The outlook is for yen weakness to be capped. The current account surplus may shrink but it still remains solid at above 2% of GDP. JPY's valuation strengthened in 2015 but recent weakness is bringing JPY back closer to fair value. Lastly, inflation expectations have finally turned higher, meaning that BoJ easing is finally having some impact. Beyond 2017 more BoJ easing appears unlikely.

USD/JPY and US interest rates

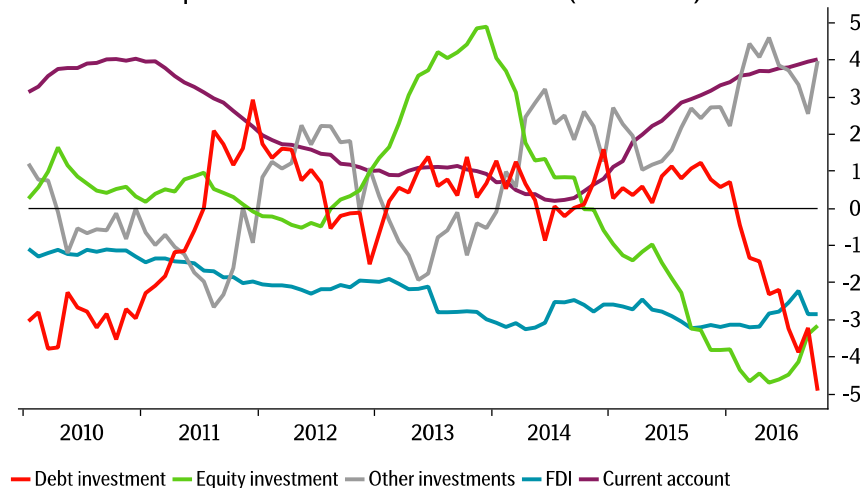


JPY Weighted score: -0.2

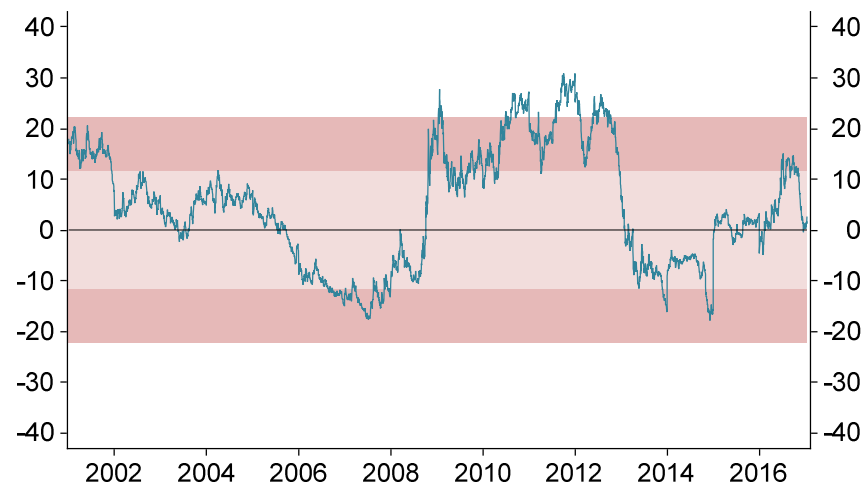


# Japan: flows supportive of JPY depreciation?

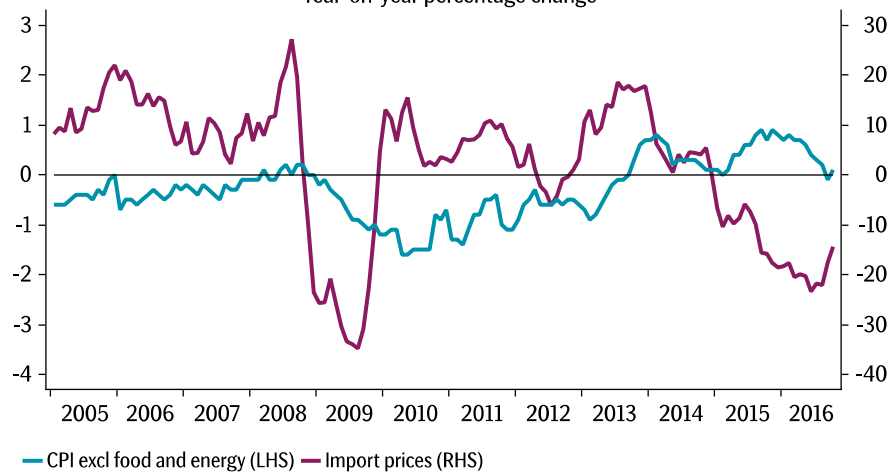
Japan: Current Account and Flows (% of GDP)



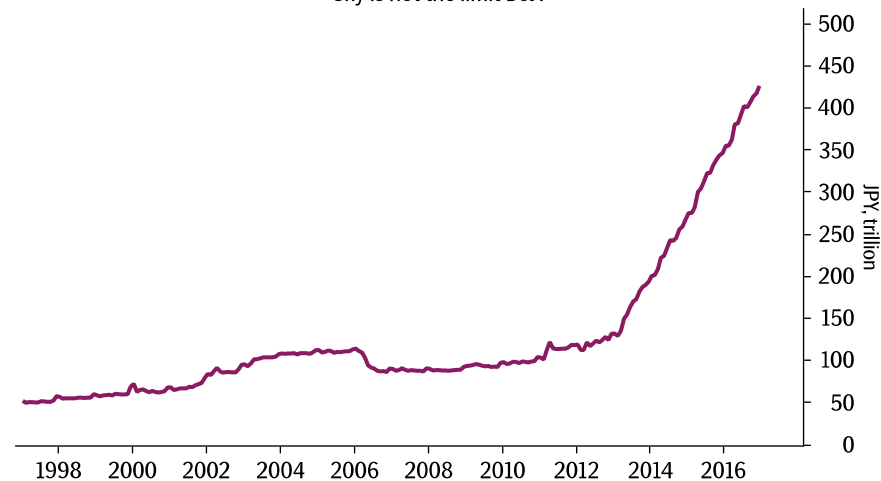
SEBEER JPY Index



Japan: CPI to lift from a weaker JPY  
Year-on-year percentage change



Japan, Monetary Aggregates, Monetary Base, Total, JPY  
Sky is not the limit BoJ?

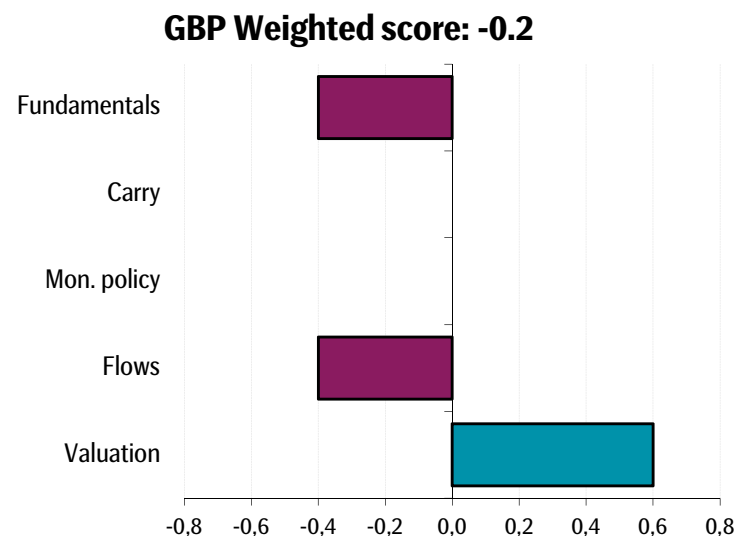
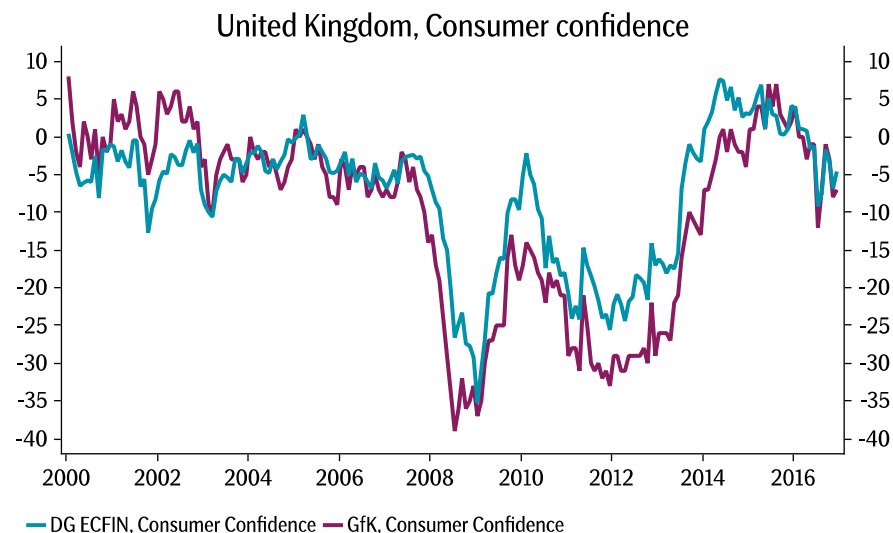


# Pound sterling: UK going for a hard Brexit

**UK TOWARDS A 'HARD BREXIT'.** It took more than 6m after the vote on EU-membership before the government revealed its plan for Brexit. However, now it is clear that a 'hard Brexit' where British access to the single market at best will be replaced with free trade agreement is the way forward. Although the transition process will be phased out uncertainty regarding the Brexit impact on UK growth is likely to weigh on the GBP. We expect EUR/GBP to peak at 0.89 in Q1 before moving lower again.

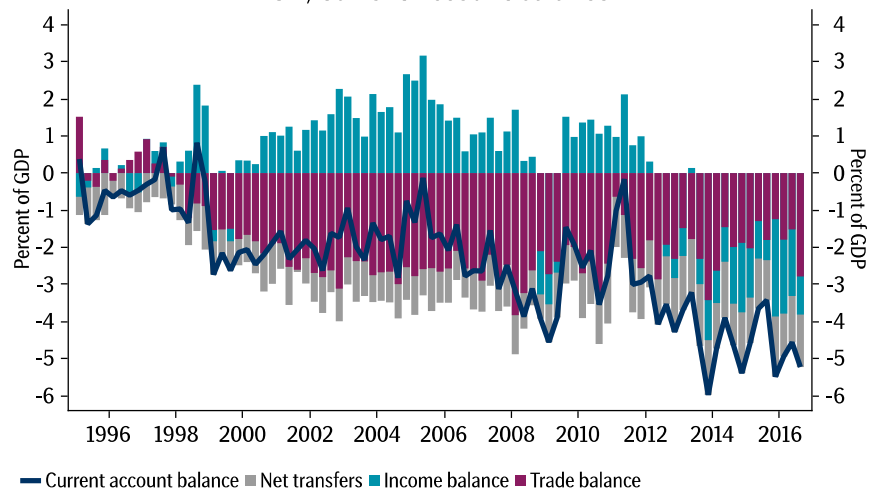
**SHORT-TERM:** So far the British economy has done better than anticipated after the referendum. In 2016 growth was actually stronger than the previous year. The large depreciation of the GBP is one reason. However, already now there are some worrying signs that growth might slow going forward and this risk has definitely increased after the government Brexit plan was revealed. Businesses are likely to delay capital spending, which already is reflected in falling investment intentions and household consumption, which has been the main driver for growth since 2013, might slow. Consumer confidence only had a short-lived recovery after the drop last summer and the labour market activity show signs of slowing. Moreover, the household savings rate has dropped to the lowest level since the beginning of 2009 while rising inflation undermines real wage growth.

**LONG-TERM:** The GBP is significantly undervalued after its depreciation. However, considering uncertainty from Brexit it seems very reasonable at this point. Twin deficits is another negative factor for the GBP. The current account deficit is 5.2% of GDP, which certainly is a risk for the currency.

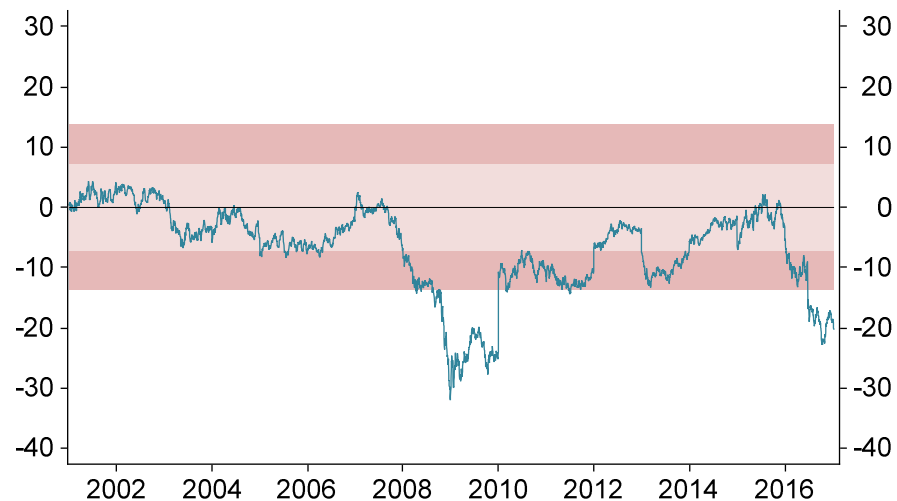


# UK: Watch out for signs of weak growth

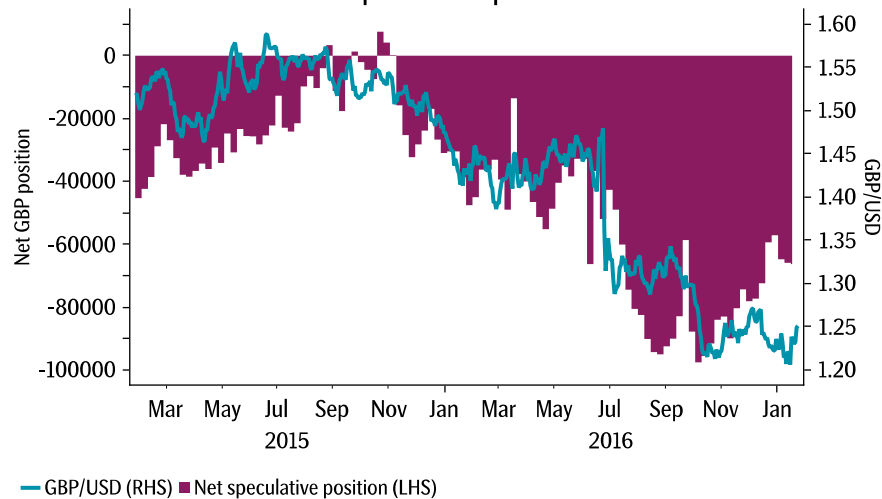
UK, Current Account balance



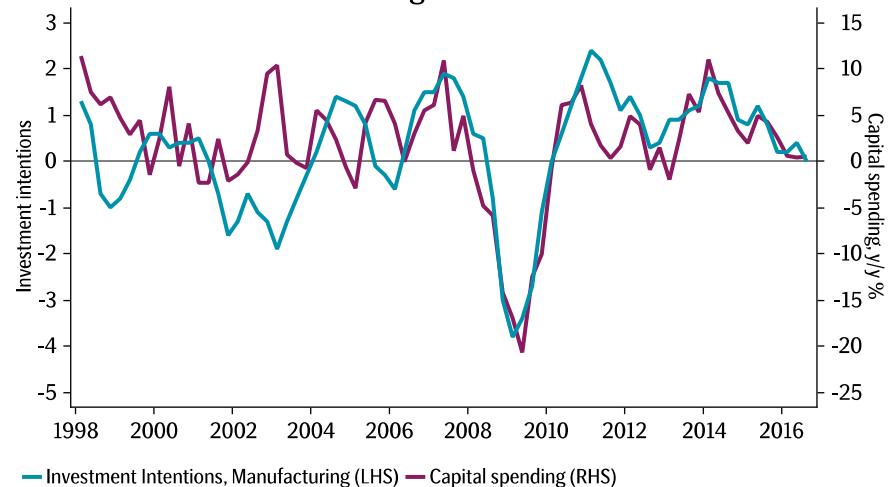
SEBEER GBP Index



GBP speculative positions



UK Manufacturing investment intentions



# Canadian dollar: economy on the mend

**WE EXPECT CAD TO STRENGTHEN.** The Canadian economy is on a mend, though slack still remains. We expect CAD to be supported by benign risk appetite, a correction of current undervaluation and growth accelerating due to its extensive connections to the US economy. Main risks are the possibility of higher tariffs on export to the US and the current high oil price.

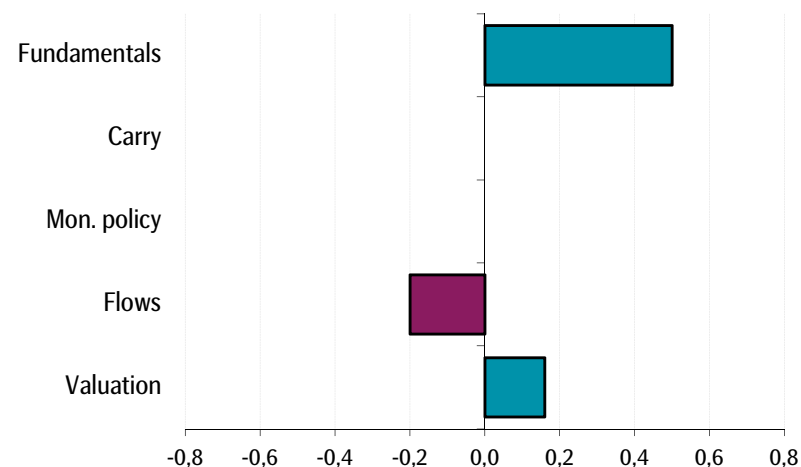
**SHORT-TERM:** Many indicators currently show that the economy is on the mend. BoC's latest quarterly *Business Outlook Survey* shows that businesses are most optimistic about investment and hiring since before the oil priced slump in 2014. January data also showed the first trade surplus in more than two years and a surge in full-time employment. However, inflation has not exceeded its 2% target for about two years which shows that the economy operates with material excess capacity. May we rule out another cut? No, BoC Governor Poloz reiterated in January that a cut remains on the table as long as there is elevated uncertainty mostly so with the negative risks from the Trump presidency and the high oil price. However, we think it is more likely that BoC's next change is a rate hike. Supporting stronger CAD is also a fair value model, based on terms of trade and relative rates, which shows that USD/CAD ought to trade around 1.25. However, one limit to CAD strength could come from the oil price which we expect range between \$50 and \$60/bbl this year.

**LONG-TERM:** The score is higher than most other G10 currencies and is mainly a product of improving fundamentals, positive carry and a correcting undervaluation. BoC expects the economy to be at full capacity mid-2018 and our forecast is also unchanged rate at 0.5% until a hike in July 2018.

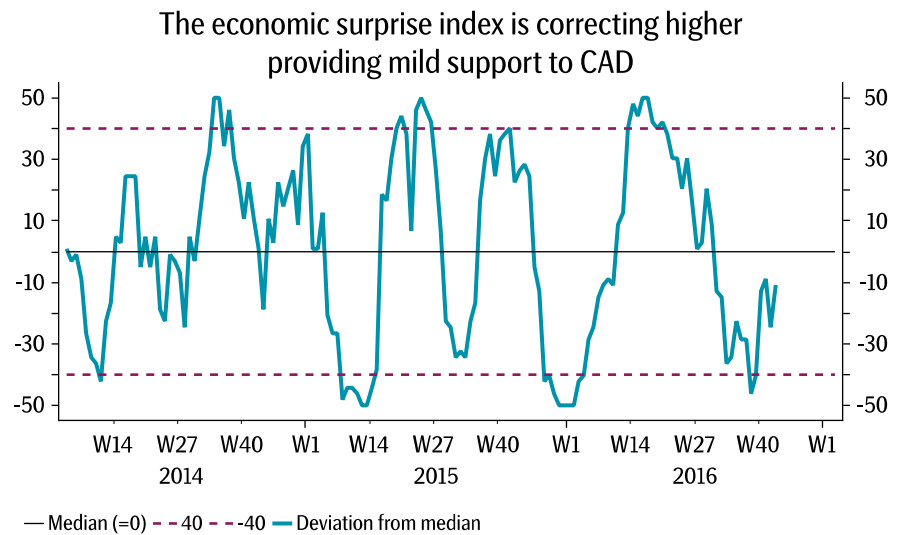
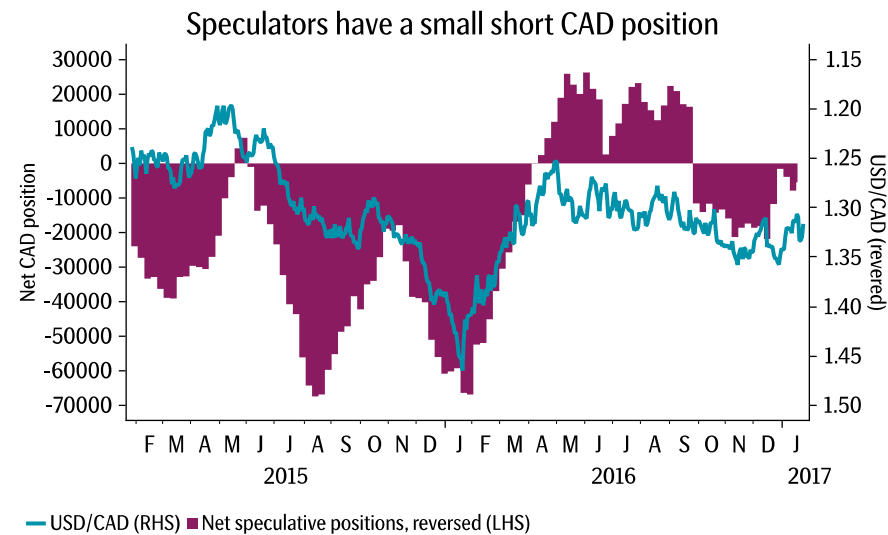
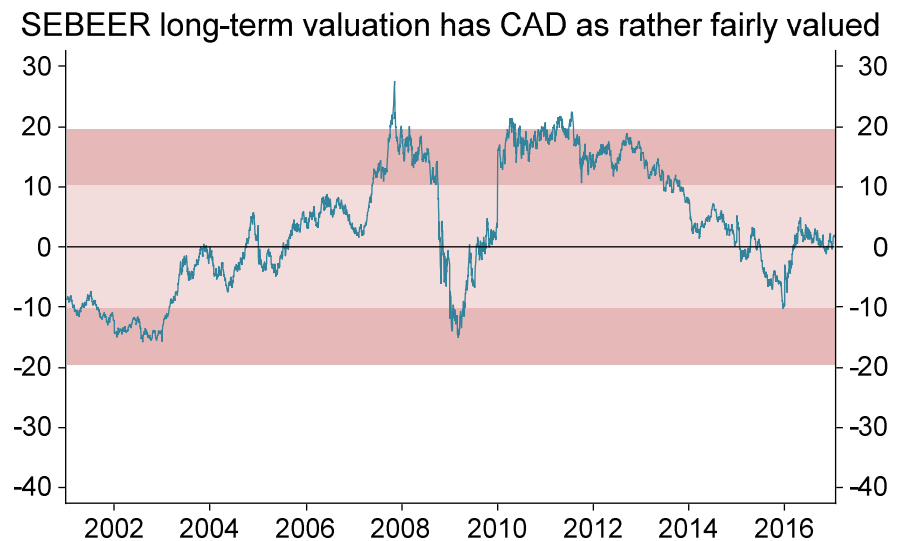
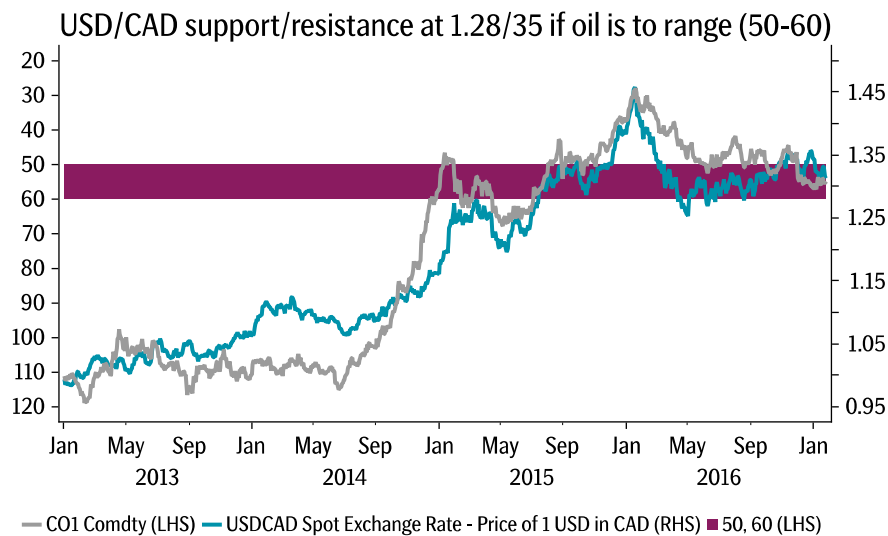
CAD is fairly valued at 85 corresponding to USD/CAD at 1.25  
Replica of RBA's fair value model



## CAD Weighted score: 0.5



# CAD strength limited by range-bound oil price?



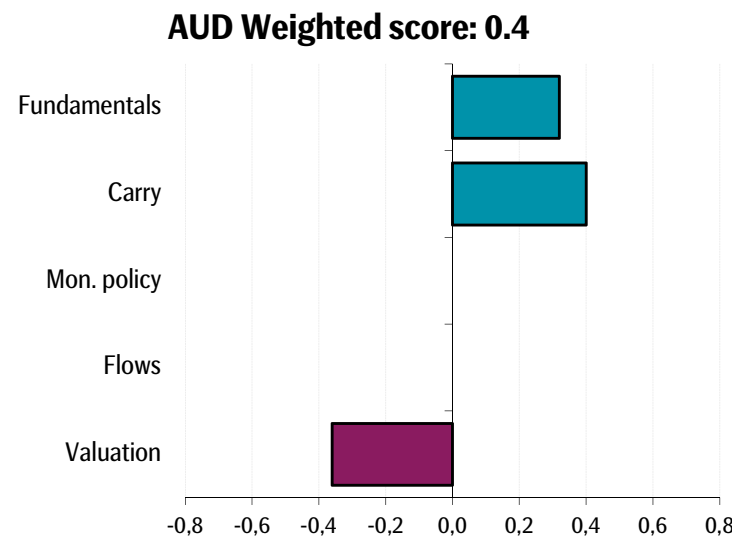
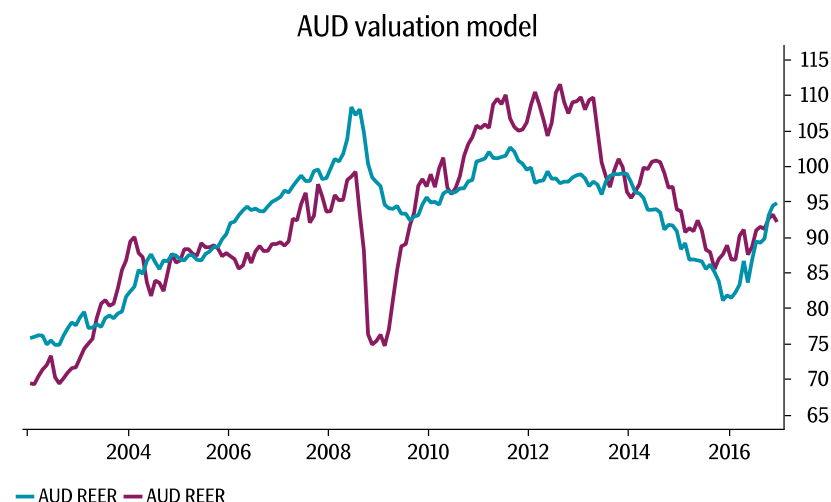


# Australian dollar: Rising commodity prices support

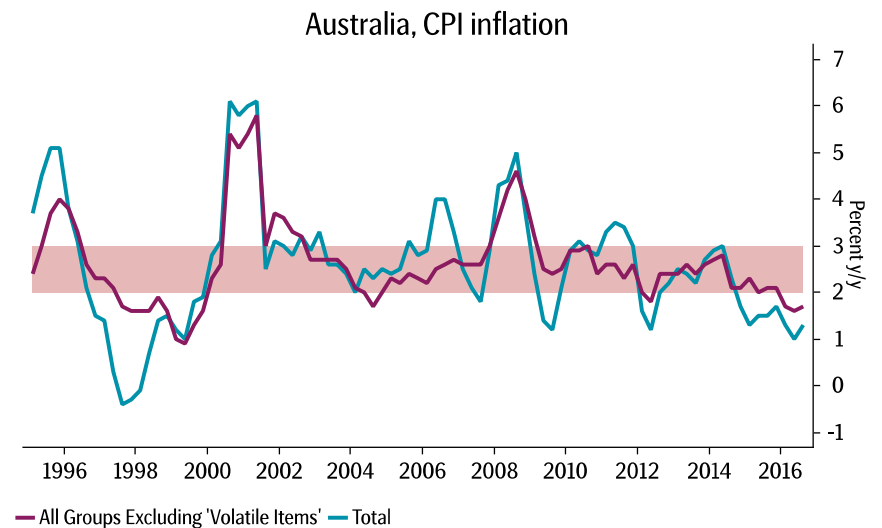
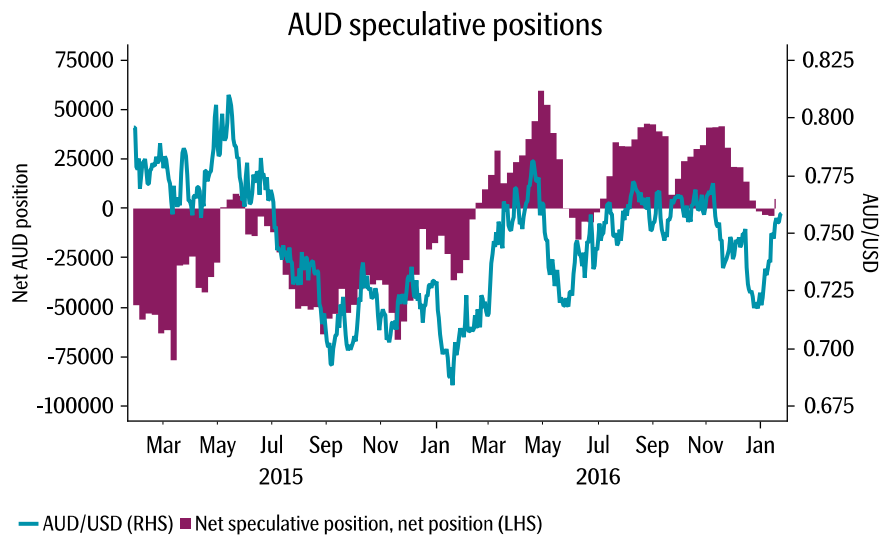
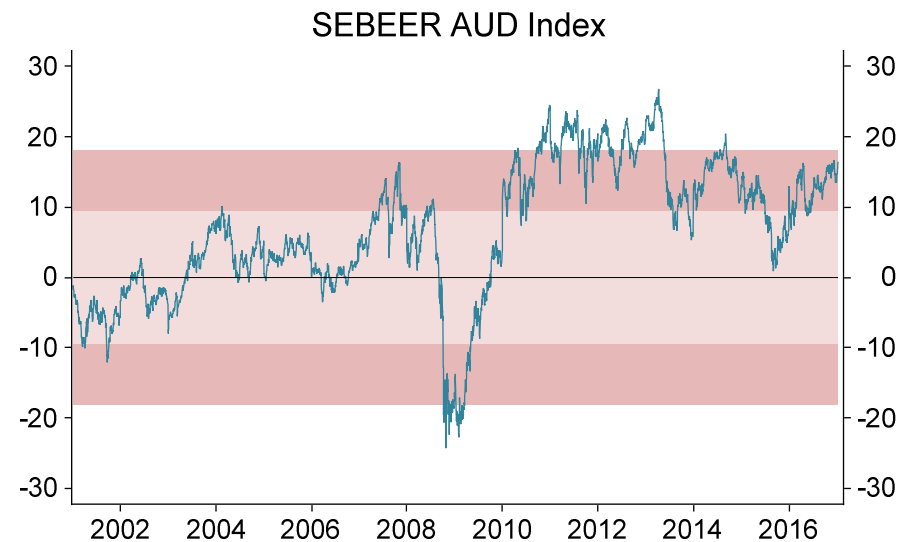
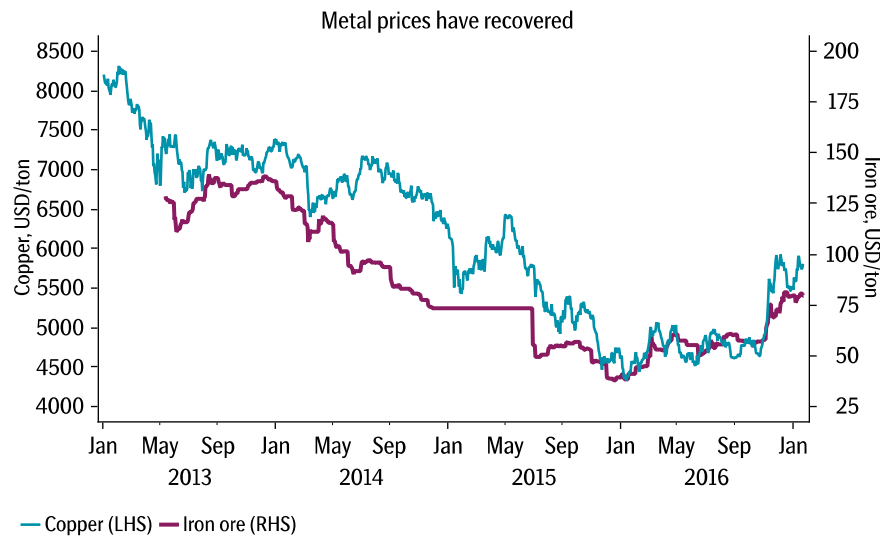
**HIGHER COMMODITY PRICES MAIN DRIVER.** Simplifying things the AUD continues to trade closely related to Australia's terms-of-trade (ToT) and its monetary policy outlook. While ToT improved substantially in 2016 the RBA decided to lower the cash rate twice (May & Aug). A simple model based on the ToT and rates indicates roughly 15% appreciation of the AUD in trade weighted terms from Nov 2015, while the AUD appreciated by 6% in 2016. As long as the RBA refrains from further easing we expect the AUD to appreciate.

**SHORT-TERM :** While commodity prices are likely to stabilize or continue higher, monetary policy outlook is more uncertain. Currently analysts are divided whether the RBA will continue to lower rates in 2017 with a majority expecting unchanged policy. The decisions to lower the cash-rate last year were due to low inflation. Inflation is still below the target range and cost pressures in the economy remain subdued, which makes further rate cuts a risk for the currency in 2017. Conditions in the housing market have also eased and credit growth has slowed making the housing market less of a concern for the RBA.

**LONG-TERM:** The Australian economy is still heavily exposed towards resource exports and sensitive to global growth. Activity outside the mining sector has shown signs of improving due to low interest rates and past years depreciation of the AUD. Weak household income growth is one concern though. Large household savings should give some support to consumption but income has to improve for spending to show sustainable growth. The AUD remains substantially overvalued against its trade weighted index, which is a long-term risk for the currency.



# Australia: Low inflation could trigger another cut



# New Zealand dollar: Gains on strong fundamentals

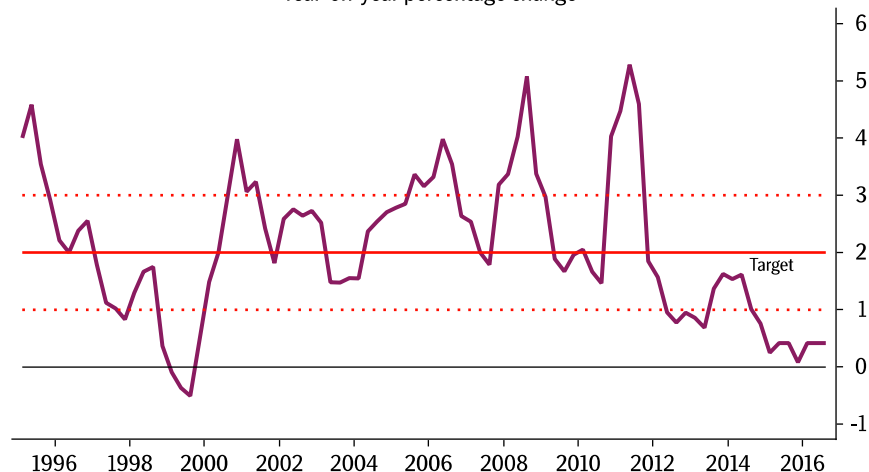
**CAPACITY PRESSURE IS BUILDING.** The terms-of-trade have improved recently but external demand is still subdued. However, strong domestic demand is driving growth and is causing capacity pressures to build. The NZD is strong, we expect Fed tightening to dampen upward pressure in 2017.

**SHORT-TERM:** Growth has accelerated driven by net migration, a strong construction sector, tourism, and accommodating monetary policy. The RBNZ forecasts growth of 3.7% in 2017; well above potential. Capacity pressure is building, primarily in the construction sector, and will contribute to rising inflation through a tightening of the labor market. Headline inflation has remained below target so far, however, primarily due to continued negative tradables inflation. Short-term inflation expectations have stabilized and long-term expectations are close to target. The RBNZ cut the policy rate by 100 bps to 1.75% in 2016 but has removed earlier statements that more rate cuts are necessary. We do not expect any changes in the policy rate in 2017 but a renewed fall in inflation expectations could force the central bank to resume cuts. The housing market is still a key risk. Price increases have moderated somewhat but price pressure has spread from Auckland to the rest of the country.

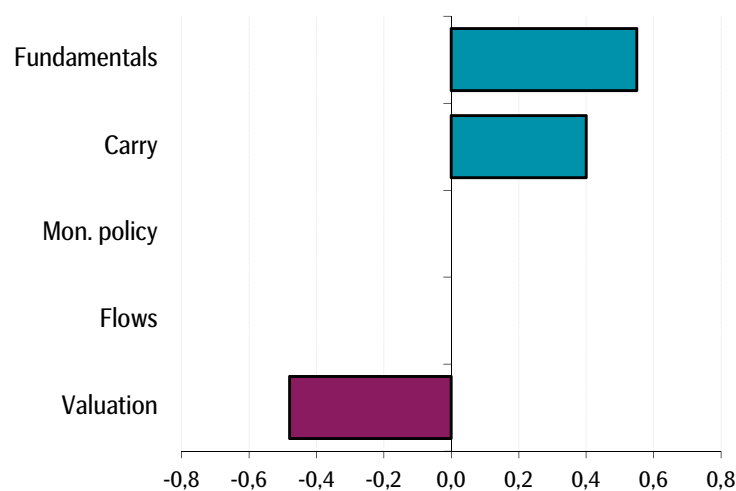
**LONG-TERM:** The SEB valuation model indicates that the trade-weighted currency is somewhat overvalued. This is in line with the RBNZ statement that “a decline in the exchange rate is needed”. The current account deficit is expected to remain around 3% of GDP. Yields are still relatively high vs. to other advanced countries providing some scope for carry trade inflows. **Our base case is that the USD/NZD will appreciate.**

New Zealand: Inflation remains below target

Year-on-year percentage change

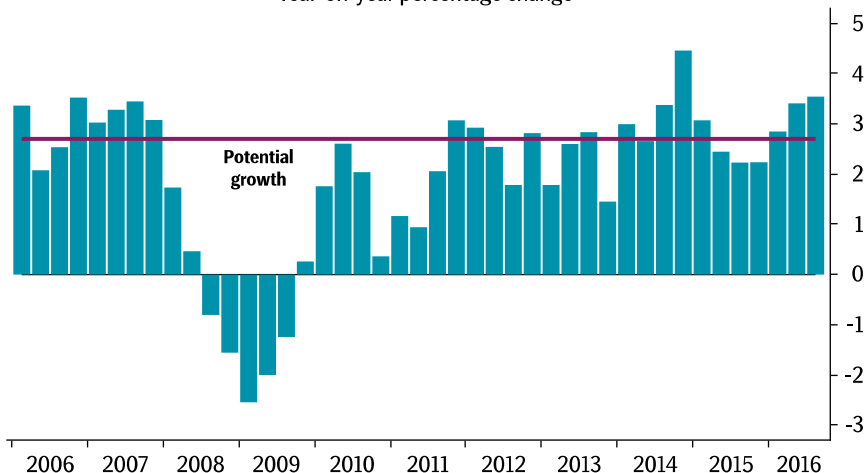


NZD Weighted score: 0.5

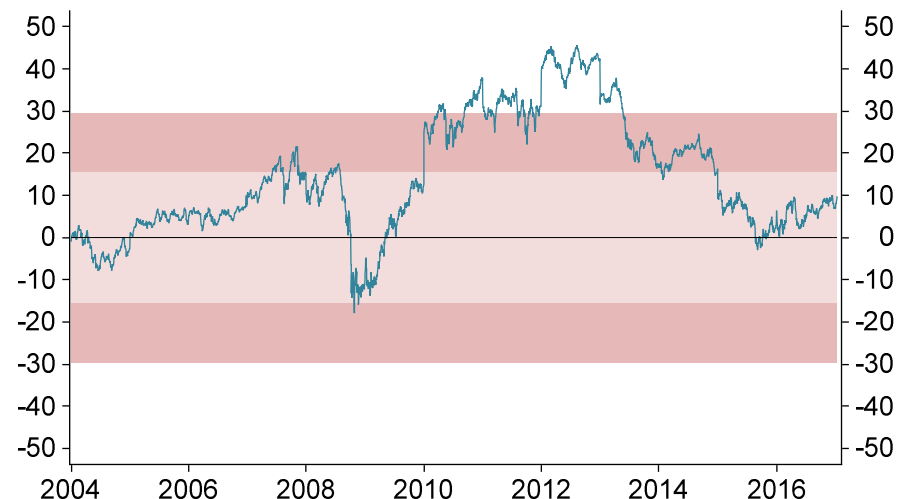


# New Zealand dollar: higher inflation eventually?

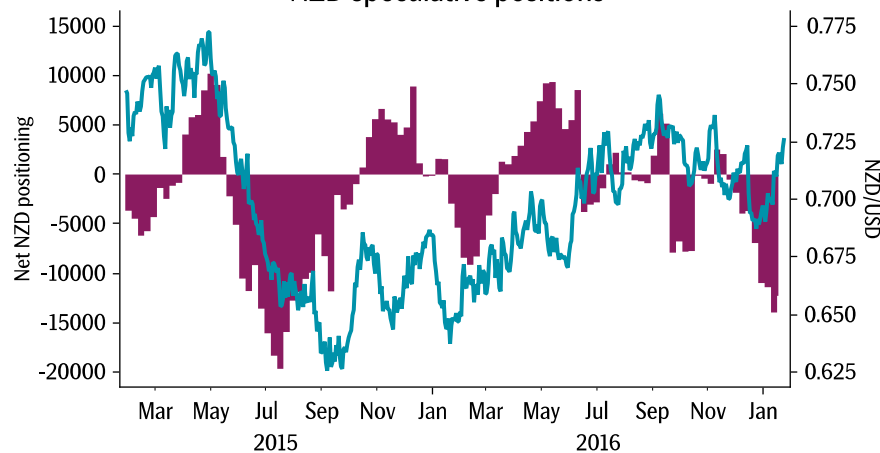
New Zealand: GDP growth above potential  
Year-on-year percentage change



SEBEER NZD Index

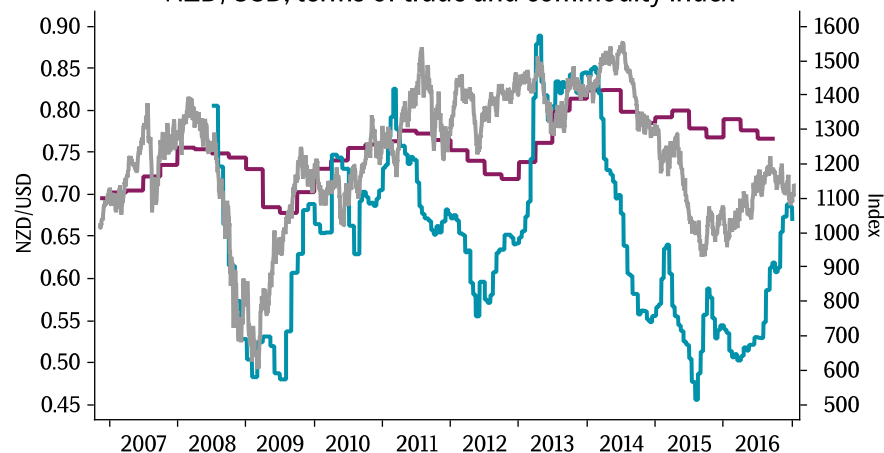


NZD speculative positions



— NZD/USD (RHS) ■ Net speculative position (LHS)

NZD/USD, terms of trade and commodity index



— NZD/USD (LHS) — Commodity Index (RHS) — New Zealand Terms of Trade (RHS)

# Swiss franc: towards a "free float"?

## A MORE FREELY FLOATING (STRONGER) SWISS FRANC?

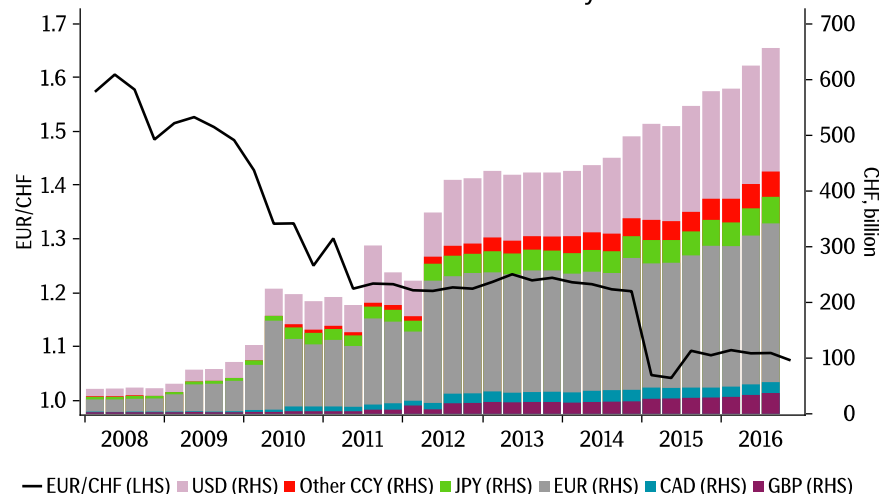
SNB has previously defended 1.08 in EUR/CHF but seems to have lowered that boundary recently to 1.07. Still **FX reserves continue to increase**: growth is nearly CHF 200bn in the past two years which looks to be **long-term unsustainable**. Ultimately inflows will abate or the CHF will continue to appreciate.

**SHORT-TERM:** Inflation is slowly rising, the Swiss National Bank expects CPI marginally above 0% 2017. The economy has done reasonably ok in the past year and the SNB projects the economy to grow by 1.5% 2017. Despite the talk of a suffering exporting industry, the **current account surplus remains elevated**. **SEB valuation model (SEBEER)** also indicates that **the trade-weighted currency is near the level we estimate to be long-term fair value**. However SNB continues to state that the CHF is significantly overvalued.

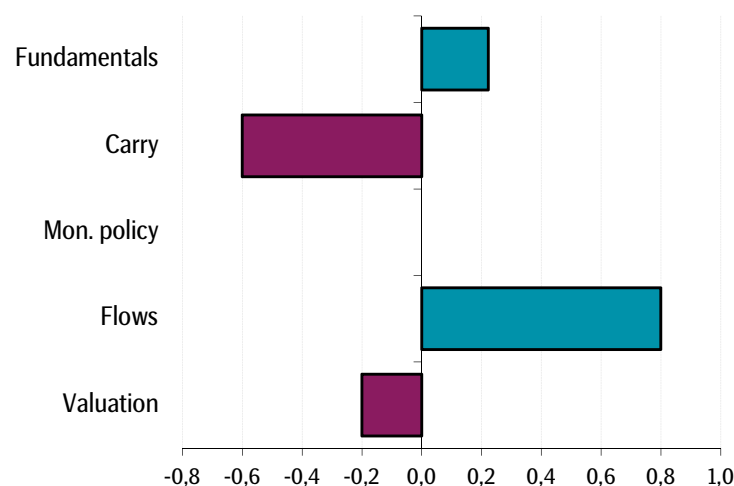
One crucial question remains: from where are the capital inflows emanating? Europe is recovering but economic and political risks remain high. 2017 holds a number of key European elections which could make investors run for safe-haven again. **Our base case is a slow grind lower in EUR/CHF as inflows continue and the cost outweighs the benefits of continued, big FX interventions**. Could Switzerland introduce a tax on foreign capital inflows (low probability)?

**LONG-TERM:** We count on stronger for longer as the external sector seems to cope just fine with current CHF strength. Having likely tested levels below 1.05 H1 2017 we think a broad range 1.04-1.08 will be established longer-term.

FX reserves: a limit to how far they can rise?

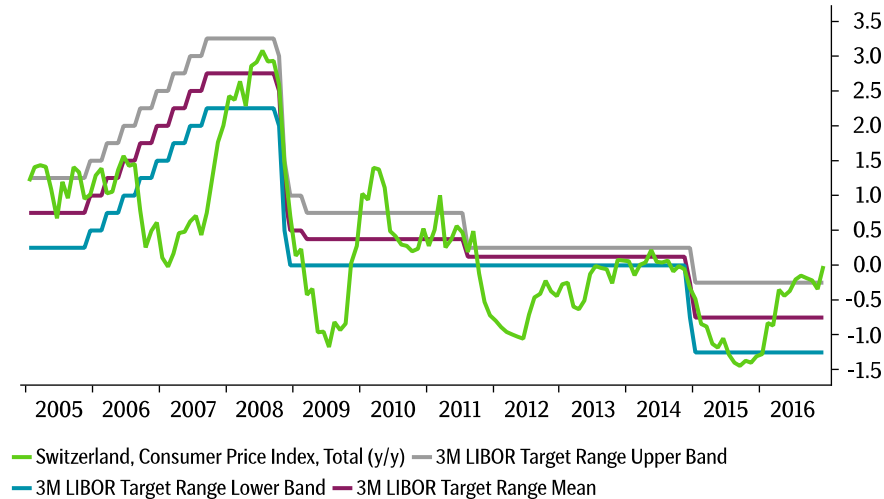


## CHF Weighted score: 0.2

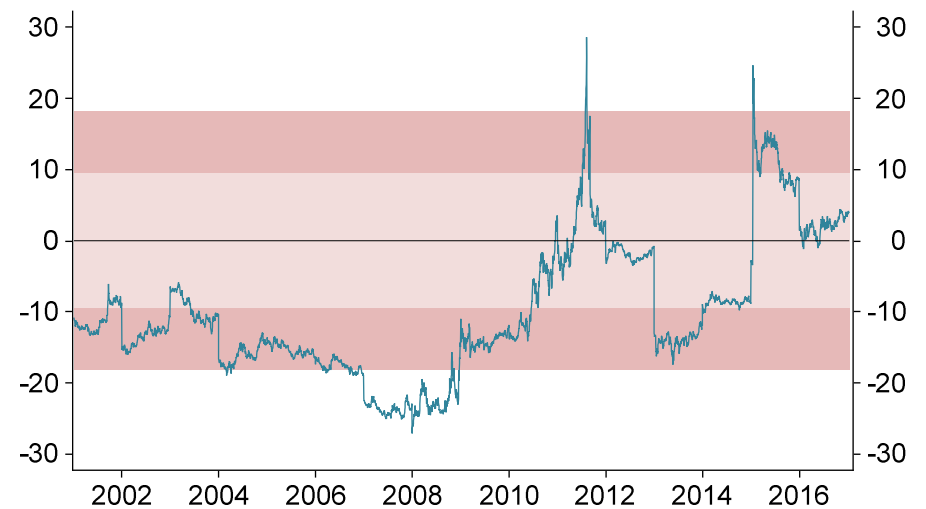


# The Swiss franc is not overvalued...

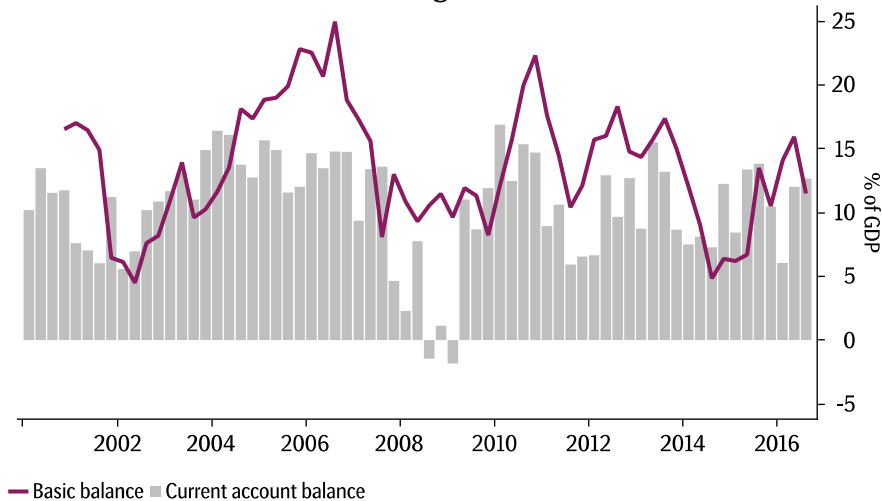
Switzerland: Inflation back above zero



SEB valuation model: Swiss franc is not overvalued



Current account balance: no signs of an overvalued CHF here..



Switzerland: GDP & CPI

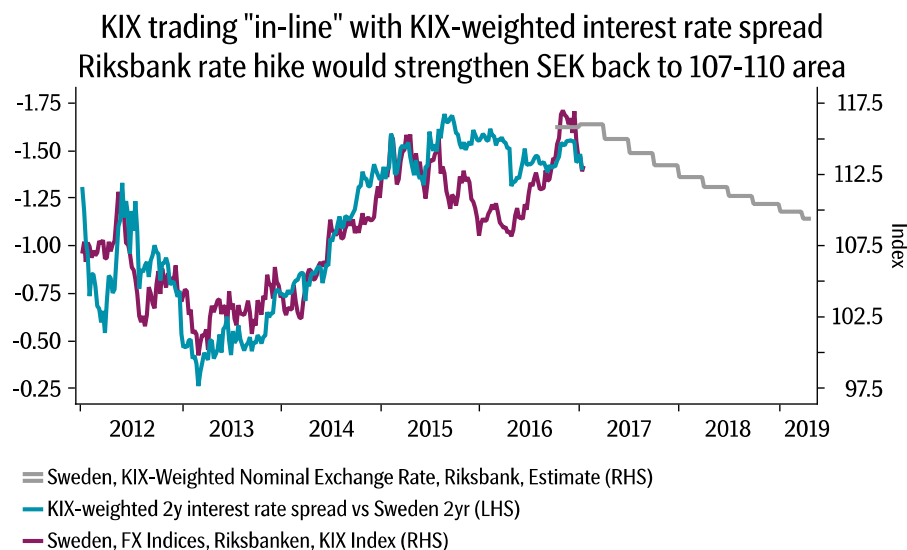


# Swedish krona: market against the Riksbank

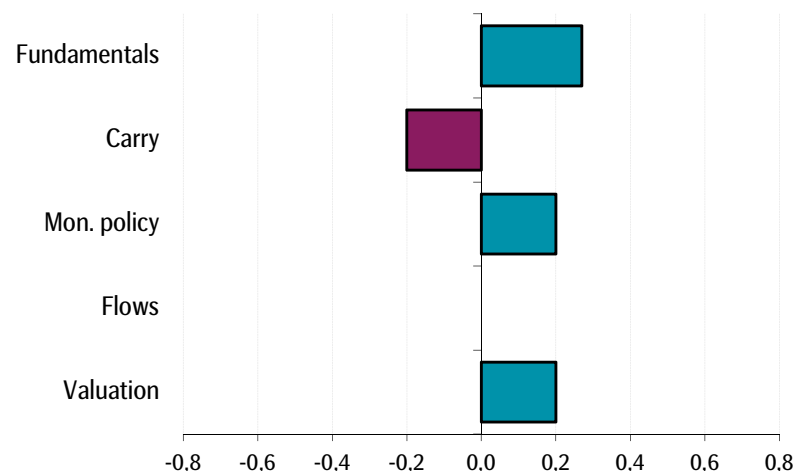
**TOUGH BALANCING ACT FOR RIKSBANK 2017.** The Swedish economy continues to grow strongly and SEB remains with a GDP forecast (2.8% 2017) above consensus. Domestic demand provides the bulk of expansion but as global growth improves and SEK remains weak, the export sector will certainly be a positive factor to consider as well. 2017 will be a defining year for the Riksbank and SEK: will economic strength finally pave way for increasingly tight resource utilisation and rising wages? Or will underlying inflation fail to rise as temporary effects leave CPIF. Despite inflation below target SEB expects a first rate hike to happen before year-end, this will certainly be a strong factor for pushing SEK in a stronger direction. **We target EUR/SEK just below 9.00 by YE-17.**

**Near-term we are less positive:** although the Riksbank board was split 3-3 since the December meeting, we don't think the shift towards a neutral/hawkish stance is about to happen until mid-2017. The repo rate remains at -0.5% and QE-policy continue. This means SEK will suffer from a very punitive central bank policy for a while longer. Furthermore, KIX is now 3% stronger vs current Riksbank forecast and another 1-2% would certainly trigger dovish comments from the board members.

**SHORT-TERM:** Based on a strong Swedish balance sheet and open domestic FX exposure we think SEK will take on more defensive long-term qualities. This means SEK can appreciate even tough global growth slows down/enters a recession. Only a domestically generated crisis would work to weaken SEK back above 10.00 vs euro which we hold as very unlikely. Rising rates will undoubtedly appreciate SEK which will limit the extent of rate hikes. 2018 EUR/SEK target is 8.75.



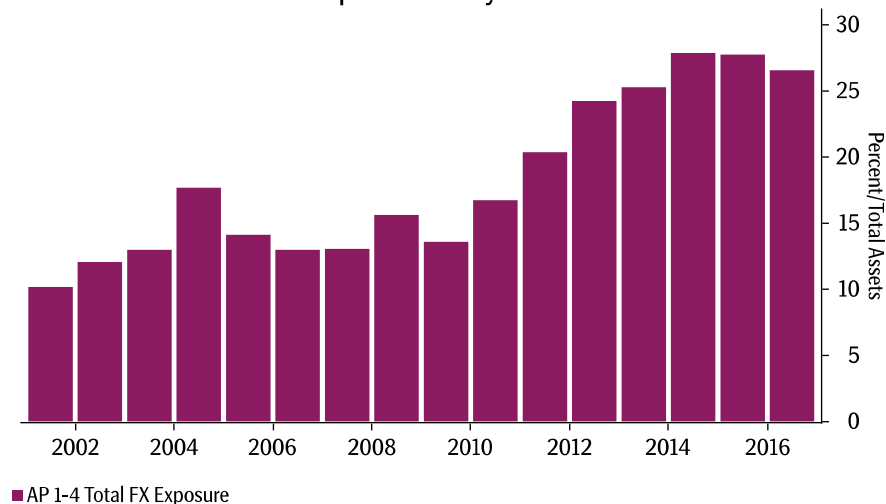
## SEK Weighted score: 0.5



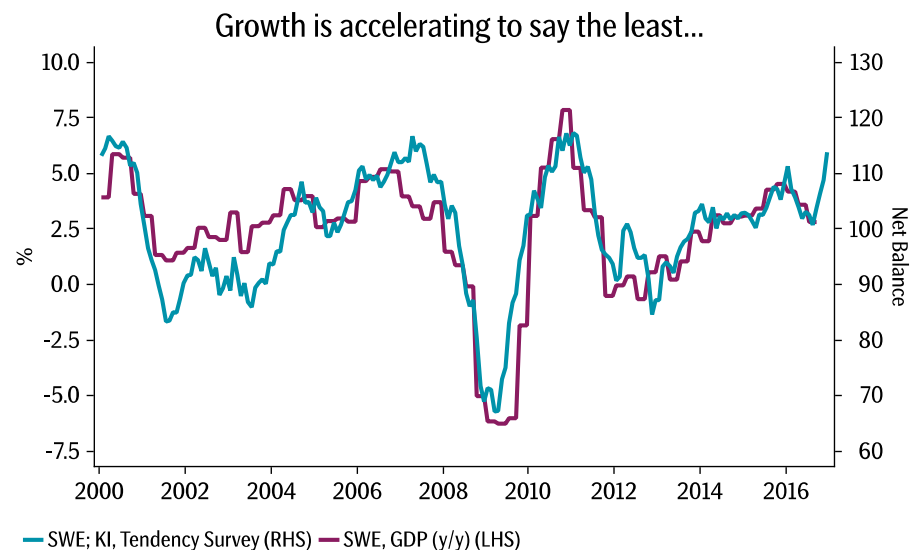
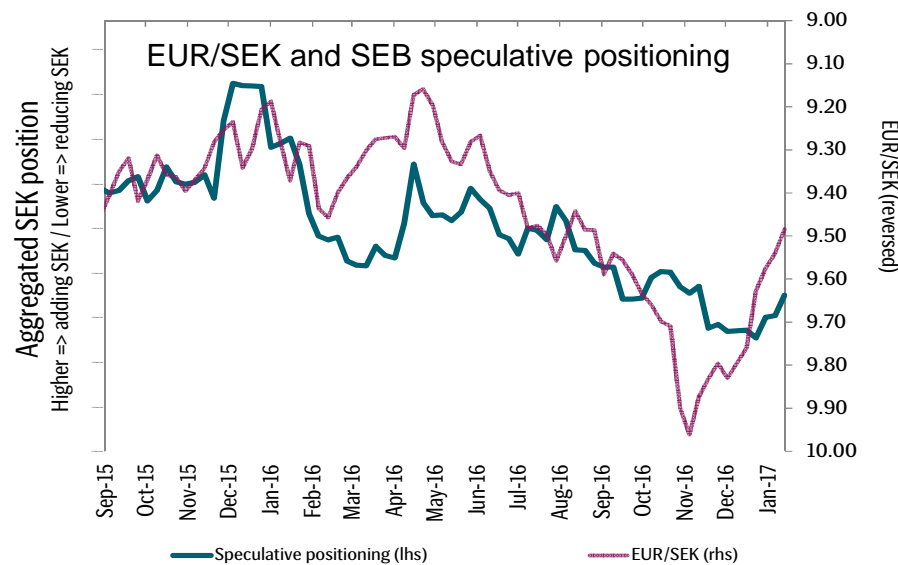
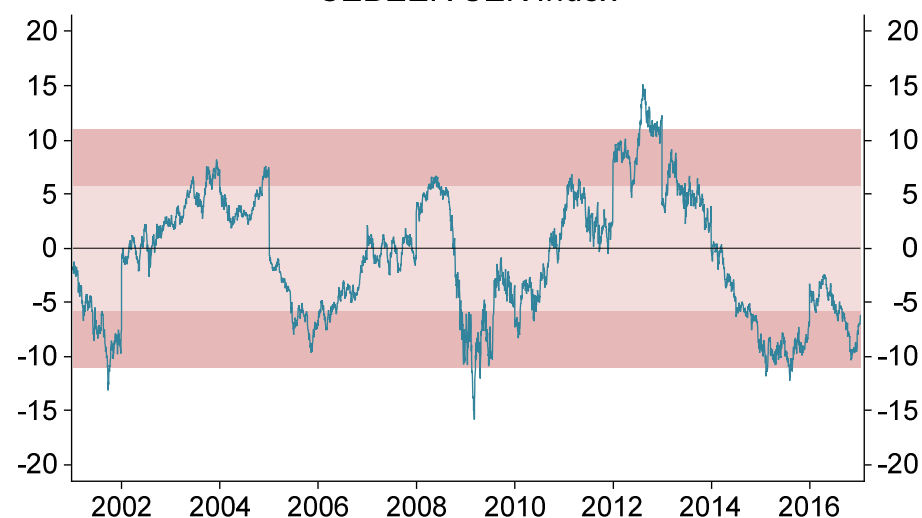


# Swedish krona: positive drivers dominate

AP 1-4 Total FX Exposure: likely to be trimmed further



SEBEER SEK Index

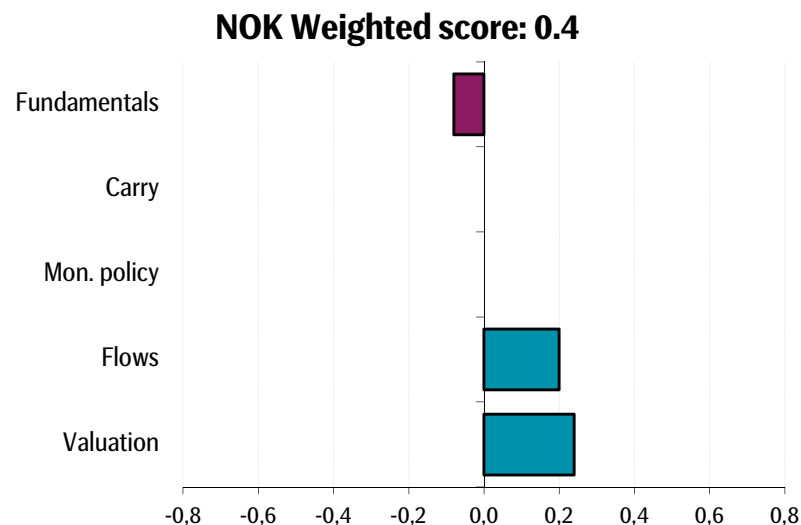
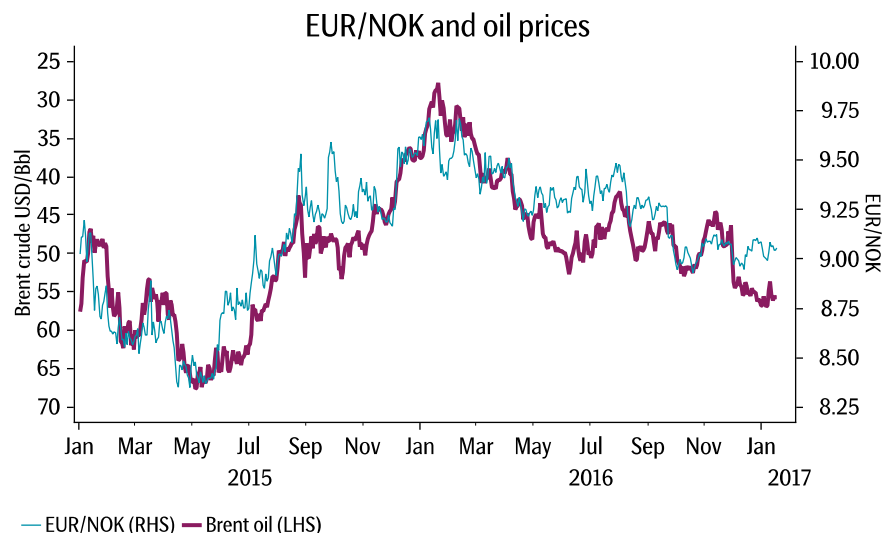


# Norwegian krone: Unresponsive to key drivers

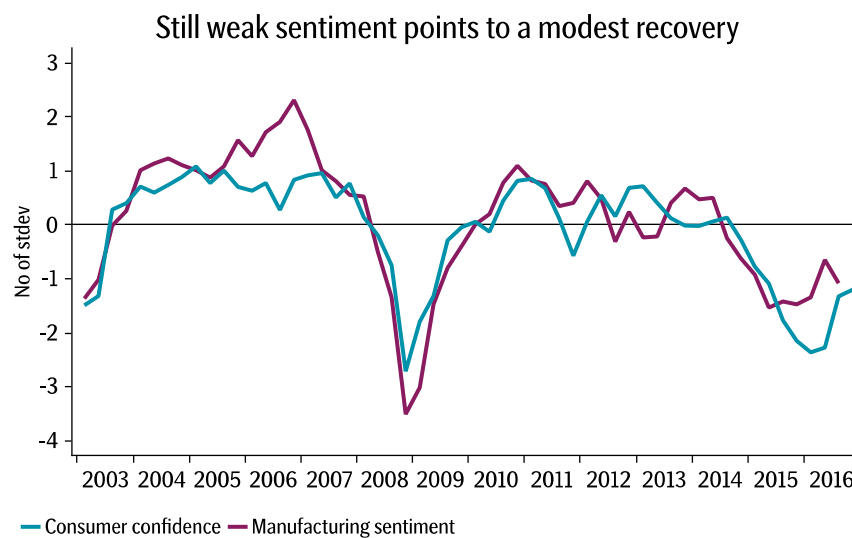
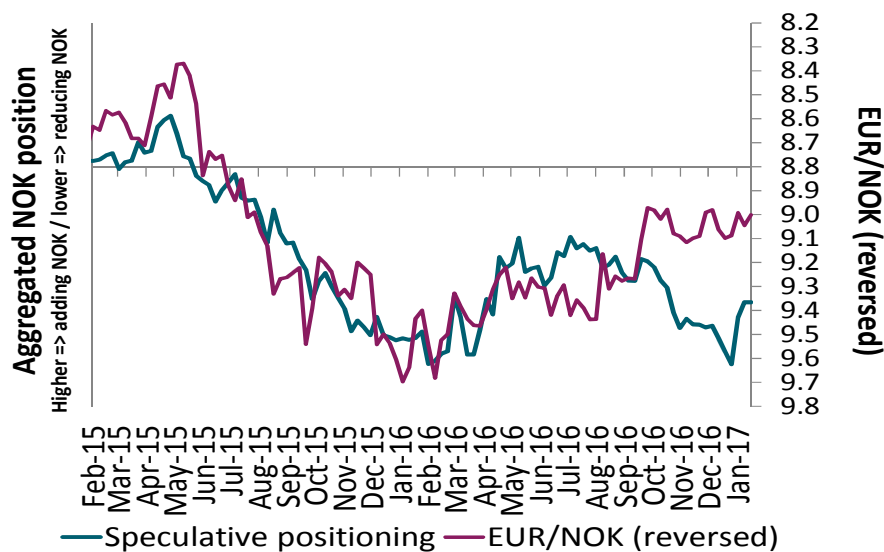
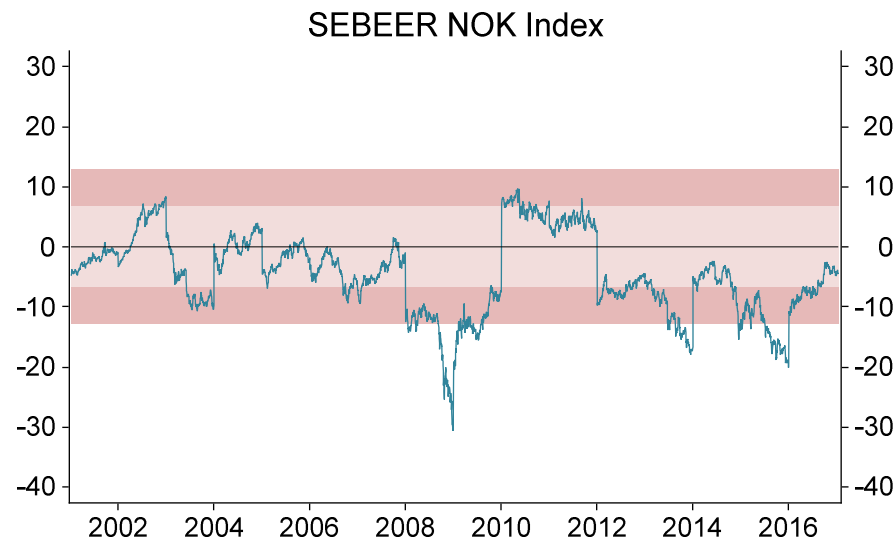
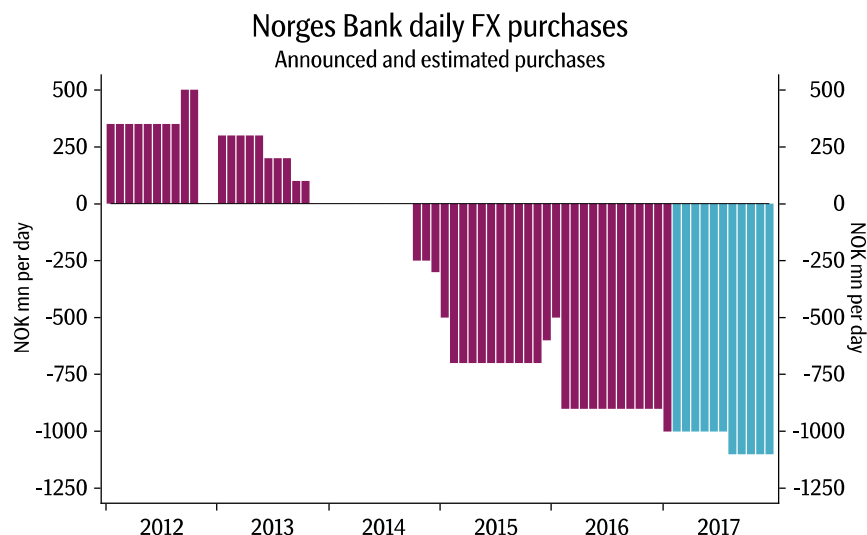
**POSIED TO STRENGTEN.** We maintain our constructive view on the NOK based on improving fundamentals, attractive valuation and substantial capital inflows. We expect NOK to resume its appreciation in 2017 and look to sell EUR/NOK on rallies around 9.20-9.30.

**SHORT-TERM:** We are positive on the NOK as we think it has some catch-up to do given its normal drivers (oil price and relative rates). We expect the oil price this year to range between \$50 and \$60/bbl, which historically has seen EUR/NOK around 8.75. Norges Bank is likely to stay on hold this year as rising financial risks related to the housing market hinders further rate cuts. If the NOK would appreciate substantially NB is likely to verbally intervene, which has proven sufficient to delay further strengthening. One risk against our view is that stronger NOK in 2017 seems like a consensus bet and positions may already be on the books. Any disappointment like weaker economy, lower oil price or increased risk for NB policy easing may therefore have a substantial negative impact on the NOK.

**LONG-TERM** Since the oil price started to fall in 2014 the NOK has been undervalued against most G10 currencies. Although the NOK has recovered from extremes of more than 2 std dev below its long-term fair valuation it has potential to move much further. The flow outlook is clearly NOK-positive after Norges Bank increased NOK-purchases to NOK 1bn/day in January and we expect purchases to increase further going forward. One risk against our long-term constructive view is a faster easing in inflation as it could prompt Norges Bank to remain on hold while other central banks begin reversing monetary policy.



# Norway: Modest recovery but flows are supportive



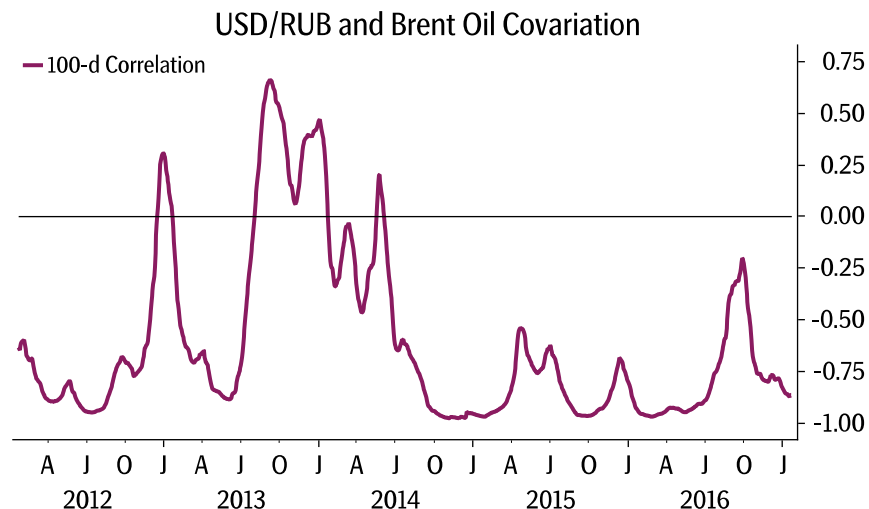
# Russian rouble: Still looking good

## STABLE OIL PRICES WILL SUPPORT THE RUB IN 2017.

The correlation between oil and the RUB has grown stronger again after a brief disconnect in 2016. Oil will be the key driver of the RUB and we expect Brent crude oil to average \$55.0/bbl in 1Q, \$57.5/bbl in 2Q, \$55.0/bbl in 3Q, and \$52.5/bbl in 4Q. However, when oil prices rise, the RUB will not fully recover losses from periods when oil falls, due to relatively high inflation. Thus, USD/RUB will be 60.5 in 1Q, 61.0 in 2Q, 62.0 in 3Q, and 63.5 in 4Q.

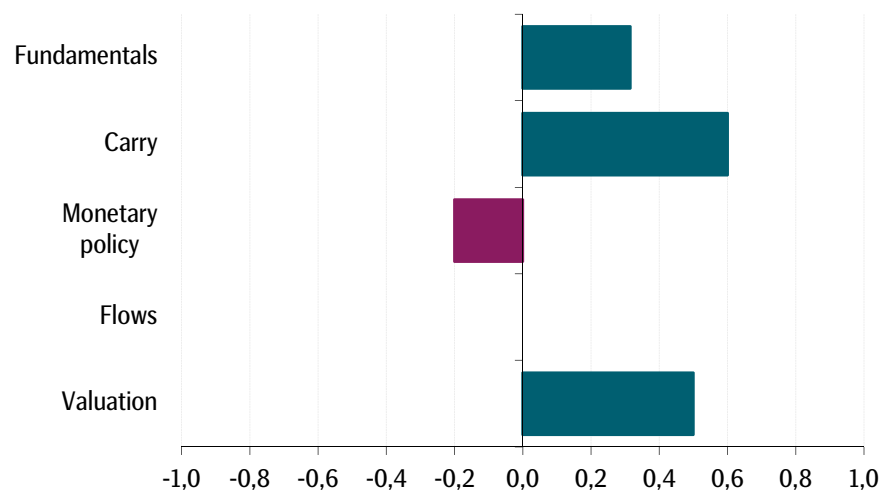
**SHORT-TERM: Expect RUB strength.** Investment in Russian assets has become a favourite theme among analysts. The economy is coming out of a recession, the current account surplus will continue, carry is high with OFZ yields at above 8%, and the RUB valuation is low by historical standards. In addition, we do not expect an immediate removal of US and EU sanctions – indeed, the EU just extended them to July 2017. Yet, relations with the US will improve gradually and support the RUB. Another supporting factor is the CBR's hawkish stance. Inflation fell to 5.4% y/y in December. Nevertheless, because of very sticky expectations the CBR has maintained the policy rate at 10.0%, and will cut by no more than 200bps in 2017.

**LONG-TERM : RUB vulnerabilities.** The government intends to reduce the budget deficit to 1.2% of GDP by 2019, which in theory looks achievable with the current price of oil and exchange rate. However, fiscal and international reserves need to be replenished and elections in 2018 will put pressure on public finances. Hence, we expect the CBR to buy foreign currency reserves, which will weaken the RUB (and support import substitution) especially in 3Q and 4Q.



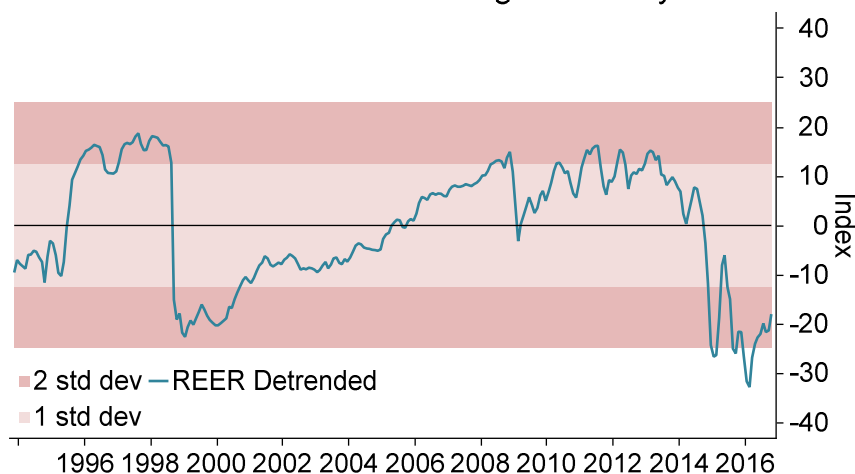
Source: Macrobond, SEB

## RUB Weighted score: 1.2



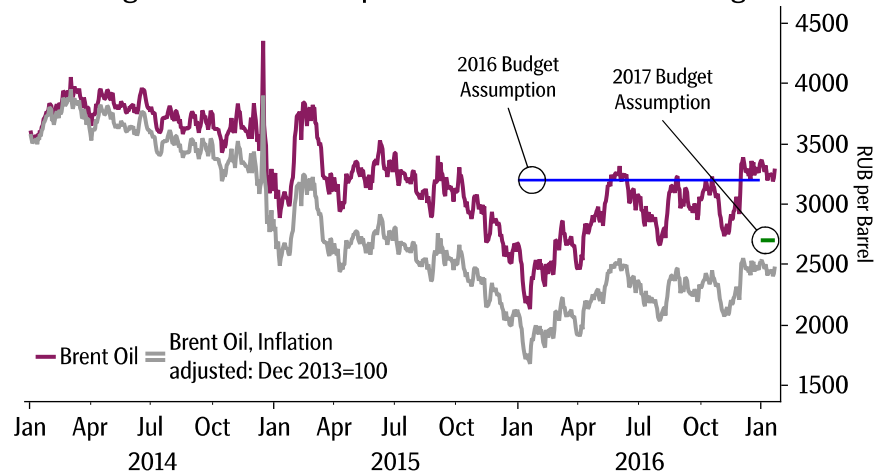
# Oil & fundamentals point to RUB strength

Russia: Real effective exchange rate lowly valued



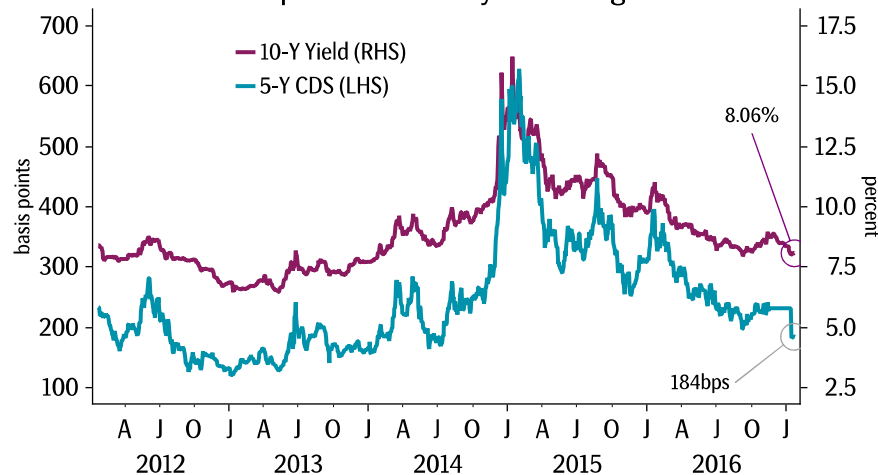
Source: International Monetary Fund (IMF), Macrobond, SEB

Budget revenues under pressure from inflation & strong RUB



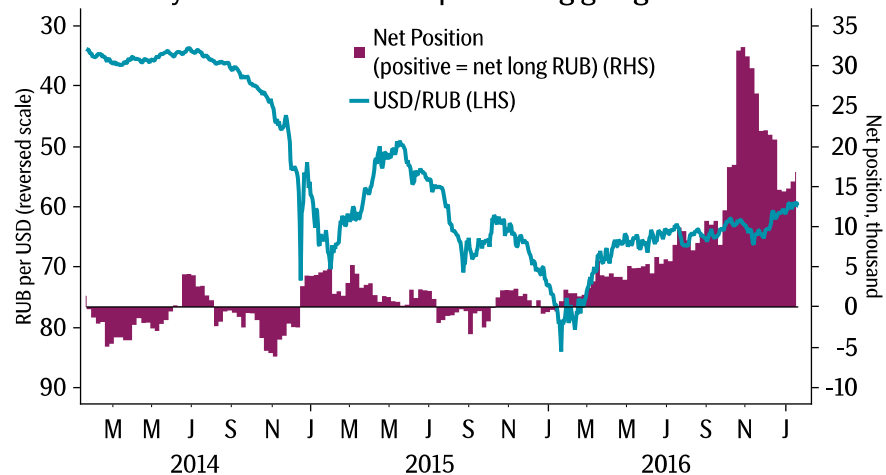
Source: Macrobond, SEB

Downside potential in OFZ yields luring investors



Source: Bloomberg, Macrobond, SEB

Very RUB bullish investor positioning going into 2017



Source: Commodity Futures Trading Commission (CFTC), Macrobond Financial AB, SEB

# Chinese yuan: gradual and limited decline ahead

## CNY WILL DEPRECIATE SLIGHTLY VS USD TO END 2017 AT 7.05.

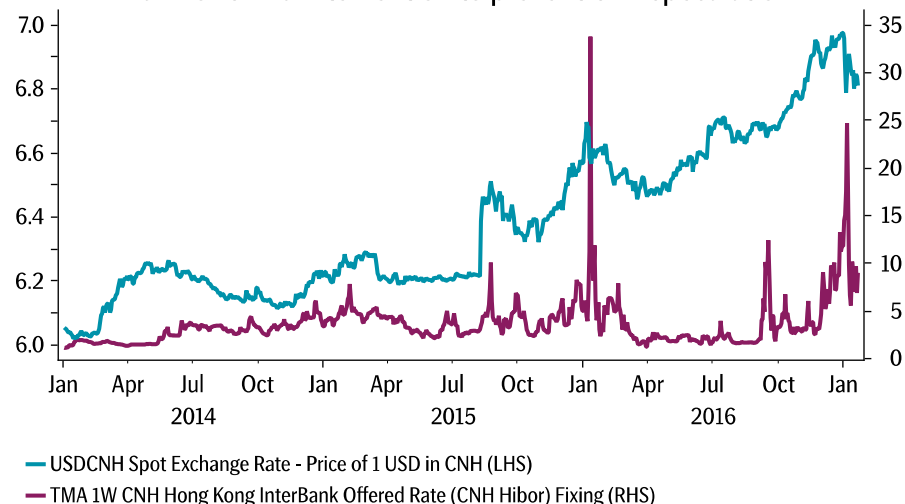
Relative fundamentals of weaker Chinese growth vs an accelerating US economy with rate hikes will weaken CNY. CNY will become a cyclical currency like all other currencies and we don't see a recovery in CNY until economic fundamentals accelerate. The economy will continue its slow grind lower from 6.7% (2016) and 6.6% (2017). Manufacturing and heavy industry will be the main drag on growth as the government rebalances towards less capital and debt intensive services and consumption. President Xi will move forward with lower growth as a cost to avoid a debt crisis in the future. Monetary policy will be slightly tighter, which will buffer CNY weakness. The government will tighten to prevent reverting to the old borrow and grow model and rising property prices that can increase hard landing risks. The government adjusts by regulation and window guidance and thus interest rate levels will not change. CNY weakness will also be limited in 2017 because of the political transition and President Xi will limit volatility before the transition.

The CNY policy changed in 2016 to be managed more on a basket rather than vs USD. Current policy is to keep CNY stable on a trade weighted basis, which resulted in bigger moves in USD/CNY due to big swings in EUR/USD and other trade partners of China. SEB is expecting most of the DXY move to be priced in and hence the limited move in USD/CNY.

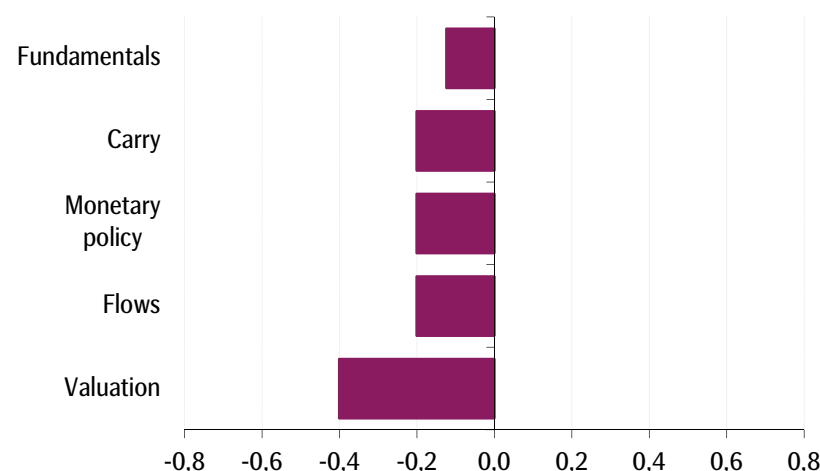
## LONG-TERM OUTLOOK: CNY will be under weakening pressure until it further opens up the capital account.

Current account surplus is diminishing as Chinese tourists travel more abroad. Capital outflows are occurring as Chinese savings get diversified into non-RMB assets. China needs to allow more foreign capital to get the CNY back stronger again.

Bank of China Intervention to prevent CNY speculation

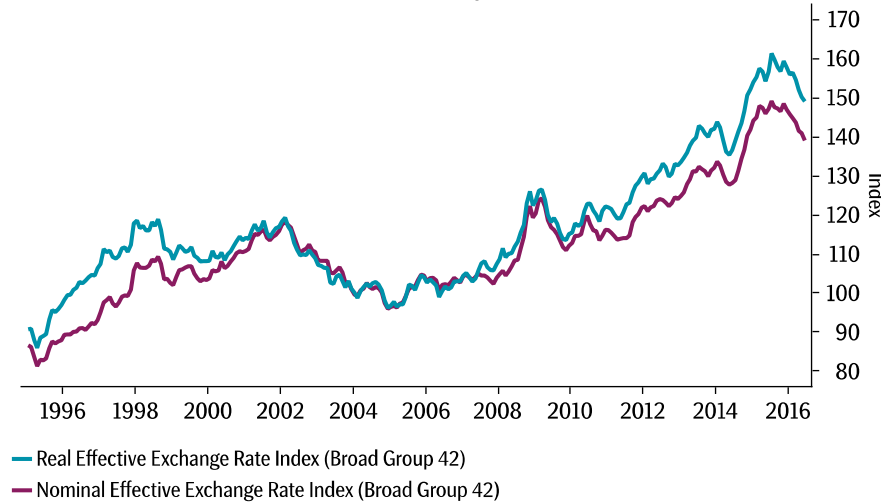


## CNY Weighted score: -1.1

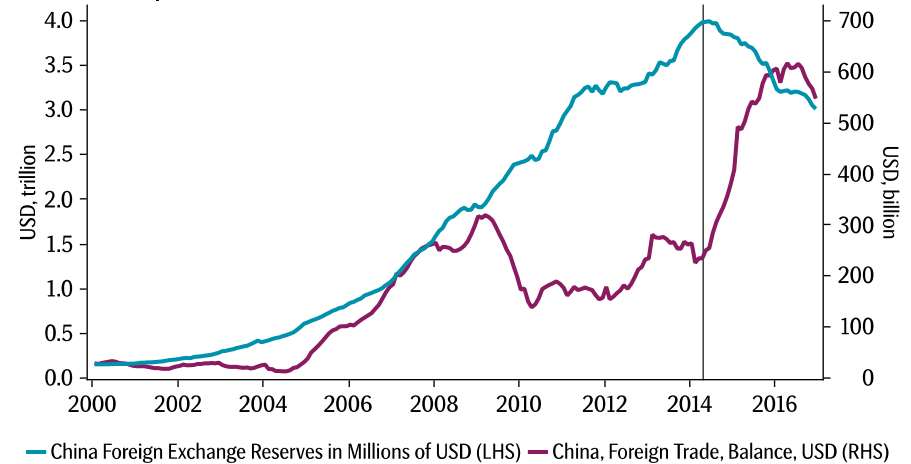


# Chinese yuan: USD pause to limit capital outflows?

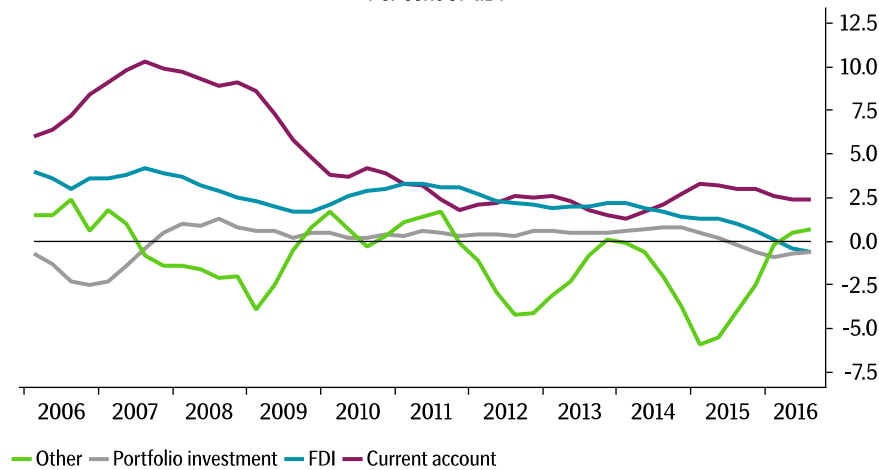
China, FX Indices, European Commission



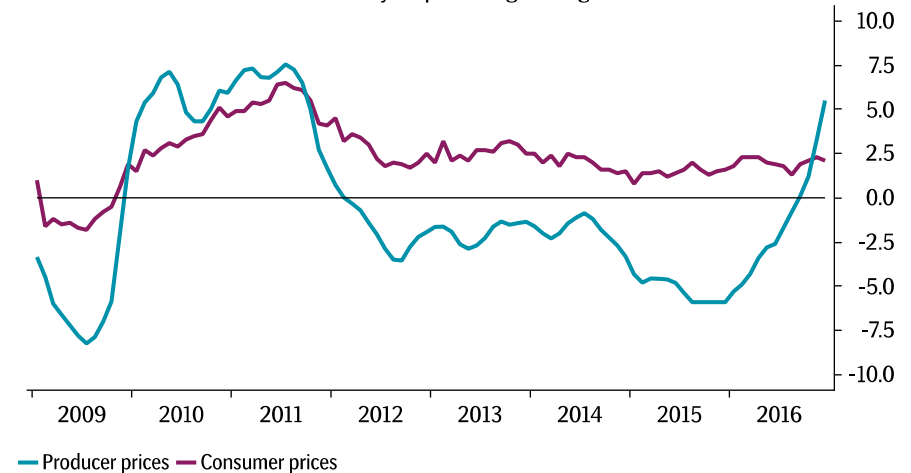
FX Reserves falling despite elevated Trade surplus  
Capital outflows amount to USD 2.4 trn since mid-2014



China BOP  
Per cent of GDP



China: PPI & CPI  
Year-on-year percentage change





# Notes

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# Themes

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Themes	Pages
US economy and Trump	32-35
Brexit and the GBP	36-38
Swedish krona	39-42
Norwegian krone	43-47
Investment styles	48-49
Low volatility environment	50-51
EM Resilience	52-53

# Fed policy: Gradual tightening this year and next

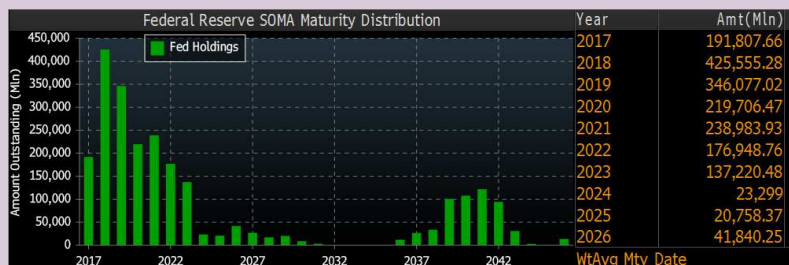
**Fed policy:** The Fed will *gradually tighten monetary policy*. We expect 2 rate hikes in 2017 (Jun & Dec) and 3 hikes in 2018. Less than the Fed forecast but more than priced by the market.

**Rule based policy:** Republicans have previously argued for a more rule based approach for monetary policy => Most rules indicate a much higher policy rate.

## Cease reinvesting maturing bonds?

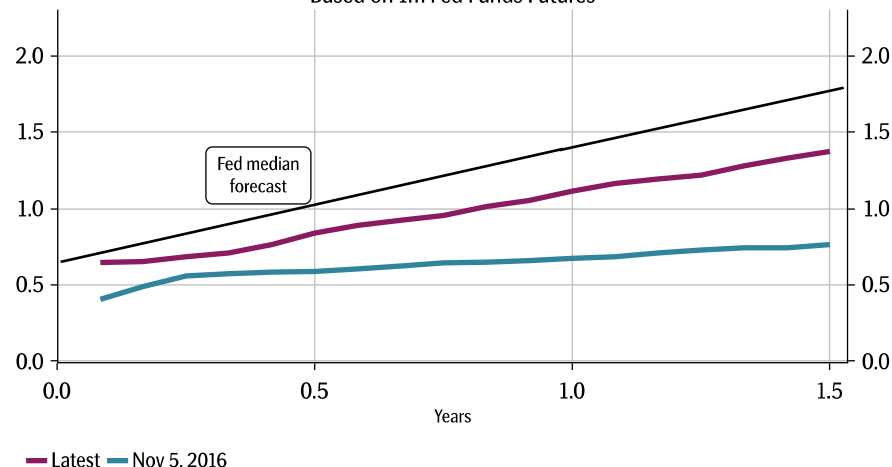
The message has been that the Fed will continue to reinvest coupons and maturing bonds *until some time after they begin raising interest rates*.

- Has recently been suggested by FOMC-members as a less dollar positive way of tightening monetary policy.
- **Passive policy tightening:** The fact that average maturity in Fed's bond portfolio declines and the end-date for reinvestments draw closer => Upward pressure on 10y treasury yield estimated to 15bps  $\approx$  +50bps in Fed funds.
- **Asymmetric risks:** Fed funds rate still too close to zero bound. Limited scope to use monetary policy to respond to negative shocks.
- The Fed will discuss ceasing reinvestments this year but it is unlikely to be implemented before 2018.
- Large expiries in 2018 => will continue to reinvest a proportion of maturing bonds.

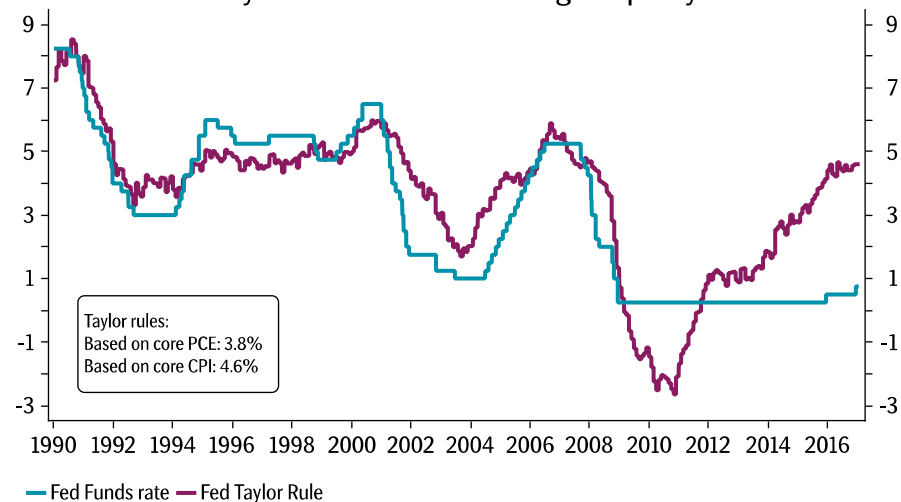


## Fed Market expectations and FOMC forecast

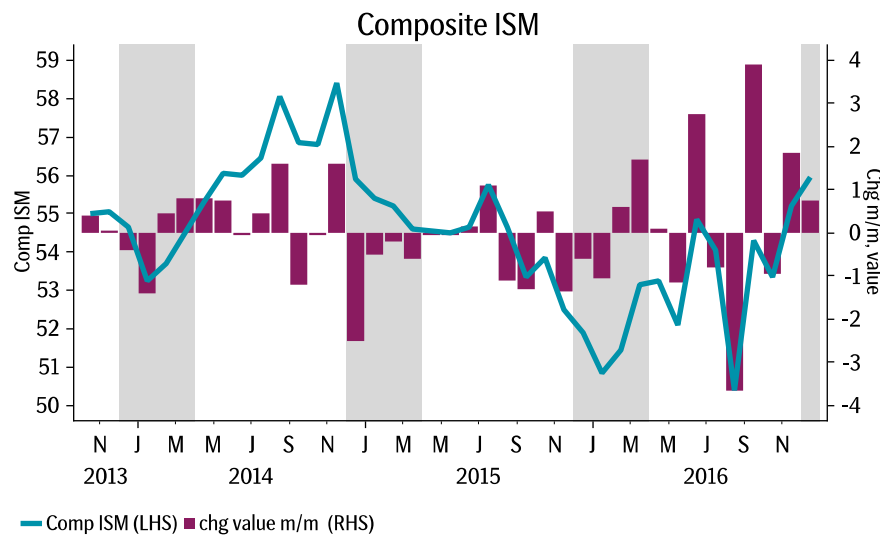
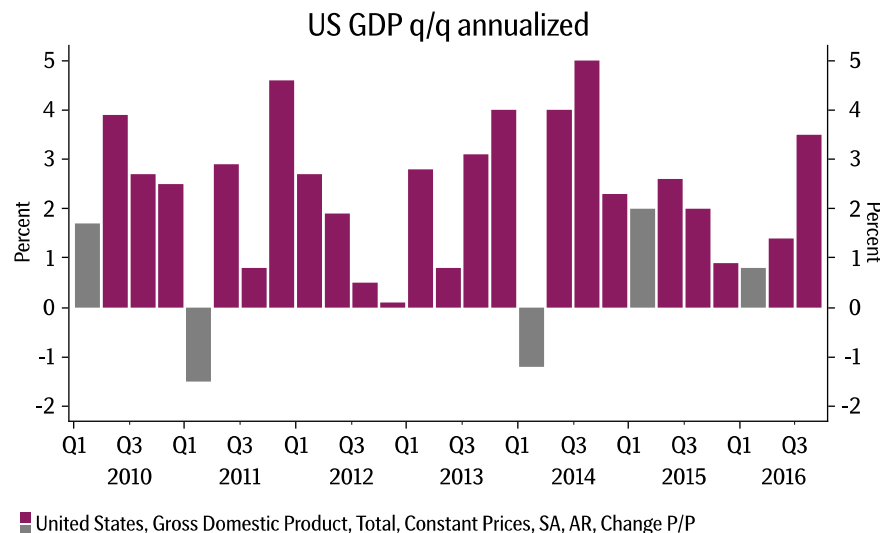
Based on 1m Fed Funds Futures



## Taylor rules indicate much tighter policy



# US economy: Weak Q1 growth unlikely this year



- In 5 out of the 7 last years since 2010 US growth has disappointed in Q1.
- Sometimes weakness has been related to unusually bad weather conditions, but the weather impact is probably not enough to explain Q1 weakness.
- Generally the Q1 weakness seem to be related to weaker than normal growth in household spending (weather related or due to incorrect seasonal adjustment). However, every time, except last year, it was also combined with negative contributions from net trade, inventories or public spending (in 2011).
- Should the economy disappoint again it would most likely be very negative for the dollar outlook considering that most of the appreciation since the US election in Nov last year is related to expectations of stronger US growth.
- Traditionally the ISM has served as reliable leading indicator for growth. **Considering the last three years when growth has been weak in Q1 it followed either on falling business sentiment, which begun already in Q4 in the previous year or a very low PMI-level.**
- However this time the composite ISM (manufacturing and service sector) has recovered in Q4 and currently it is at levels normally combined with above trend growth.

=> Weak Q1 growth **seems unlikely** in 2017

# Trump economic policy

So far we can only speculate what sort of economic policy Trump will introduce.

## What we have figured out so far:

- Substantial cuts in income taxes for households and businesses: **USD 5tn** in reduced revenues over next decade
- Plans for infrastructure spending: **USD 1tn** over 10 years
- Extensive plan for reducing federal bureaucracy and spending: **USD 8-10tn** in spending cuts over 10 years (Document with main priorities expected to be published in **45 days** from installation and a comprehensive budget to be presented in **100 days**.)
- The net impact on the federal budget and the debt situation of Trump policy are very uncertain as there are still few details revealed on planned spending cuts
- Consequently the net impact on US growth from the various proposals is extremely difficult to estimate given all the uncertainty. We expect that the net effect will be positive for growth in coming years and particularly next year. We are a bit cautious though.
- Changes in tax levels and some spending cuts could be implemented already in June to August this year. However, infrastructure spending and changes in tax bases are likely to take longer to implement.

## Trump tax proposals

### Individual income tax:

- Lower the top income tax rate from 39.6% to 33%
- Increase standard deductions to \$15,000 (\$6,300 in 2015).
- Tax dividends and capital gains at a maximum rate of 20%

### Business tax:

- Reduce corporate tax rate to 15% from 35%
- Limit top individual income tax rate on pass-through businesses to 15%
- Impose a one-time transition tax of 10% on existing, unrepatriated foreign income.
- Simplify the tax code and close loopholes

## The “border tax” (Border adjustment tax)

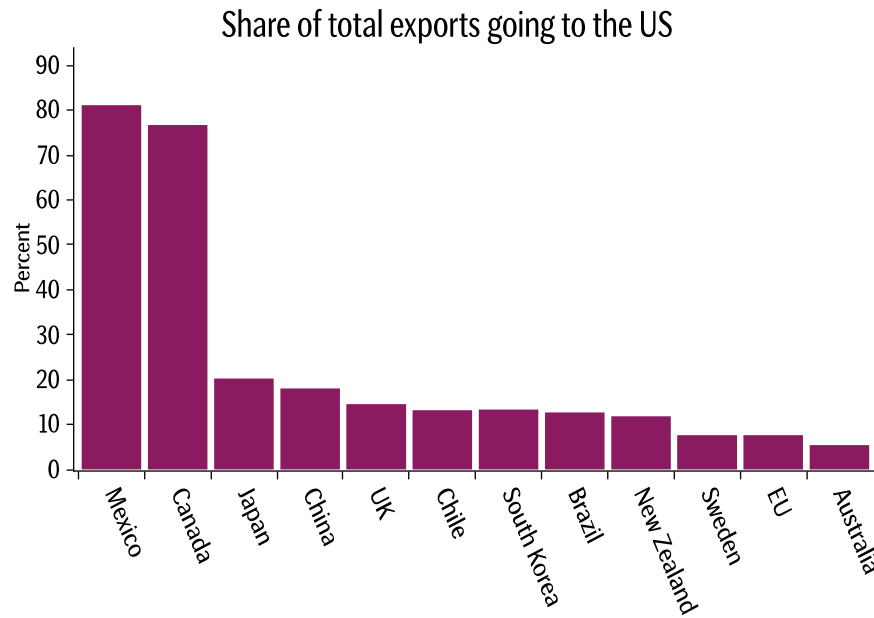
*‘We Are Going to Be Imposing a Very Major Border Tax’ Trump, Jan 23*

### What is a border adjustment tax?

- Generally a border adjustment tax means that businesses will be taxed based on the destination basis. Products and services exported outside the US will not be subject to US tax while imported products sold in the US will subject to US tax regardless of where they are produced.
- However, according to WTO rules border adjustments are not permitted for direct taxes (income tax)
- Therefore the approach for taxing business income in the US has to change to allow for border adjustment taxes.
- GOP suggest changing business taxation from an income to a cash-flow approach. Investments are fully deductible...which is similar to a consumption based tax.

**=> Imposing a border tax would be USD positive**

# Trump trade policy



**Background:** Reviving the ailing manufacturing sector is one of Trump's key objectives and according to Trump the sector's weakness is a result of unfair competition from countries such as China and Mexico => **protectionism is the Trump administration's "solution" to support the manufacturing sector.**

## US trade policy to shift towards protectionism

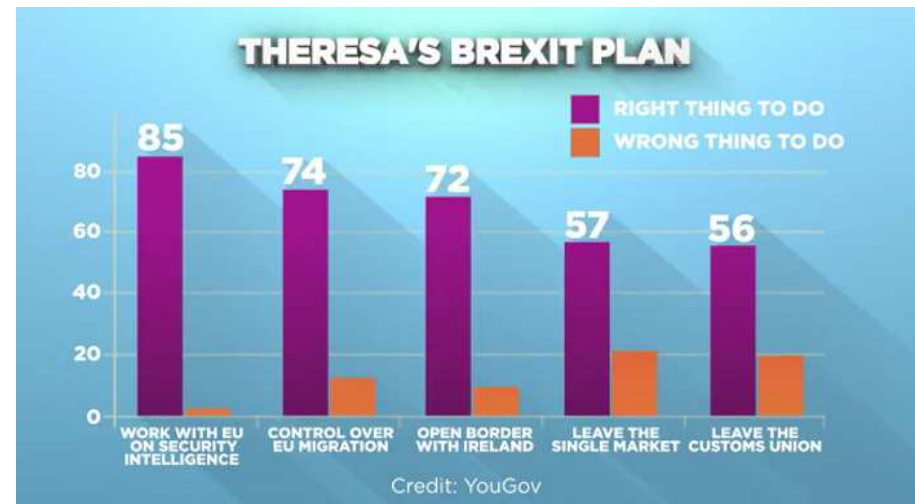
- Hopes that Trump's economic advisors and the traditional support for free trade among Republicans would moderate his fiercely protectionist stance in the election campaign has not materialized so far.
- The trio Lighthizer, Navarro and Ross, all with key positions in the new administration, have protectionistic and China critical views.
- US presidents have good opportunities of launching trade restrictions through a variety of laws and statutes, allowing for imposing tariffs or quotas.

## What to expect?

- The Trans-Pacific Partnership (TPP) will not be ratified
- Renegotiate NAFTA with Canada and Mexico
- Partnership (TTIP) trade agreement between the US and the EU is unlikely to be sealed.
- During the election campaign Trump suggested that high across the board tariffs should be introduced on US imports from China and Mexico.
- China has excellent opportunities to retaliate against US tariffs and is likely to respond in a proportional manner through introducing own tariffs. China could restrict market access for US companies operating in China.

# UK: Brexit – from member to partner

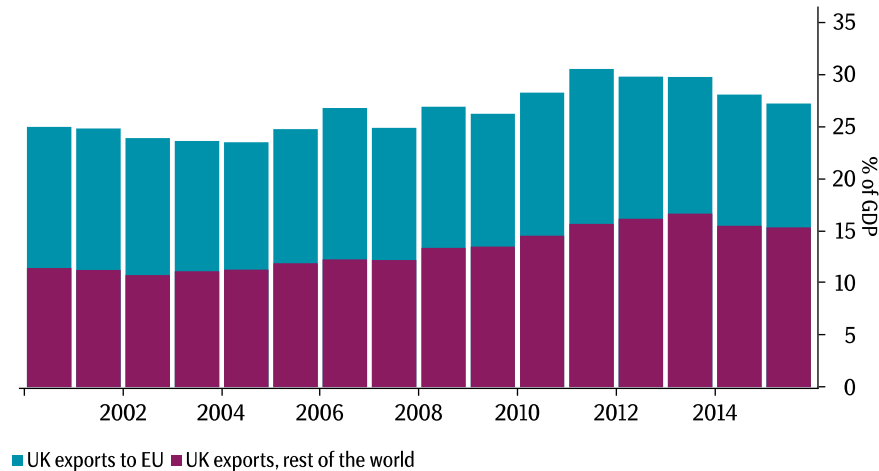
- After the government revealed its plan for leaving the EU it is now time to move from talk to action. However the parliament will have to approve initiating exit negotiations.
- Wide public support for her Brexit plan among voters according to YouGov survey
- Being part of the single market is not an option as long as the UK wants to control immigration from other EU countries => replace today's membership with a new partnership including a free trade agreement with EU and continued cooperation in certain areas.
- A deal on leaving the EU and a new free trade agreement have to be negotiated within the 2-year time frame, which in reality means 18 months as all EU-members must approve the deal. Both chambers in the British Parliament will have to approve the deal.
- PM May opened up for a phased process, a transitional period for implementing the new regulations to avoid a cliff edge.
- Financial contributions to EU from Britain will end after the divorce.
- British threats in negotiations:
  1. Exports to the UK from the EU exceeds British exports to the EU.
  2. More aggressive tax competition.



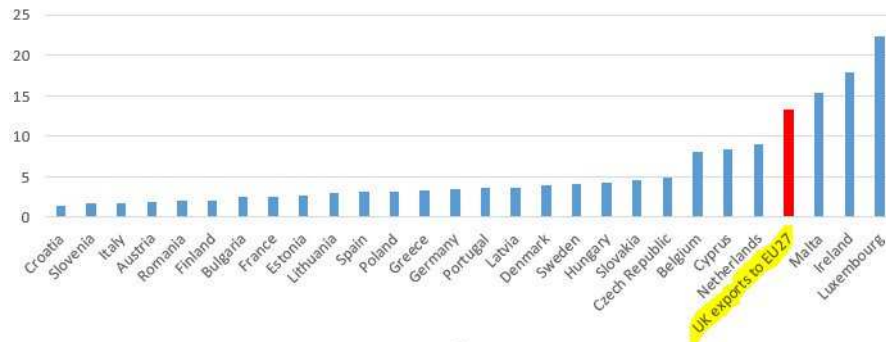


# UK: Hard Brexit – what's at stake?

UK exports to EU and the rest of the world  
% of GDP



Exports of goods and services: EU members to UK and UK to EU27  
Measured as a percentage of their GDP in 2014  
Source: Eurostat; ONS; World Bank



- Currently almost 44% of UK exports (goods and services) representing 12% of British GDP go to countries within the EU.
- This is one reason why it would be very negative for the economy if the UK would fail to reach a free-trade agreement with the EU and instead had to rely on WTO-regulation.
- According to IMF estimates a hard Brexit would cause UK GDP to fall by approximately 5% to 2020.
- The value of imports to the UK from other EU countries is, however, even larger. In 2015 the UK trade deficit with the rest of EU was almost EUR 90bn. This has been used as an argument why the UK will have a strong position in exit negotiations. However, the proportion of exports going to the UK is much smaller in most EU countries except Ireland, Luxembourg and Malta.
- The financial sector is also vulnerable. According to the IMF approximately one third of exports of UK financial services are to EU countries.
- Financial sector: Loosing its passporting rights 40-50% of EU-related activity in the British financial sector may disappear, representing around GBP 18-20bn in annual revenue and more than 30,000 jobs in the financial services sector \*(i.e. roughly 5-10% of all jobs in the financial sector).

\* Report by Oliver Wyman

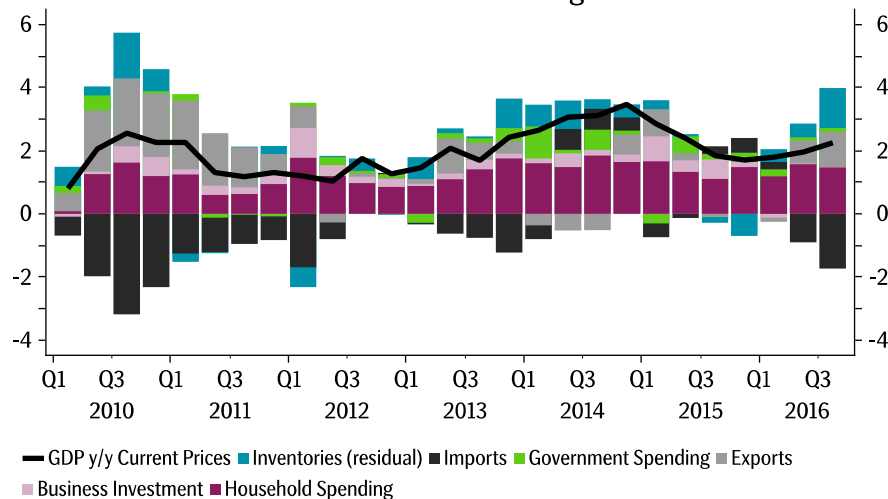
# UK: Worrying signs that spending might slow

- Household spending has been the main reason for UK growth since 2013 supported by rising employment, increasing house prices and lower savings.
- Recovery in consumer confidence after summer seems to have been short-lived and it has declined again in recent months. In Dec retail sales fell by almost 2% from previous month – biggest drop since 2011.
- Data indicates that annual growth in nominal wages is around 2.8%. We expect inflation to rise to towards 3%, which means that real wage growth could be almost flat.
- In recent years households have lowered savings and this is unlikely to continue from today's level.
- Weak consumption growth is clearly a downside risk for UK growth and the GBP going forward.

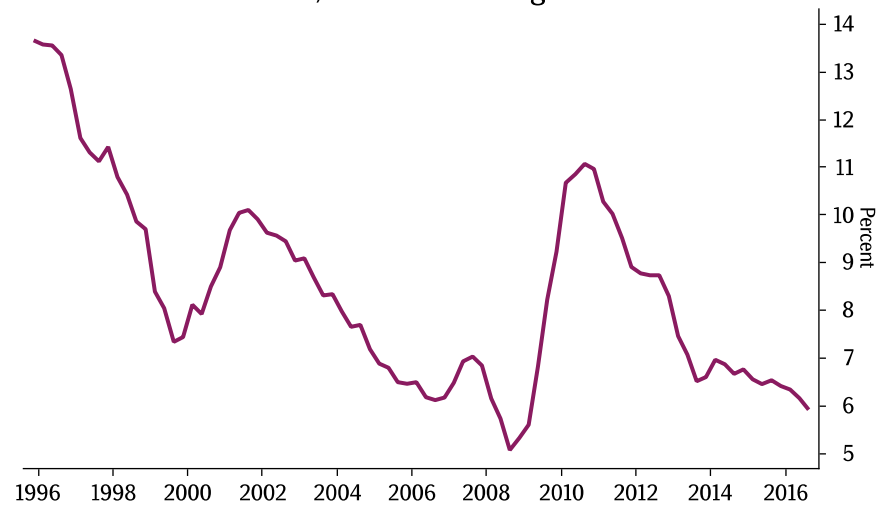
United Kingdom, Consumer confidence



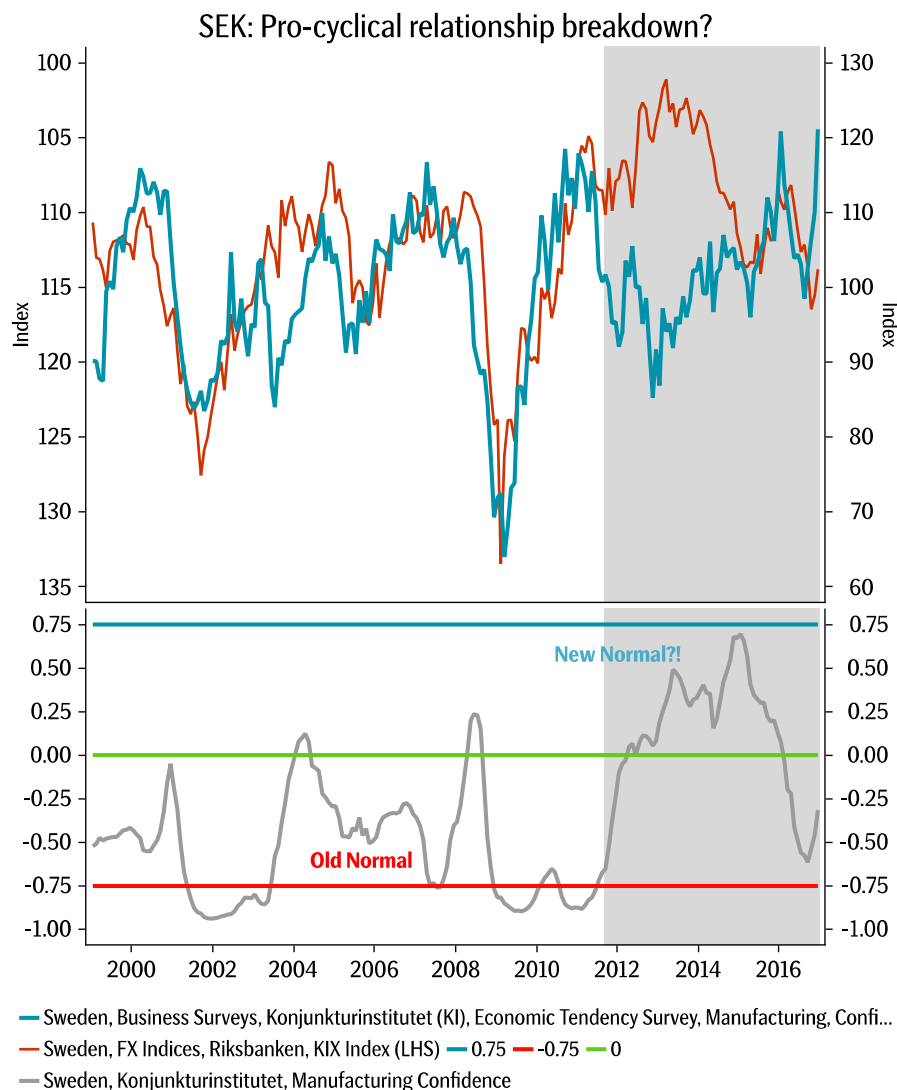
UK Contribution to annual growth



UK, Household Saving Rate



# SEK is not a pro-cyclical currency?



**DON'T EXPECT A MATERIALLY WEAKER SEK IN THE NEXT ECONOMIC DOWNTURN.** We have made a deeper study of the Swedish balance sheet and found that Sweden probably has a larger **positive net Investment Position** than officially stated by Statistics Sweden (**today +5-10%/GDP**). Assets understated are likely to be found in the corporate sector (net FDIs held abroad). Positive SEK-flows which could emanate from this characteristic of a more defensive currency are: 1) increased equity hedging of FDI and/or; 2) repatriation of capital held abroad for investment purposes on-shore. Although we hold both as relatively unlikely (especially #2) we do expect some positive SEK flows on the back of increasing equity hedging 2017. As regards portfolio investments, Sweden **holds a large positive net equity position** (and is instead indebt-ed to foreigners in debt related instruments). Periods of falling risk appetite has meant that foreign held equity funds have been sold and repatriated back home. This is what happened during H2 2015 (falling equity markets) contributing to a stronger SEK as Sweden net sold foreign equities. And in H1 2016 the reverse took place as risk appetite improved and equity capital left for foreign markets.

Apart from a strong(er) balance sheet, **Swedish growth continues to be driven by domestic factors**. This means growth in Sweden will not be as sensitive to the global growth cycle as before. The final argument for expecting a less pro-cyclical SEK comes on the back of the combination of an **undervalued currency combined with an open domestic exposure to FX**. We expect Swedish clients to lower their FX exposure in general.

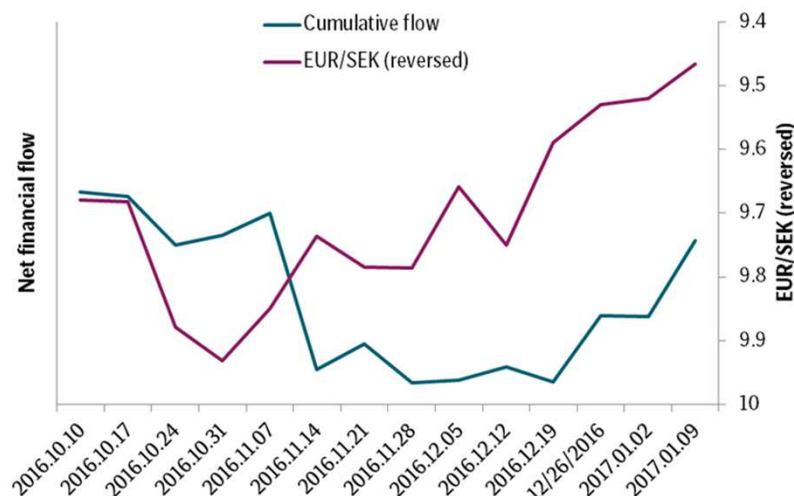
# SEK: flows moving EUR/SEK from 9.50-10.00-9.50

**WHO SOLD AND THEN BOUGHT SEK?** SEK suffered from being a **funding currency H2 2016** with a negative repo rate and Stibor rates between -0.5% to -1.0%. This was a period when Riksbank monetary policy and the **implicit exchange rate target** finally became **credible** with market participants (negative rates dominated strong fundamentals). Immediately after Brexit and during periods of risk-off over summer EUR/SEK appreciated to the levels (9.50/60) where most market participants looked to buy SEK -> our **SEK Views survey revealed on Oct 19th** that the **market was near-record long krona**.

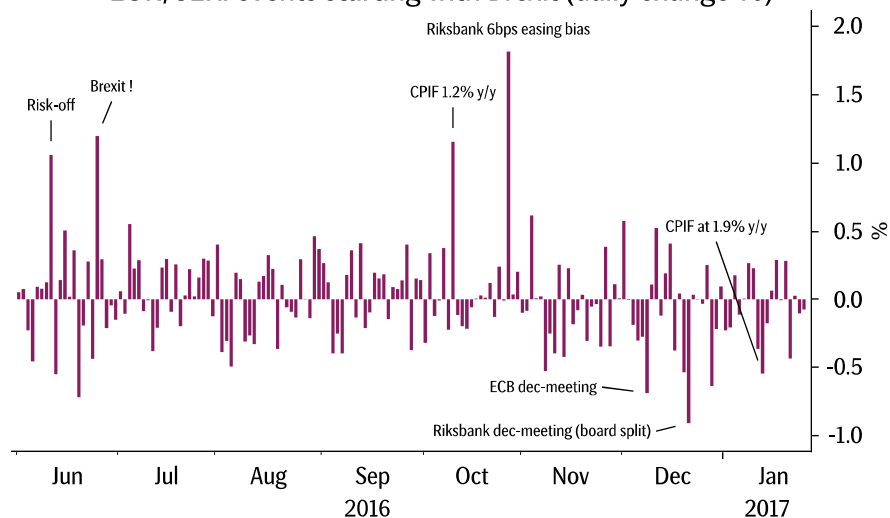
The outlook for FX hedging changed as **CPIF (sept)** surprised substantially on the downside (1.2% y/y) and **Riksbank** followed-up with a **6bps easing bias** at the Oct 27<sup>th</sup> meeting. Stop-losses on previous SEK buying followed as Riksbank made its best to weaken the exchange rate. We also think that part of the move higher was driven by algo **and momentum-driven trading strategies** although most of the sharp rise higher to +10.00 primarily came from stop-losses from local accounts. Looking at our **internal SEB speculative flows**, it is unfortunately not clear who were the main EUR/SEK sellers. Financial institutions have only started to buy SEK again following the “hawkish” Riksbank rate decision on Dec 21<sup>st</sup>.

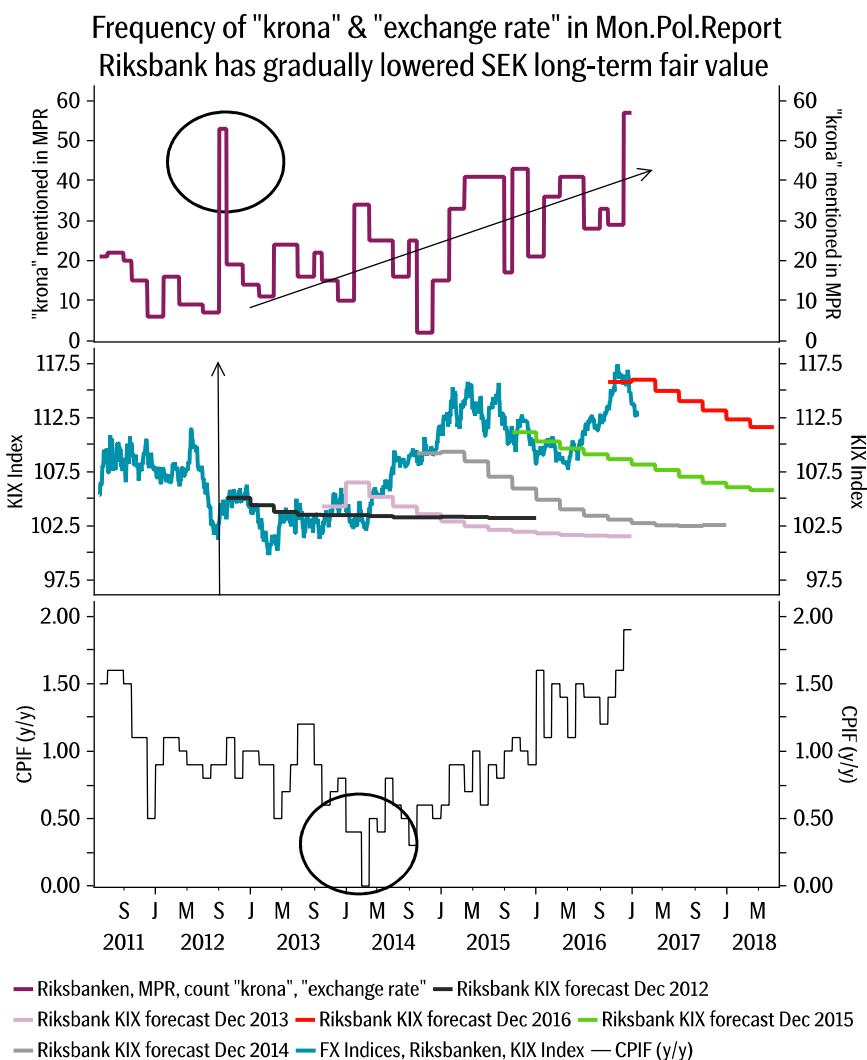
**Monetary policy clearly governs the outlook for SEK.** Looking at the daily changes in EUR/SEK it is fairly clear the major moves up and down has been generated by events connected to the outlook for monetary policy. The future development will surely continue to depend on inflation and central bank policy outlook.

SEB SEK speculative flows  
Financial flows not behind the early SEK recovery Nov-Dec



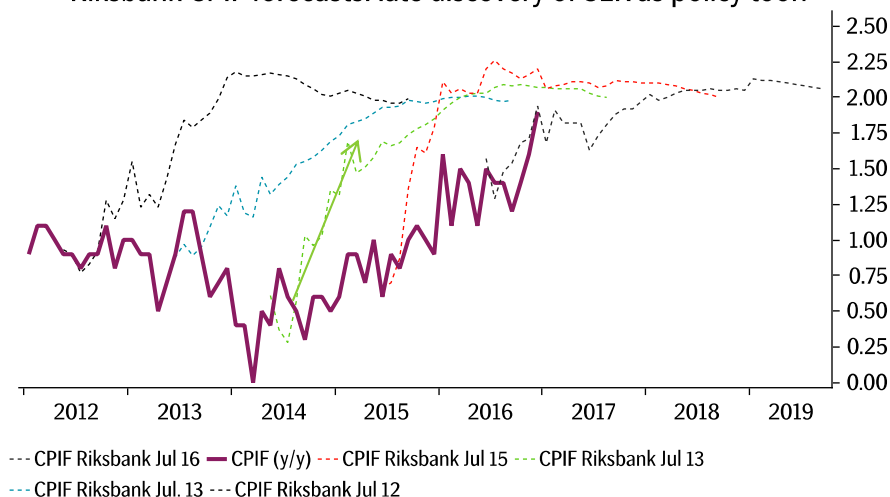
EUR/SEK: events starting with Brexit (daily change %)





**THE 100% FOCUS ON SEK TO ABATE?** Swedish FSA has the responsibility for financial stability since 2013 -> Riksbank has focused solely on its inflation target. Looking at the **frequency of “krona” and “exchange rate”** in the Monetary Policy report, the record-strong SEK 2012 only temporarily increased the frequency (sept 2012). Hence despite a strong SEK and very low CPIF, Riksbank **showed no “panic” most probably related to their faith in their inflation forecasts** pointing towards 2% in the not too distant future. Since 2014 the focus on the SEK has steadily increased as CPIF failed to increase in-line with the very optimistic Riksbank forecasts. Today Riksbank has a **more “reasonable” inflation forecast today** which should make the current elevated focus on SEK starting to decline as spot CPIF and inflation expectations are near the policy target -> **less sensitivity to the exchange rate is anticipated** .

## Riksbank CPIF forecasts: late discovery of SEK as policy tool?

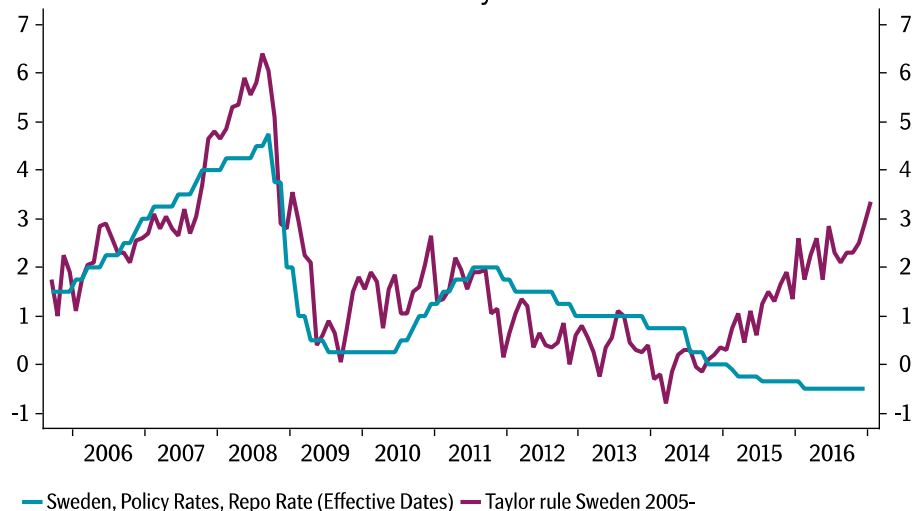


# Repo rate hike will undoubtedly appreciate SEK

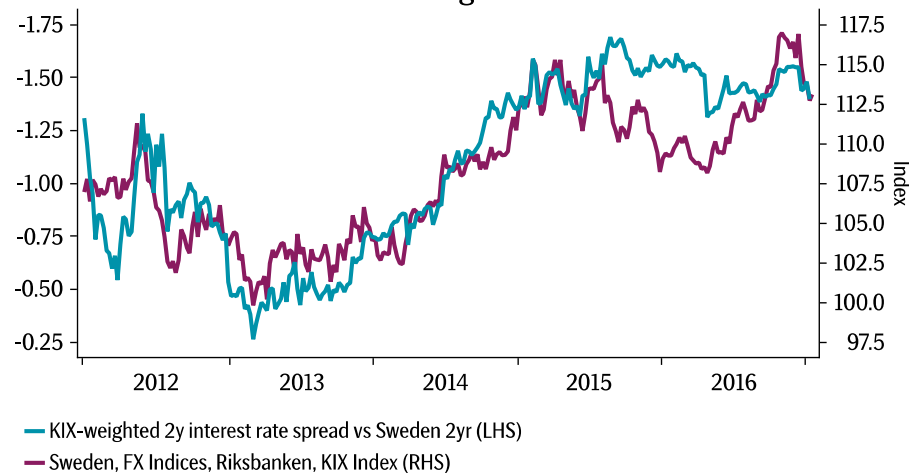
**"IMPOSSIBLE" TO CURB SEK STRENGTH AS REPO RATE IS HIKED.** Although concept such as NAIRU is debated today (very hard to estimate where the labour market equilibrium is), the Taylor rule for Sweden nevertheless tells a fairly convincing story for how Riksbank has conducted policy over the past 2-3 years. Low spot inflation/inflation expectations have pushed policy to a (much) more expansionary level compared to what the Taylor rule stipulates. The Riksbank (implicit) exchange rate target pushing interest rates below trading-partners has finally worked – obviously with the consequence of further inflating an already hot domestic housing market.

**Now, Swedish growth is driven primarily by domestic demand, the weak exchange rate will contribute to an improving outlook for exports as well.** This is the reason SEB continues to forecast GDP growth above trend in the coming year. With CPIF and inflation expectations near target we anticipate rates to be increased in dec-17. Adjusting the policy rate to positive territory (lets say to 0.5%) will undoubtedly strengthen SEK – the simplistic rule in the chart (bottom right) indicates KIX will move back towards the lows in 2013/14. The risk of a too strong exchange rate will not be accepted by Riksbank near-term (as it may derail to surge in spot CPIF). But worth remembering also is that the outlook for Swedish Financial conditions (and implicitly future GDP development) is almost uncorrelated to the level of the krona – inflation has, is and will be the focus as regards SEK). **The conclusion to make is that the upcoming Riksbank tightening cycle will be very gradual as long as underlying inflation risks falling back on too strong a currency. We would buy SEK and possible hedge by longer-dated FRAs.**

Sweden: Taylor rule



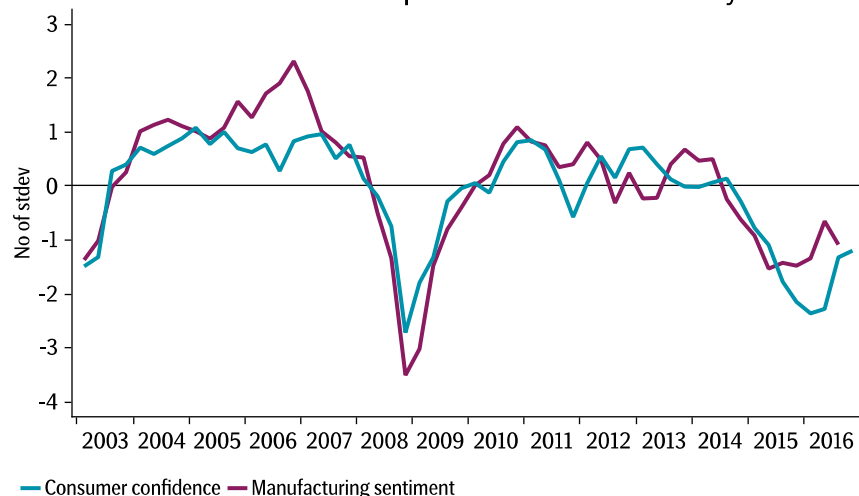
KIX trading "in-line" with KIX-weighted interest rate spread  
Riksbank rate hike would strengthen SEK back to 107-110 area





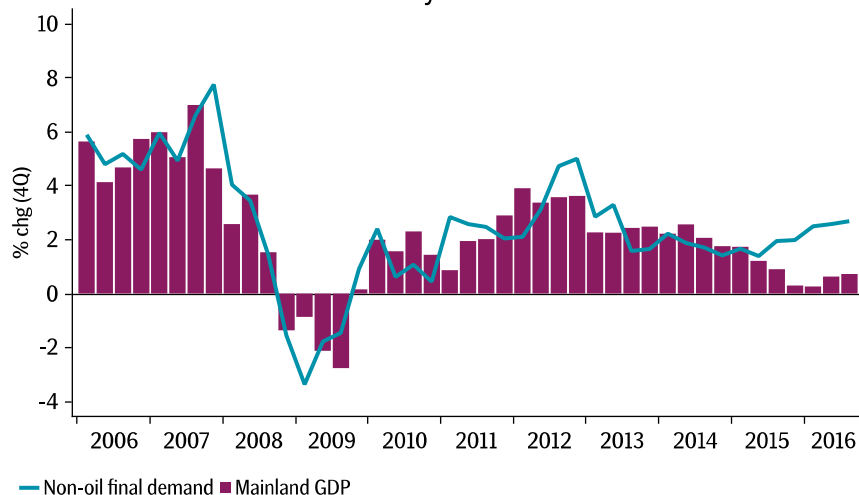
# Norway: A short relief rally or sustained recovery?

Still weak sentiment points to a modest recovery

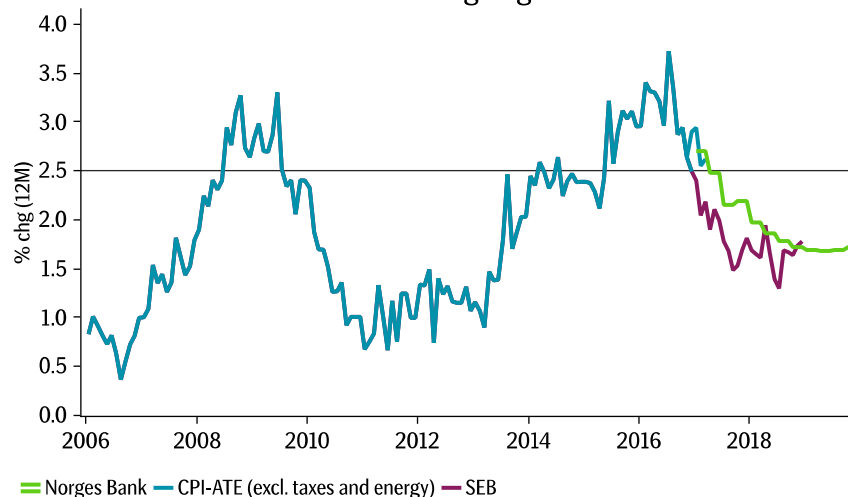


- **Ongoing but moderate recovery:** The economic upswing is driven by non-oil domestic demand, in particular a turn in private mainland investment. Still weak sentiment points to a modest recovery.
- **An uneven recovery:** Continued contraction in petroleum investment (although less than in 2016). Suppliers to the oil industry are negatively affected by the domestic and global capital spending cycle.
- **Labour market slack remains high:** Unemployment has peaked but sluggish growth and a job growth which will broadly match the increase in the labour force will keep unemployment high.
- **Inflation below target:** Muted wages and service inflation imply that core CPI will ease when the NOK effect subsides.

Growth driven by domestic demand



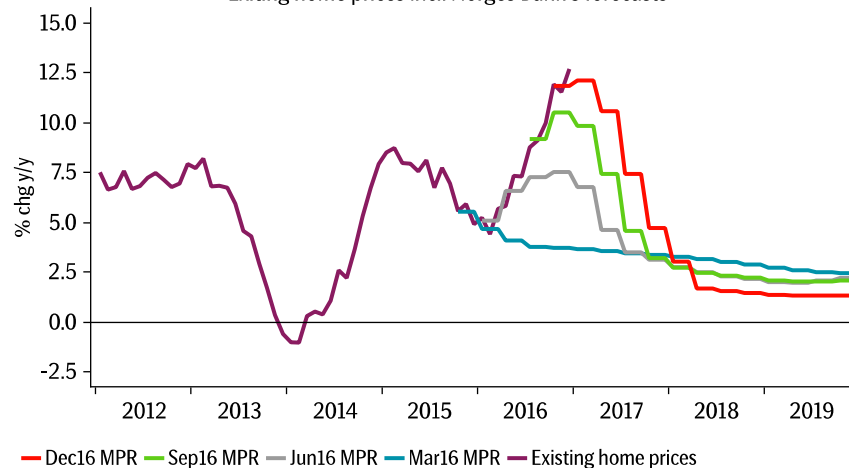
Inflation to ease going forward



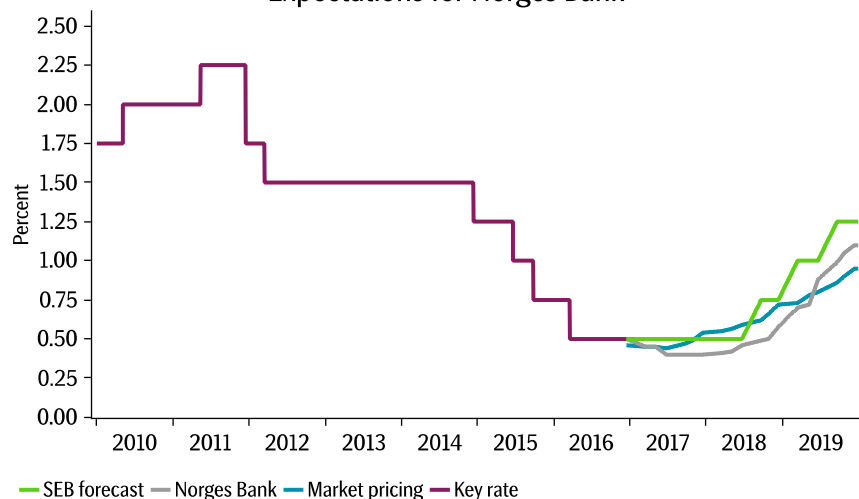
# Norges Bank's policy dilemma

- **No further rate cuts:** Brighter growth prospects and rising financial imbalances (due to accelerating home prices) suggest both the need and willingness to cut rates further have disappeared.
- **Rate path with a dovish bias in 2017:** Stronger NOK and still very loose monetary policy abroad. Verbal interventions cannot be ruled out should NOK appreciate rapidly and more than suggested by fundamental factors.
- **On hold until late 2018:** Growth remains below trend and inflation will ease suggesting NB will be in no hurry to hike.
- **Risks:** A more rapid downturn in core inflation would motivate NB to remain on hold for longer and maintain a strong focus on the exchange rate.

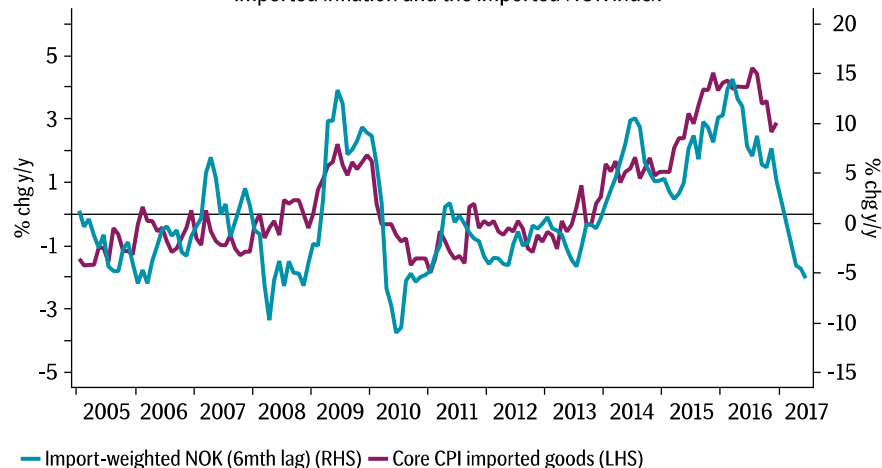
Rising financial imbalances...  
Exiting home prices incl. Norges Bank's forecasts



Expectations for Norges Bank

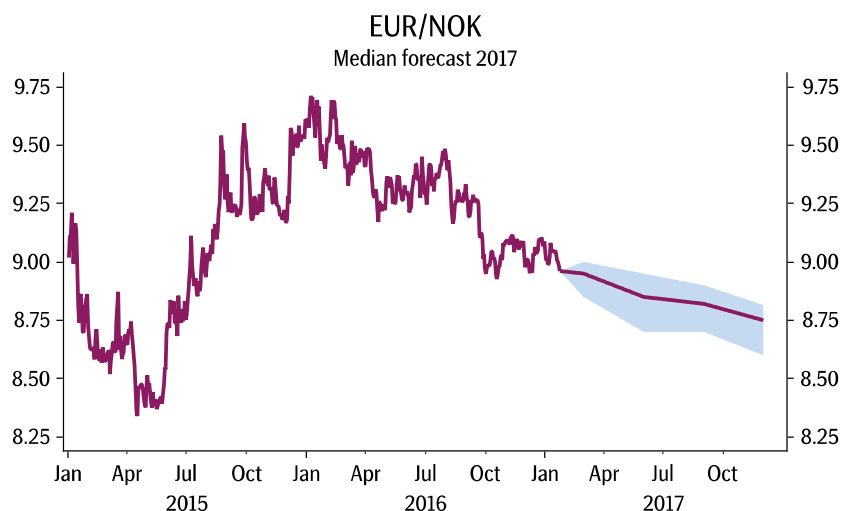


...but easing inflationary pressure  
Imported inflation and the imported NOK index





# Stronger NOK and SEK are 2017 consensus bets



Median FX forecasts for 2017

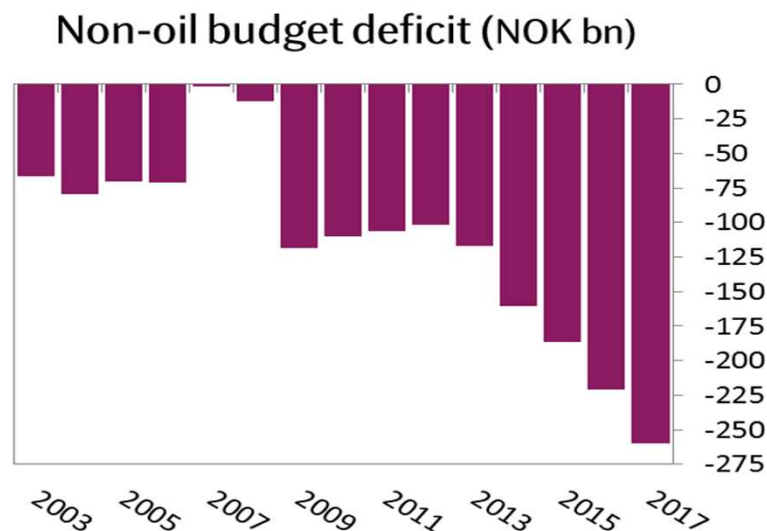
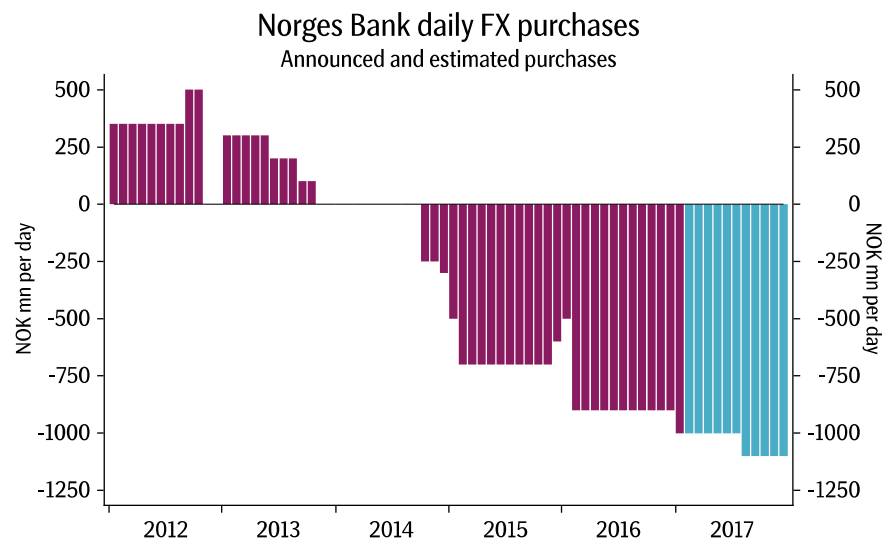
	Q4 2017 forecast	1st quartile	3d quartile	Norm. Range
EUR/USD	1.06	1.02	1.10	7.7%
USD/JPY	112.5	107.5	117.0	8.1%
GBP/USD	1.25	1.20	1.30	8.1%
EUR/NOK	8.75	8.60	8.82	2.4%
EUR/SEK	9.25	9.00	9.50	5.2%
AUD/USD	0.73	0.71	0.76	6.9%
NZD/USD	0.68	0.66	0.71	6.5%
USD/CAD	1.36	1.30	1.41	8.2%
EUR/CHF	1.10	1.07	1.12	4.7%

Source: Bloomberg

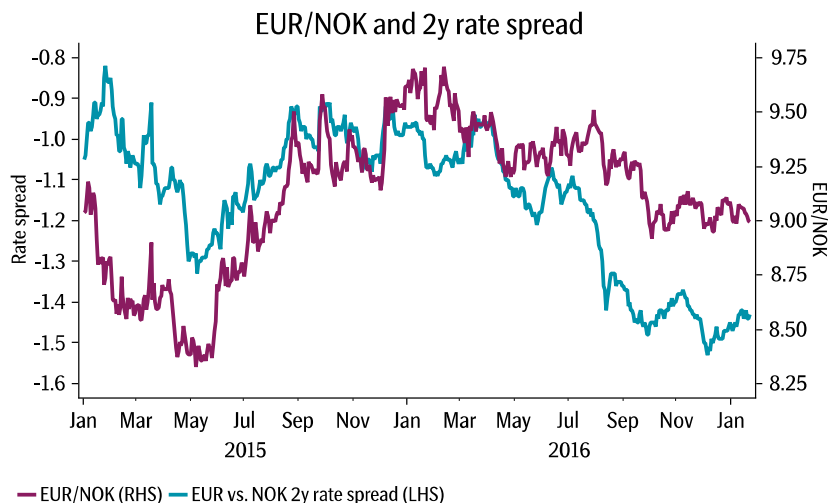
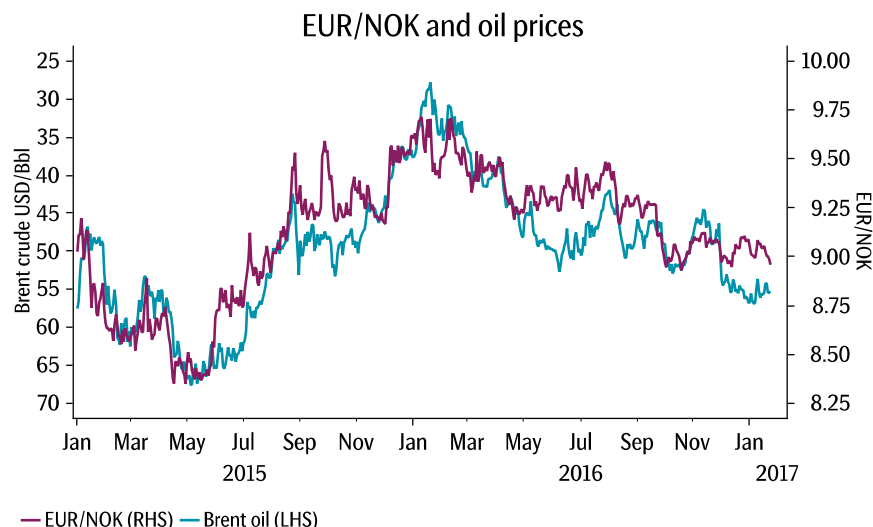
- A firmer NOK (and a higher SEK) appear to be the most obvious consensus bets for this year. Based on the median estimate EUR/NOK is expected to reach 8.75 towards the end of 2017.
- Projections are skewed towards an even stronger NOK with the interval between the first and third quartiles of year-end EUR/NOK forecasts being only 22 big figures (8.60-8.82) → this reflects little uncertainty regarding the direction of the currency pair.
- Stronger NOK in 2017 thus seems like a consensus bet and positions may already be on the books. Hence, NOK is vulnerable towards disappointing data/lower oil prices.
- Similarly the general view is that the SEK will strengthen this and the variation in SEK forecasts are also smaller than for most currency pairs.

# Capital flows will be even more NOK-positive 2017

- Norges Bank have announced they will increase NOK-purchases to NOK 1bn per day from Jan 2.
- This is more than 10% above their daily NOK purchases in 2016.
- According to the government budget the deficit will continue to grow to NOK 260bn in 2017 compared to NOK 220bn last year and NOK 185bn the year before.
- Government expenditures will continue to increase by NOK 47bn this year after rising by NOK 60bn in 2016 => **Higher government spending is the main reason why the non-oil budget deficit continues to grow rapidly this year.**
- Government petroleum revenues are expected to increase slightly to NOK 164bn this year from NOK 152bn last year due to the recovery in the oil price. This is, however, well below the non-oil budget deficit, which means the government will continue to tap the oil fund.
- Nonetheless the oil fund is expected to continue to grow this year as total return on the fund exceeds the amount transferred to the government.
- Altogether (based on our view on USD/NOK and the oil price) we estimate that Norges Bank will have to buy around NOK 255bn in the market this year.
- Subsequently not even 1bn/day in NOK-purchases will be enough to cover this amount and we expect them to increase further to NOK 1.1bn in the 2nd half of 2017.
- **NOK-purchases will remain NOK-supportive and historically this kind of amount has had an impact on the NOK.**



# NOK unresponsive to key drivers



- The last couple of years the NOK has traded closely related to relative monetary policy expectations (captured by the 2 year relative rate) and changes in the oil price.
- With the Brent oil price around \$55/bbl the relationship since 2014 would suggest a much stronger NOK around 8.80 against the euro
- Similarly relative rates between Norway and the euro area suggest EUR/NOK should trade just above 8.50.
- In addition Norges Bank has increased daily purchases to NOK 1bn from Jan 2 this year which also should be NOK supportive.

## How come the NOK has failed to appreciate?

### Lack of triggers:

With the NOK trading at long-term undervalued levels most people by now have probably anticipated the NOK will strengthen and are already positioned for a stronger NOK. Indeed forecasts for EUR/NOK appears to have the smallest variation. It probably takes a positive surprise to trigger a move.

### Once burned, twice shy:

Thin liquidity and aggressive central bank policy interventions (verbally and through policy changes) to weaken the currency generated abnormal moves in NOK in 2013-15. This probably generated substantial losses among investors and caused many of them to leave the NOK-market. We doubt they have returned.

### Limited interest:

With the next NB rate decision in March and little information until then the NOK currently flies under the radar.

# Investment styles: Carry dominated in 2016

## CONTINUED CARRY MARKET WITH GLIMPSES OF VALUATION TRADES.

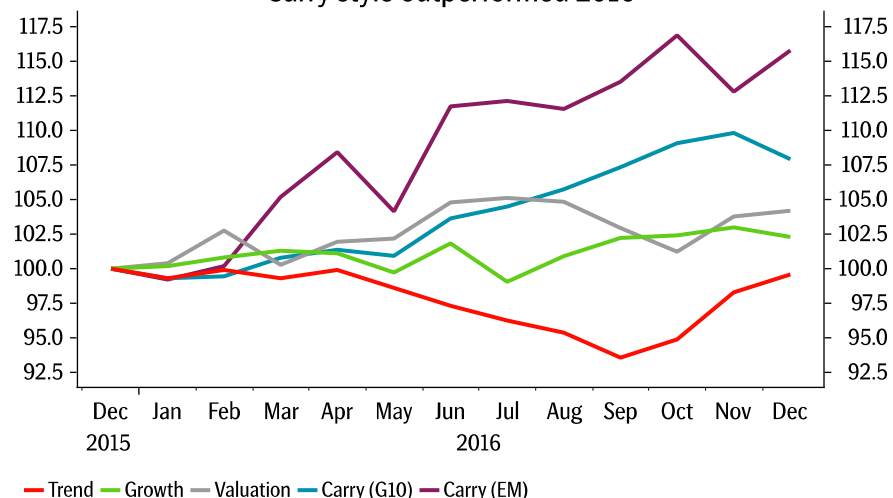
Looking back at how different investment styles performed in 2016 it is clear that **carry** was the theme of the year and especially so EM carry. However, in the spring the **valuation style** also performed well. One reason could have been valuation corrections as uncertainty increased with the Brexit referendum. Clear is however that the positive momentum ceased after summer and valuation ended the year with a more modest gain.

Worst performance came from the **Trend style** which after being flat most of the spring lost five months in a row starting summer (again Brexit?). A hefty recovery in the fall, probably due to trends created by rising expectations of the second Fed hike in Dec, left the trend strategy close to flat over the year.

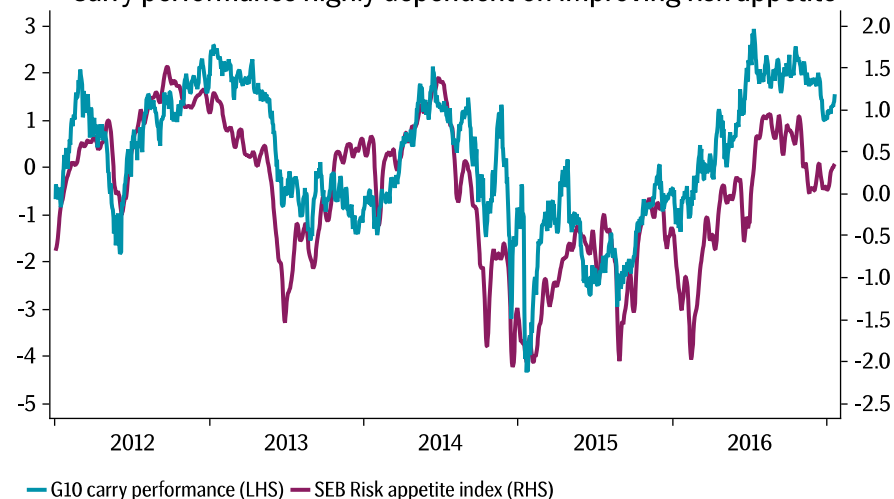
Interestingly our **Growth style** performed well the second part of the year. With more focus being directed to economic growth and rate hikes, this strategy could continue to perform in 2017. However that could be a theme for the second half of the year

As may be seen in the bottom chart to the right, carry performance and risk appetite are in a close relationship. Furthermore, SEB's forward looking GLEI and risk appetite also are closely correlated (see next page). The GLEI is pointing higher this spring (in agreement with generally rising PMI's etc) and thus provides an improving rising risk appetite. Due to this **we expect carry to continue to be a well functioning strategy.**

Carry style outperformed 2016

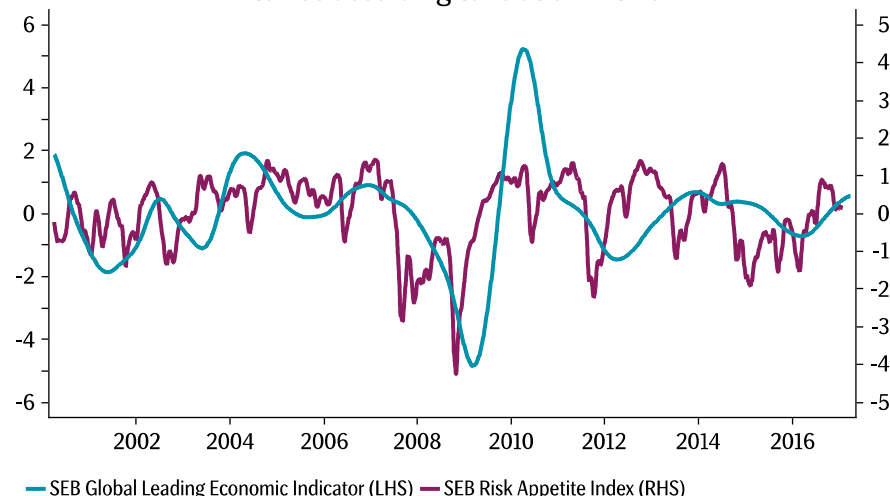


Carry performance highly dependent on improving risk appetite



# A risk-on scenario further supports Carry

RAI to rise according to relation with GLEI



Ahead of risky events such as the EU political elections this spring **valuation might temporarily take over as the best performing style.**

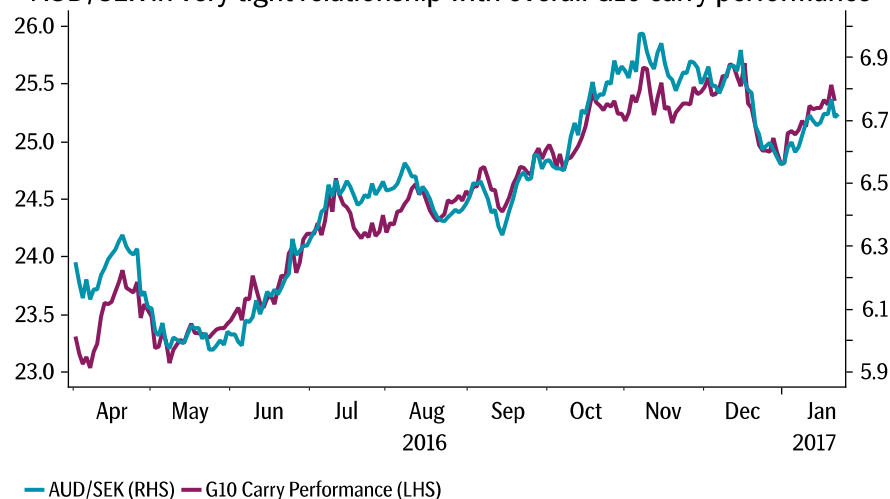
## G10 Carry positions

Looking into our own investment style for G10 carry as well as tradable indices the proposed general strategy is:

- Long: AUD, NOK and NZD
- Short: SEK, EUR and CHF

The tight relationship between AUD/SEK and Carry performance (chart to the left) backs that long AUD/short SEK is one major position in general G10 carry strategies. With continued performance money should flow into Carry strategies which would support AUD and limit the SEK strength we expect due to other factors as well.

AUD/SEK in very tight relationship with overall G10 carry performance



## Currency positions for the different styles Based on Currency Strategy scores

Style	Long 1	Long 2	Short 1	Short 2
Fundamental	NZD	CAD	GBP	NOK
Carry	AUD	NZD	CHF	EUR, SEK
Valuation	GBP	JPY	NZD	USD

# Low volatility/high impact environment to last

## LOW VOLATILITY ENVIRONMENT WITH TEMPORARY BUT SHORT INTERRUPTIONS.

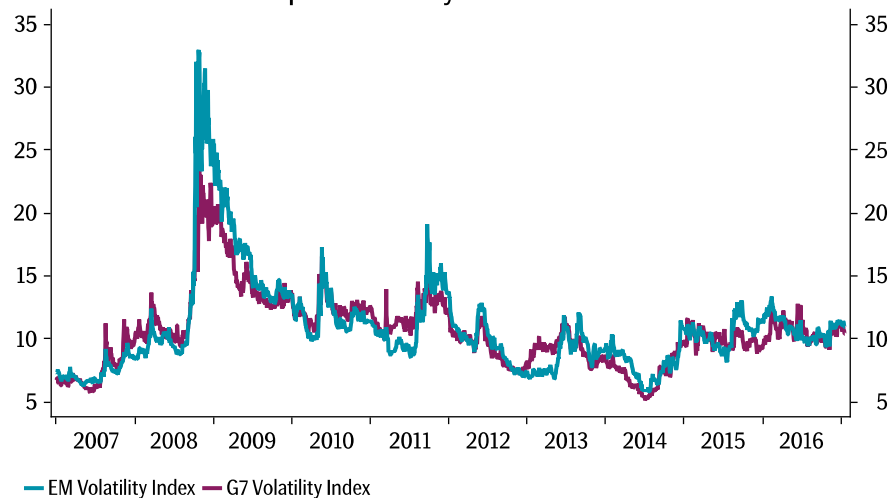
The current volatility environment is not easy to manage. Generally volatility is low but currencies have a tendency to react sharply whenever central banks act or when political events occur. However, soon after the events, volatility tends to settle down to lower levels.

This low volatility/high impact (LV/HI) regime is illustrated in the bottom right chart. It shows that the average daily range (a volatility measure) has fallen after the financial crisis, i.e. a “low(er) volatility regime”. However, it also shows that the maximum daily range fell the first years after the financial crisis but lately it has increased again, i.e. moving into a “high(er) impact regime”.

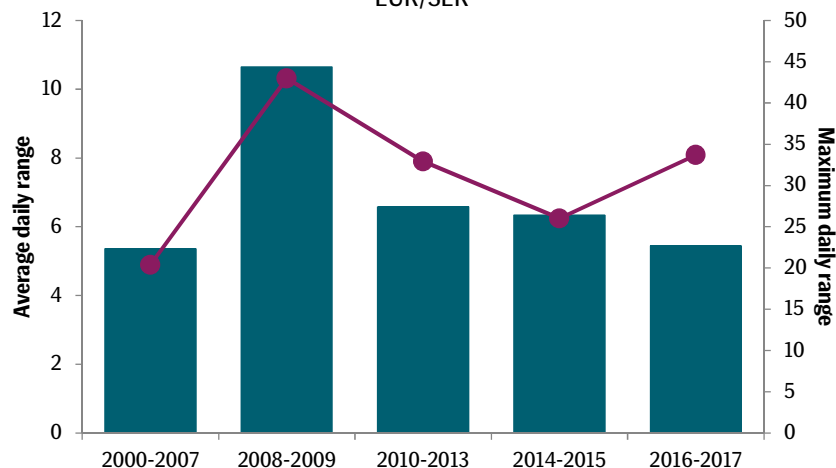
In this unusual LV/HI regime, being long volatility requires a perfect timing in order to be a winning strategy. Instead, running short volatility positions generally pay off but deep pockets are required as volatilities spike around events. In a market where neither long or short volatility strategies work well, fewer market participants will trade. Thus liquidity becomes scarce, further increasing the risk for temporary/irregular moves around events. The current environment is thus in part self re-enforcing and in need of a general change for the regime to shift.

In order to identify factors that could facilitate a regime shift we first have to establish factors behind the current low volatility regime. Such factors are illustrated in the top left chart on the next page.

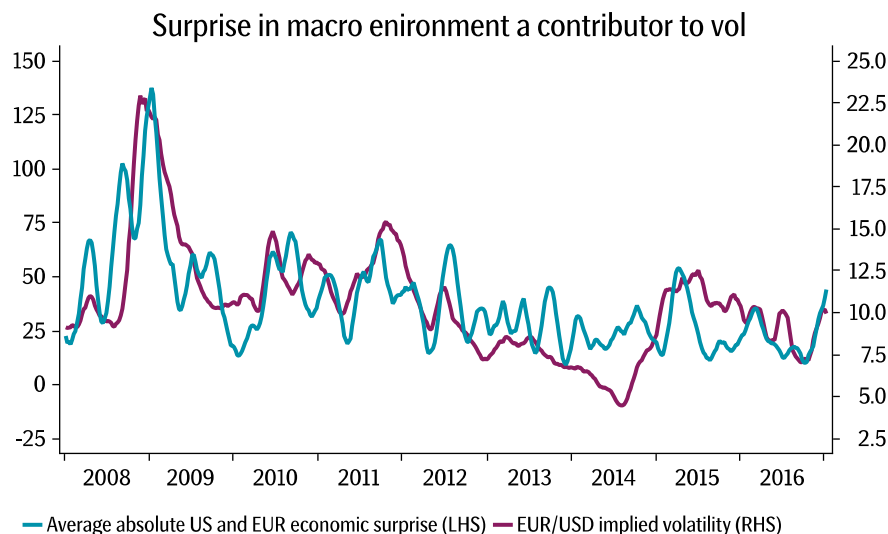
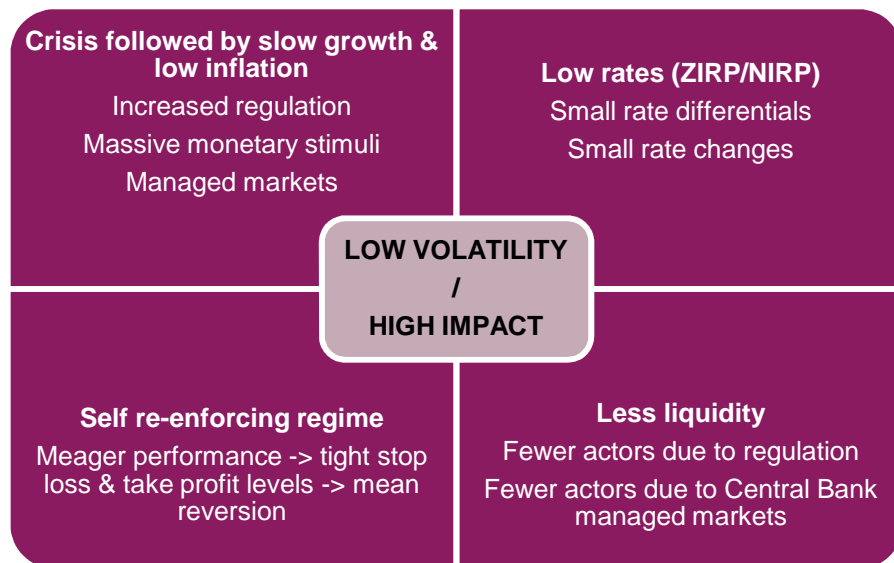
FX implied volatility stuck at low levels



Average daily range falling but extreme days are larger lately  
EUR/SEK



# Buy realized volatility over scheduled events



## What could increase the volatility level?

With economic growth picking up surprises in economic data outcomes should also become larger. As surprises seem to correlate well with volatility (see bottom left chart) this could be one factor contributing to generally higher volatility. Furthermore, the current low interest rate environment will eventually give way as more countries join the US hiking cycle. Then rate differentials as well as rate changes and their frequency will increase - > assets price to be driven more by the usual factors (growth, inflation and diverging monetary pol).

If this happens then hedge funds would probably begin to explore these profitable strategies more deeply making a case for more active trading with larger stop-loss/profit targets. This could allow for increasing realized volatilities.

Until we get more clear signs of increasing volatilities, we have instead identified a **mean-reversion strategy** which could work well in current environment:

Mean-reversion strategy 2010-2016						20160				
Ccy	Return	Annual	Duration	Trades	Hit-ratio	Ccy	Return	Duration	Trades	Hit-ratio
NOK/SEK	28%	4.0%	25	14	64%	NOK/SEK	5.0%	27	2	50%
EUR/SEK	31%	4.4%	22	16	75%	EUR/SEK	-1.5%	47	1	0%
CAD/NOK	34%	4.9%	30	12	92%	CAD/NOK	5.9%	50	1	100%
EUR/PLN	41%	5.8%	7	15	80%	EUR/PLN	7.7%	17	3	100%
AUD/CAD	37%	5.3%	29	12	75%	AUD/CAD	4.4%	23	2	100%
NZD/CAD	22%	3.1%	27	13	85%	NZD/CAD	-0.9%	27	1	0%
NZD/NOK	37%	5.2%	38	9	67%	NZD/NOK	6.9%	27	2	100%
AUD/NOK	26%	3.6%	39	9	67%	AUD/NOK	11.6%	17	2	100%
<b>Total</b>	<b>257%</b>	<b>37%</b>	<b>29</b>	<b>14</b>	<b>75%</b>	<b>Total</b>	<b>38.2%</b>	<b>28</b>	<b>15</b>	<b>1</b>
If investing 100k in each signal:						If investing 100k in each signal:				
				<b>257 k</b>	<b>100</b>					<b>39.10 k</b>
Per year				<b>37 k</b>	<b>14</b>	Per year				<b>14</b>
					<b>75%</b>					<b>79%</b>



# EM currencies: resilience on strong growth

**The EM rebound will last.** Uncertainty around the prospects for Emerging Markets is great. It always is, but the election of the big-talking Donald Trump as president of the US has made forecasting particularly fraught. What will he actually be able to achieve, and how far is he prepared to drive potentially globally disruptive policies are the questions on the top of investors minds. Nevertheless, although US policy is a risk factor, especially those that would cause a sharp increase in US interest rates, fundamentals generally look relatively good.

After two years of dismal growth, **economic activity is picking up** gradually, driven by continued strong growth in China and India, as well as recoveries in Russia and Brazil.

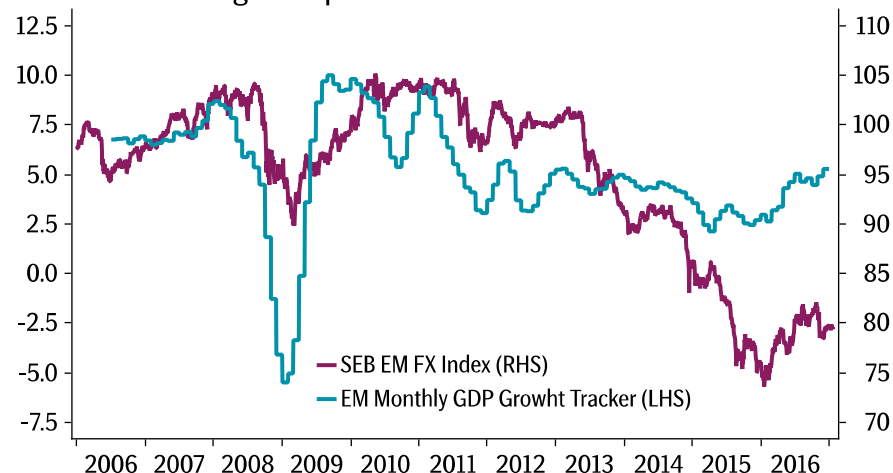
**Commodity prices have stabilised.** Much concern has been voiced over overcapacity following years of overinvestment in production during the commodity boom years. However, as data on global steel production suggest, production has responded to falling prices. With growth picking up in the US and the EU, and remaining strong in China and India, another sharp and sustained drop in commodity prices is unlikely.

Similarly, unless the OPEC production agreement falls apart, oil supply and demand will balance in 2017, supporting **oil prices** and EMs such as Russia, Colombia, and Brazil.

**Valuations are also generally low** in the EM space following three years of depreciation since the “Taper Tantrum” in 2013.

Nevertheless, **some EM countries**, notably Mexico, look **vulnerable to Trump’s agenda**. If US protectionism extends to electronics, not only will China suffer, but so will suppliers located in Southeast Asia. Turkey has home-grown problems that would be exacerbated by higher US interest rates.

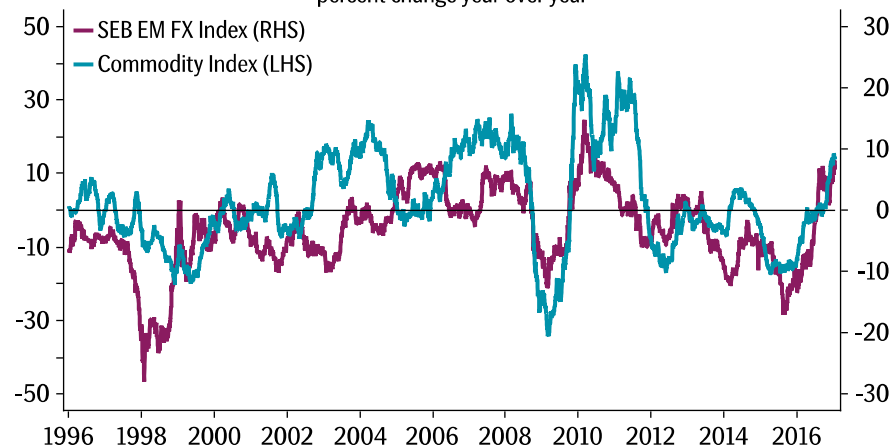
Faster growth provides tailwind for EM currencies



Source: Macrobond Financial AB, Institute for International Finance (IIF), SEB

Commodity prices lifting EM currencies

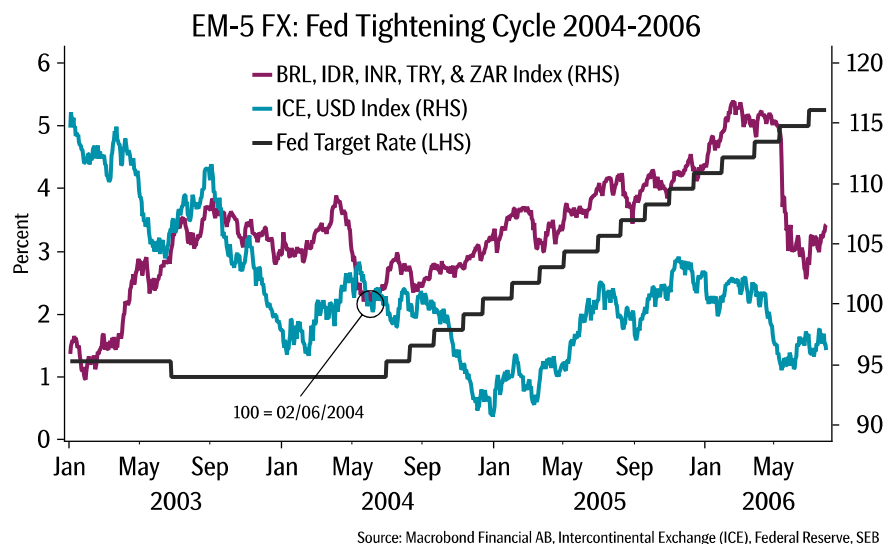
percent change year over year



Source: Commodities Research Bureau (CRB), Macrobond, SEB



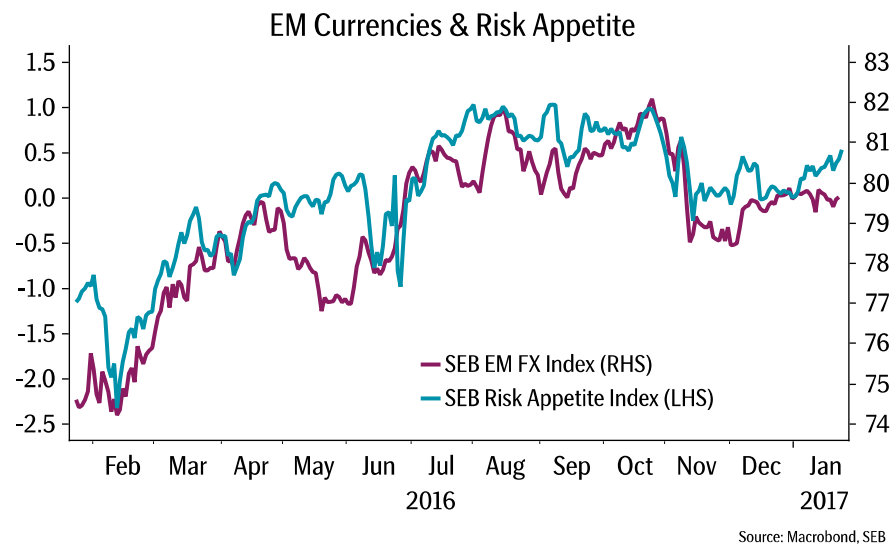
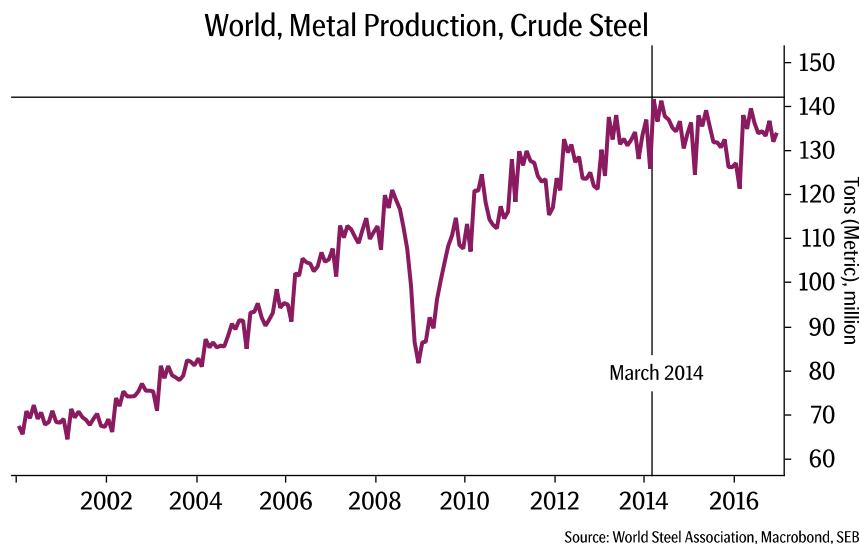
# EM currencies to weather gradual US hikes



Lastly, a key **headwind for EM currencies** will be higher US interest rates driven by two factors. First is the gradual normalisation of US monetary policy on the back of an economic recovery and reduction of slack in the economy. Second is the potential increase in US yields as a result of Trump's expansionary fiscal policy. Judging by recent communication after inauguration, Trump will not break with fiscally conservative Republicans in Congress, instead largely compensate for larger expenses by cutting costs.

Judging by the US rate-hiking cycle in 2004-2006, as long as rates are below roughly 4.5% and hikes are gradual and expected, EM currencies will benefit from faster growth, a recovery in demand for commodities, and strong risk appetite.

EM assets should be a part of any international investor's portfolio in 2017.



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# Notes

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