Currency Strategy
The disappearing dollar?

January 2018

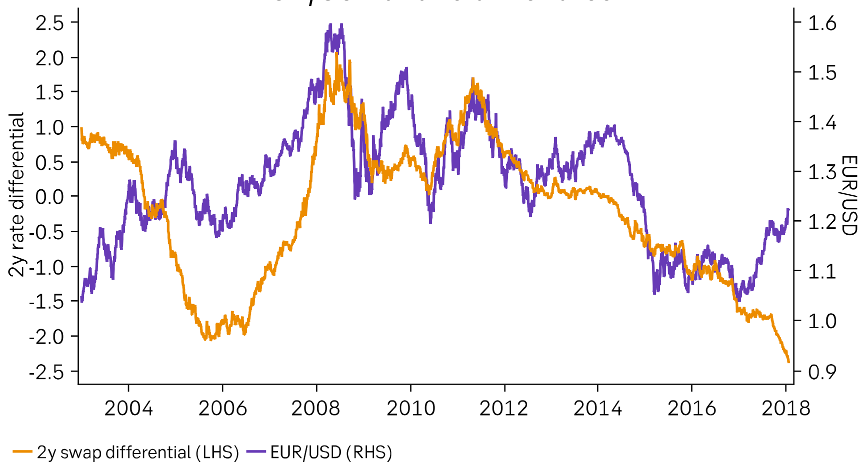
SEB

Currency Strategy: the disappearing dollar?

WHAT'S MONETARY POLICY GOT TO DO WITH IT?

The global economy remains strong, worldwide manufacturing confidence indices are at multi-year highs, global growth in 2018/19 is expected to be around 4%, equity markets are extremely bullish, and central banks will likely maintain very loose monetary polices for a long time yet. While economic recovery and central bank policies have made it reasonable to anticipate such strong risk appetite, this goldilocks scenario has not had its full expected impact on currency markets. Mid-September last year, the interest rate market was clearly discounting too little from the Federal Reserve. Since then, three additional rate hikes have been priced in for the next two years with little change in the immediate ECB policy outlook. Still, EUR/USD has continued to rally, to stand today well above historical averages and our estimated long-term fair value. There is little to suggest a rapid change in policy outlook: on the contrary we still expect continued widening of the interest rate spread in the 2 year sector as the Fed tightens policy. So what is driving the dollar these days? Clearly political and economic improvements in euroland are helping to boost overall confidence in the common currency. Global reserve managers and central banks are switching funds from the USD into Euro-denominated papers. Given further political progress in Europe with Merkel and Macron working hard to kickstart the EU integration project (a task made easier by the UK's decision to leave the union), we should expect further inflows to European asset markets. US growth has been strengthened by tax reforms, but the long-term outlook for deficits has been undermined. The US holds a net investment position of -50% of GDP. The long-term negative USD outlook is only pared by short-term quantitative measures which are indicating current EUR/USD trend being "too fast too soon".

EUR/USD and relative rates



Source: Macrobond Financial AB, Macrobond, SEB

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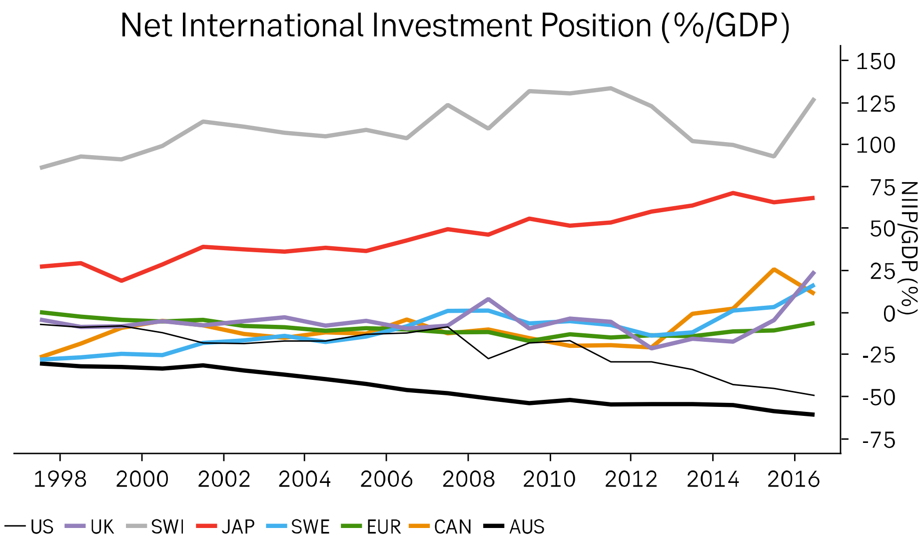

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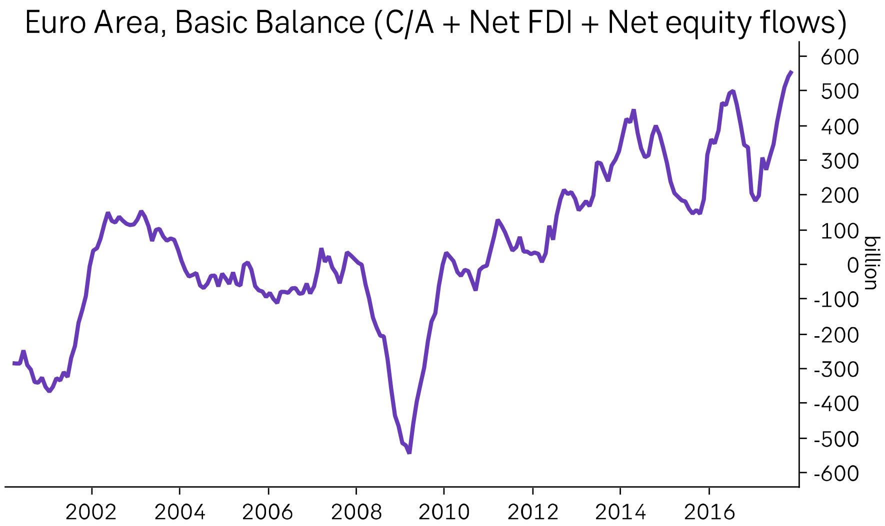


Source: ECB (European Central Bank), Macrobond, SEB

OUTLINE OF OUR NEW CURRENCY STRATEGY

Strong synchronised global growth is pushing risk appetite into new record levels. The combination with low market volatilities should normally be productive for superior returns for carry-related strategies also in the foreign exchange markets. But 2017 was a year where Carry actually gave the worst returns amongst the FX Styles we follow whereas Growth style based on relative interest rate changes was the best performing FX Style. Overall FX does not trade according to easily identified patterns. On the contrary there is little apart from the general dollar trend up or down where we currently see top-down analysis giving clear results for the FX outlook. Once central bank policies start to be less “coordinated” it is reasonable to expect FX volatilities to increase and G10 currencies to deviate more thoroughly from the general USD trend. But with the absence of a marked upturn in global inflation, the prospects for such scenario is still relatively remote.

Our G10 ranking holds the NOK as the best performing currency followed by the polish Zloty. The Chinese economic slowdown will weigh on the outlook for the AUD and we remain short-term negative on the JPY. European currencies including EUR, SEK and GBP are seen as doing ok in the current environment.

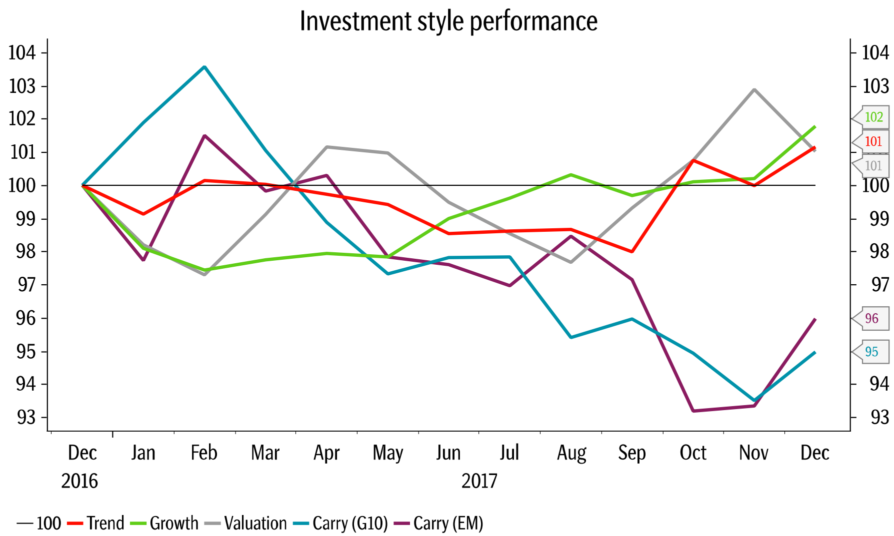
Apart from the regular currency analysis in this report, it also contains a themes sections includes articles on: Brexit, Global monetary policy; The Sharp measure for FX (risk vs return); Swedish krona outlook and flows associated with the anticipated appreciation; NOK Current account balance and Norges Bank FX purchases; Long-term FX valuation and Upside risk for Fed rate hikes .

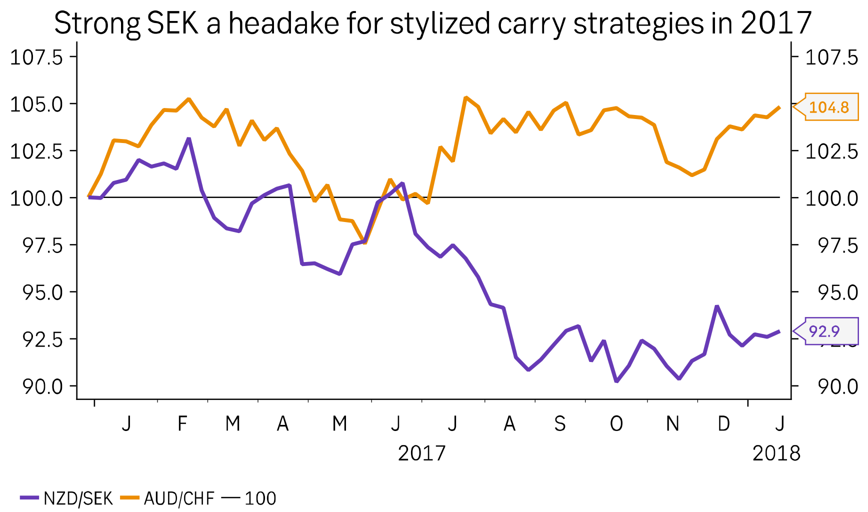
Investment styles: Carry out of style in 2017

GROWTH STYLE OUTPERFORMS ON THE EXPENSE OF CARRY
Looking at different investment styles **in 2017 it is clear that the carry style performed by far the worst** posting a 4% loss (EM) and 5% (G10). This is in stark contrast to 2016 when the carry style was the star performing style.

2017 has not been dominated by one style throughout the year as carry did in 2016. Instead carry did relatively fine in the beginning of the year but began its decline in Mar and posted a commodity currency driven recovery in Dec. The other three styles (Growth Trend, and Valuation) ended the year quite similar (+2%, +1% and +1%) but the development during the year was very different. The Trend style has really only delivered late in the year (Oct to Dec) while the Valuation style has been choppy but performed well in Sep to Nov.

Finally, the Growth style based on relative interest rate changes, is the style with the most long-lasting positive development. This was also the strategy we believed the most in Currency Strategy Sep 2017. After a negative start of the year the development has been good since March. Even if the correlation between rate spreads and currencies have fallen (e.g. EUR/USD during Q3/ Q4) there still tends to be some usable interplay between them. Going forward we still believe the Growth style should benefit as focus still is on diverging monetary policy for many currencies. However, the carry styles have recovered in Dec and Jan. Continued low volatilities combined with increasing rate differentials has made the risk-adjusted return for more carry positions attractive (see theme *The Carry Trade*). Thus more money will potentially seek carry which would weigh on funding currencies such as CHF and SEK but also to some extent on EUR.





Source: Bloomberg, Macrobond, SEB

FX Forecasts

FX forecasts		SEB				Fwd	Consensus*
	25/Jan	3m	6m	12m	Q4 19	12m	12m
EUR/USD	*1.24*	1.23	1.26	1.28	1.32	1.27	1.23
EUR/JPY	*135*	139	144	141	139	136	135
EUR/GBP	*0.87*	0.89	0.88	0.85	0.82	0.88	0.90
EUR/CHF	*1.17*	1.18	1.19	1.21	1.25	1.16	1.18
EUR/SEK	*9.81*	9.77	9.67	9.41	9.20	9.81	9.45
EUR/NOK	*9.58*	9.46	9.32	9.19	9.00	9.71	9.31
EUR/DKK	*7.44*	7.44	7.44	7.44	7.44	7.43	7.45
EUR/PLN	*4.15*	4.15	4.09	4.04	3.85	4.24	4.13
USD/RUB	*56*	58	59	61	63	58	57
USD/TRY	*3.75*	3.68	3.76	3.89	4.20	4.18	3.99
USD/JPY	*109*	113	114	110	105	107	110
GBP/USD	*1.43*	1.38	1.43	1.51	1.61	1.45	1.36
USD/CAD	*1.23*	1.24	1.23	1.21	1.15	1.23	1.24
USD/CHF	*0.94*	0.96	0.94	0.95	0.95	0.91	0.96
AUD/USD	*0.81*	0.78	0.77	0.74	0.70	0.81	0.80
NZD/USD	*0.73*	0.75	0.74	0.72	0.69	0.73	0.73
USD/SEK	*7.91*	7.94	7.67	7.35	6.97	7.70	7.68
GBP/SEK	*11.28*	10.96	10.97	11.10	11.22	11.15	10.45
JPY/SEK	*7.25*	7.03	6.73	6.68	6.64	7.23	6.98
CHF/SEK	*8.39*	8.28	8.13	7.78	7.36	8.42	8.01
NOK/SEK	*1.02*	1.03	1.04	1.02	1.02	1.01	1.02
USD/NOK	*7.73*	7.69	7.40	7.18	6.82	7.62	7.57
USD/CNY	*6.33*	6.50	6.47	6.30	5.80	6.45	6.54

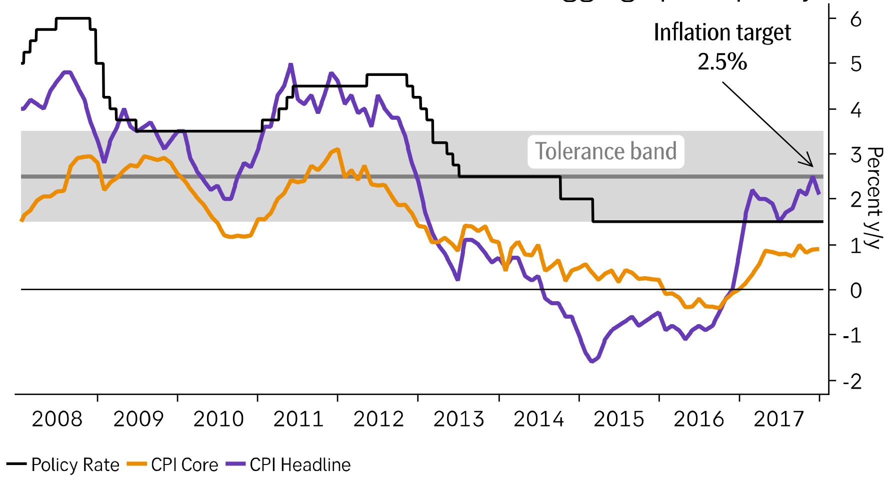
**Bloomberg survey FX forecasts.*

How to trade it?

OUR TRADE IDEAS

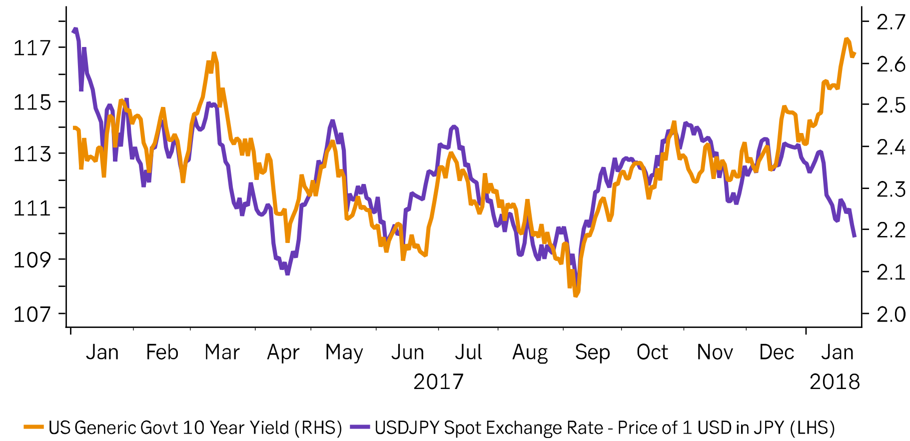
- **SELL EUR/PLN on carry and valuation.** The rate differential is just around 200 bps but realized volatility in EUR/PLN has decreased significantly to just over 3%, making the risk-reward attractive for a short carry position. Moreover, PLN remains undervalue d against the euro with LTFV around 3.75.
- **SELL EUR/SEK on rallies.** Spot has likely topped out but we lack a trigger for a fast return lower. Riksbank will deliver according to the stated repo rate path, monetary policy will be tightened (in Q3) before the ECB moves (H1 2019). Policy divergence will be krona positive but given markets are discounting the move already it will only be a slow grind lower.
- **BUY EUR/CHF.** Increasing political and economic stability in Europe is working its way to also stabilise the outlook for the common currency. EUR/CHF is not trading far from our long-term fair value but rising risk appetite and interest rates in Europe should work to lessen the appetite for the Swiss franc.
- **SELL AUD/NZD.** In 2017 the AUD outperformed its smaller peer due to excessive election weakness. However, the AUD has lost its attractiveness as a high yield currency and is more exposed should the Chinese economy slow more than expected this year. We target 1.03, which is in the lower part of the trading range since 2014.
- **BUY NOK/JPY.** The Japanese currency is undervalued and is expected to appreciate long-term. In the coming three to six months however we see continued easing from the BOJ to ensure a weak JPY. NOK is substantially undervalued and the Scandinavian currency will gain vs most G10 currencies.

Poland: Inflation will continue to rise, dragging up the policy rate



Source: Polish Central Statistical Office (GUS), National Bank of Poland, Macrobond, SEB

USD/JPY and US 10 year yield



Source: {Property Source not found.}, Macrobond, SEB

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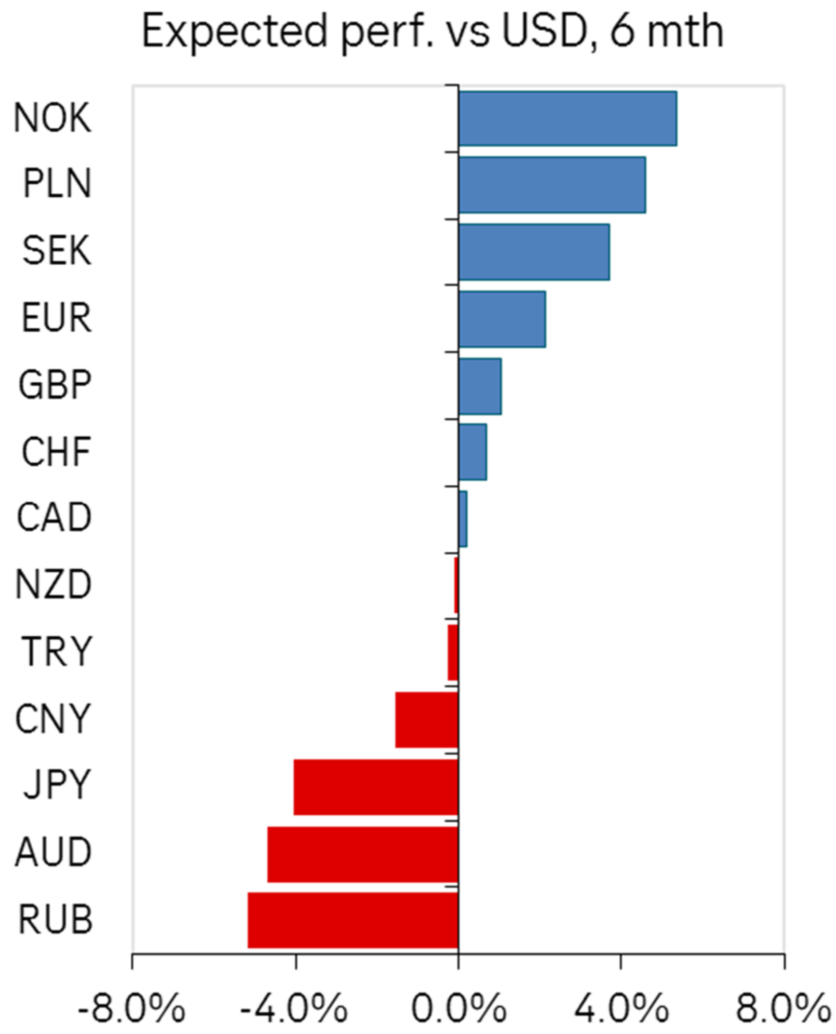
Currency overview

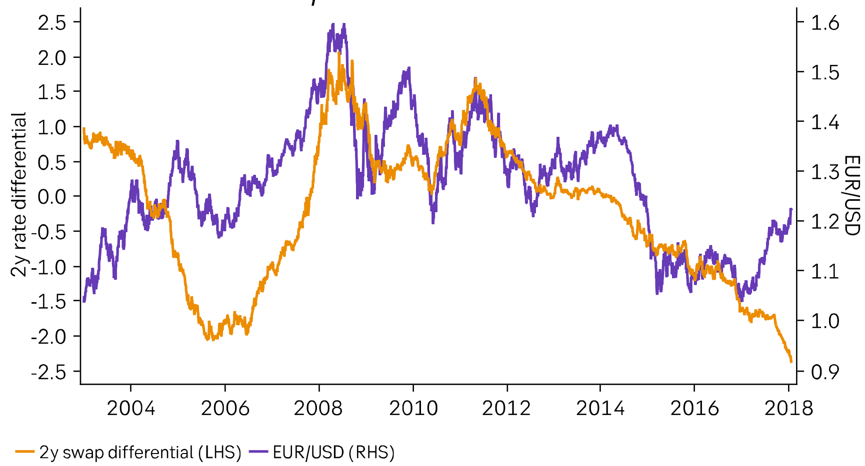


USD: Time to give up on USD recovery?

BROADBASED DOLLAR WEAKNESS. In 2017, the USD was the worst performing G10 currency. Given our expectations related to monetary policy it would be reasonable to expect the dollar to recover as the Fed is likely to continue to tighten its monetary policy while the ECB will at best end its purchases. However, this scenario has so far failed to materialize. Currently the 2y rate differential between US and Germany, which supposedly should reflect expectations on relative monetary policy, is wider than at any time in the last 18 years at -230 bps, suggesting EUR/USD should trade at 0.92 based on its traditional relationship with relative rates. The "gap" shows that relative monetary policy has lost its position as the key driver for EUR/USD.

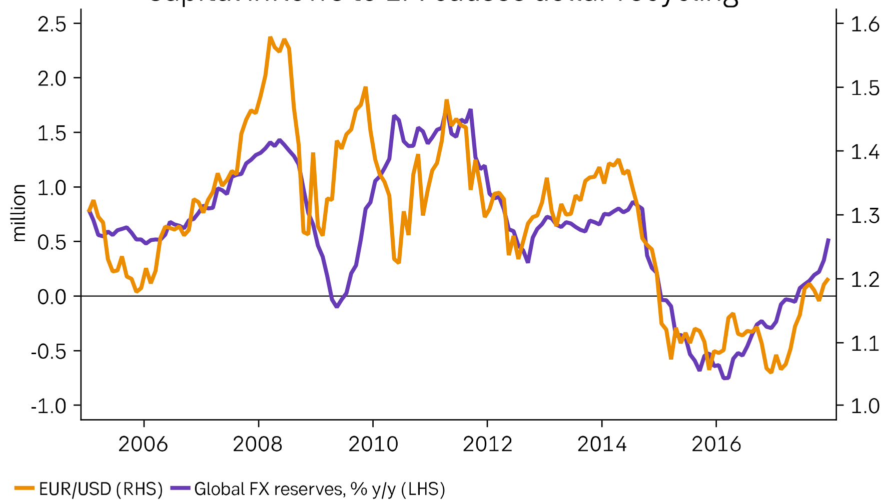
REBALANCING FLOWS SEEM TO DOMINATE. Partly, last year's USD setback was probably due to speculative accounts, which were net long the greenback a year ago following Trump winning the US presidency and on expectations for the Fed. As both Trump and US inflation failed to deliver, these accounts heavily scaled back their outstanding dollar positions, triggering the broad USD sell-off seen last year. Today positioning is much more neutral and unlikely to trigger a similar move. Instead renewed capital inflows and growing global currency reserves in China and other EM countries seem fairly well correlated with EUR/USD fluctuations over the past couple of years. This suggests that as long as these capital inflows continue to increase, currency reserves will rise creating further USD-negative rebalancing flows in the FX market. Moreover, global reserve managers appear to be in the process of reducing their dollar exposures on global currency reserves, exerting further downside pressure on the greenback. This is likely to continue going forward and remain the dominant force on the US dollar. While it may not drive the greenback much lower near term, we expect it to weaken this year and next targeting EUR/USD at 1.28 by the end of 2018 and 1.35 by end of 2019.

EUR/USD and relative rates

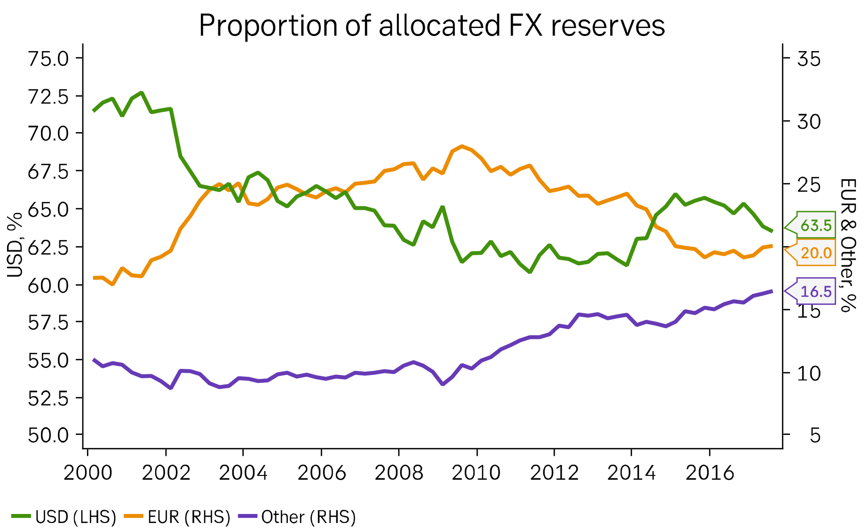


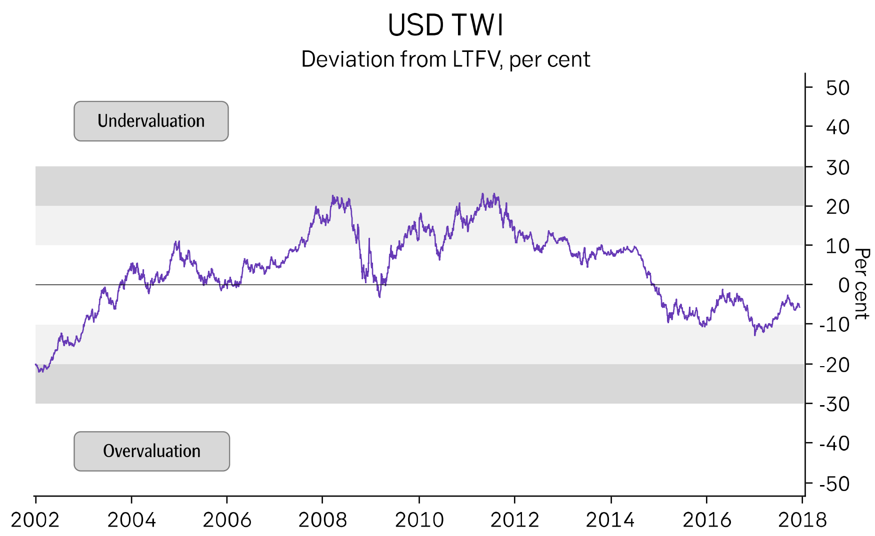
Source: Macrobond Financial AB, Macrobond, SEB

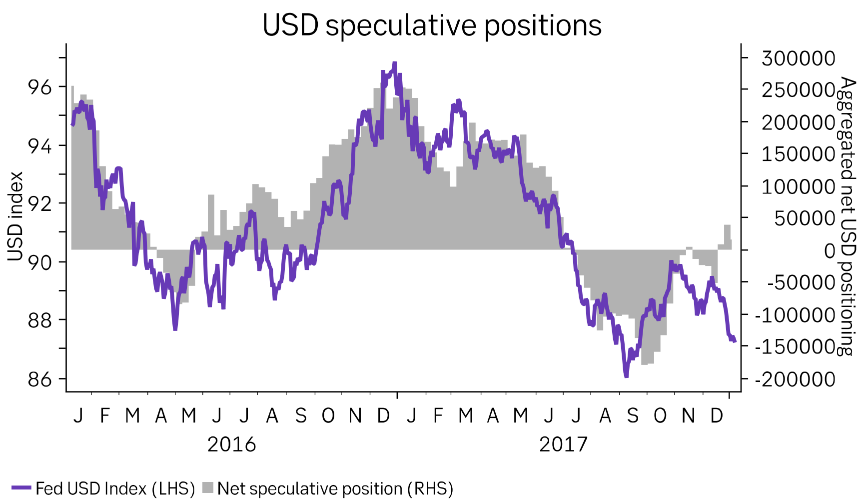
Capital inflows to EM causes dollar recycling



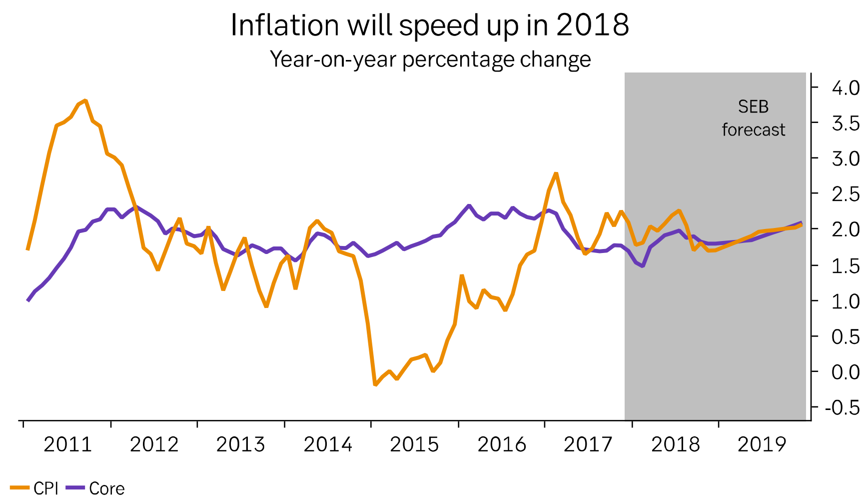
United States: Inflation to rise gradually 2018







Source: CFTC



Source: SEB, US Bureau of Labor Statistics

EUR: portfolio inflows is the tailwind currently

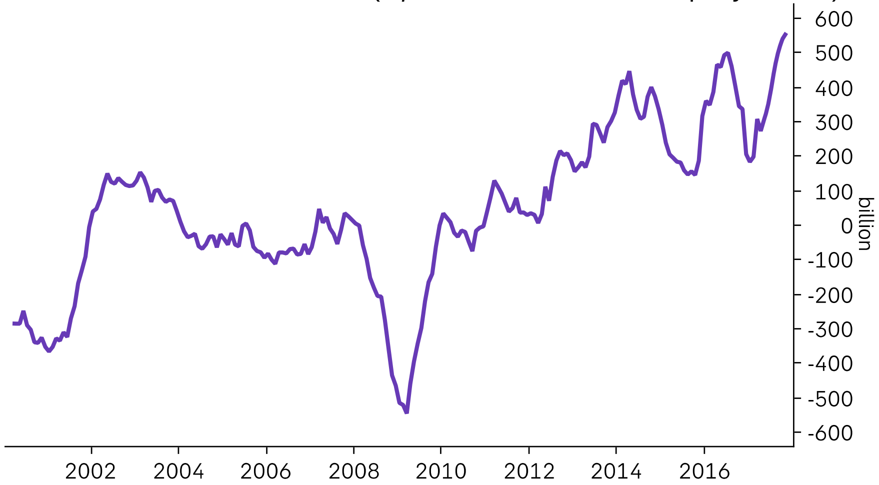
CONFIDENT SHORT-TERM OUTLOOK MAINTAINED

Euro area optimism over ongoing economic growth continues. GDP is expected to rise by 2.3% in 2018, boosted by low inflation and unemployment. Paired with record high consumer confidence and increasing levels of manufacturing activity, the outlook for the euro is indeed positive. However, a strong common currency also partly reflects a weaker dollar. Despite an additional rate hike by the Fed in December, which further widened the 2-year yield spread between the two currencies, the greenback remains weak. We still expect three Fed hikes in 2018 as the central bank is forecast to tighten monetary policy further during the year. The ECB's own policy is to continue QE by buying EUR 30bn of bonds monthly until at least September. The first rate hike is expected in H1 2019. We forecast EUR/USD to reach 1.28 in Q4 due to predicted ECB normalisation and rebalancing USD outflows.

FLOWS TO BOOST EURO LONG-TERM

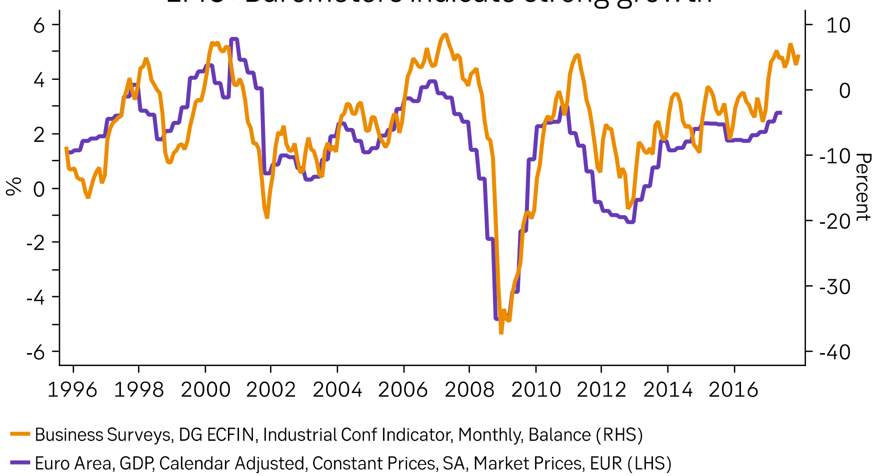
As the ECB moves closer to normalising its monetary policy, European bond yields will increase, resulting in a EUR capital inflow. And central banks will increase their euro exposure on the expense of the dollar. Moreover, overweighting European equities also contributes to positive flows, as investors resume buying risky EUR assets expecting sustained growth backed by record low interest rates. The trade balance continued to increase throughout 2017. The Current account surplus and the net equity inflows were almost EUR 660bn 12 months to Nov 2017. Simultaneously, IMM speculative positioning data reveal a record-breaking net long EUR position, further highlighting the optimistic euro flow outlook. Our fair value model shows the trade-weighted EUR remains slightly overvalued.

Euro Area, Basic Balance (C/A + Net FDI + Net equity flows)



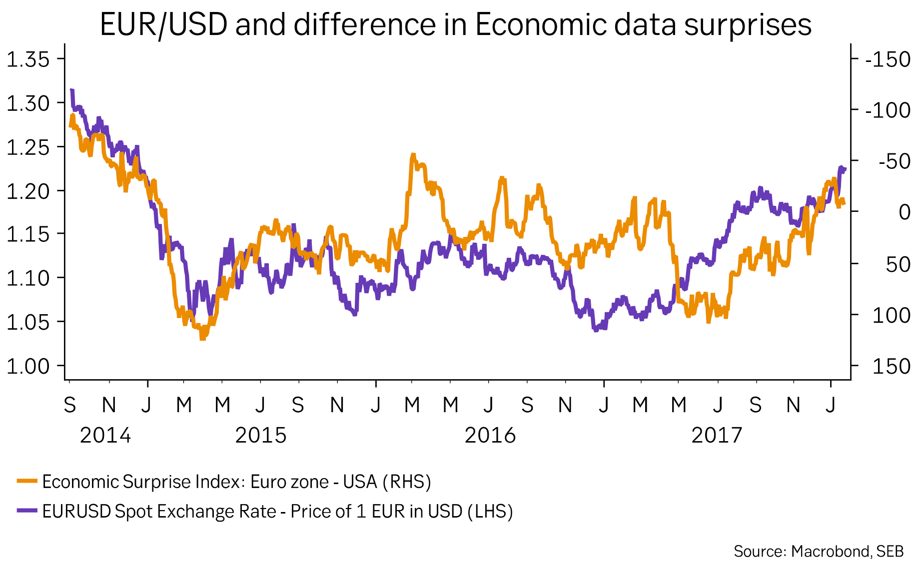
Source: ECB (European Central Bank), Macrobond, SEB

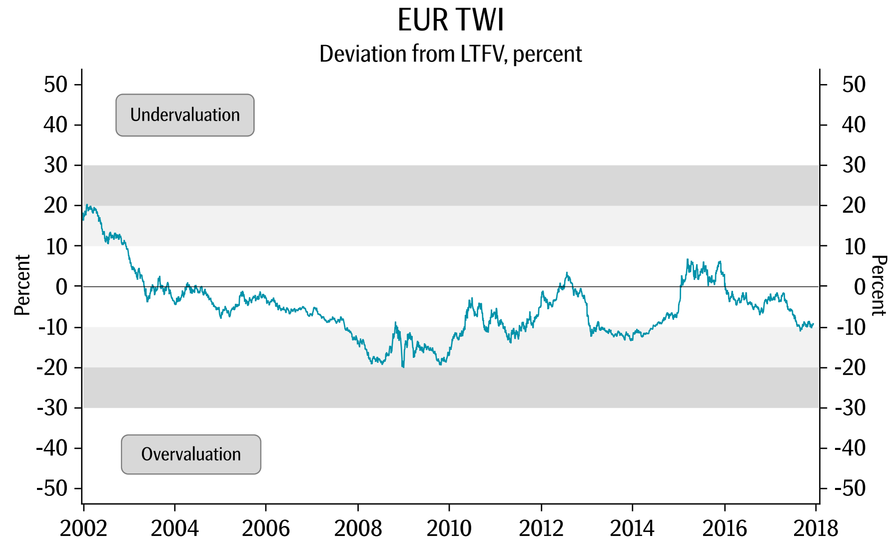
EMU: Barometers indicate strong growth

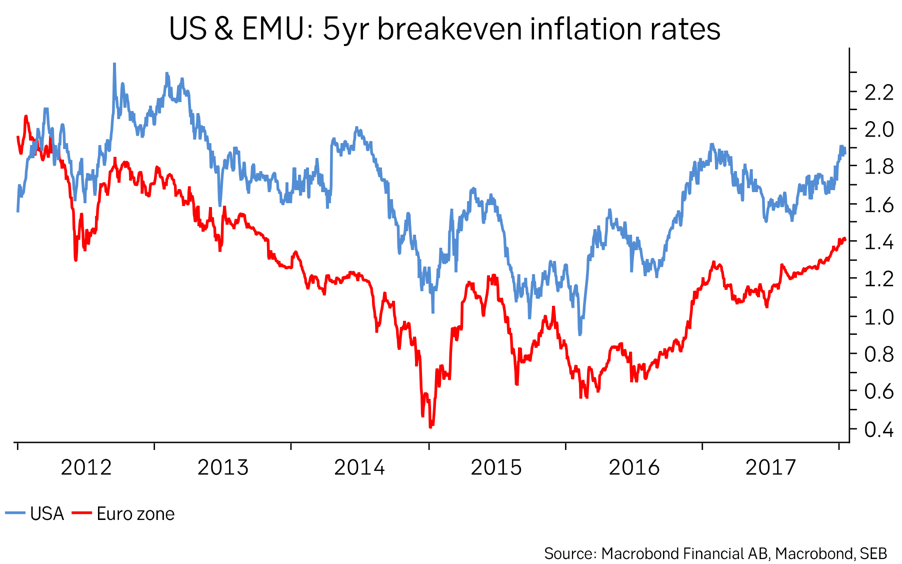


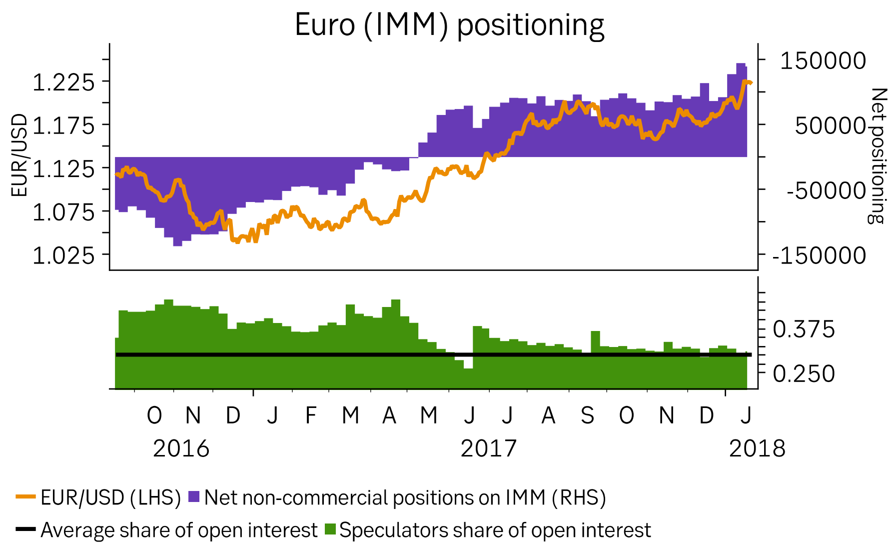
Source: Eurostat, European Commission (DG ECFIN), Macrobond, SEB

Euro zone: stronger economic fundamentals









JPY: cheap valuation kept in check by the BoJ

JPY UNDERVALUED BUT EXPECTED TO REMAIN WEAK. We think JPY will continue to be weak in H1 2018 as BoJ remains dovish. JPY will trade in the 108-115 range into H2 2018. Short term events can push JPY below 110 but they should be good buying opportunities.

The economy will decelerate to 1.2% growth in 2018 from 1.7% in 2017 as fiscal stimulus wanes and exports slow. Investment has been disappointing despite healthy business activity. Future VAT increases may make businesses cautious into 2019.

Japan's issue has been that economic recovery is too weak to reach Bank of Japan's 2% inflation target. While most central banks are exiting ultra-accommodative monetary policy, Japan stands pat. Yen has stayed stronger despite higher interest rate differential versus US because markets are pricing in the risk that BoJ will tighten next. We think markets will be disappointed and BoJ will not tighten policy until September at the earliest. BoJ has an over-shooting inflation commitment and have made 2 mistakes in the past of tightening too early and falling back into deflation. BoJ will remain accommodative and keep yen weak.

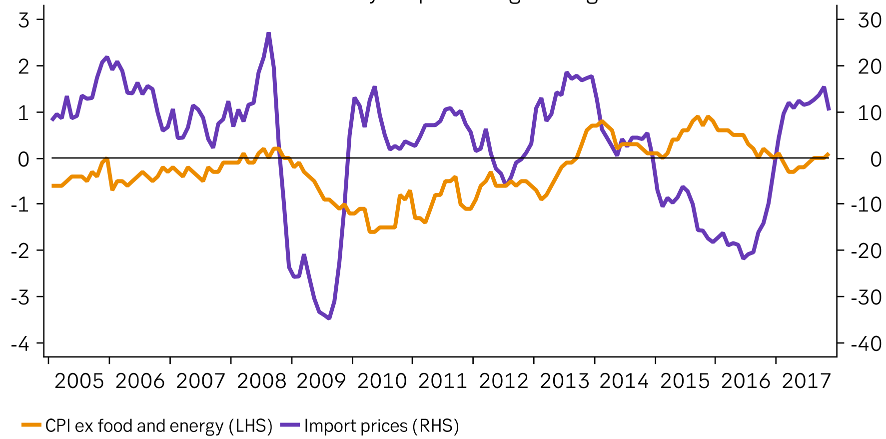
THE LONG-TERM OUTLOOK is for Yen weakness to be capped. The current account surplus may shrink but it still remains solid at above 3% of GDP. JPY's valuation strengthened in 2015 but recent weakness is bringing JPY back closer to fair value. Lastly, inflation expectations have finally turned higher, meaning that BoJ easing is finally having some impact. In late 2018, BoJ may increase the target on 10 year yield towards 10-20bps from 0%. However, we think the most likely next move is for BoJ to target the 5 year yield instead of 10 year around 0% to keep the yield curve steep and help the banking sector.

USD/JPY exchange rate

Source: Macrobond, SEB

Core CPI & import prices

Year-on-year percentage change



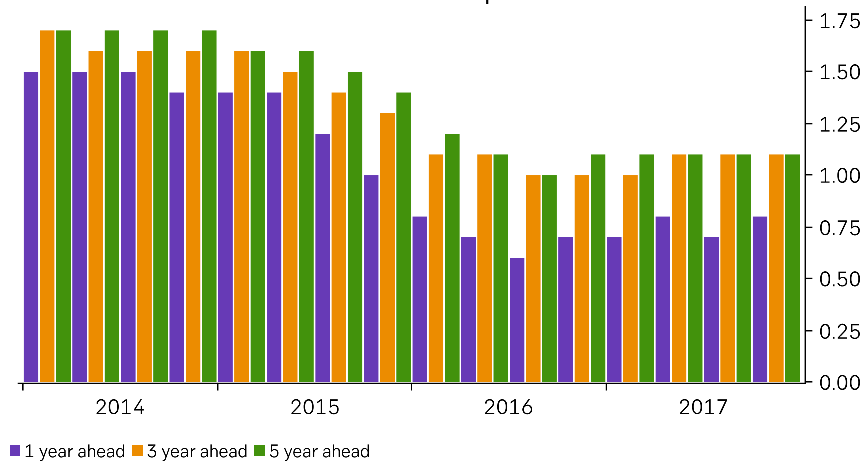
Source: SEB

Japan: flows indicate attractive JPY valuation

NEER & REER

Source: SEB

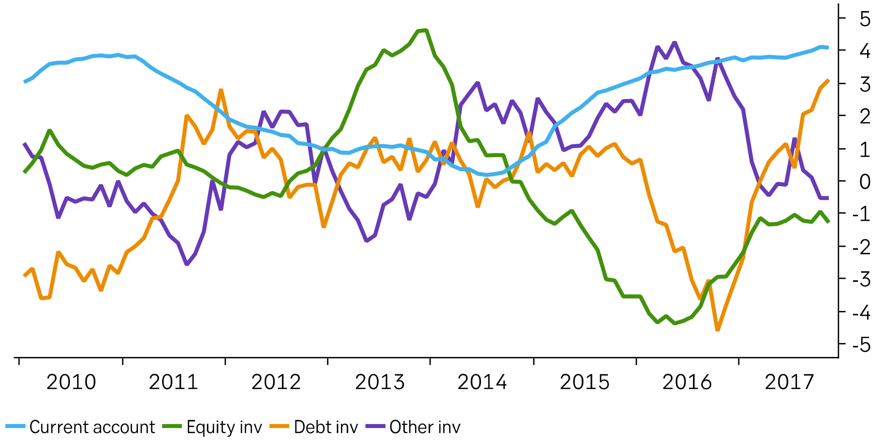
Tankan inflation expectations



Source: SEB

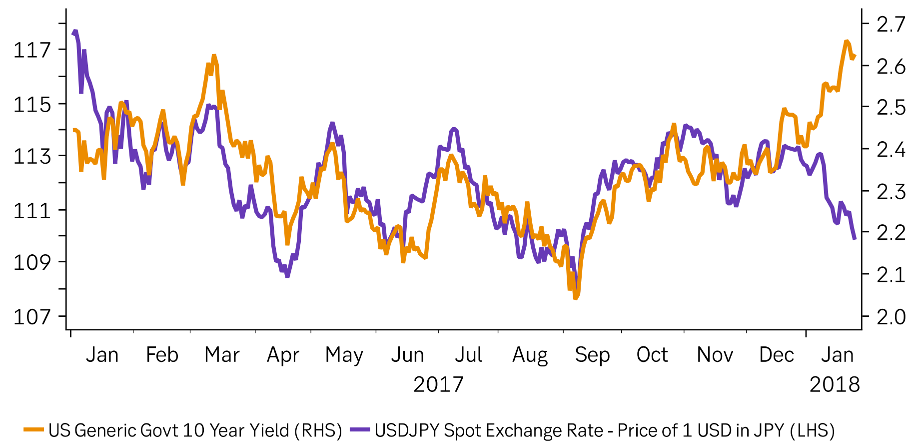
Japan BOP

Per cent of GDP



Source: SEB

USD/JPY and US 10 year yield

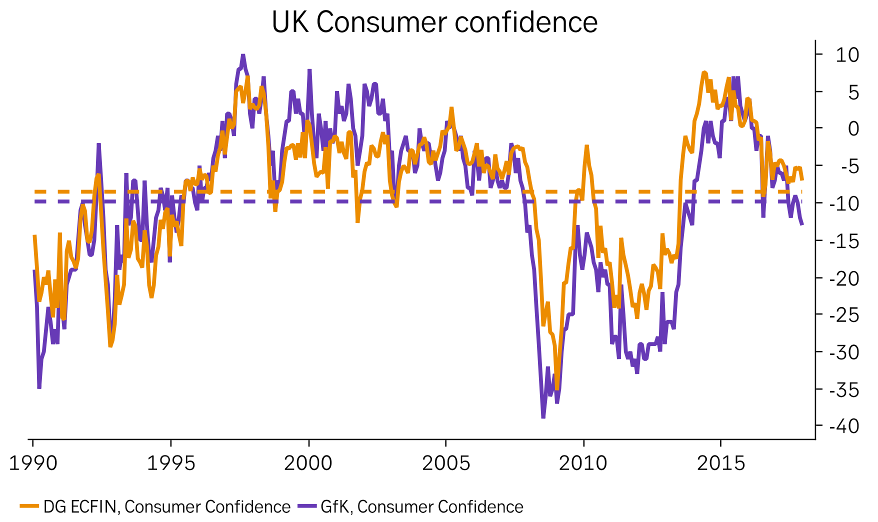


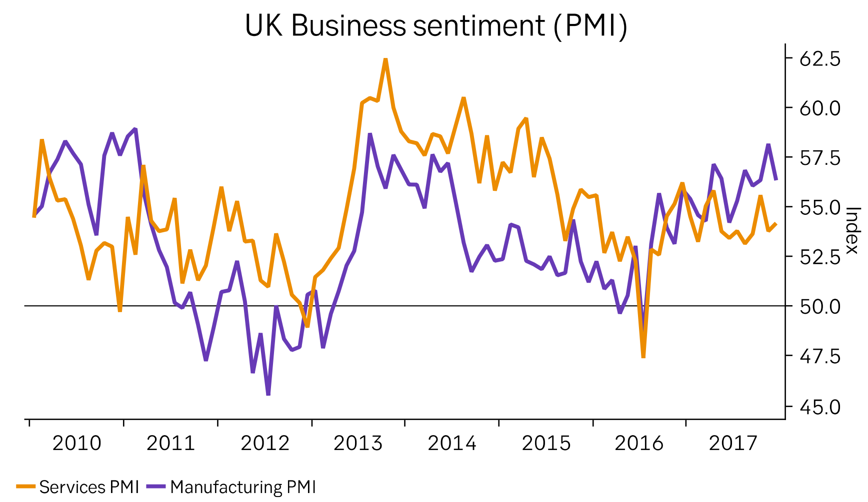
Source: {Property Source not found.}, Macrobond, SEB

GBP: Brexit outcome will determine

MOVING ON TO PHASE II. In December, following extensive negotiations, the UK and EU finally agreed terms for withdrawal that enable Phase II talks on their future relationship and particularly a trade deal to begin. Nevertheless, while the GBP's apparent estimated Brexit risk premium remains substantial (10%), sterling has recovered only slightly. Though considerable uncertainty surrounds the potential impact on the UK economy of an eventual withdrawal from the EU, we expect the GBP to rally if negotiations progress well this year.

BREXIT WORRIES REMAIN THE DOMINANT DRIVER. While sterling may seem weak today compared to the euro, it was in fact one of the strongest in 2017. During the year, the GBP appreciated by an average of ~3% against its G10 counterparts. The strong performance of the UK economy in Q3 after two weak quarters together with rising inflation triggered a rate hike by the BOE. However, the currency's recovery is unlikely to progress much further while Brexit worries persist. Further, while some industries enjoy strong support from a weak sterling and robust growth in key export markets, more domestically focused sectors are doing less well. Despite a strong labour market, households are being squeezed by low wage growth and high inflation of almost 3%. Indeed, in December, consumer confidence slumped to its lowest level since mid-2013, and therefore also below its 2016 Brexit referendum print, suggesting household spending will remain weak. Overall, the outlook for the GBP is closely related to the outcome of Brexit talks. A deal and transitional agreement ahead of the UK's scheduled withdrawal from the EU in Q1 2019 would reduce economic risks and trigger a recovery by sterling. Near-term progress in negotiations is unlikely which will keep the GBP on the weak side but reaching a deal it should strengthen to 0.85 against the euro by year-end.

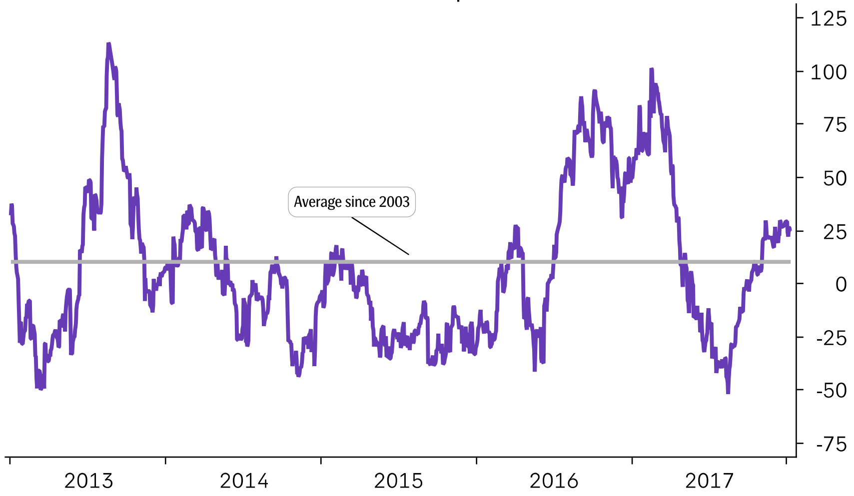




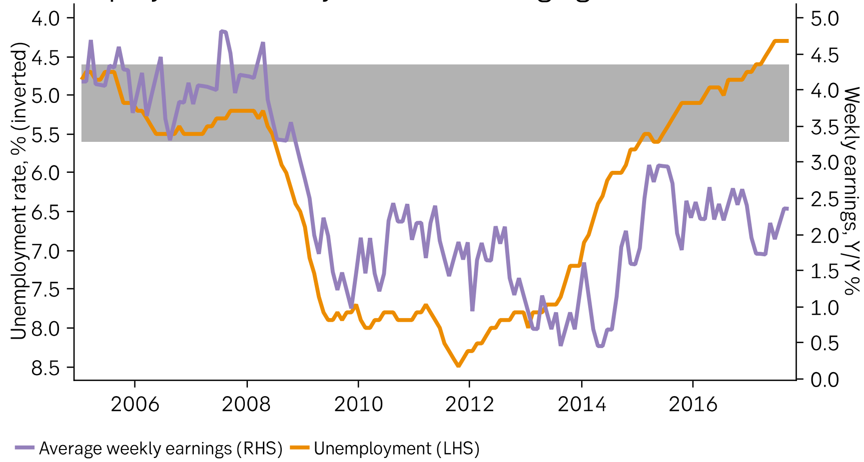
Source: Markit

United Kingdom: Valuation stretch

UK Economic surprise index

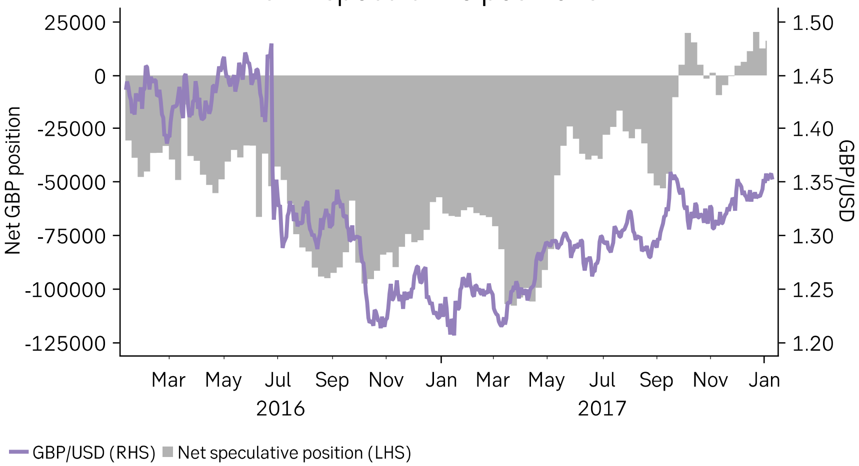


Unemployment at 42-year low - no wage growth acceleration



Source: Macrobond

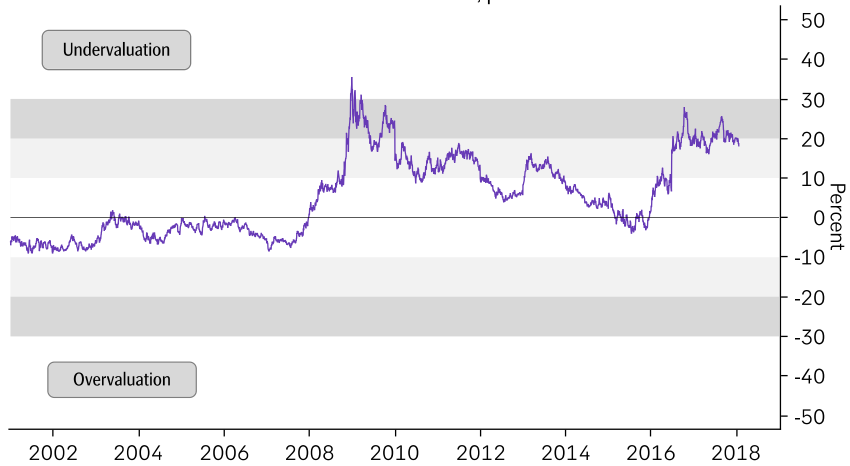
GBP speculative positions



Source: CFTC

GBP TWI

Deviation from LTFV, percent



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CHF: Expansionary policy making its ways

GRADUAL DEPRECIATION TO CONTINUE

We expect the Swiss Franc (CHF) to continue the gradual decline witnessed in 2017 (-9% vs EUR and –6% in trade weighted terms). The main driver is the continued divergence in monetary policy where the Swiss national bank (SNB) will remain with their highly expansionary policy whereas ECB is moving towards a gradual normalisation. Also generally increasing risk appetite and falling European risk premia makes the CHF less attractive.

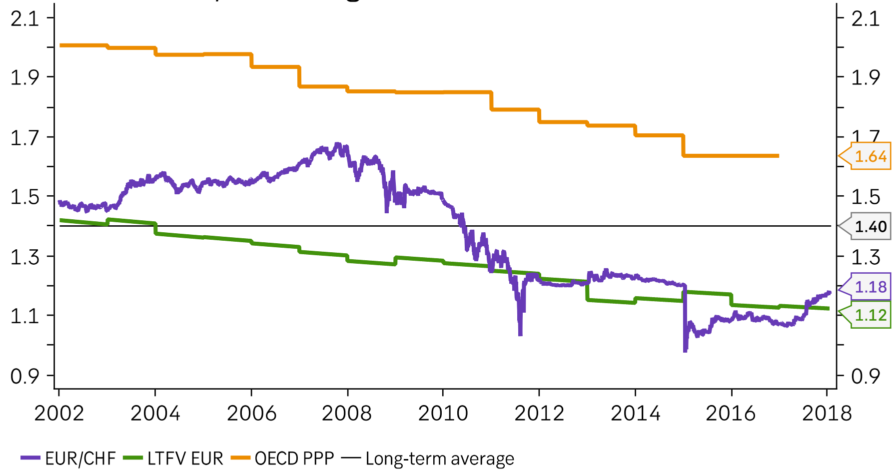
SHORT-TERM: EXPANSIONARY POLICY TO WEAKEN CHF

The weakening of CHF in 2017 has been highly welcomed by SNB, but the level of the exchange rate is probably still well above what they consider fair. Hence they will continue to say that they stand ready to intervene in the FX market and refrain from reducing their balance sheet as long as EUR/CHF is below the 1.30/40 area (Sight deposits show they have not conducted FX interventions since the beginning of 2017). Hiking the policy rate is likely not an option before ECB hikes (March 2019 in our fore-casts) but **looking at Swiss fundamentals it will probably take even longer before a first hike: 1)** SNB expects GDP growth of 1.0% in 2017 and 2.0% in 2018; **2)** Inflation has stabilized around 0.5% but SNB does not expect it higher than their upper level 2.0% until Q3 2020; **3)** Their estimates show that the negative output gap has narrowed in 2017 but, at least assuming a linear development, it will take around 2 years for it to close which is why the consensus forecast for a first rate hike in Q4 2019 seems reasonable. A game changer for SNB policy would be if flows begun to reverse weakening the Swiss franc substantially.

LONG-TERM: PROBABLE OVERSHOOT BEYOND LTFV

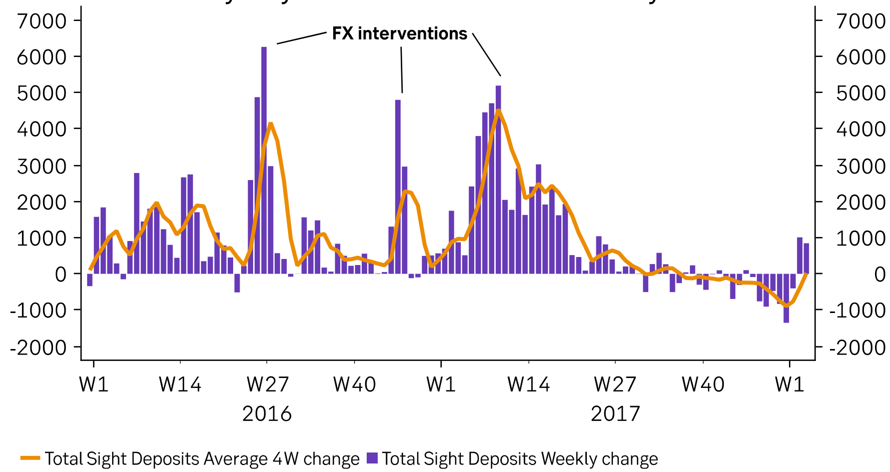
Long-term fair value for EUR/CHF is around 1.12. However, after undershooting for about 3 years a prolonged period overshooting (between 10-20%) would not be surprising.

EUR/CHF rising towards more normal levels



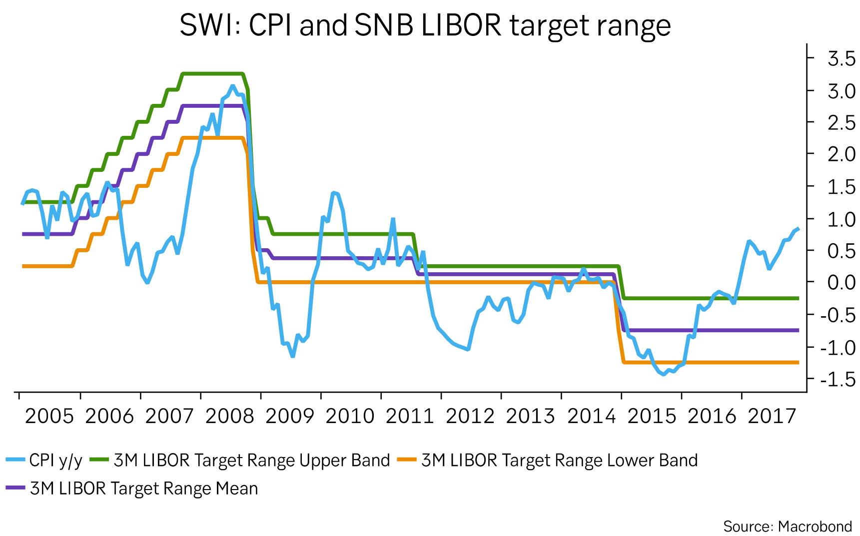
Source: Bloomberg, Macrobond, SEB

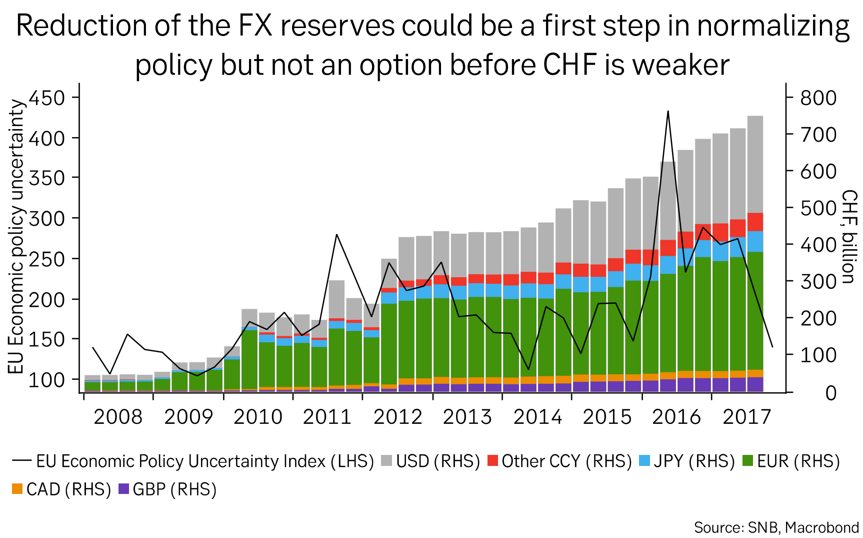
Hardly any FX interventions since May 2017

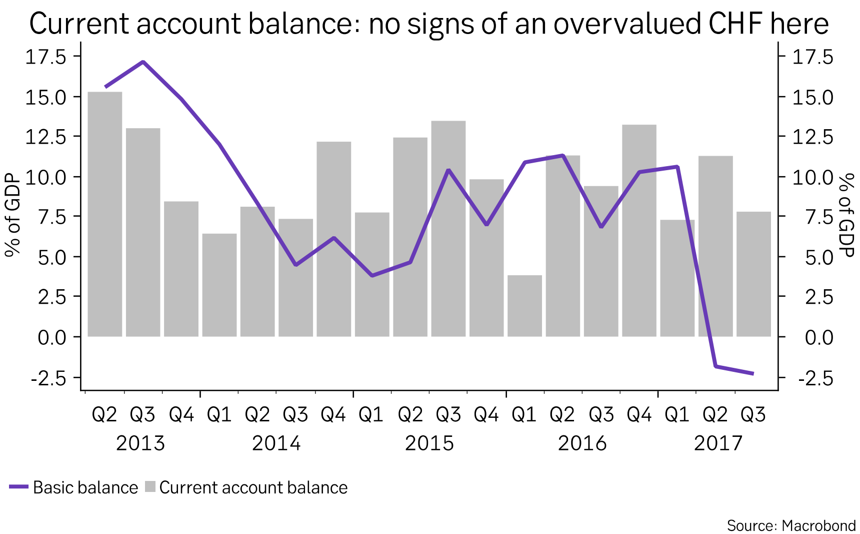


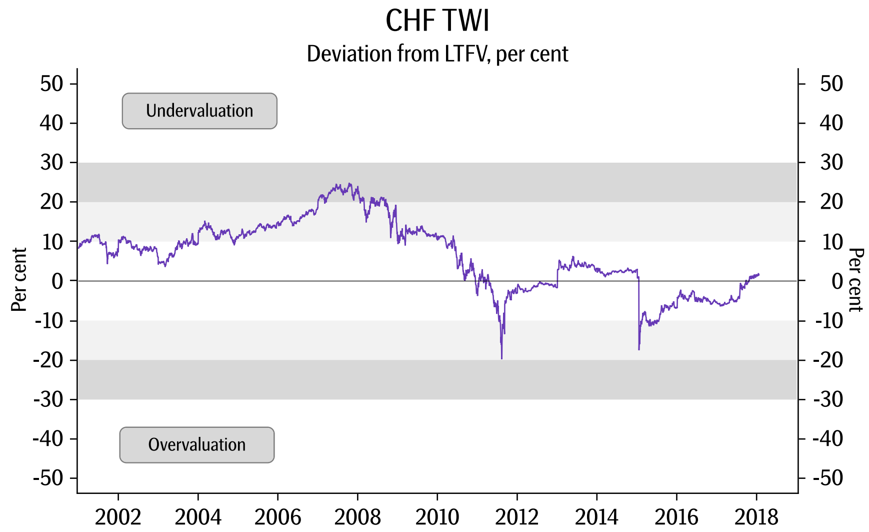
Source: SNB, SEB

Switzerland: Capital inflows to moderate further?







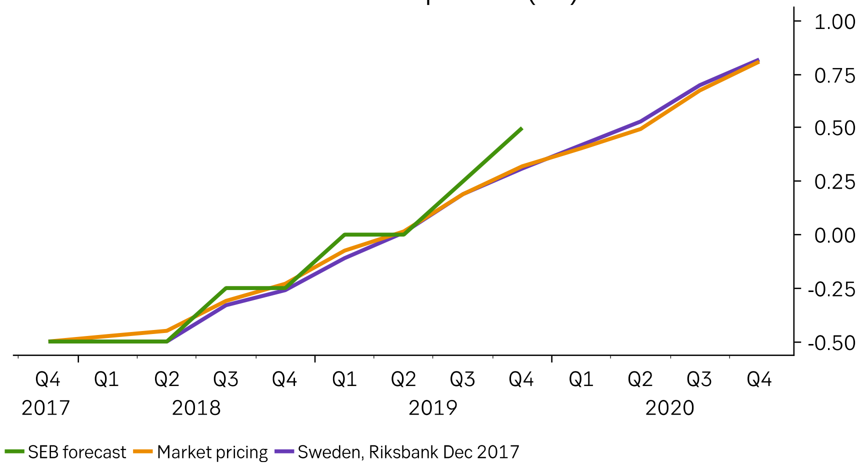


SEK: krona is no barrier to rate hikes now

LIMITED GDP-IMPACT FROM HOUSE PRICE CORRECTION
The Swedish growth outlook remains strong despite the country's on-going house price correction. During the spring, we expect prices to rise again as demand outstrips supply. However, their recent 10% fall will depress construction activity which will contribute negatively to GDP in 2018/19 following a strong contribution in 2015-17**.** Other pockets of growth will ensure activity remains relatively high. The ultimate question still concerns how much wages may at last accelerate as the economy enters full resource utilisation? Current wage rate of 2.5% is not enough to secure CPIF close to Riksbank 2%-target.

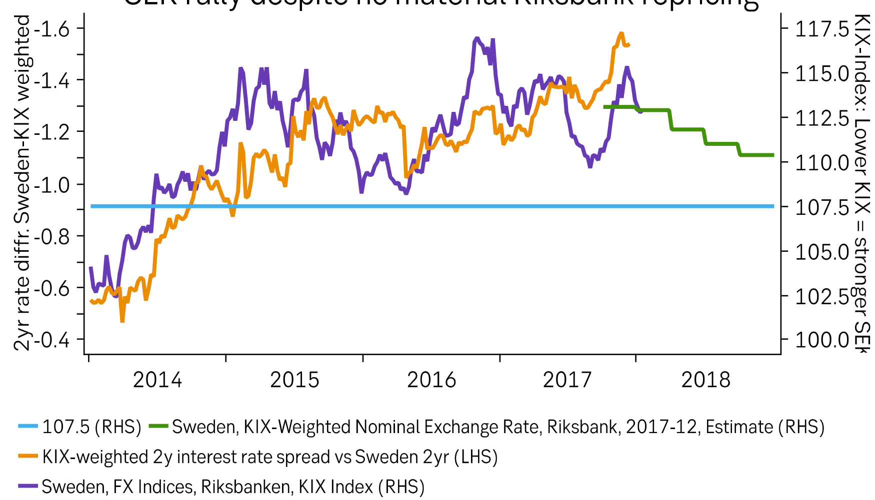
RIKSBANK HAS A PLAN FOR THE REPO RATE
The Swedish central bank has left the repo rate projection unchanged for four consecutive meetings (see graph right). Market participants have adapted to this forecast and are now fully discounting such a scenario. If therefore, as seems increasingly likely, the board delivers on this plan, reactions in financial markets should be relatively restrained. It also means the SEK will probably appreciate less sharply than we and the consensus feared. When the first rate hike occurs in Q3'18, we expect mainly foreign accounts to be krona buyers. As Swedish corporates maintain a cautious hedging policy, they will not become large SEK purchasers when the Riksbank hike interest rates. However, part of their large accumulated FX-denominated reserves will be exchanged for SEK once rates hit 0%. As Swedish pension funds have sufficiently modified their overall FX exposures (current average 22%), we do not expect further massive SEK buying from these institutions. **We forecast EUR/SEK at 9.70 and 9.45 respectively end of Q2 2018 and Q4 2018. The risk is weaker SEK short-term, stronger SEK H2 2018.**

Riksbank repo rate (%)



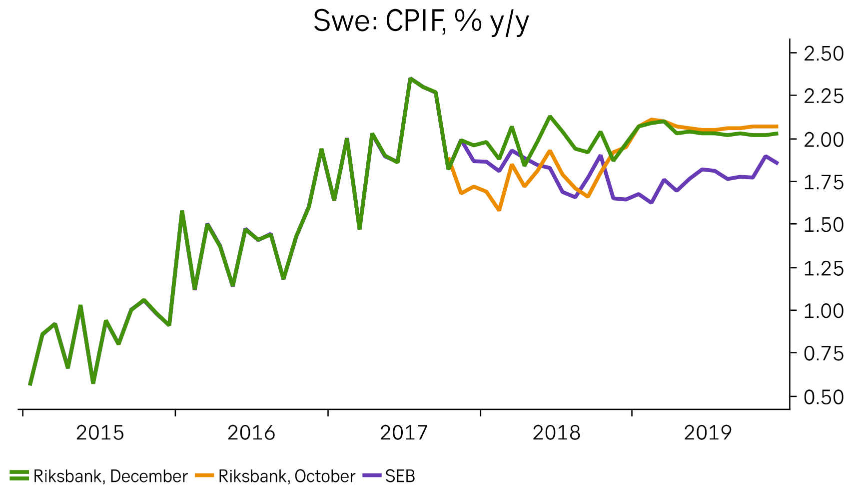
Source: Riksbank, Macrobond, SEB

SEK rally despite no material Riksbank repricing

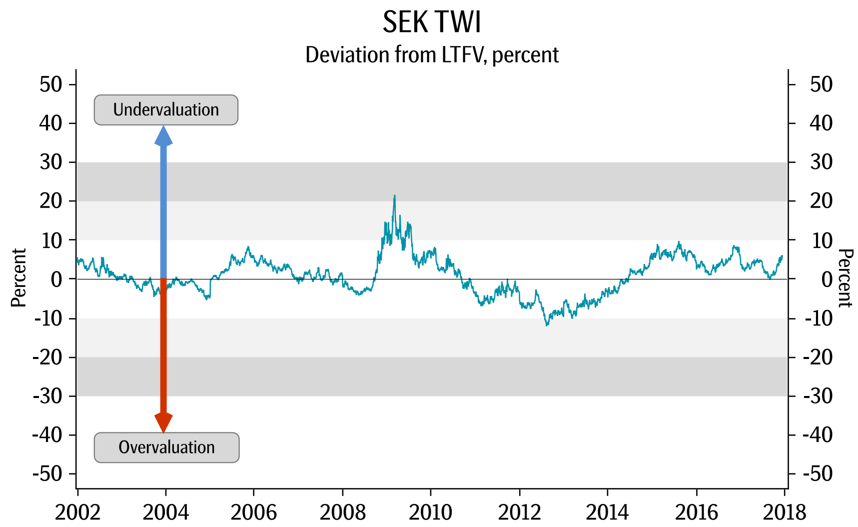


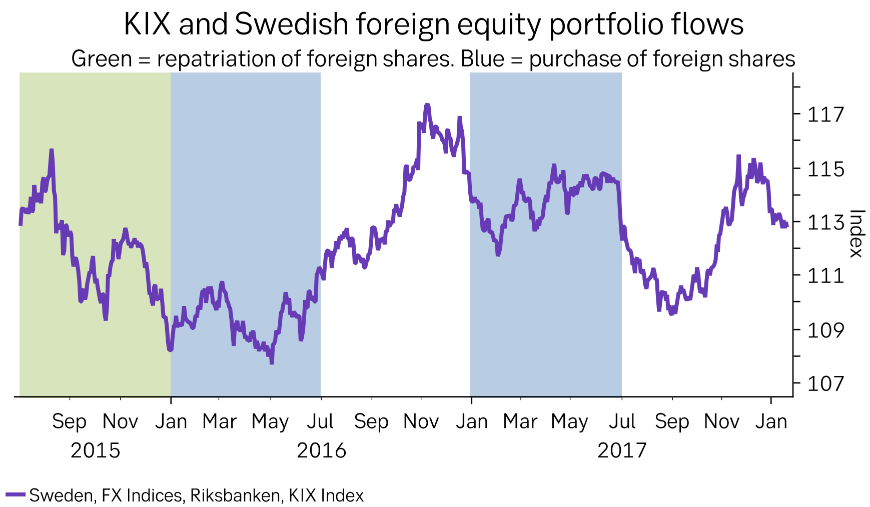
Source: Macrobond

Sweden: flows suggest only gradual SEK appreciation

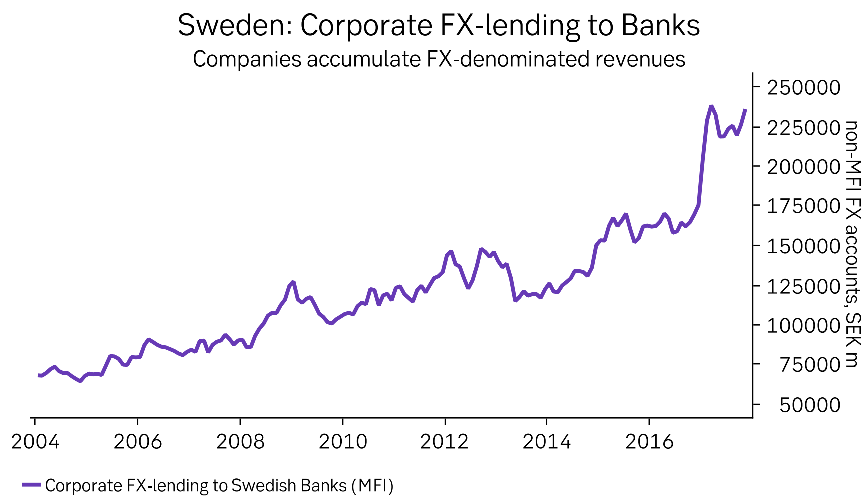


Source: Central Bank of Sweden (Riksbanken), Macrobond, SEB





Source: Central Bank of Sweden (Riksbanken), Macrobond, SEB



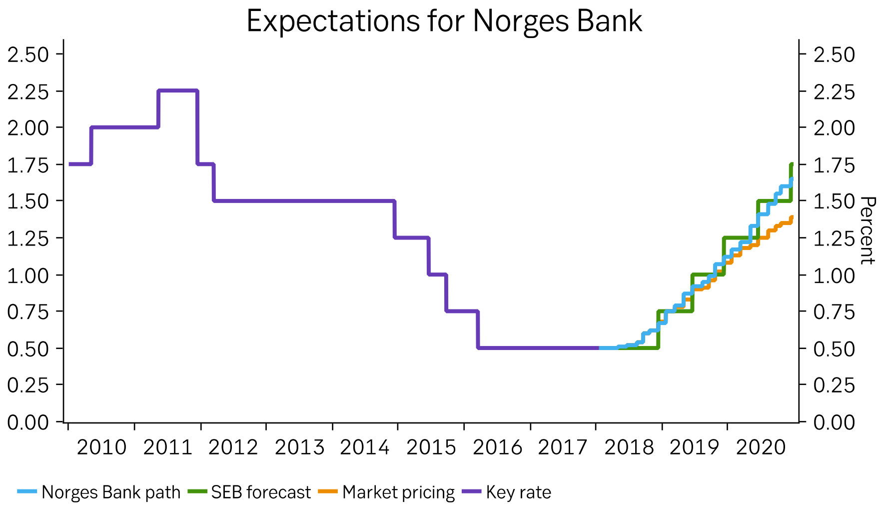
Source:

NOK: Short-lived krone weakness

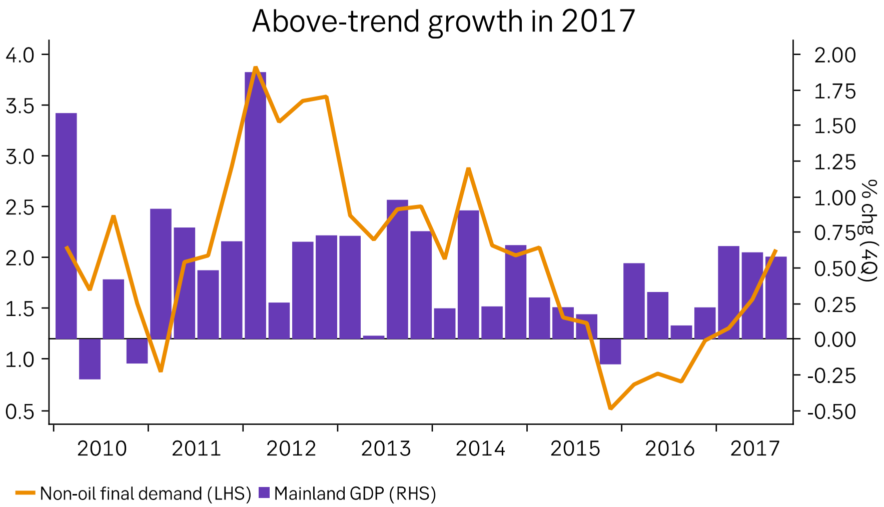
RECOVERING. The NOK has rebounded from the severe weakness seen late last year. We believe there is potential for a further rebound. Strong growth in the mainland economy opens up for rate hikes later this year. A stabilization in house prices during the summer and higher-trending inflation should also support the krone. **We maintain our forecast of a gradual move lower in EUR/NOK towards 9.20 by year-end.**

LAGGING STRONGER FUNDAMENTALS. The recovery in the Norwegian economy accelerated in 2017 and there was a broad-based improvement in labour markets. We expect mainland GDP to grow above trend in 2018. The correction in the housing market will slow construction activity, but mainland exports should improve and there is evidence of a sharp turn in the petroleum investment cycle. A more hawkish stance by Norges Bank is thus motivated. We have long argued for a December hike, which is consistent with the rate path from December. However, markets rate expecta-tions are still a tad too cautious, especially beyond 2019. Despite fundamentals being markedly more positive, EUR/NOK is well-above levels seen during 2015 when oil prices plunged and wide-spread speculations of a recession was lingering in markets. We expect markets to increasingly price in solid fundamentals in the exchange rate. A stabilization in home prices during the summer, as we expect, should also help to improve market sentiment.

The large inflows created when the government supplements its budget with large-scale oil revenues will continue in 2018. Despite Norges Bank having bought an average of NOK 830mn per day throughout 2017, the impact on the krone has negligible as net selling by foreign banks have more than outweighed the positive created via the budget. Long-term valuation of the krone remains attractive. We estimate a fair value in EUR/NOK of 8.70 and 7.60 in USD/NOK.

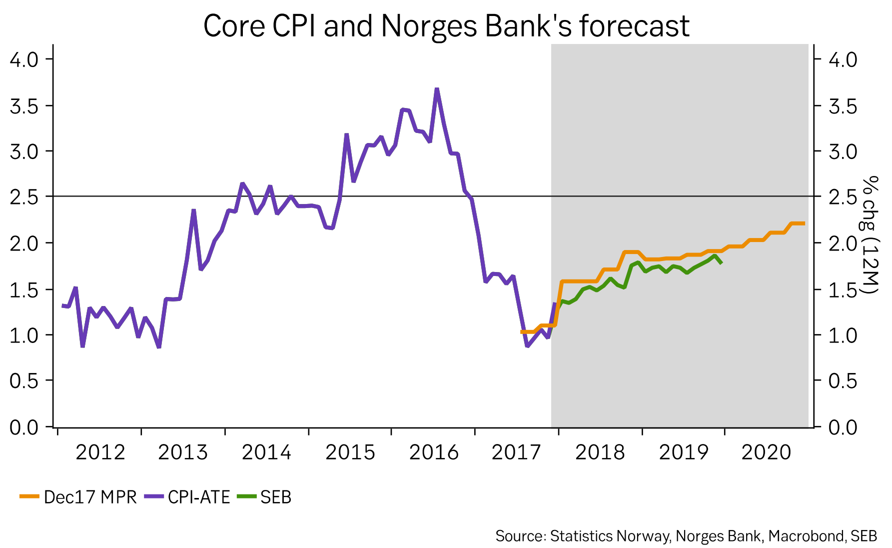


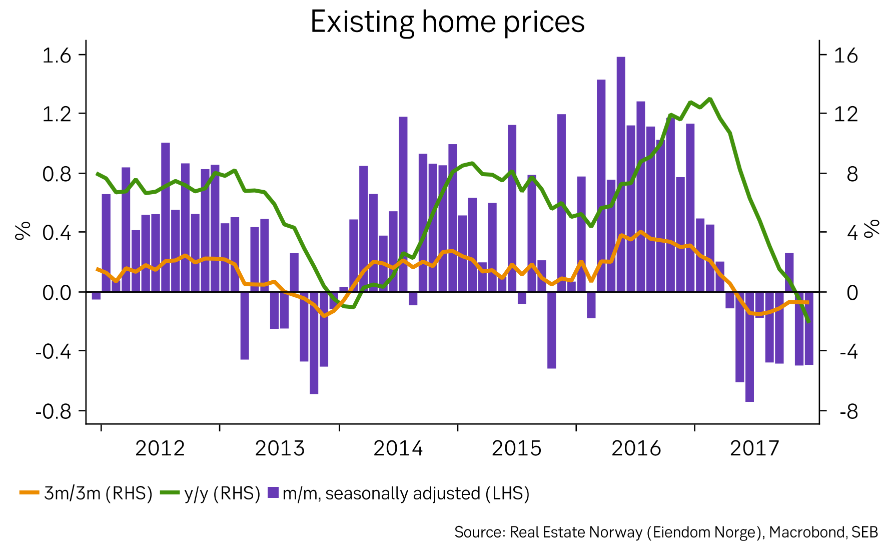
Source: Norges Bank, Macrobond, SEB

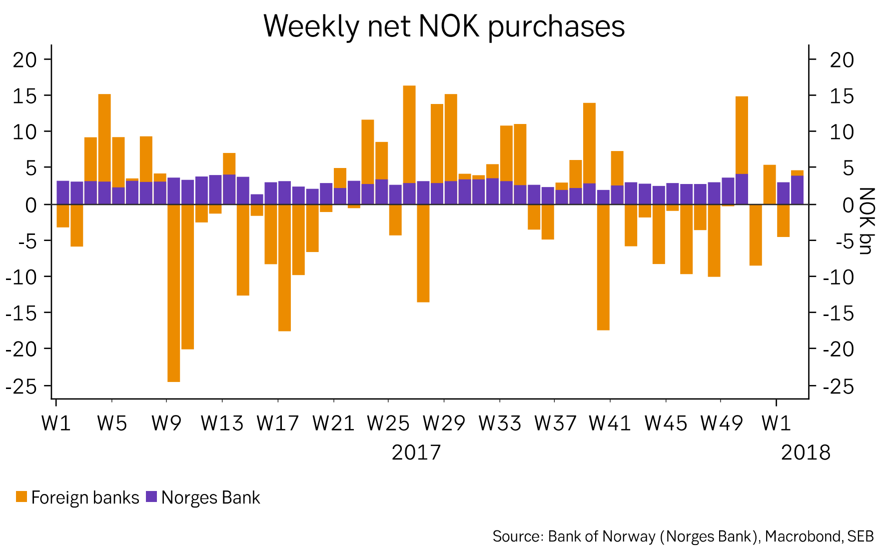


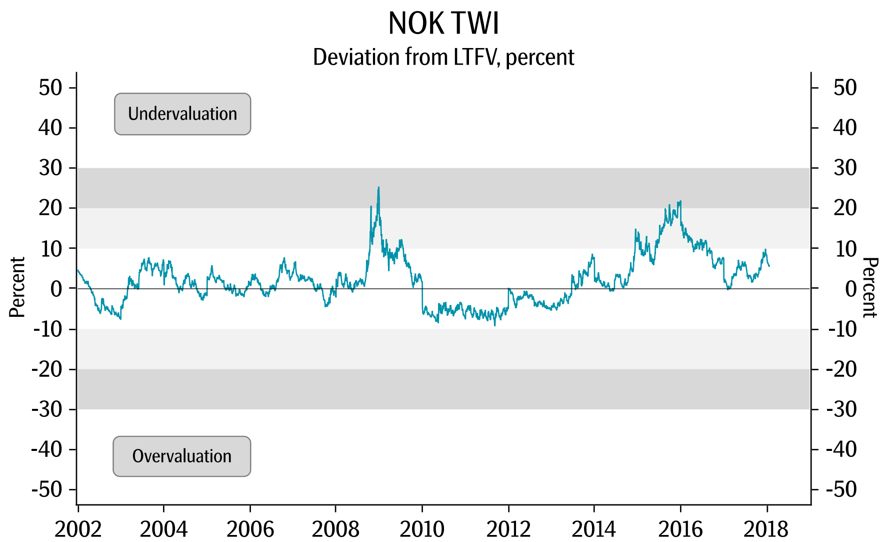
Source: Statistics Norway, Macrobond, SEB

Norway: Undervalued NOK









Canadian economy on thinner ice than it seems

STILL GOOD REASONS FOR POLICY CAUTION

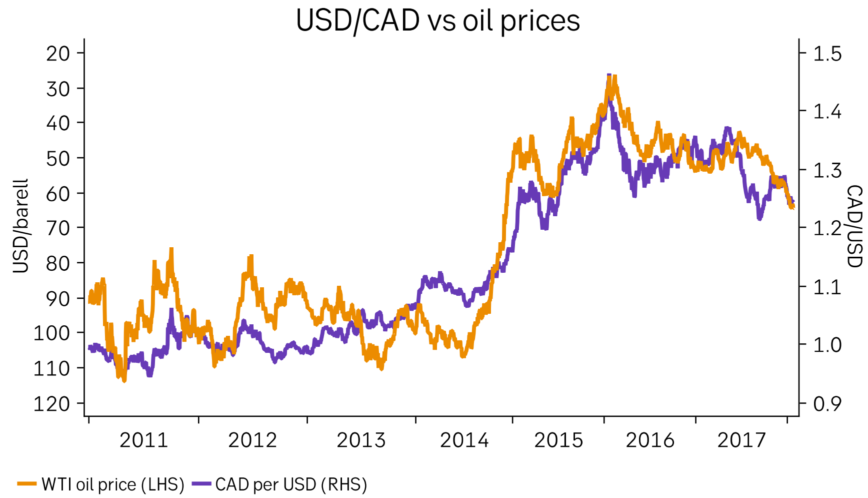
After the impressive spurt in the first half of 2017 the Canadian economy is now decelerating and real GDP for Q4 is coming in well below the 2.5% target. But with respect to the output gap, the current very low unemployment rate is suggesting that the output gap is closed.

While wage growth is increasing again, the Bank of Canada has not hit its core inflation target in 1.5 years and just 2/3 of the time in the past 10 years. The increase in the Ontario minimum wage will put upward pressure on 2018 wage growth but also impair job growth at the same time.

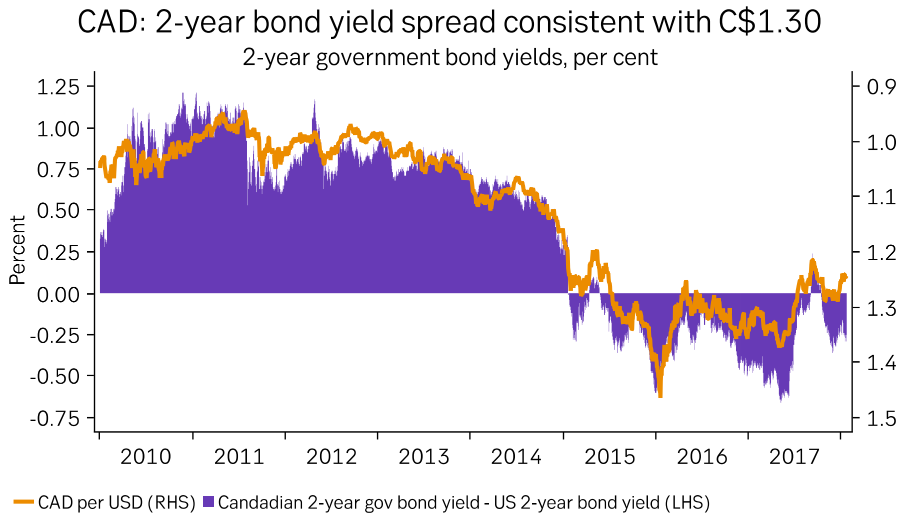
The growth outlook in 2018 is uncertain. Because of the tighter mortgage rules that just kicked in, the Canadian housing market has brought forward a lot of growth late last year so arguably there is no pent-up demand left. Moreover, the fiscal outlook is clouded while trade uncertainties is generating downside risks. President Trump has recently indicated that he will not make a decision on NAFTA until after the Mexican elections at July 1st.

After the "dovish hike" at the January 17th meeting, we expect only one more hike in 2018 and two hikes in 2019, respectively. As such the BOC will lag behind the Fed and the CAD, which has had a strong run of late, will likely trade sideways in 2018.

In 2019, when oil prices are trending higher according to our forecast, we expect the CAD to strengthen. CAD per USD will trade at 1.15 at the end of 2019.

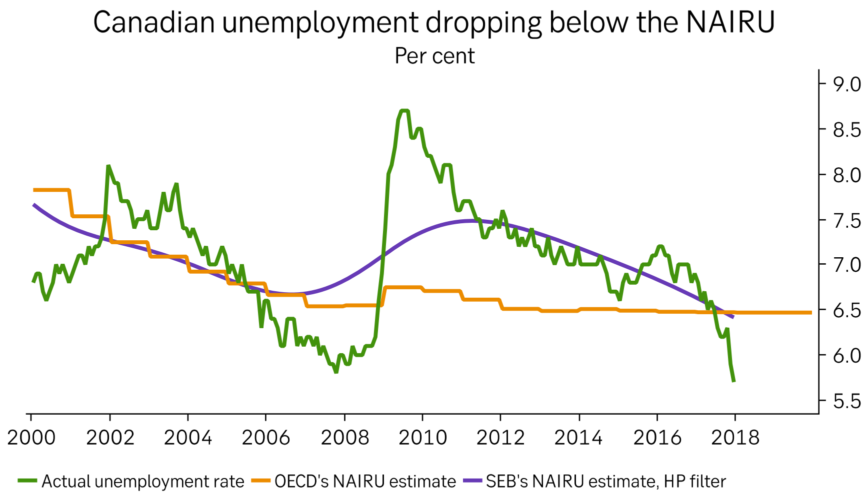


Source: Macrobond Financial AB, Macrobond, SEB

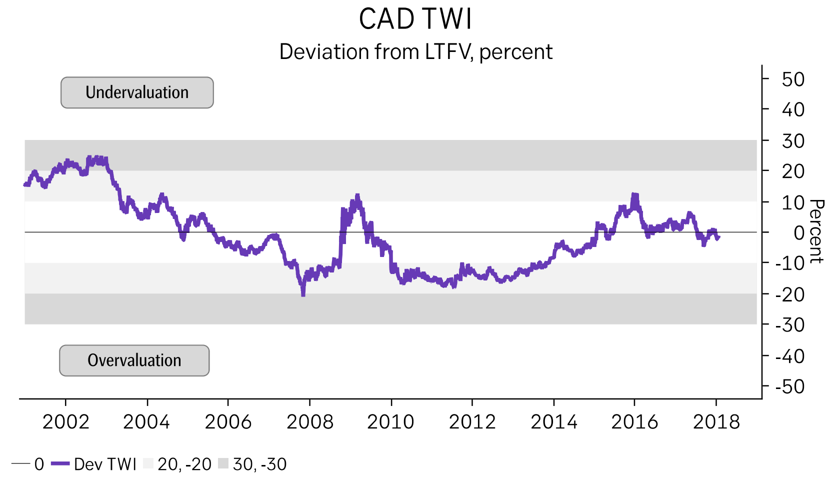


Source: Bank of Canada, Macrobond Financial AB, Macrobond, SEB

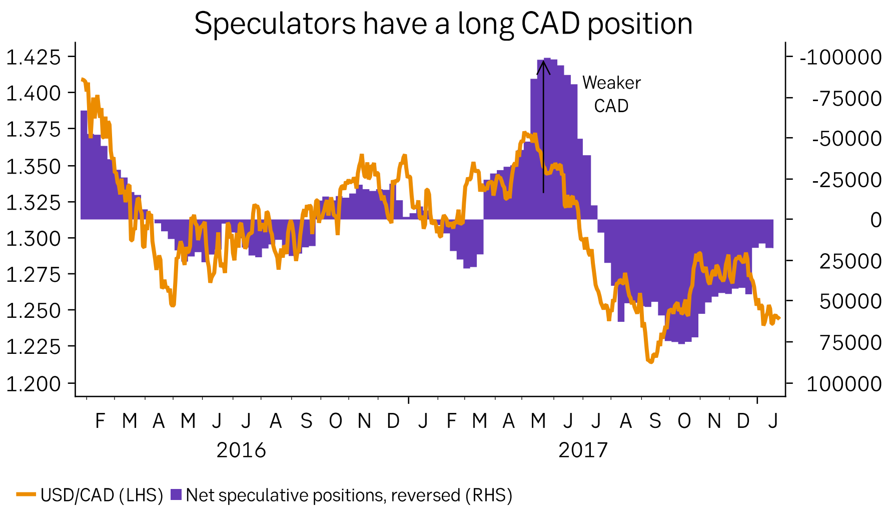
Canada: CAD is fairly valued

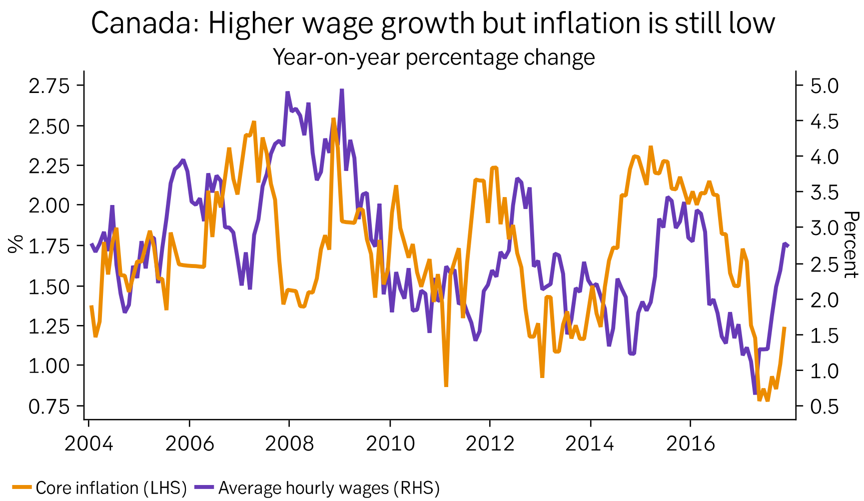


Source: Statistics Canada, OECD (Organisation for Economic Co-operation & Development), Macrobond, SEB



Source: Macrobond, SEB





Source: Statistics Canada, Macrobond, SEB

AUD: No longer a high-yielding currency

RATE NORMALISATION WILL START IN 2018

After cutting the cash rate to record low 1.5% in August 2016, the Reserve Bank of Australia (RBA) has left interest rates unchanged as it waits for growth and inflation to pick up. Meanwhile the RBA is entertaining the idea that the economy is less inflation prone than it once was; the RBA sees "considerable uncertainty" around when and how quickly wage pressures might emerge. Indeed, inflation/ wage growth are on the low side but more recently real GDP growth has picked up again.

While this still is suggesting that the RBA still is in no hurry to start the rate normalisation, our analysis is showing that Australia actually is one of the countries where the Phillips curve is the strongest. That conclusion holds both for a "core inflation" Phillips curve specification and a "wage growth" Phillips curve specification. As such, we continue to expect higher wage growth and inflation to gradually picking up. Our forecast is for two rate hikes in 2018, in May and November.

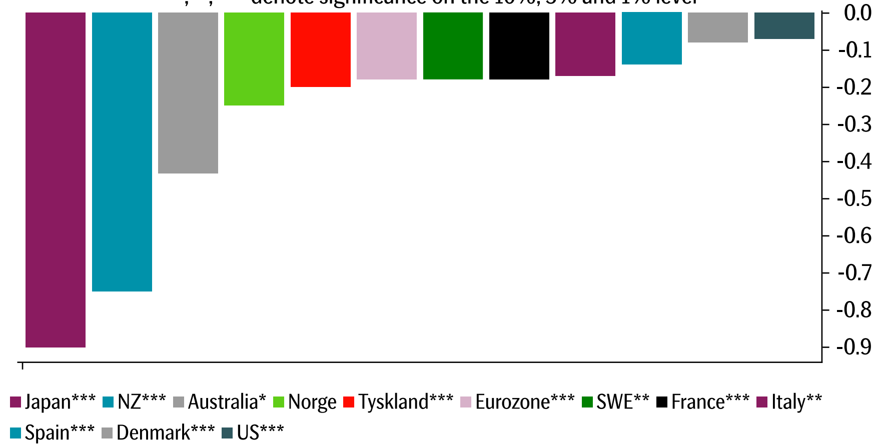
THE YIELD PREMIUM HAS EVAPORATED

The Aussie has performed well since early December but not necessarily because of a more hawkish RBA. As the Fed will continue its rate normalization, the rate gap vis-à-vis the Fed has disappeared and the Aussie is losing its standing as a high-yielding currency. The last time the spread was this narrow was in 2001 when the Aussie was as weak as 47.8 US cents.

Against that backdrop we see a weaker AUD and our forecast is that the Aussie will decline to 75 US cents by the end of 2018. The consensus estimate is 80 US cents.

Phillips curve effects across major economies (Core inflation)

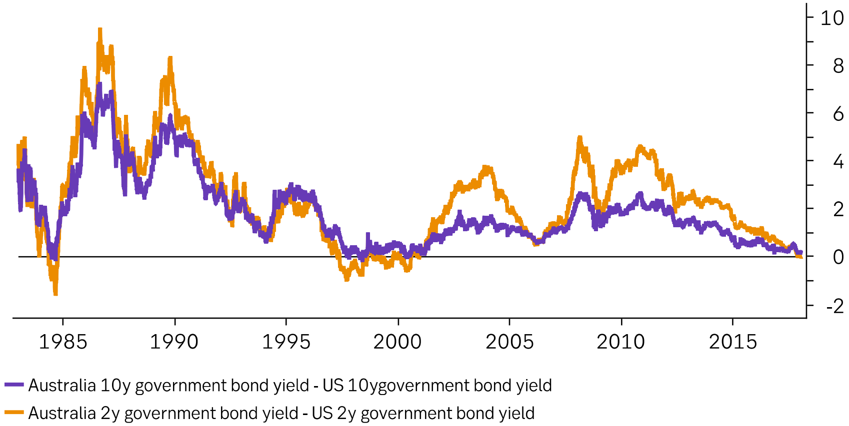
*,**, *** denote significance on the 10%, 5% and 1% level



Notes: Estimated on core inflation. No significant effect for Switzerland, Canada and the UK. Sample period: 1996-2017.

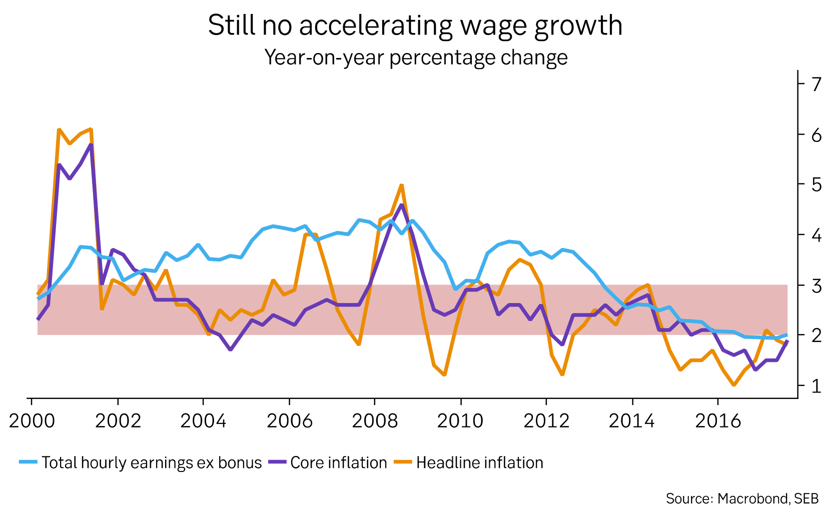
AUD: No yield premium left

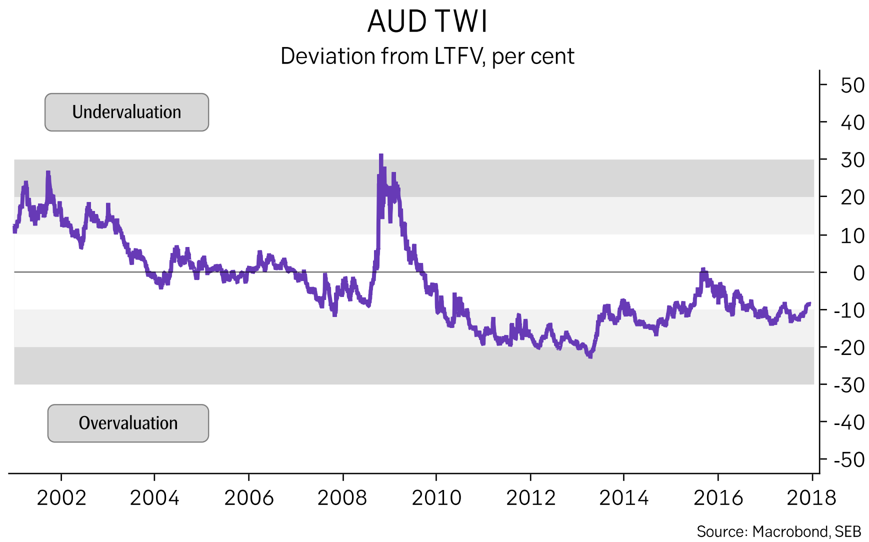
Per cent

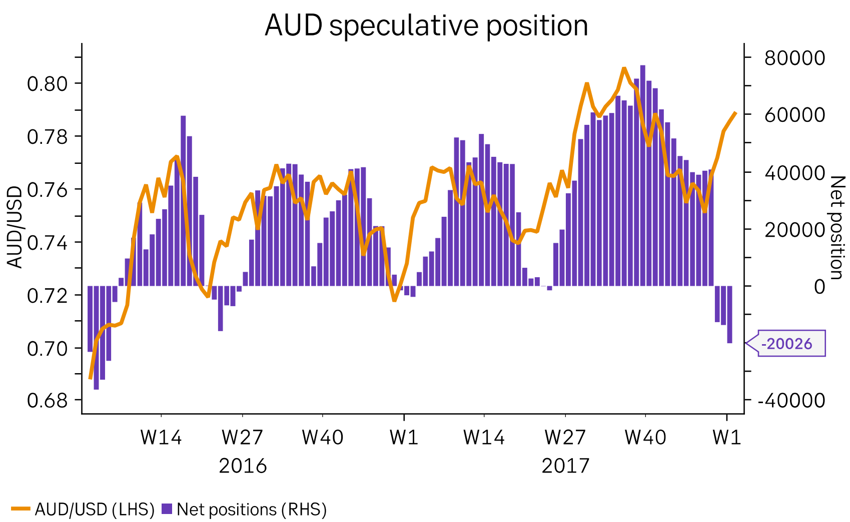


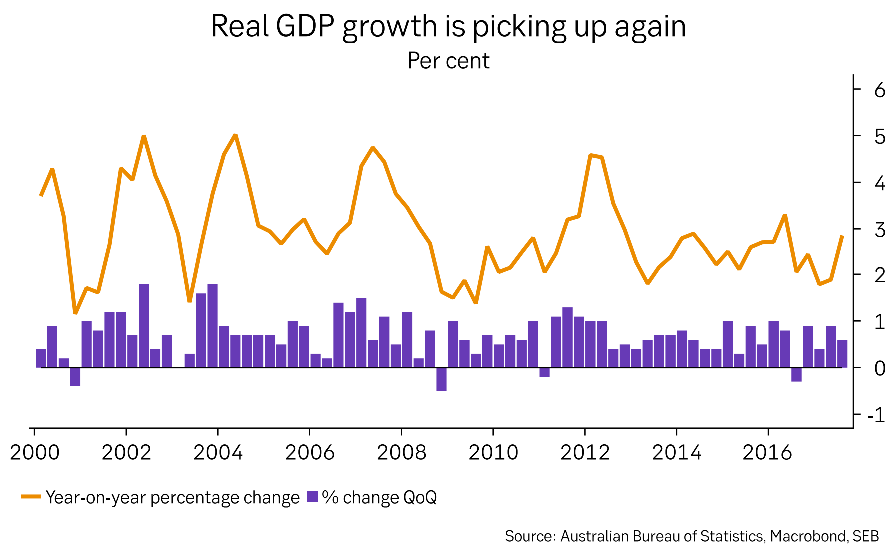
Source: Macrobond Financial AB, Macrobond, SEB

Australia: The Aussie is still overvalued









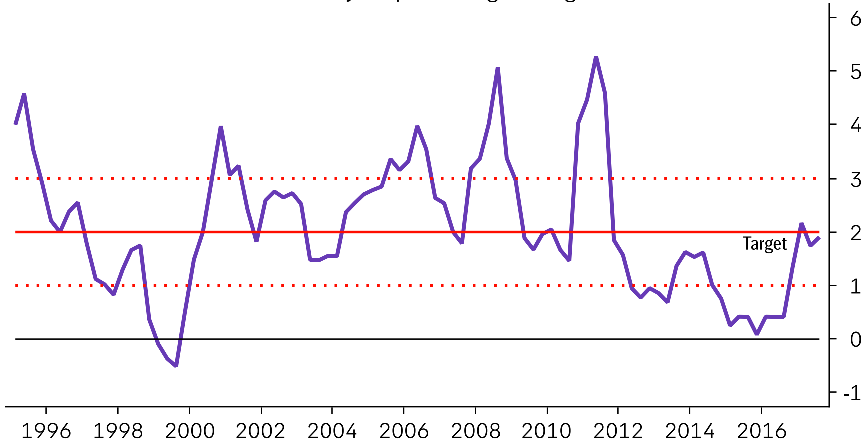
NZD: Near-term rally precedes further decline

HEALTHY GROWTH AND INFLATION NEAR TO TARGET. New Zealand's year-on-year GDP growth slowed steadily over several quarters to 2.7% y/y in Q3. Though higher levels of activity within the economy are still mainly driven by domestic demand, terms of trade have improved. Fiscal policy will likely become more expansionary following the change in government. The Reserve Bank of New Zealand (RBNZ) forecasts an above-potential increase in GDP of 3.0% in 2018, causing pressure on capacity to build. CPI inflation was 1.9% in Q3, just below the target midpoint. While tradables inflation is expected to decelerate, a projected increase for non-tradables prices as capacity pressures grow will keep overall inflation close to target. The RBNZ has left its policy rate unchanged at 1.75% since November 2016; we expect it to remain on hold until H2 2018. Home price increases have continued to slow, due to tighter loan-to-value policy conditions and affordability constraints. Housing market risks have decreased slightly.

CHANGE IN GOVERNMENT HAS WEAKENED THE KIWI. The unexpected outcome of the September 23 election was a Labour-led coalition government. Uncertainty following the poll and worries about economic policy have weakened the NZD. The government plans to add employment to the RBNZ's mandate suggesting that monetary policy could become more dovish. The NZD continued to weaken during the autumn, reaching a low of 0.68 in November before recovering sharply. The SEB valuation model indicates that the kiwi is overvalued, while speculative positioning suggests that investors are now shorting it. We regard post-election NZD weakness due to the change of government as excessive and expect the currency to continue to rally over the near term. However, further out we forecast the kiwi will lose ground again to end 2018 near 0.72.

New Zealand: Inflation near target midpoint

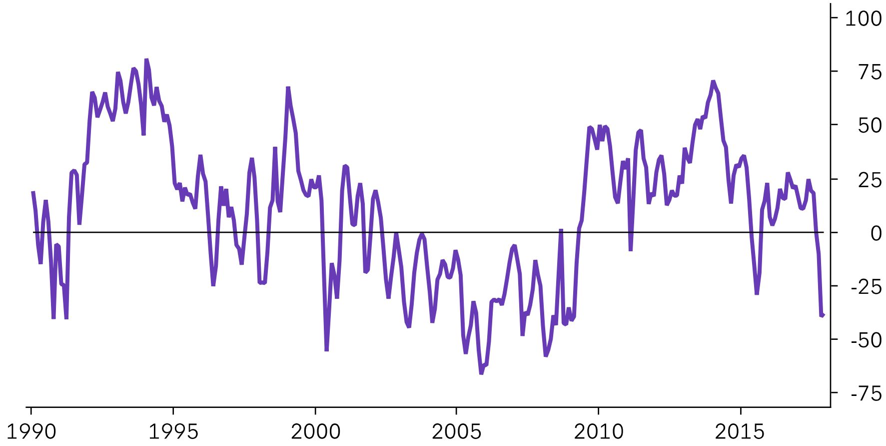
Year-on-year percentage change



Source: New Zealand National Statistical Office, Macrobond, SEB

New Zealand: Business confidence slumps following election

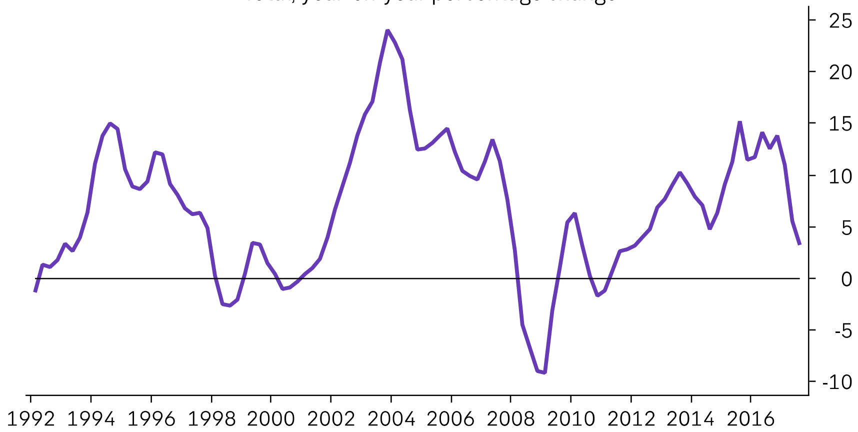
Net balance



Source: National Bank of New Zealand, Macrobond, SEB

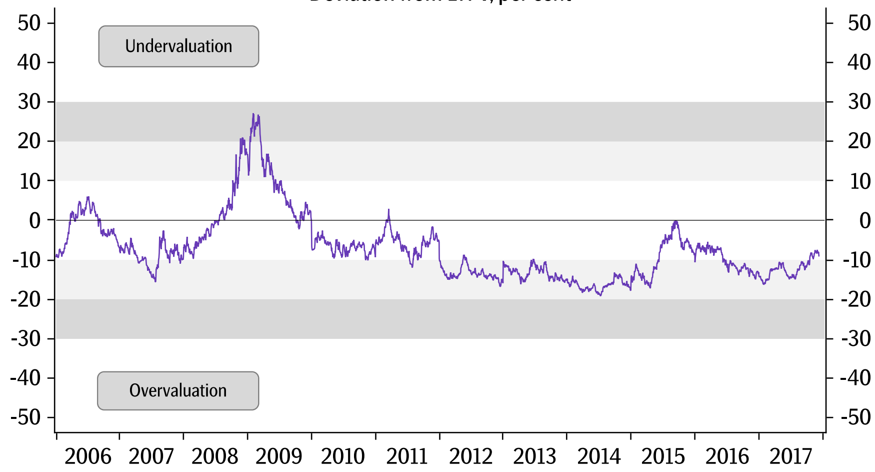
New Zealand: Kiwi still overvalued

House price increases continue to moderate
Total, year-on-year percentage change

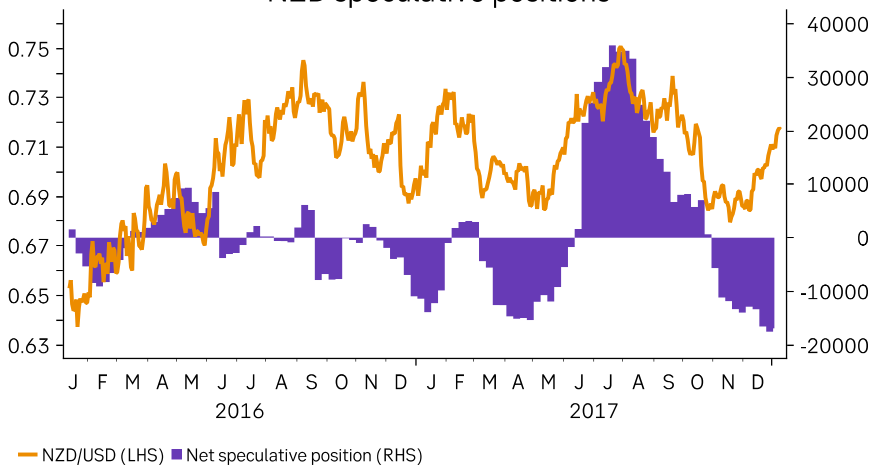


Source: Quotable Value, Macrobond, SEB

NZD TWI
Deviation from LTFV, per cent

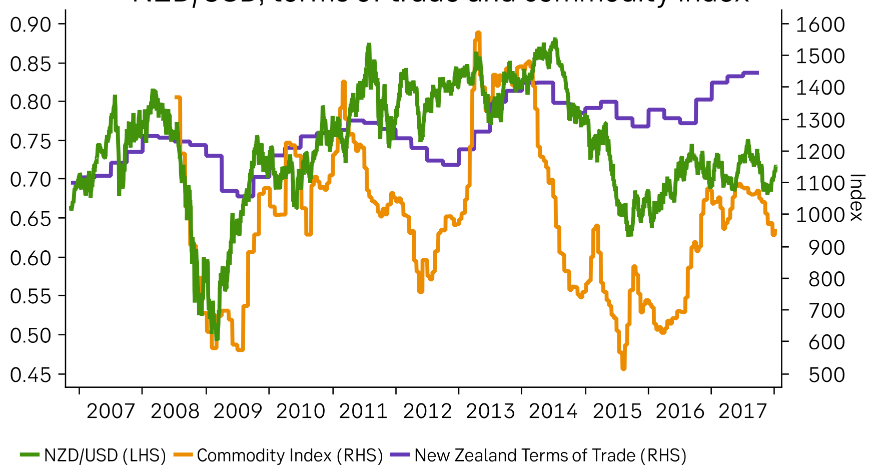


NZD speculative positions



Source: Macrobond, SEB

NZD/USD, terms of trade and commodity index



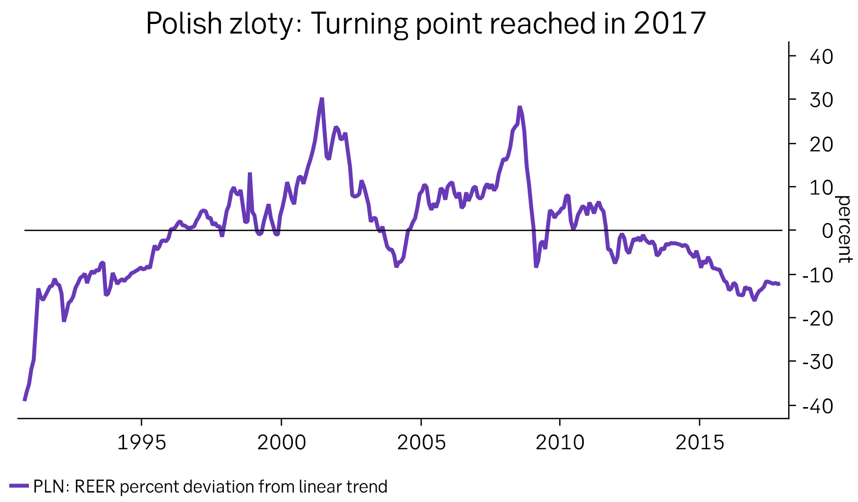
Source: Macrobond

PLN: Zloty starts to move from undervaluation

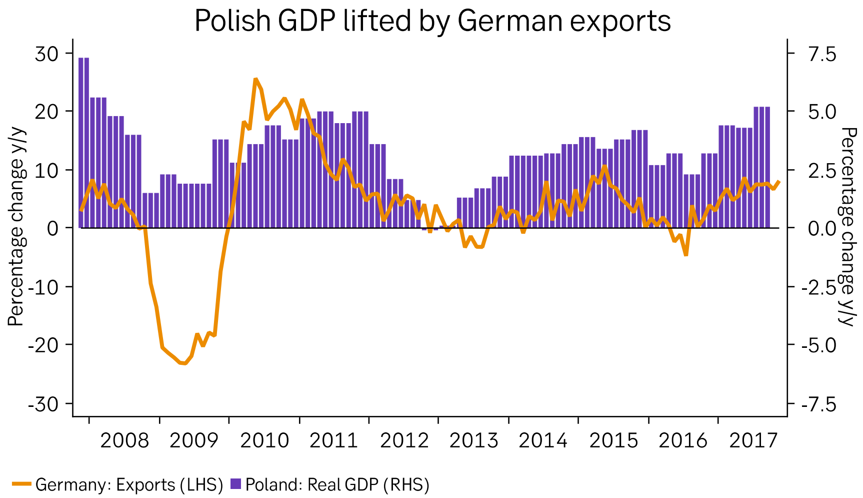
STRONG GROWTH AND POLICY TIGHTENING TO LIFT PLN. The PLN will appreciate over the next 12 months. We expect that EUR/PLN exchange rate will stay around 4.17 in Q1, before moving down to 4.10 in Q2, 4.08 in Q3, and 4.05 in Q4.

SHORT-TERM VIEW: PLN APPRECIATION HINGES ON NBP. The PLN is undervalued, but a correction has been prevented by the dovish National Bank of Poland (NBP), with Governor Glapinski signalling that the **policy rate may remain on hold at 1.50% through 2019.** Yet, disagreement in the NBP's policy committee is now starting to show, as wage growth and GDP accelerate. Inflation moderated to 2.1% y/y in December, but we expect inflation to rise above the NBP's 2.5% target in the coming months, prompting a majority of MPC members to defy Glapinski and hike the policy rate already at its July meeting.

LONG-TERM VIEW: PLN WILL APPRECIATE TOWARDS ITS FAIR VALUE. Real GDP expanded by 4.3% y/y in Q1- Q3 2017 and looks set to have reached 4.4% in 2017. In 2018, growth will stay high between 3.5% and 4.0%, driven by exports the German export sector and EU structural funds. Domestic demand will also be boosted by the government's social welfare spending programmes. Pre-election spending before the 2019 elections will help to lift PLN sentiment, potentially already in 4Q 2018. **Politics is the main risk for the PLN.** The lowering of the pension age will weigh on public finances from next year. The EU has initiated an Article 7 process against Poland over its judicial reform, which will keep relations frosty. A plan to push through a CHF-mortgage conversion bill and a limitation on foreign ownership of media companies may also hurt investor sentiment. Despite a reshuffling of the government, relations with Brussels look unlikely to improve as long as PiS is in power at least to November 2019.



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

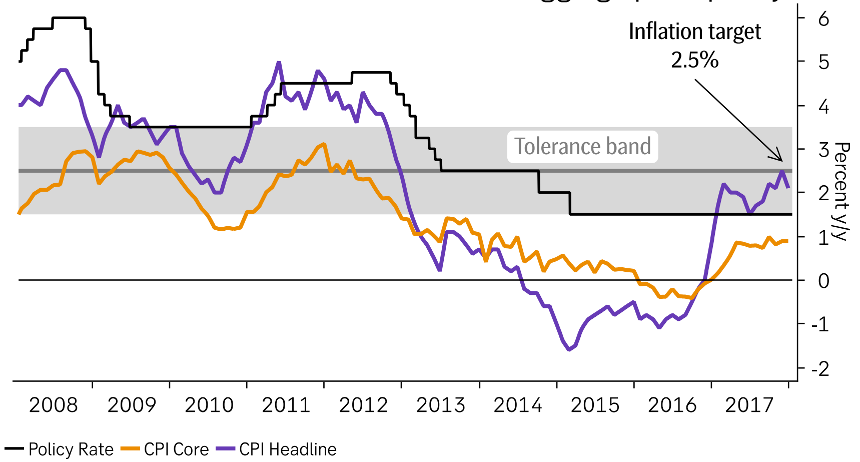


Source: Polish Central Statistical Office (GUS), Central Bank of Germany (Deutsche Bundesbank), Macrobond, SEB

SEB

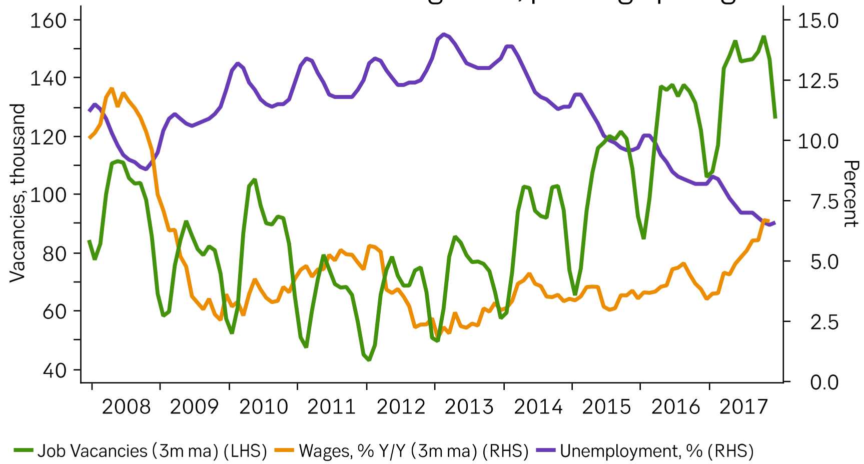
Poland: Economy is running out of slack

Poland: Inflation will continue to rise, dragging up the policy rate



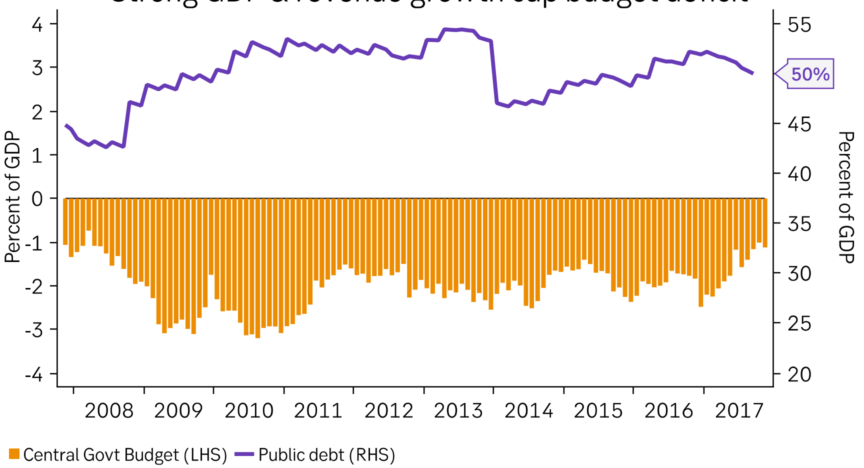
Source: Polish Central Statistical Office (GUS), National Bank of Poland, Macrobond, SEB

Poland: Labour market tightens, pushing up wages



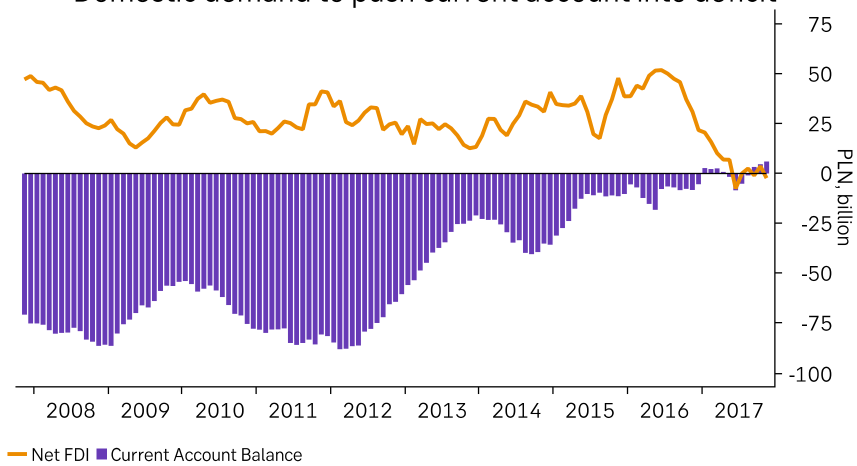
Source: Polish Ministry of Family, Labour & Social Policy, Polish Central Statistical Office (GUS), Macrobond, SEB

Strong GDP & revenue growth cap budget deficit



Source: Polish Central Statistical Office (GUS), Macrobond, SEB

Domestic demand to push current account into deficit



Source: National Bank of Poland, Macrobond, SEB

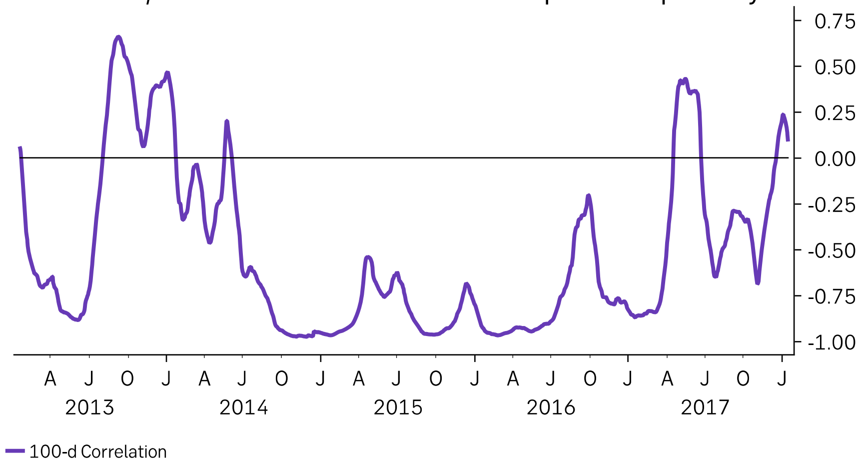
RUB: Carry partially offsets CBR & Fin Min policy

RUB WEAKNESS ON CBR RATE CUTS AND FINANCE MINISTRY RESERVE PURCHASES.
The RUB will weaken moderately to 60.5 against the USD in 2018. The main determinants of the RUB will be monetary policy easing by the CBR and interventions by the MoF in combination with a stagnant, or weaker oil price in 1H 2018. A high carry and the ongoing economic recovery will only partially offset that pressure.

SHORT-TERM VIEW: OIL PRICES & RUB HAVE PEAKED.
The correlation between oil and the RUB has weakened. Yet, the price of oil is a key factor for the RUB. With oil prices (Brent) surging to a 3-year high in January 2018, the RUB has moved close to the strongest levels since April 2017. But, we do not expect oil to move sustainably higher in the first half of 2018 as shale oil production increases and inventories hit the OPEC target, suggesting an easing of production limits. Soft oil prices will have a dampening effect on the RUB. The economy is gradually recovering. Real wages are below 2014 levels, but have started rise, lifting household sentiment and consumption. Investment is lagging, but construction and durable goods including vehicles sales look set to grow. Support for the RUB also comes from net capital inflows, but will not be enough to reverse the effect of CBR easing and Fin Min reserve purchases. Inflation fell to 2.5% y/y in December 2017, well below the 4% target. An orthodox monetary policy by the CBR has so far supported the RUB, but a gradual easing and yields dropping will allow the RUB to weaken.

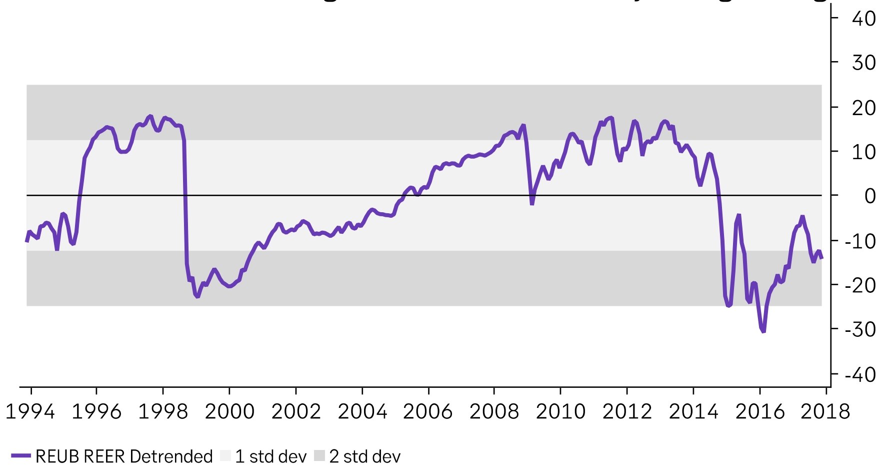
LONG-TERM VIEW: RUB WILL SUFFER FROM WEAK MACRO.
Economic policy won't change, but rhetoric may after the March presidential election. The private sector is small and higher productivity growth rates are unlikely. **Russian-produced goods will need support from a weak RUB to stay competitive.**

USD/RUB and Brent oil have decoupled temporarily



Source: Macrobond, SEB

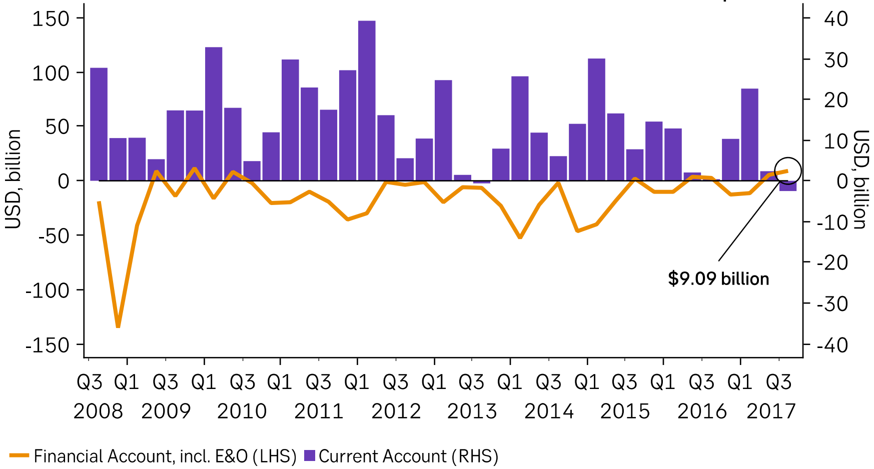
Real effective exchange rate to move sideways in tight range



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

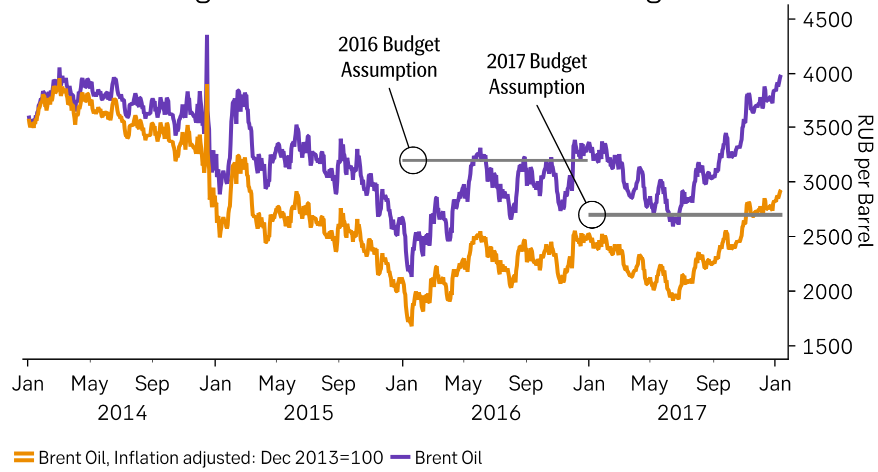
Russia: Economy getting back to its normal

Russia: Current & financial accounts back in surplus



Source: Central Bank of the Russian Federation (CBRF), Macrobond, SEB

Budget revenues recover with oil and growth

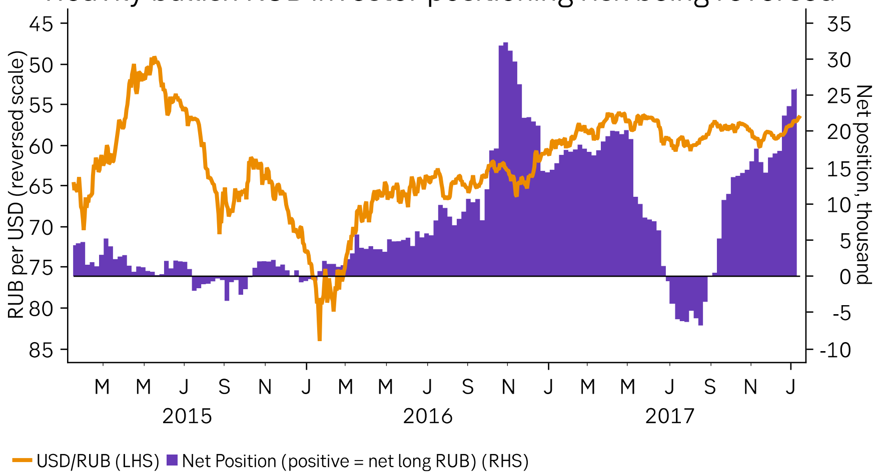


Source: Macrobond, SEB

Downside potential in OFZ yields lure investors

Source: Macrobond, SEB

Heavily bullish RUB investor positioning risk being reversed



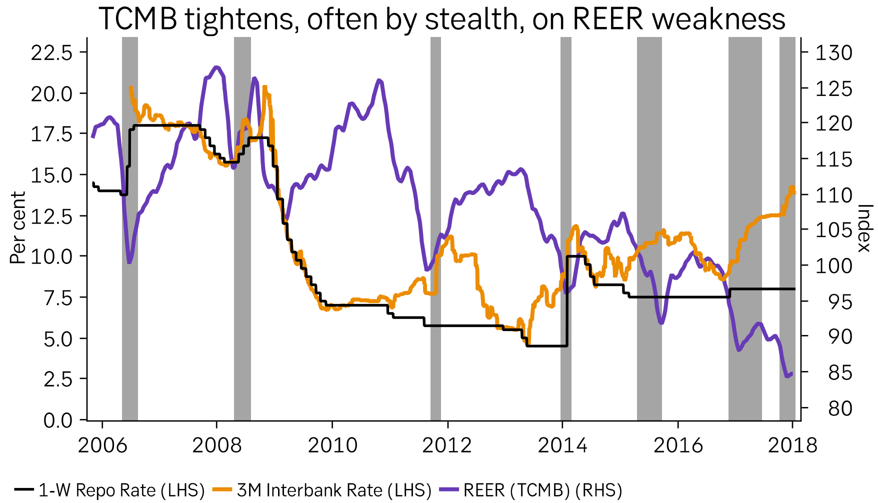
Source: Commodity Futures Trading Commission (CFTC), Macrobond Financial AB, Macrobond, SEB

TRY: TCMB, TRY's last defence

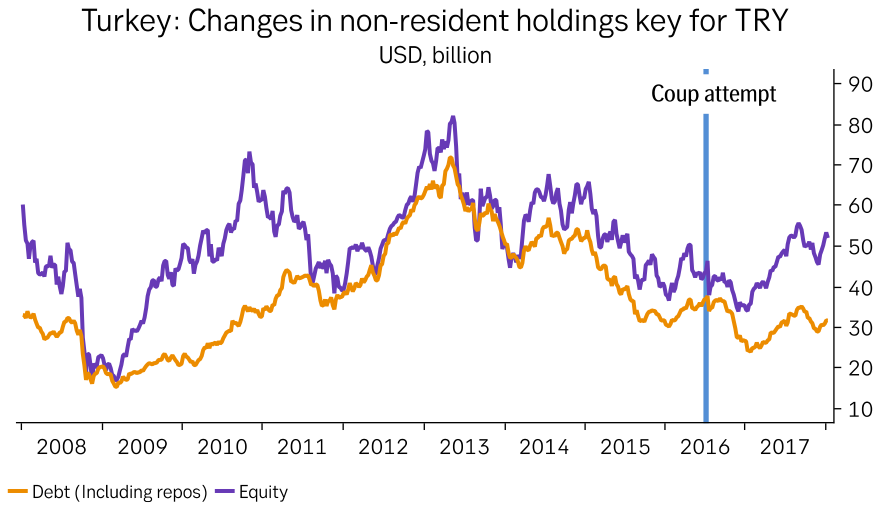
POLITICAL UNCERTAINTY VS. TIGHT MONETARY POLICY
We expect the USD/TRY rate to end Q1 at 3.65, Q2 at 3.75, Q3 at 3.80, and Q4 at 3.85. The two main factors behind the relative strength of the TRY are Turkey's high nominal interest rates and strong GDP growth outlook. However, **the risk is skewed towards a higher USD/TRY rate** as a result of political pressure on the central bank to loosen policy and event risks associated with the war in Syria and relations with the US.

SHORT-TERM VIEW: ECONOMIC GROWTH AND HIGH CARRY TO SUPPORT TRY
GDP growth was a strong 7.3% y/y in the first three quarters of 2017. Although it will slow in 2018 as the government's stimulus programmes wear off, growth will be strong enough to sustain generally positive investor sentiment. Inflation will fall below 10% y/y in 2H, still leaving the central bank with few options but to maintain a tight monetary policy stance in order to attract foreign portfolio flows to cover the excessive 25% of GDP external financing requirement. The TCMB hiked the rate on the "late liquidity window" in December, a sign that TRY weakness has reached a critical point in the near term. President Erdogan and his AK Party will try to boost their popularity ahead of local elections in 2019 through pork-barrel spending and by adopting an increasingly nationalistic rhetoric. Nevertheless, we expect President Erdogan and his administration, using quiet diplomacy, to prevent relations with the US from deteriorating much further.

LONG-TERM VIEW: THE TRY WILL CONTINUE TO WEAKEN
The CB's inflation target is 5.0%, but inflation will stay above 9% 2018. **The TRY will depreciate to keep Turkish exports competitive and contain the current account deficit.** In addition, concerns about **politics will weigh on the TRY.**



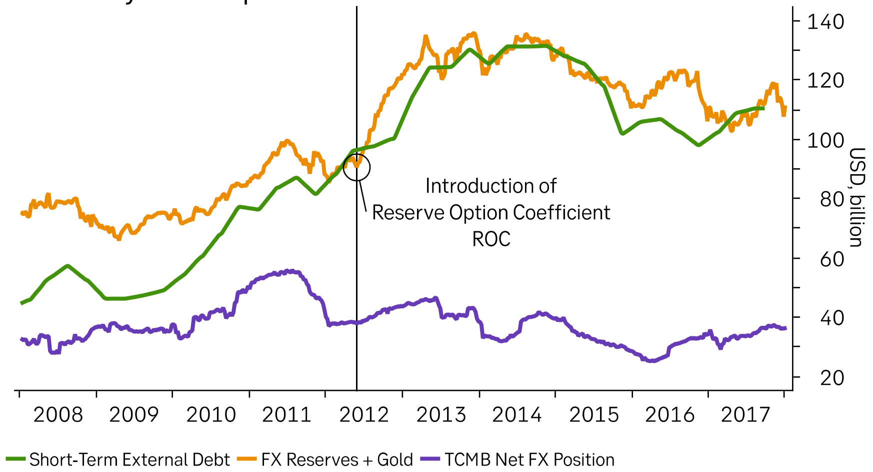
Source: Central Bank of the Republic of Turkey (TCMB), Bank Association of Turkey, Macrobond, SEB



Source: Central Bank of the Republic of Turkey (TCMB), Macrobond, SEB

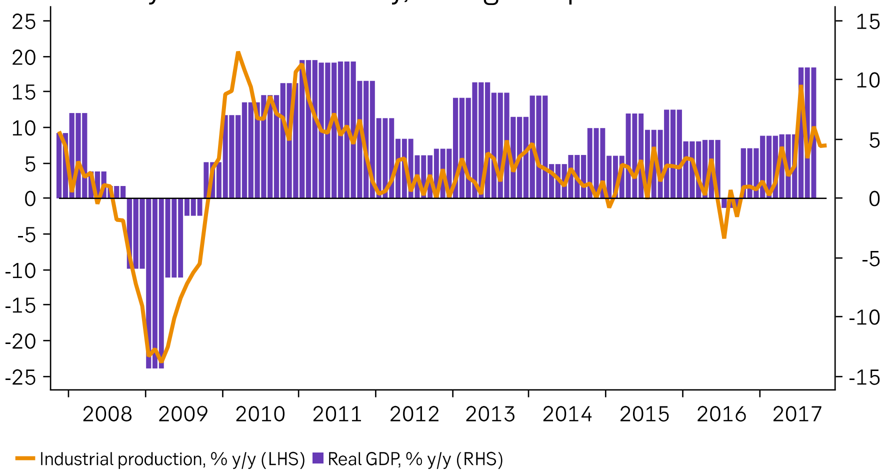
Turkey: Achilles' heel is short-term external debt

Turkey: Inadequate reserves for short-term external debt



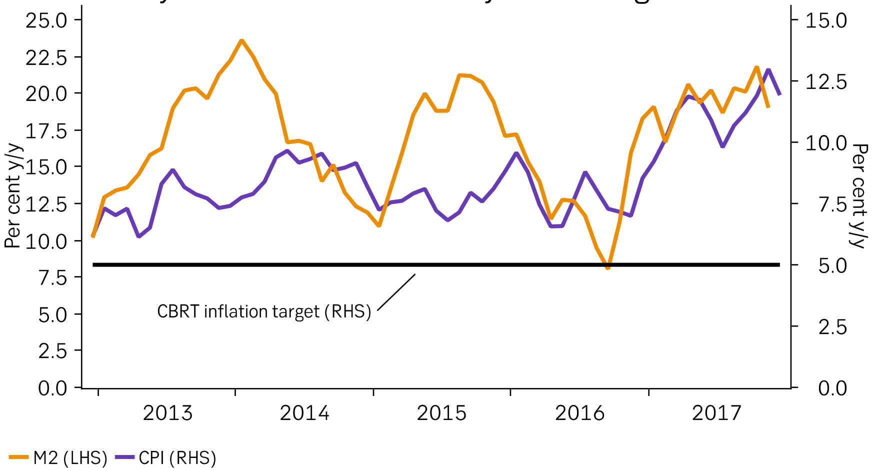
Source: Central Bank of the Republic of Turkey (TCMB), Turkish Prime Ministry Undersecretariat of Treasury, Macrobond, SEB

Turkey: Growth recovery, enough for positive sentiment



Source: Turkish Statistical Institute (TurkStat), Macrobond, SEB

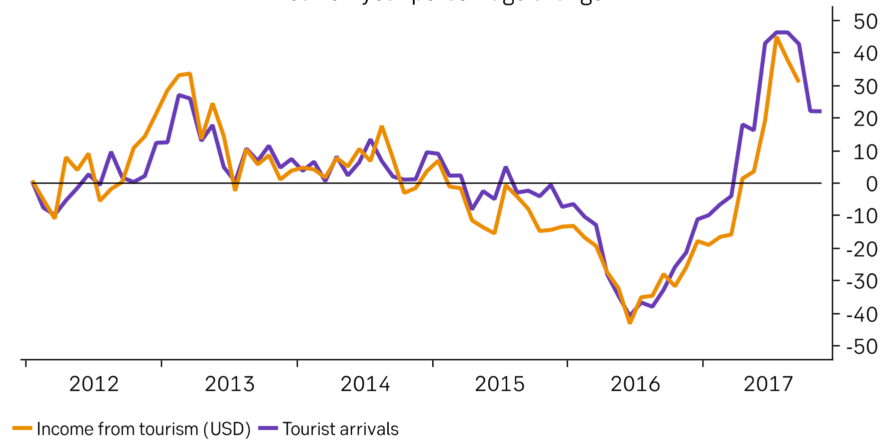
Turkey: Inflation to remain way above target in 2018



Source: Turkish Statistical Institute (TurkStat), Central Bank of the Republic of Turkey (TCMB), Macrobond, SEB

Turkey: Tourists return and so will spending

Year-on-year percentage change



Source: Turkish Ministry of Culture & Tourism, Turkish Statistical Institute (TurkStat), Macrobond, SEB

CNY: Stronger in the year of the "bull" dog 2018

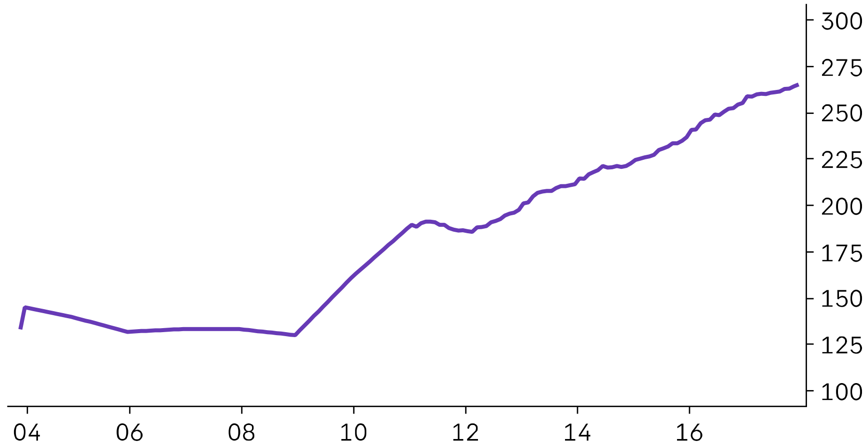
SLOWER ECONOMY BUT STRONGER CNY TO 6.30 BY END-2018. The economy will slow to 6.6% in 2018 from 6.9% in 2017. Government policy has switched to reduce risk. President Xi sees rising debt as hazardous to political stability. The healthier global growth and export environment provide room for domestic slowdown and de-risking without hitting total growth significantly. Total debt growth slowed in 2016 but we expect further slowdown that will reduce debt as percent of GDP (i.e. deleveraging).

The currency will continue strengthening. We expect USD/CNY to end at 6.30 in 2018 and 6.10 in 2019. PBoC has adjusted to keep the currency stable with a small strengthening bias to attract foreign capital inflow to support the domestic equity and bond markets. A stable or mild appreciating currency will attract inflow. Also, with US and European recover, exports should stay healthy and support the trade balance. Exporters can withstand a stronger currency if volumes are stable. Finally, the central bank will keep interest rates elevated and hike starting in H2 2018 to facilitate de-risking and deleveraging. That is negative for growth but supports the currency. PBoC has been one of the few who have pushed up rates to keep up with the US Federal Reserve.

Rest of Asia will follow China and CNY and hike rates and strengthen their currencies. In addition to China, Korea hiked rates in late 2017 and Malaysia has signaled for a hike in early 2018. We think Singapore will follow in April. In addition to higher rates, Asian central banks will allow for currency strength to fend of the rise in inflation pressures.

Total debt

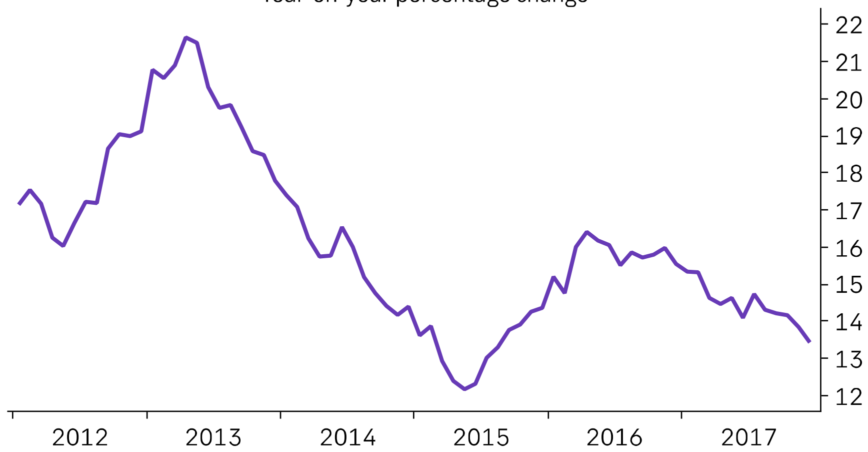
Per cent of GDP



Source: SEB

Total financing

Year-on-year percentage change

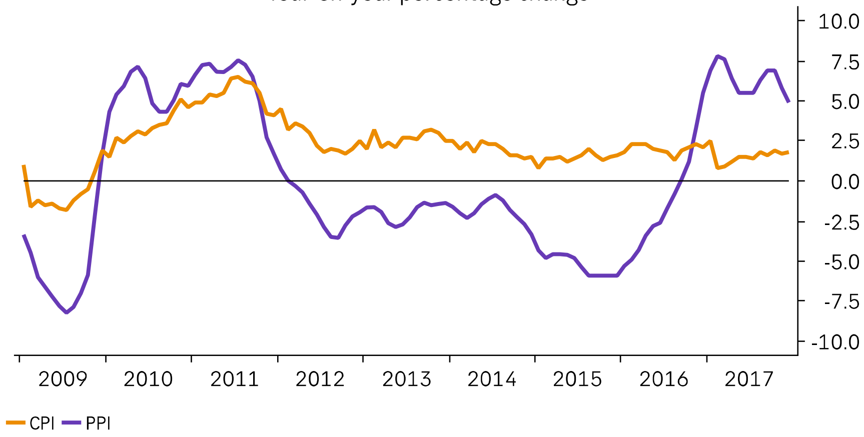


Source: SEB

China: growth slowing but deceleration is orderly

CPI & PPI

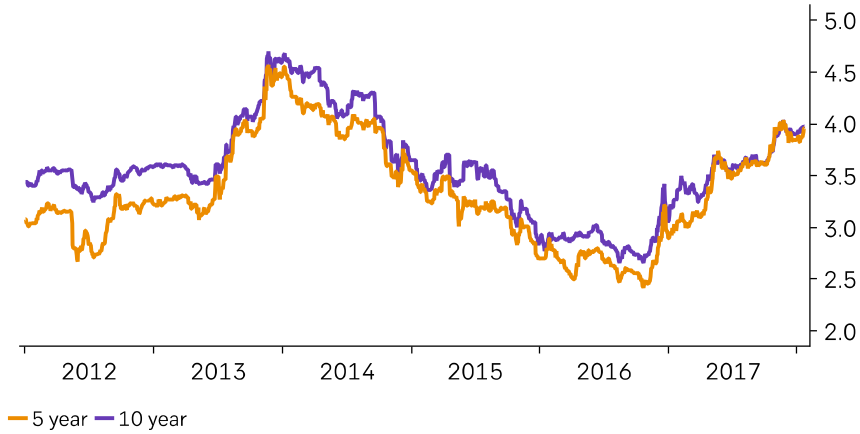
Year-on-year percentage change



Source: SEB

Government yield

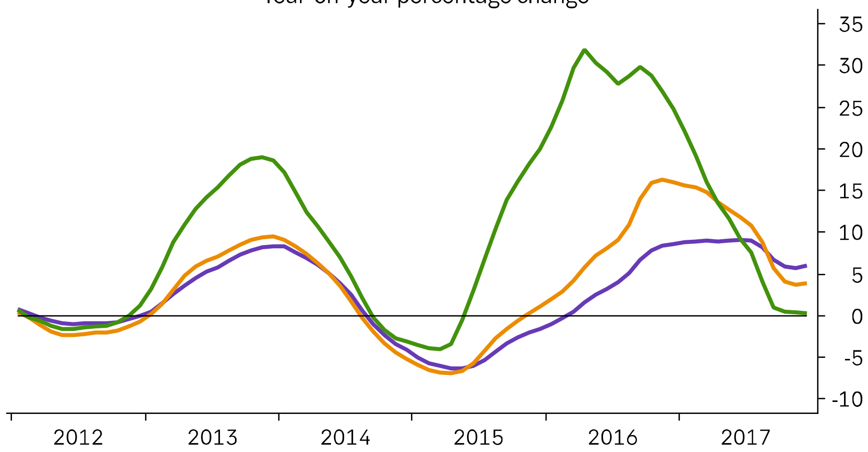
Per cent



Source: SEB

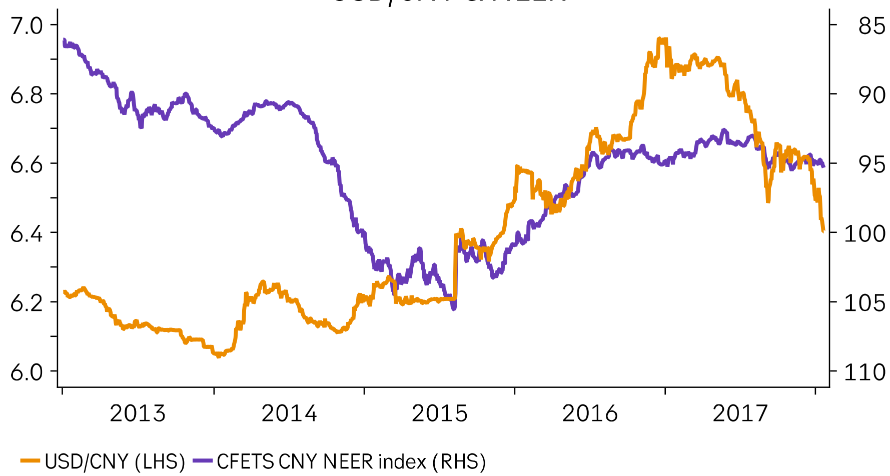
New residential property price

Year-on-year percentage change



Source: SEB

USD/CNY & NEER



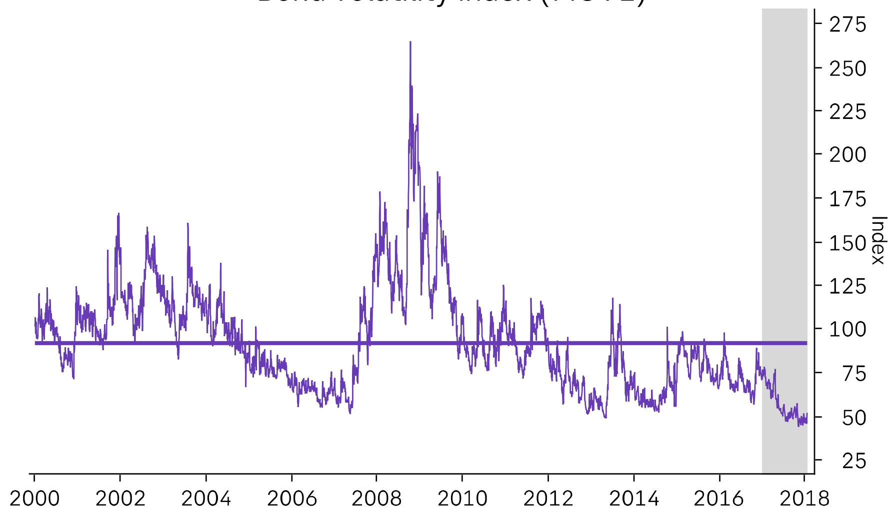
Source: SEB

Themes

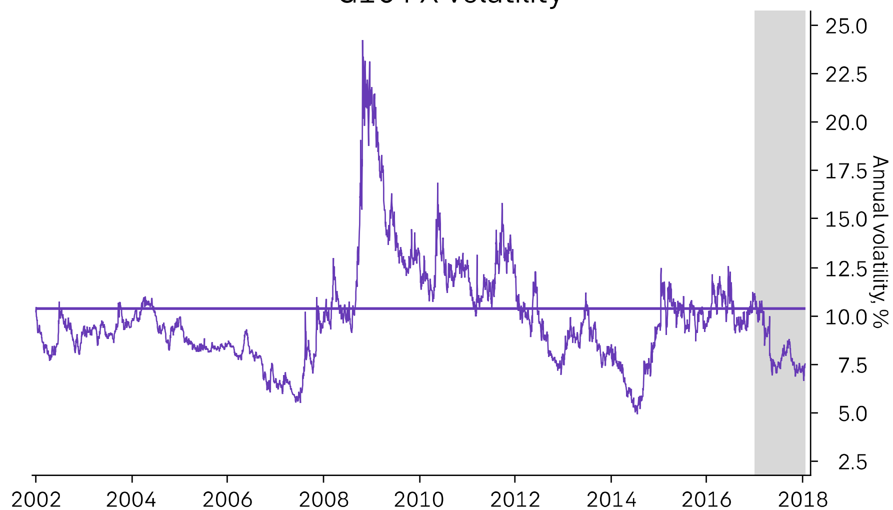
Goldilocks scenario to sustain low volatilities

- Volatility in financial markets in general fell significantly in 2017. Bond market volatility has reached the lowest on record and equity market volatility is close to historical lows.
- Although FX market volatility also fell substantially in 2017 it is still well above the historical lows from 2007 and 2014.
- The low implied volatilities simply reflect that realised volatility has dropped in financial markets. Moreover it is a sign that expectations on future moves currently are very low due to the fact risk appetite remains supported with strong global growth this year, ample global liquidity and predictable and very cautious central banks amid generally very low global inflation.
- These conditions are unlikely to change significantly and should remain in place over the next 3-6 months.

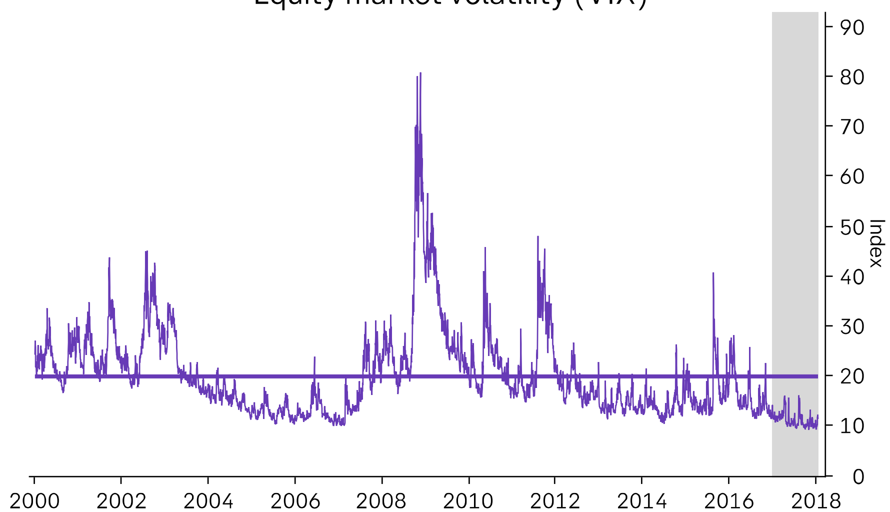
Bond volatility index (MOVE)



G10 FX volatility



Equity market volatility (VIX)



Market positioning

LEVERAGED FUNDS ARE BULLISH GBP & EUR / BEARISH JPY
With the OTC structure of the FX market positioning aggregates are not available. Instead the market has been using CFTC's weekly *Commitment of traders* report as a proxy for positioning. However, lately it has also become increasingly common to use the more detailed report *Traders in financial futures* report where positioning is divided into different classes of speculators where the category leveraged funds attracts most attention.

The top chart shows the current positioning of leveraged funds in different currencies in comparison with its three year history (100 equals the largest net long position and 0 the largest net short). It shows that **leveraged funds are most bullish positioned in GBP and EUR** compared to their average holdings (which have been short positions for both) **while their most bearish position compared with history is held in the JPY** (where a small net long has been the average). One way of using the positioning information is to identify excessive positioning, which tend to predict normalization which also tend to impact the currency rate.

POSITIONING MEAN-REVERSION HAS WORKED WELL IN 2017
To determine if mean-reversion in positioning has worked to identify corrections in currencies we have developed a systematic trading model. The model **uses COT data on speculative positioning to spot excess situations** and sells (buys) currencies with an excessively large long (short) position. This strategy worked very well between 2009 and 2013 but have been less successful since then. However, **revisiting the model in 2017 it is clear that positioning could have helped in timing correction trades.**

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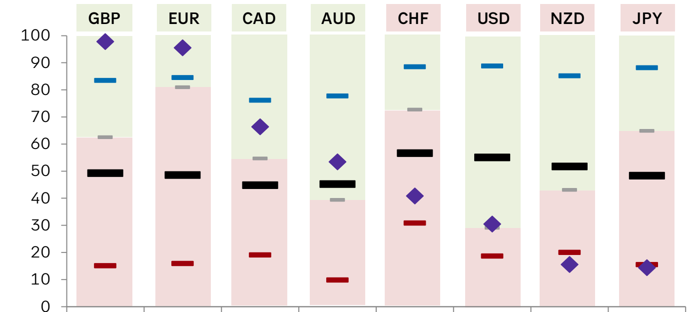
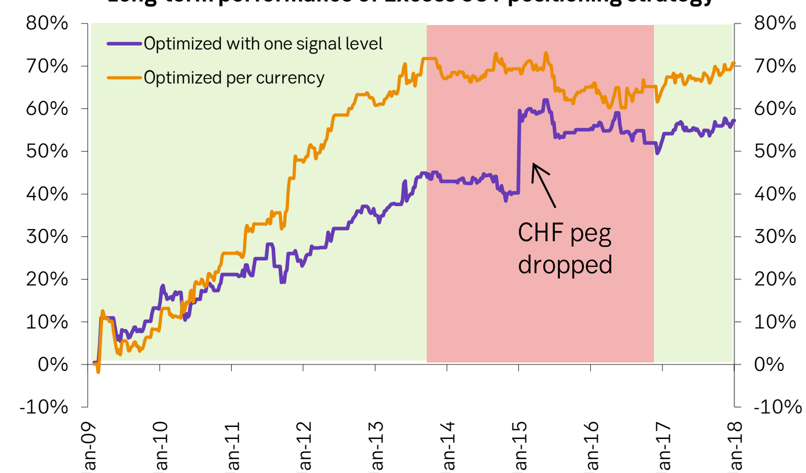
Leveraged funds most bullish GBP & EUR / most bearish JPY



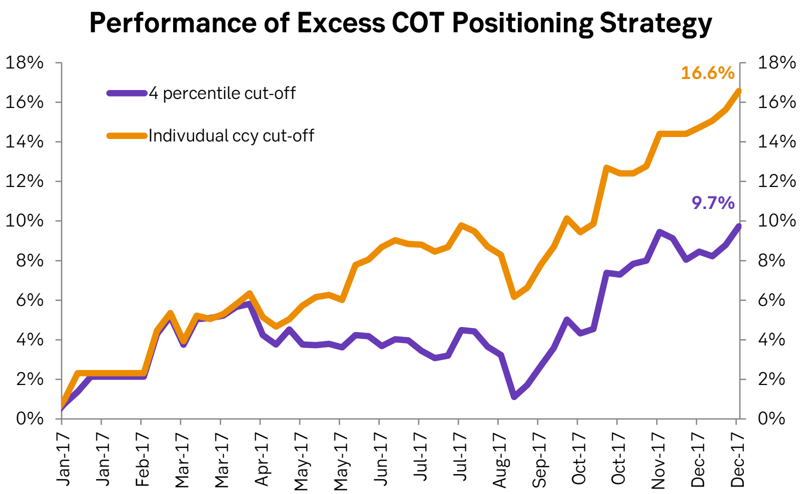
	GBP	EUR	CAD	AUD	CHF	USD	NZD	JPY
90th	83	84	76	78	88	89	85	88
Average	49	49	45	45	57	55	52	48
Net balanced	63	81	55	39	73	29	43	65
10th	15	16	19	10	31	19	20	15
Current	98	96	66	53	41	30	16	14

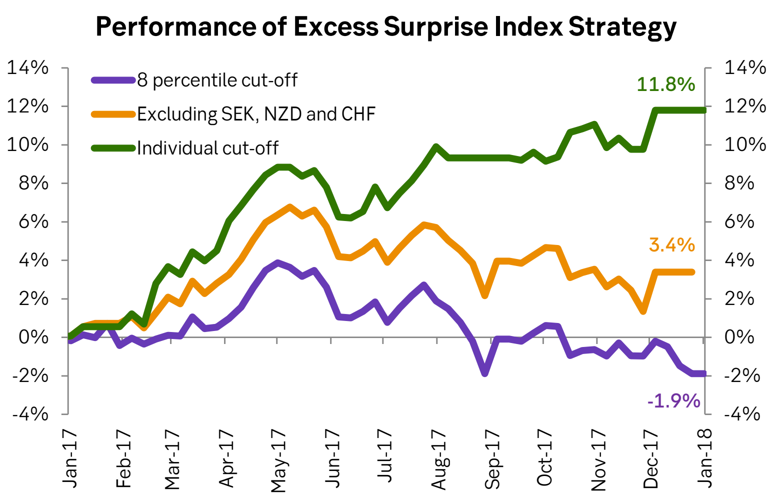
Area where positioning is long   Area where positioning is short

Long-term performance of Excess COT positioning strategy



Excess positioning predicting corrections again





The bottom chart (left page) shows weekly investment strategies based on COT data where the blue line is a strategy where one would have used the same signal level for all currencies. Such a strategy would have rendered **+9.7%** return based on the average performance of the currencies invested each week. If optimizing the signal levels per currency the performance would have been even better (**+16.6%**).

However one has to be clear we use backward looking data when constructing such strategies. I.e. they are not investable but instead serve to show the potential of the data set as well as when tested per currency also show which currencies that tends to have mean reverting properties connected to these data. For instance EUR and CHF should be excluded in positioning strategies as they do not show any mean reverting properties.

MEAN-REVERSION IN DATA SURPRISES LESS POWERFUL IN SPOTTING CORRECTIONS IN 2017

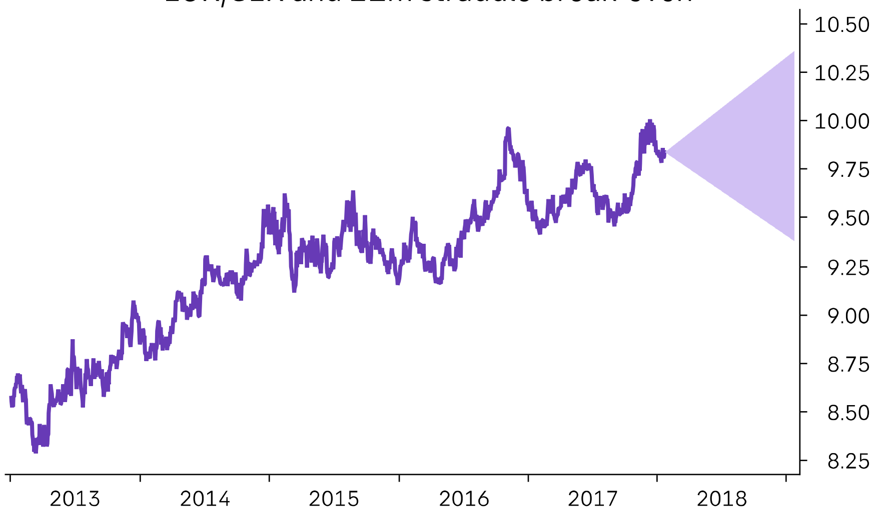
Another method to spot potential corrections in currencies is to use **economic data surprise indices.** Same as for the positioning strategy such a strategy sells (buys) a currency with an excessively high (low) index. As the bottom chart illustrated **this method did not workout in 2017 (-1.9%) indicating that the market was focusing on other things than macroeconomic data**. However, if optimizing the signal level individually for the currencies it follows that some currencies (SEK, NZD and CHF) were detrimental to the strategy and if excluded the strategy worked better (+3.4%) i.e. one should be aware of turning points in economic data surprises for JPY, CAD, GBP, USD, AUD and NOK. However, for it to work really well individual signal levels would have had to have been used (+11.8%).

Market pricing suggests below average FX moves

	Spot	DNS	**Straddle, 12m figs**	Break-even levels		Avg chg 12m, figs*	Avg chg 12m, figs**
EUR/USD	1.22	1.26	**7.3**	1.19	1.33	9.9	10.1
USD/JPY	111	108	**7.3**	101	116	9.4	10.7
EUR/GBP	0.88	0.89	**5.2**	0.84	0.95	5.9	7.7
EUR/CHF	1.18	1.17	**5.5**	1.12	1.23	7.5	7.4
AUD/USD	0.80	0.80	**5.6**	0.75	0.86	9.2	7.1
NZD/USD	0.73	0.73	**5.5**	0.68	0.79	7.0	7.1
USD/CAD	1.25	1.25	**7.5**	1.17	1.32	8.2	9.6
EUR/SEK	9.8	9.9	**49.0**	9.38	10.36	49.1	23.0
EUR/NOK	9.6	9.8	**56.3**	9.21	10.33	49.9	48.7

*Since 2009, **Since 2015

EUR/SEK and 12m straddle break-even



- One approach to get a sense for how much the exchange rates are expected to move over the coming 12 months is simply to calculate the market price of straddles.
- In a straddle strategy option strategy the investor is simply long one ATM-forward call option and one ATM-forward put option. The premium cost for this strategy represents the discounted/expected market move over the period.
- The table highlights current prices of straddles in the most commonly traded currency pairs. For instance the cost of a 12 months straddle in EUR/USD is 7.3 figures, which means that break-even for the trade in EUR/USD currently is 1.19 and 1.33. This defines the range where the market currently expects EUR/USD to trade over the next 12 months.
- The table also includes the average 12 months change in spot since 2009(*) and 2015(**). For instance it is 9.9 figs. in EUR/USD, which means that on average since 2009 EUR/USD has moved almost 10 figs. over a 12 months period.
- This suggests that EUR/USD currently is seen to move less over the coming year than what it has done historically.
- Except for EUR/NOK and EUR/SEK the 12m straddles are currently below or much below the average historical 12m changes in all currency pairs. It suggests that market pricing currently discounts below average moves in most exchange rates over the coming 12 months.
- The biggest gap between the average 12m move in the spot rate and implied volatility is in EUR/SEK, where the straddle reflects an almost 50 figs. move while the average 12m move since 2015 only has been 23 figs. Hence, this straddle seems very expensive.

Monetary policy to tighten gradually

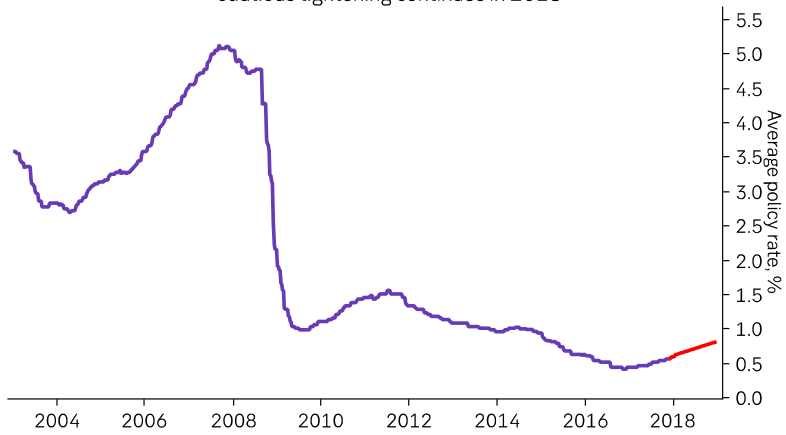
Different interpretations of inflation dynamic provide flexibility
The weak price and wage response enables different interpretations of the inflation dynamic which may influence monetary policy in 2018:

1) Disinflationary forces are irresistibly strong due to globalisation and automation. Price and wage growth will remain depressed, with central bank responses serving only to cause asset price inflation.
2) The Phillips curve has a trick knee. At some low level of unemployment inflation will eventually spike higher. If reached central bank flexibility will evaporate.
3) Blurry Philips curve. At some point "bottlenecks" will exert upward pressure on wages and prices, but only after significant delays. Weak productivity growth may be a reason.

Generally we expect central banks to find different ways in 2018 to justify beginning the slow normalization of monetary conditions.
- "Lean against the wind", including risks of excesses related to the debt situation and asset prices in the decision.
- Moving towards a dual mandate for inflation and unemployment targeting and a tight labour market could justify tighter monetary policy even if inflation remains below target.

POLICY TIGHTENING BROADENS
In 2018 more central banks are likely to join the Fed in tightening policy. We expect three more hikes by the Fed in 2018, which is more than currently discounted by the market. This allows two further rate rises by the BOC while other central banks are set to move more gradually. Indeed, we even expect Norges Bank and the Riksbank to take their first cautious steps towards normalizing monetary policy in 2018 by each making a single hike towards year-end. Some central banks will continue to focus on inflation targeting and/or persistent high political uncertainty.

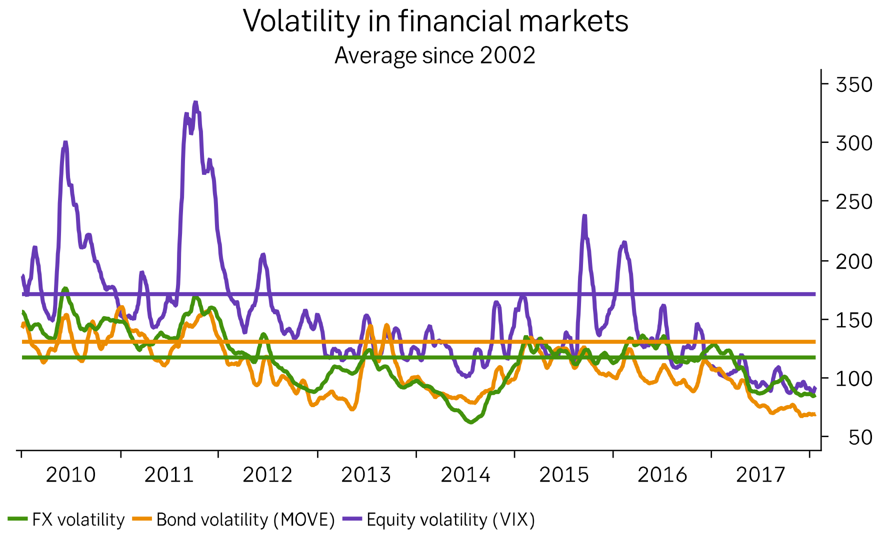
G10 Monetary policy
Cautious tightening continues in 2018

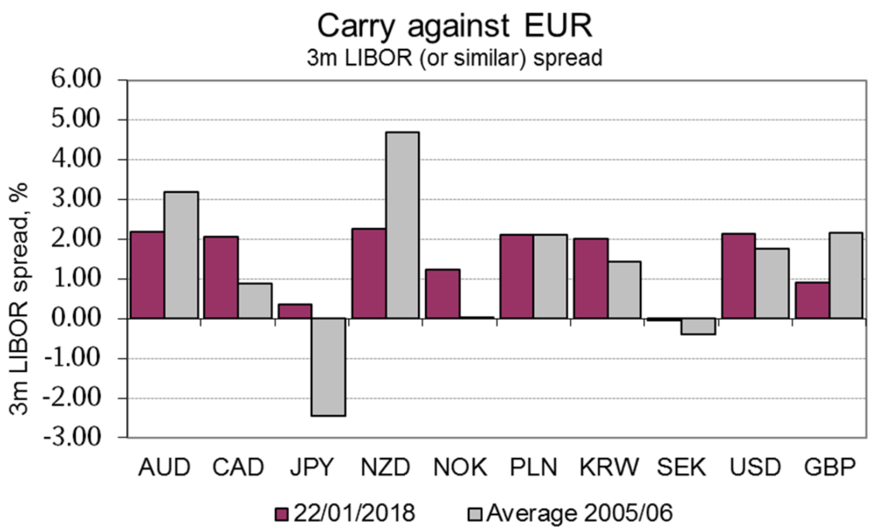


%	Central Bank	End-17	End-18	Chg in 18
	United States	1.25-1.50%	2.00-2.25%	+0.75%
	Euro zone (dep.)	-0.40%	-0.40%	-
	Sweden	-0.50%	-0.25%	+0.25%
	Norway	0.50%	0.75%	+0.25%
	Denmark	-0.65%	-0.55%	-
	Switzerland	-0.75%	-0.75%	-
	United Kingdom	0.50%	0.50%	-
	Japan	-0.10%	-0.10%	-
	China	4.35%	4.60%	+0.25%
	Canada	1.00%	1.50%	+0.50%
	Australia	1.50%	2.00%	+0.50%
	New Zealand	1.75%	2.00%	+0.25%

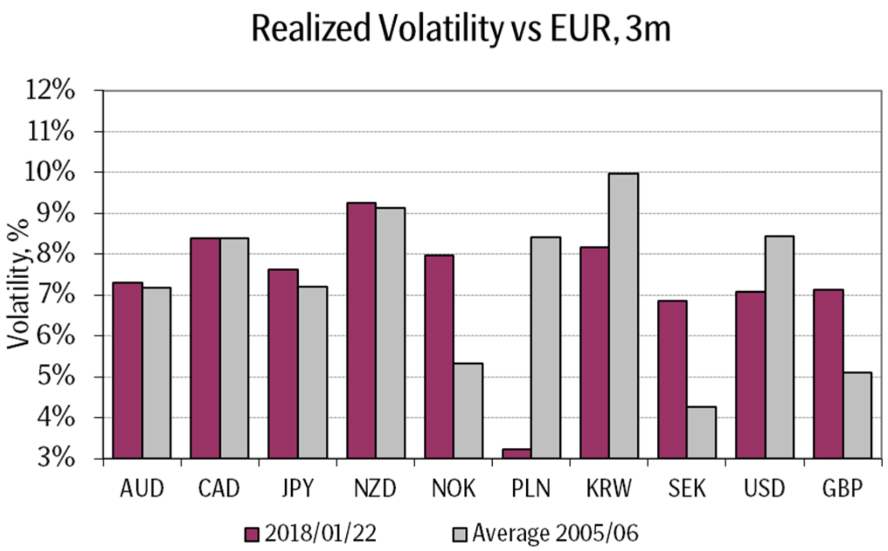
Theme: Time for a carry trade in 2018?

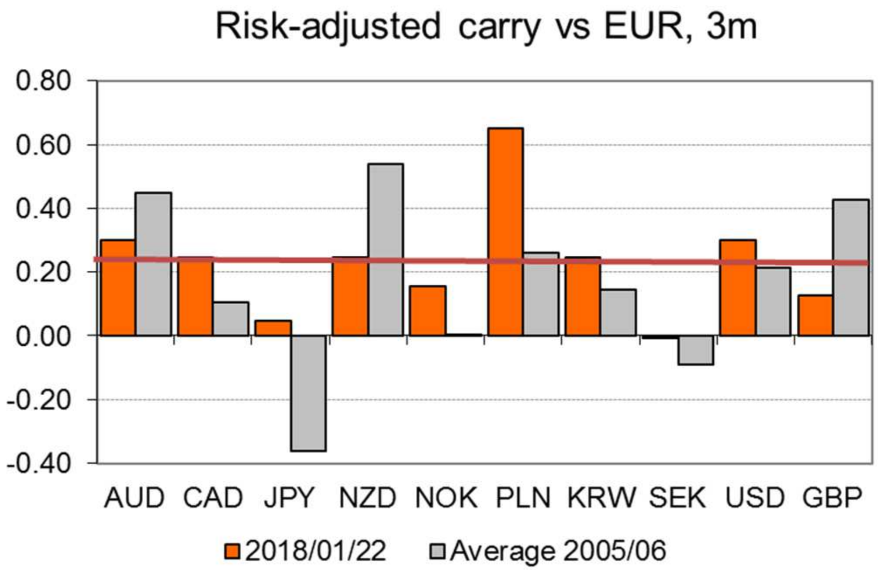
- **Low volatilities declined further in 2017.** One obvious trend in 2017 was that volatilities in financial markets have continued lower. The decrease in volatility was broadly based and included equity, bond and FX markets.
- Generally, implied volatilities are currently well below their historical averages and almost at record lows. Usually low volatilities would provide an excellent environment for carry trades. However, **out of all of our trading styles** the "G10 carry style" was by far the worst performer in 2017.
- **Growth outlook suggests that volatilities will remain low.** We expect global growth to improve further in 2018. However, disinflationary forces seem to persist. This suggests that central banks will remain cautious not to commit any policy mistakes that could harm the economic recovery. Although there are several geopolitical risks these seem only to cause short-lived periods of stress in financial markets. This suggests that carry conditions will persist in 2018 or in fact improve further.
- Back in the golden era of carry prior to the financial crisis in 2008, the funding currency of choice in carry positions was the JPY. Of course, this reflected its superior liquidity and very low interest rates at the time. But the **JPY is no longer the best funding currency** as Japanese short-term interest rates are no longer the lowest. In fact short-term interest rates in the Euro area and Swedish interest rates are currently less.





Theme: Carry trade – Sell EUR/PLN





- While liquidity in the krona may cause concern in a stressed market situation, the euro offers excellent liquidity, almost equally low interest rates and a central bank that isn't even close to tightening its policy. Therefore, the euro has many qualities of a perfect funding currency.
- **Too small rate differentials?** Although EUR rates are low so are those in other currencies. Carry using 3m interest rates is at best around 2% per annum, which makes several carry positions unattractive despite low FX volatilities.
- By rule of thumb, annual carry should be at least a quarter of expected annualized volatility for the trade to make sense. This essentially disqualifies several alternatives.
- However, we see one outstanding alternative, PLN. Although the rate differential is only around 200 bps, realized volatility in EUR/PLN has decreased significantly to just over 3%, making the risk-reward attractive.
- Although the euro outperformed most currencies in 2017 the zloty in fact appreciated by 5.7% against the euro last year. Still we believe that PLN remains undervalued against the euro with LTFV around 3.75.
- There are as well a few other alternatives like the USD, AUD, NZD and KRW, which in fact offer a risk adjusted carry of around 0.25 today. This is the first time since before the financial crisis that conditions are good enough to make carry attractive from a risk-reward perspective.
- Given the low volatilities in the FX market the euro may face increased headwinds as a funding currency if carry strategies become more widespread going forward. Probably it takes slightly higher rates outside the euro area

Weak correlation with risk appetite unless…

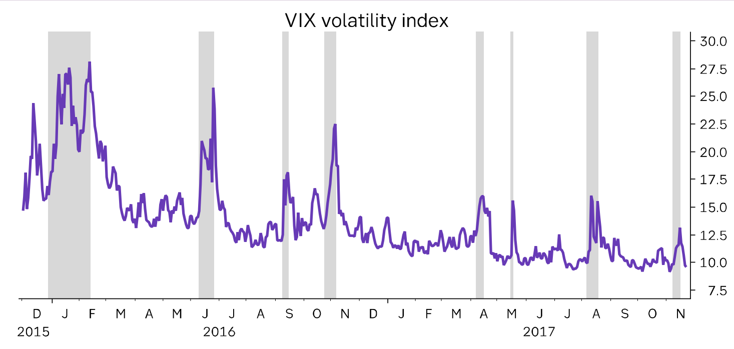
Synchronized global growth, disinflation and cautious central banks suggest good risk appetite in 2018. This is also captured in low and still falling volatilities in global financial markets and in FX.

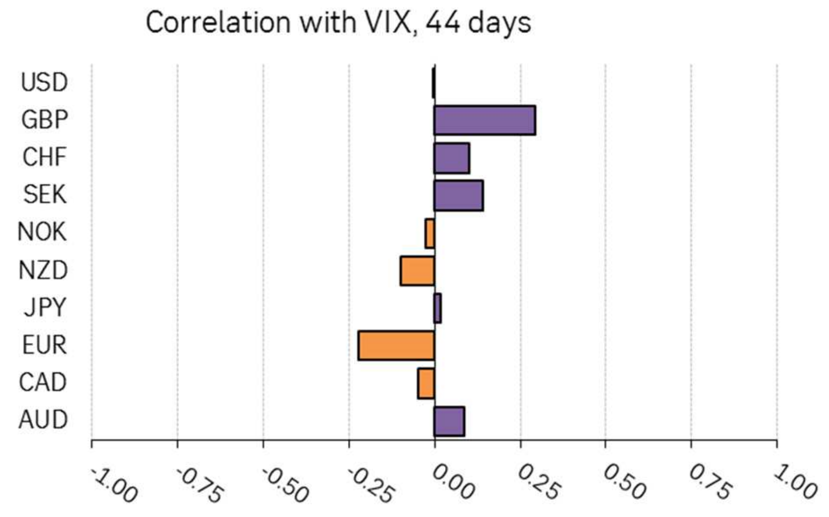
Using daily changes in the VIX-index as a proxy for changes in risk appetite suggests that correlations between exchange rates and risk appetite currently is very weak. Hence it is difficult to say which currencies that will benefit this year as a consequence of changes in risk appetite.

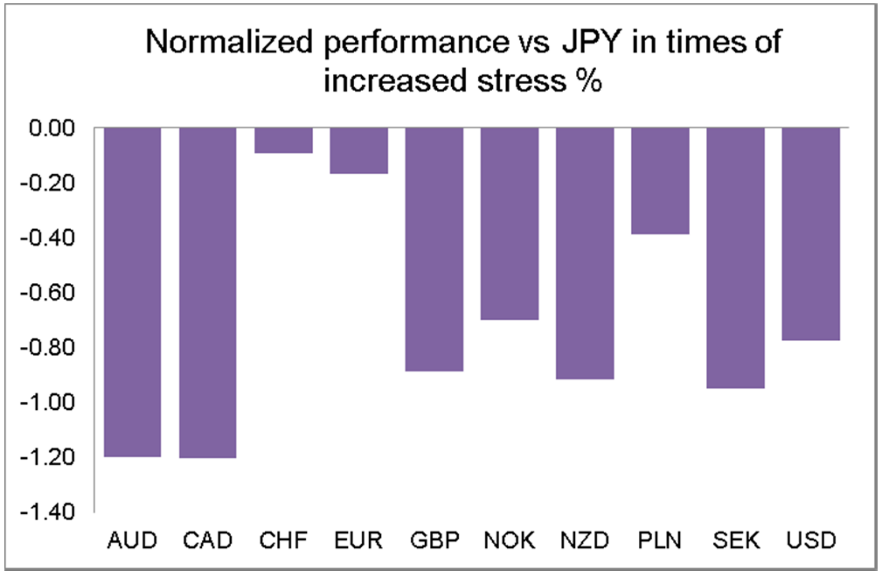
One alternative approach is to consider the performance in times of event driven stress in financial markets indicated by a sharp rise in the VIX-index as shown in the chart below.

Normalizing the performance vs the JPY in those specific periods shows that the JPY remains the leading destination for preservation flows. However, the EUR and CHF appear to provide almost as effective protection against increased stress in financial markets while commodity currencies tend to have the worst performance.

Interestingly the SEK and the USD both underperform the JPY, CHF and the EUR significantly in these short periods of a increased stress.

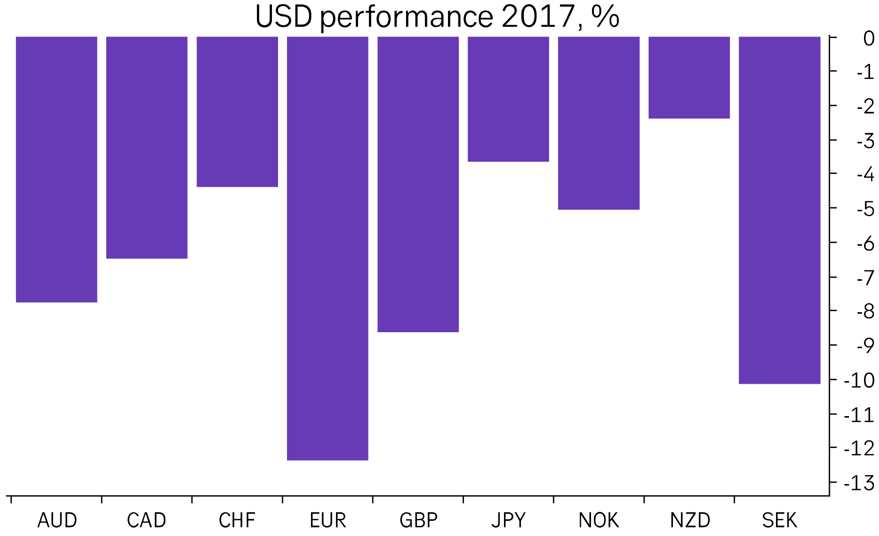


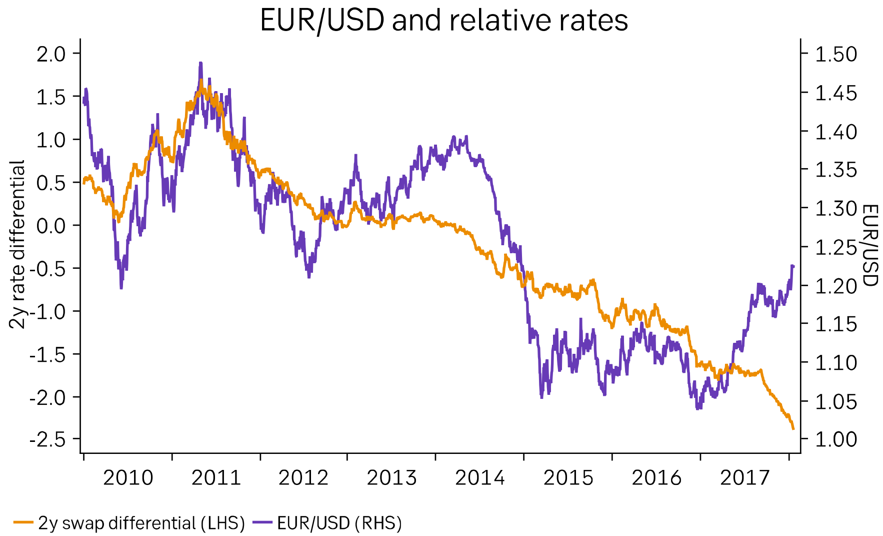




EUR/USD: Time to identify other drivers?

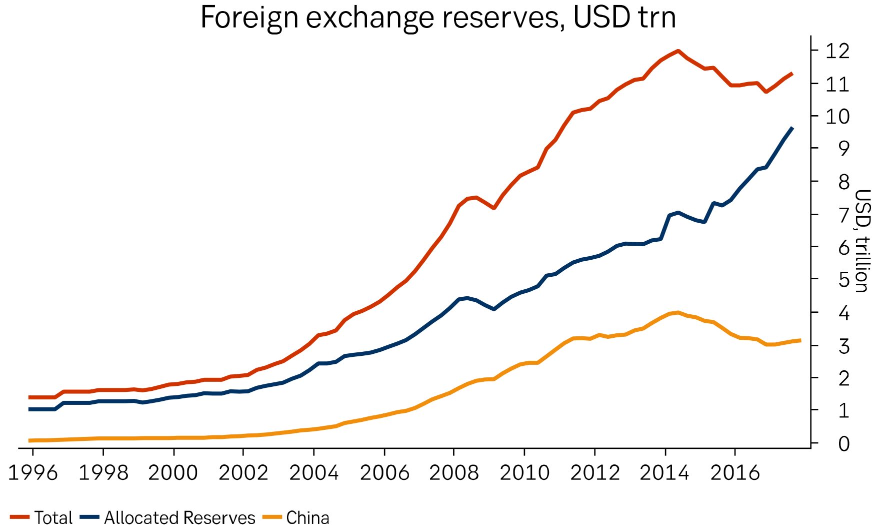
- Since Q2 2017 the dollar has weakened. Initially the triggers were probably an extreme positioning among speculative accounts, disappointing US inflation which caused a repricing of Fed expectations and reduced political risks in the euro area.
- Given the soft expectations on the US central bank captured by market pricing last summer it seemed reasonable to expect a repricing of Fed policy expectations in a hawkish direction, offering some renewed support for the dollar.
- Although this repricing of Fed policy materialized in Q4 2017 and was reflected in the relative 2 year yield differential between US and Germany, which widened significantly, the dollar did not react at all => The EUR/USD exchange rate is detached from relative monetary policy. But what else then?
- In the following slides we argue that an ongoing shift in portfolio exposures among global investors and reserve managers in particular, causing large euro positive capital flows, may be one explanation to what is going on in EUR/USD. Would this be correct there is plenty more to do before allocations between currencies in global currency reserves have been restored to where these were in 2009 => EUR supportive capital flows will continue and this will push EUR/USD higher in coming years.
- One risk to this scenario is obviously low interest rates in the euro area which makes the euro the prime funding currency in carry trades. So far rate differentials between currencies have been too small to attract carry positions. However, low and falling volatilities in the FX market suggest that the attractiveness of this kind of strategies have started to grow and might in fact gain traction going forward. Would this be the case the euro seems vulnerable.

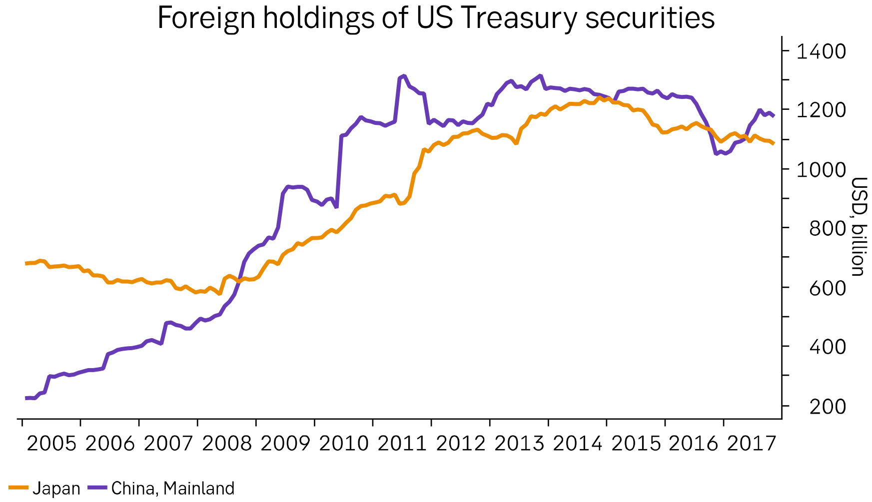




Global foreign exchange reserves grow again

- In Q3 2017 global currency reserves were $11,300 bn.
- After falling from Q2 2014 until Q4 2016 central bank reserves started to grow again in 2017 and a shift in Chinese FX reserves is the most important contribution to this development.
- Between Q4 2016 and Q3 2017 the total value of global currency reserves increased by USD 532bn
- Given the huge size of total currency reserves it only takes small shifts to create large capital flows. 1% of total global currency reserves represents USD 113bn.
- The two largest holders of US treasury securities are China and Japan.
- In 2016 Chinese holdings of treasury securities fell quite dramatically amid capital outflows from China and a decreasing foreign currency reserve.
- In 2017 these capital flows were reversed and since February 2017 the Chinese currency reserve has started to grow again on a monthly basis. This has led to an increase in Chinese holdings of treasury securities of USD 129bn. In fact this is roughly the same as growth of total Chinese FX reserves since the end of 2016. Is it a coincidence or is China in fact investing almost all in treasury securities?
- Japanese holdings of treasury securities have trended slowly lower since the peak in 2014. This continued in 2017.

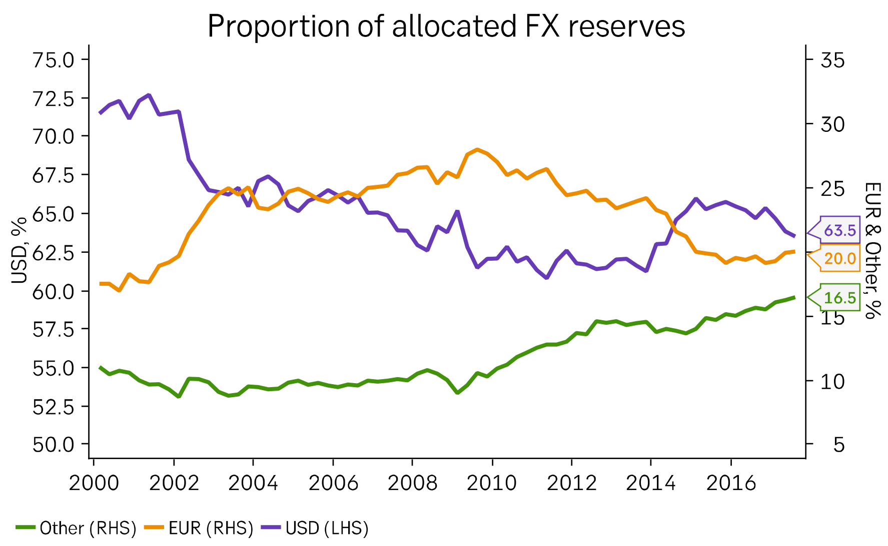


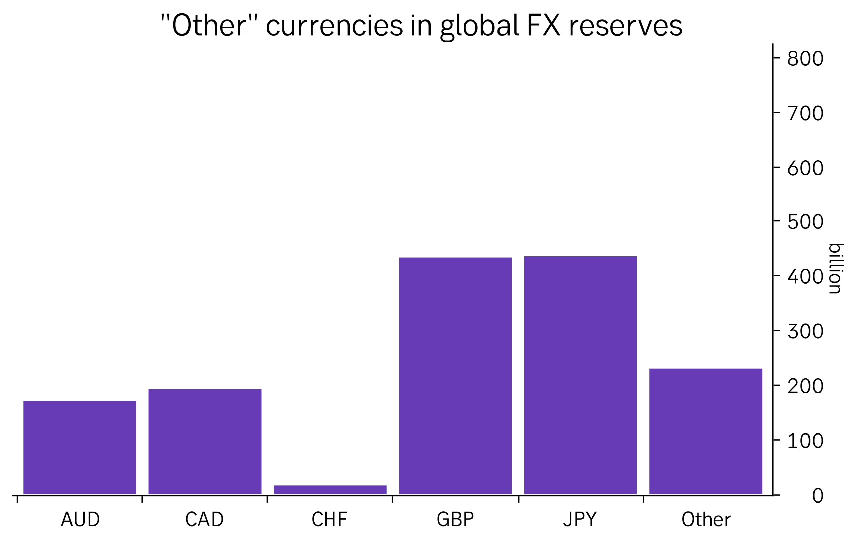


Source: US Department of the Treasury, Macrobond, SEB

USD suffers from renewed rebalancing flows

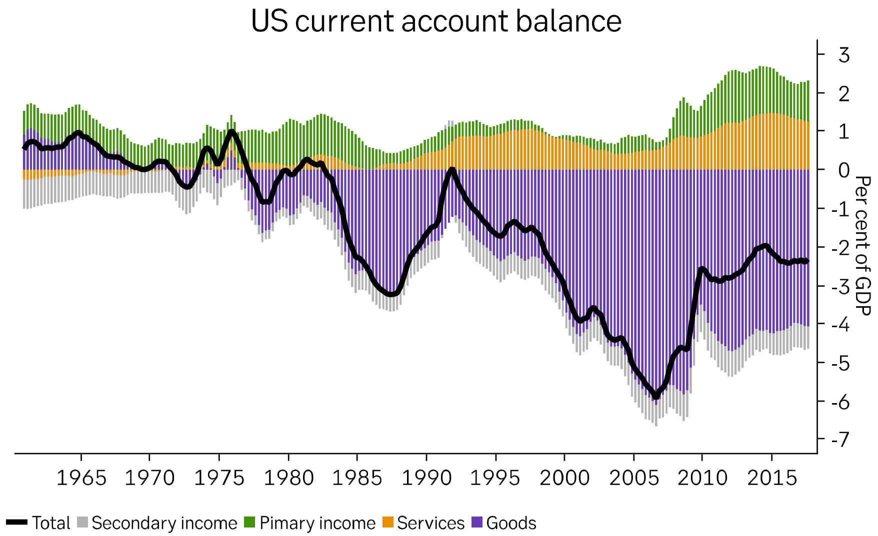
- The appreciation of the dollar since mid-2014 and an uncertain outlook for the euro boosted the dollar's proportion of global central bank reserves substantially. It peaked at 66% of total allocated reserves in Q1 2015.
- Meanwhile the euro's proportion of global reserves fell substantially to below 20% (19.1% in Q4 2016), which means it was back at the same proportion as in 2001/2002.
- Simultaneously the proportion of other smaller currencies have increased. This trend started in 2009 on the back of the euro crisis and it now seems to continue as reserve managers seek increased diversification.
- In 2017 a shift of reserve holdings out of the dollar began and until Q3 last year the USD-proportion fell to by almost 2%-points. Based on the current size of total global currency reserves 2%-points represents USD 226bn in USD-negative capital flows.
- At its trough in 2011 the dollar exposure was below 61% => there is still a risk that the USD will remain under pressure just to restore the proportion to where it was, and most likely the diversification will go further below 61%.
- The recovery of the euro in global currency reserves last year is a sign that the improving euro zone economy has reinforced confidence in the common currency.
- At its peak in 2009 the euro accounted for almost 28% of total global reserves compared to 20% in Q3, which means there is still a long way to go just to restore the historical exposure.
- Given the current size of global reserves 8%-points represent USD 900bn in EUR-positive flows.

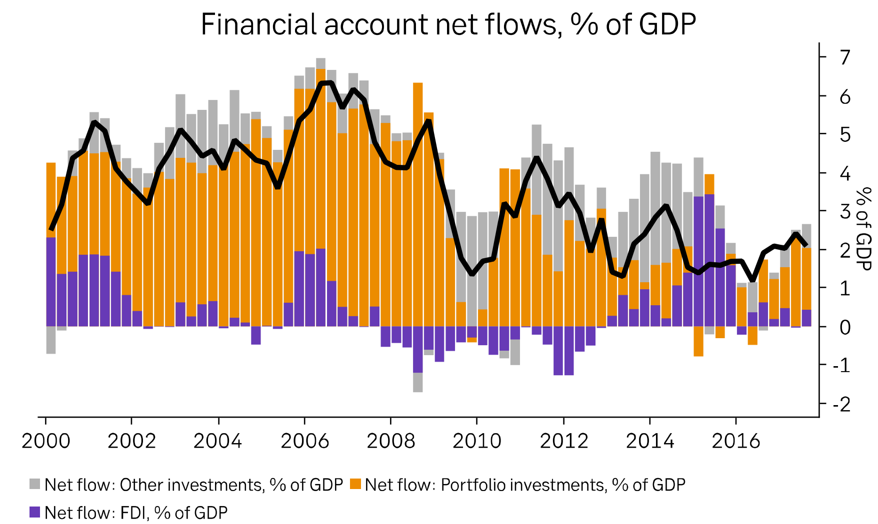




USD: Current account deficit not an issue

- The US current account deficit has been quite stable at between 2 and 3% of GDP since 2010.
- Lower imports of crude oil have more or less cancelled out a growing deficit in non-petroleum goods trade with the rest of the world, while the trade surplus related to services remains stable.
- Furthermore the US continues to generate positive income flows, which is the return on its overseas investments.
- Of course, the deficit has to be financed by capital inflows. In recent quarters the main source of foreign capital inflows has been portfolio investments.
- Digging a little further into the details of net portfolio flows, it turns out that what is mostly attracting net capital inflows is purchases of long-term debt instruments, which have generated net inflows of around USD 300bn a year.
- In contrast, equity-related net portfolio flows have been quite negative (almost USD -500bn annually) since 2014, although they improved sharply last year and are currently almost in balance.
- For a long time, the US current account deficit has been discussed as a negative factor for the USD. However, since it possesses the single most important reserve currency, the US economy has the ability to attract sufficient capital inflows into debt-related securities to fund the current account deficit. This will be the case going forward as well.





SEB

The case for more aggressive Fed tightening

Our main scenario includes three hikes in 2018. However, the case for four hikes is growing stronger. If the Fed hikes four times we estimate EUR/USD will close at 1.25 at the end of 2018 rather than 1.28 in the main scenario.

1. THE LABOUR MARKET IS BECOMING EXTREMELY TIGHT. Labour market data suggest very little slack remains and unemployment may reach a critically low level where wages and inflation accelerate rapidly.

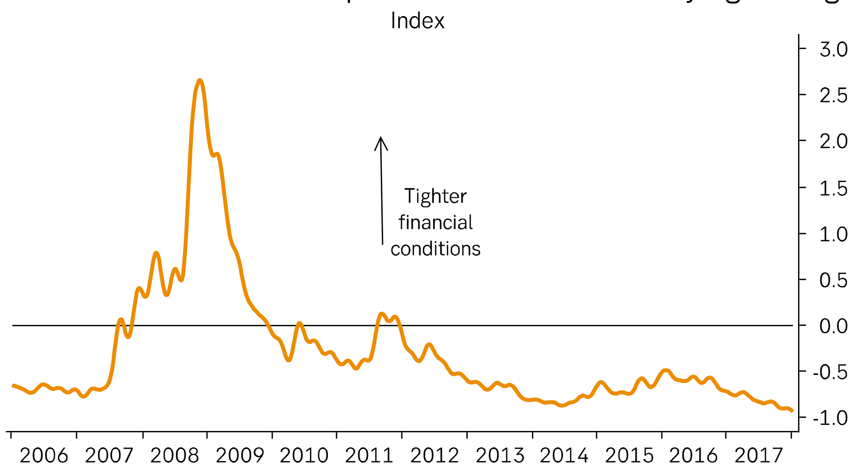
2. FOMC COMPOSITION WILL TURN MORE HAWKISH IN 2018. The four incoming regional Fed presidents voting in 2018 have a more hawkish bias than their predecessors.

3. GROWTH FORECASTS FOR 2018 MIGHT BE TOO CONSERVATIVE. In December, the Fed raised its 2018 growth forecast to 2.5%. However, since the impact of the tax cuts may have been underestimated, stronger than expected growth would support a more aggressive Fed.

4. FINANCIAL CONDITIONS HAVE CONTINUED TO SOFTEN. Financial conditions softened in 2017 despite the Fed's rate hikes. This has continued in early 2018.

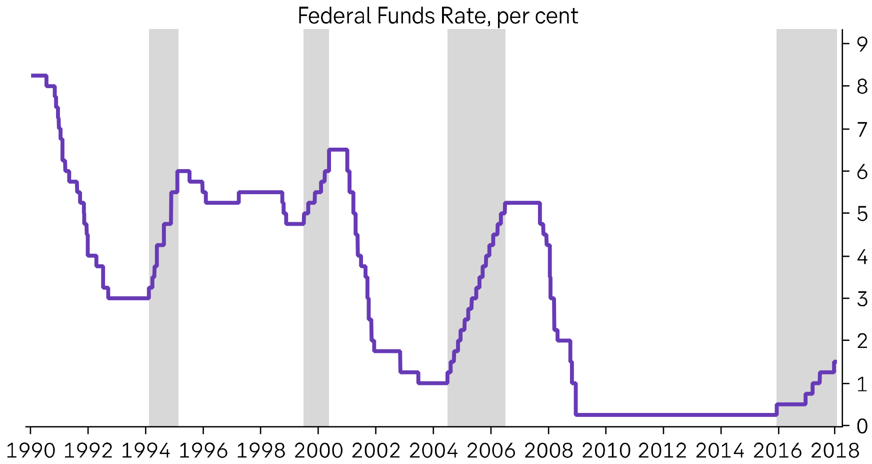
5. THE FED IS CURRENTLY TIGHTENING VERY SLOWLY. The current tightening cycle is exceptional in being extremely cautious considering upside risks to inflation. In 2005, the Fed hiked at all eight policy meetings.

Softer financial conditions provide room for monetary tightening



Source: Federal Reserve Bank of Chicago, Macrobond, SEB

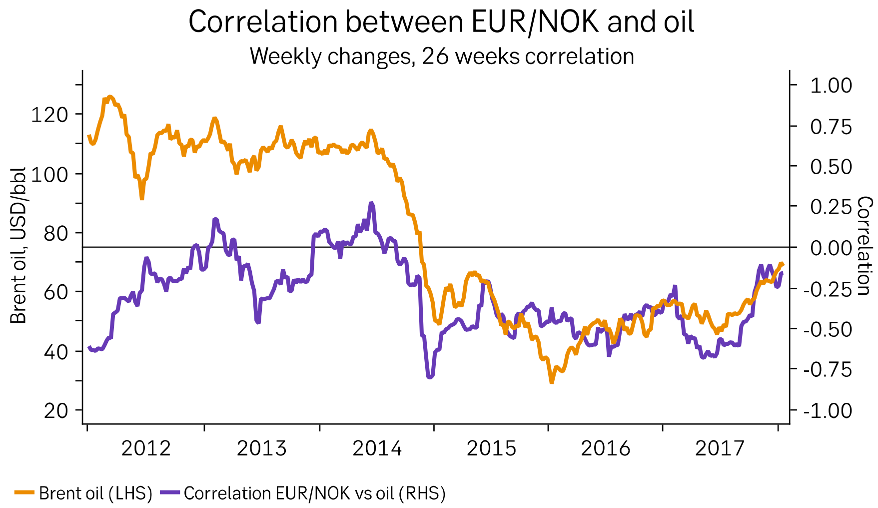
Fed's current tightening is super slow



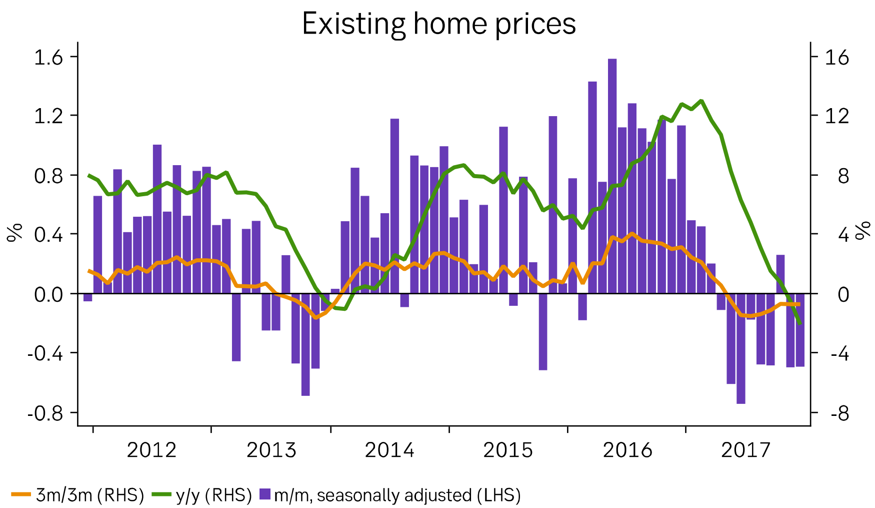
Source: Federal Reserve, Macrobond, SEB

All-time high in EUR/NOK

- The krone weakened substantially late last year as EUR/NOK moved from 9.40 to just below 10 during Q4. This may be surprising given that oil prices rallied, economic data improved and Norges Bank sent a hawkish message at its December meeting. Below we try to explain drivers behind the krone weakness and expected recovery:
- A weaker krone against the euro and dollar in December is in line with the seasonality and liquidity reportedly waning.
- The rise in oil prices hasn't boosted the krone. The correlation between the two has weakened to be almost non-existing. We have long argued that a weaker correlation is reasonable; cost reductions in the petroleum sector have reduced break-even levels for new fields considerably. Consequently, the economy (and thus monetary policy) has become less dependent on the oil price outlook. However, the weak follow-trough to the krone from higher oil prices may have caused some speculative accounts to close their long NOK positions. The resilience of the economy and the positive growth outlook, opening up for rate hikes, should nonetheless have been reflected in a stronger krone.
- Currencies related to weak housing markets have suffered. Although Norwegian home prices peaked already in March 2017, it gained attention in markets when also the Swedish housing market turned. We expect a moderate correction of 4% in 2018 relative to last year, with modest negative demand effects on the broader economy. It is easy to assume that a more severe correction is priced in the krone. Our forecast implies that existing home prices will stabilize during summer, which should increase markets' expectations of rate hikes and a stronger krone.



Source: Macrobond, SEB



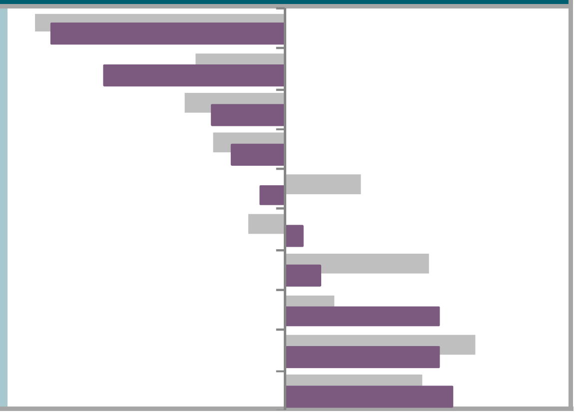
Source: Real Estate Norway (Eiendom Norge), Macrobond, SEB

Long-term fair value

- In 2017 there were unusually few changes in currency rates compared to our long-term valuation estimates.
- **The GBP remains the most undervalued** of all G10 currencies in trade weighted terms. Our models suggest it is undervalued by 17% slightly below its valuation a year ago, mostly due to the Brexit risk premium.
- **Apparently, the AUD is the most overvalued** currency after appreciating slightly in 2017. In 2016, the NZD followed by the USD were most overvalued but these currencies have depreciated in 2017, with only minor changes to their LTFVs. Still, the NZD remains overvalued, by 11%.
- **Compared to a year ago, the USD and EUR exchange rates have changed most** relative to their **estimated LTFVs.**
- Today the dollar is only marginally overvalued in trade weighted terms (3%) while the appreciation of the euro in trade weighted terms last year has pushed it far into overvalued territory (11%).
- By the end of last year the JPY was undervalued by 7% in trade weighted terms and today the undervaluation has increased to 13%. This is almost entirely related to a change in the LTFV estimate for the JPY (-5%) while the currency itself trades roughly were it was year ago in trade weighted terms. LTFV is 97 in USD/JPY and 115 in EUR/JPY.
- **Scandies today trade slightly closer to their LTFVs** although they remain undervalued in trade weighted terms (4% for the SEK and 5% in the case of the NOK). The corrections are entirely related to downward revisions of LTFVs.

TWI Long-term valuation, Jan 19 2018 and Dec 30 2016

Ccy pair	Dev. from LTFV
GBP	-17%
JPY	-13%
NOK	-5%
SEK	-4%
CHF	-2%
CAD	1%
USD	3%
EUR	11%
NZD	11%
AUD	12%



USD Long-term valuation

Ccy pair	LTFV	*Spot*	Dev. Spot	*12m fwd*	Dev. Fwd
EUR/USD	**1.18**	*1.22*	**-3%**	1.26	-6%
USD/SEK	**7.72**	*8.03*	**-4%**	7.82	-1%
USD/NOK	**7.33**	*7.86*	**-7%**	7.75	-6%
GBP/USD	**1.62**	*1.40*	**15%**	1.42	13%
USD/JPY	**97.00**	*110.84*	**-13%**	108.14	-11%
AUD/USD	**0.73**	*0.80*	**-10%**	0.80	-10%
NZD/USD	**0.65**	*0.73*	**-12%**	0.73	-11%
USD/CAD	**1.25**	*1.24*	**0%**	1.24	1%
USD/CHF	**0.95**	*0.96*	**-1%**	0.93	2%
USD TWI	**101.9**	*99.3*	**3%**	-	-

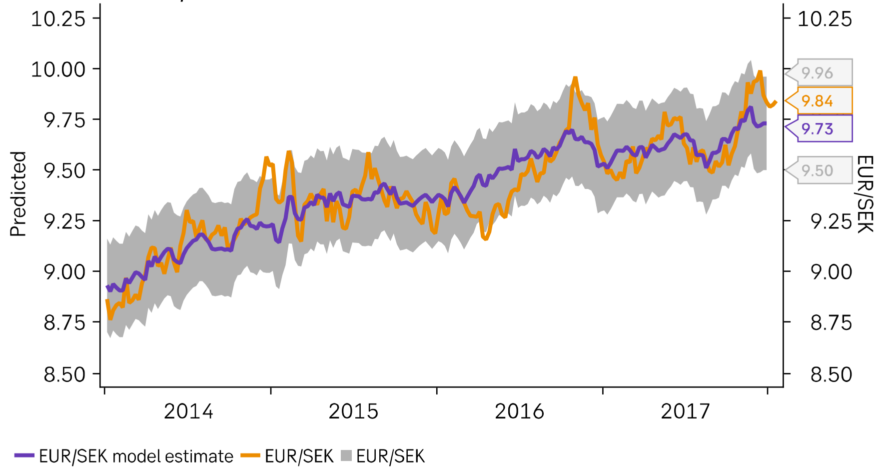
EUR/SEK correction lower loosing steam

EUR/SEK NOT EXPECTED LOWER SHORT-TERM
In mid-December we presented a FX Ringside article on "when and where to sell EUR/SEK" (2017-12-13) **advising to sell above 10.00 but also to only expect a return back to 9.80/85**. Dec 15 EUR/SEK reached levels above 10.00 and Jan 10 lows just below at 9.80 was recorded. Since then EUR/SEK has bounced back somewhat in accordance with our expectations.

Looking once again at the medium-term fair value model (MTFV), one important input for our analysis, it reveals that besides the correction lower in EUR/SEK, the model now seems to regain its long-term trajectory higher (rising fair-value estimate). In light of this, a continued correction lower in EUR/SEK is of course possible but **it rather seems the lion part of the correction lower in EUR/SEK is done for now**.

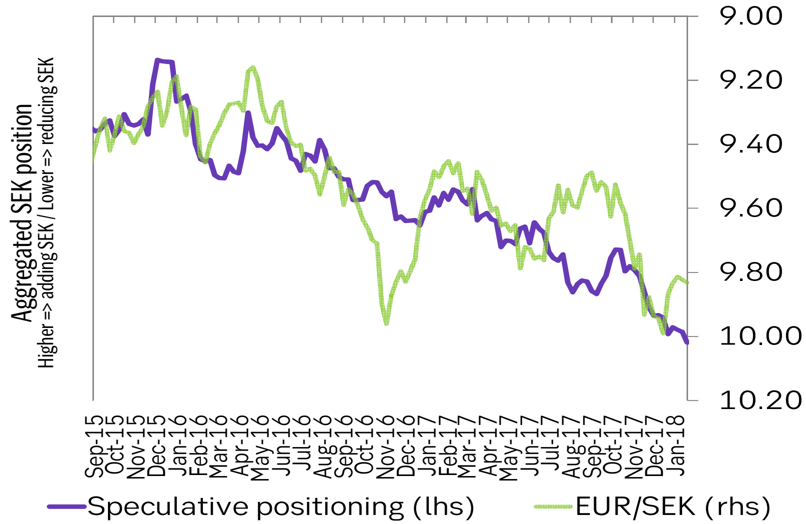
Further support for a turn higher in EUR/SEK is derived from the gap in the relationship between EUR/SEK and our speculative positioning index. Historically when EUR/SEK has deviated to much from our index there has eventually been a correction. In July to September 2017 the deviation lasted unusually long but the rise in EUR/SEK October to November closed the gap. Thus there is of course a chance that the "gap" can increase agaIn (EUR/SEK heading towards its fair value around 9.70) before the usual closing begins. But just as for the MTFV indication it seems more probable, also judged by the late rise in EUR/SEK, that the gap should begin to close now. A more hawkish Riksbank will work to change all that but we expect that signal to come later in the spring/early summer.

EUR/SEK has corrected lower towards its MTFV



Source: Macrobond, SEB

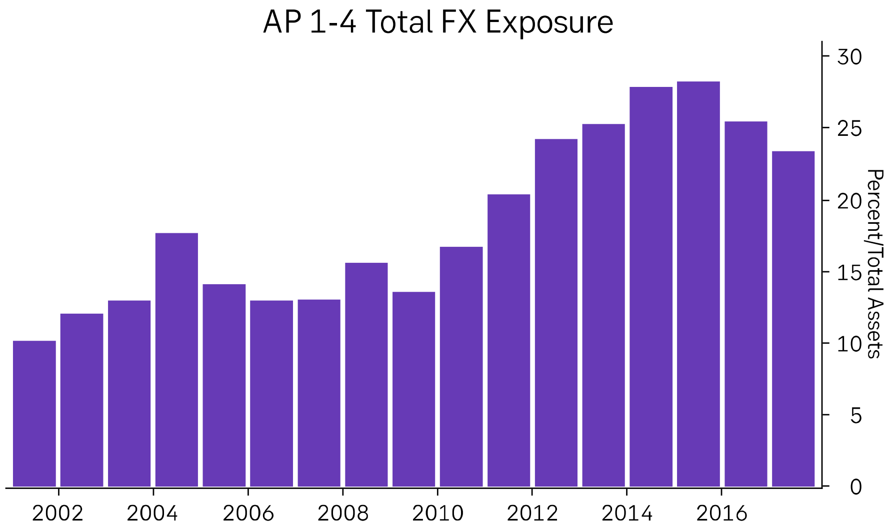
Speculative positioning indicative of higher EUR/SEK



Flows will be cautiously SEK positive 2018

WHY FLOWS ARE ONLY CAUTIOUSLY SEK POSITIVE 2018
Domestic krona positioning differs between companies and institutions. We think the pension funds including AP-funds have strategically started to position for a stronger SEK through lowering their FX exposures. A neutral level is guesstimated to be around 20% and so in this respect there is frankly relatively small amounts left to be purchased. Looking at the corporate sector there is SEK to be bought once Riksbank starts to hike its policy rate: 1) Swedish companies have shown a greater reluctance to FX hedge their exposures and maintain a fairly open FX exposure. Given SEK weakness and expensive hedging costs this has probably been the right strategy. Once rates are rising in Sweden, this behavior will change; 2) Companies have furthermore maintain some export revenues denominated in FX and once rates are taken to and above zero we would assume that some of these FX funds are exchanged back to SEK again. The prime destination for finding positive flows however is of course the speculative accounts: they will surely buy SEK (vs EUR and USD) once the Riksbank is approaching a rate hike. We suspect that the move will be less aggressive than previously thought one rate hike will not alter the negative status SEK has as a funding currency still.

POSITIVE SEASONALITY AT THE START OF THE YEAR
Pointing in a negative direction for EUR/SEK in January is seasonality. However, this pattern is not by far as robust as the one for EUR/SEK to fall after mid-Dec and the average fall is also very small. In March to May Swedish companies are also distributing Equity dividends normally a SEK negative event.



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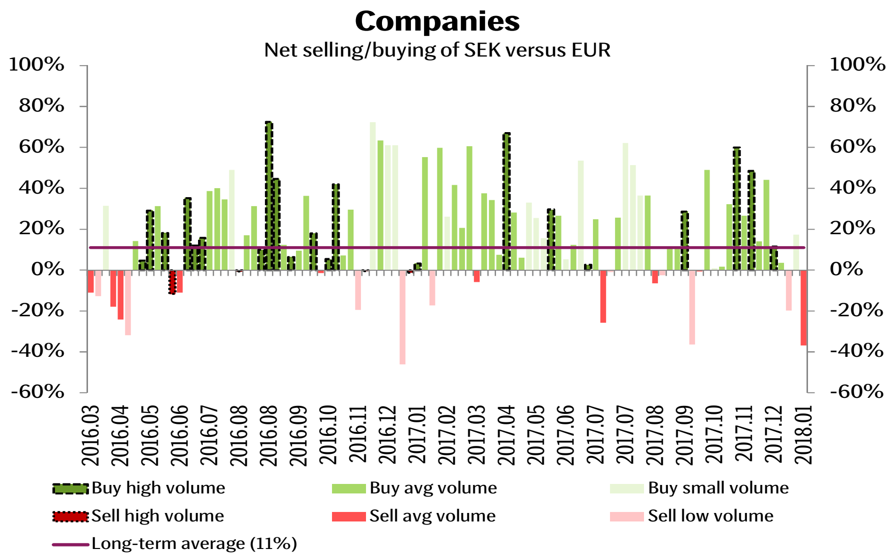


NOK: Flows are neutral for a different reason

THE TRADE SURPLUS IS GONE

Since the millennium when oil prices started to rise rapidly Norway has generated large current account surpluses with the **record at 20% of GDP in 2005**.

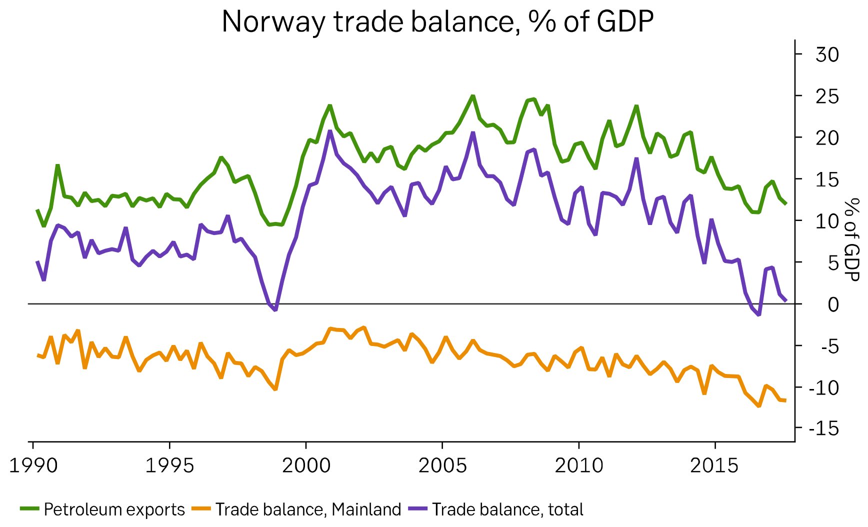
The surpluses in the current account and trade with the rest of the world were **entirely related to petroleum exports**, while the mainland economy consistently generated trade deficits of around 10% of GDP. Meanwhile portfolio and direct investment flows were negative.

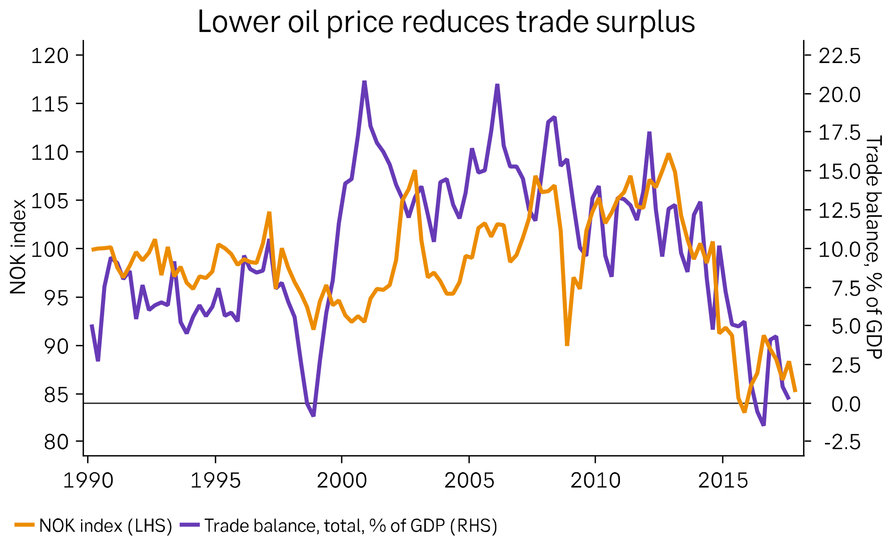
However, the drop in oil price since 2014 has **significantly reduced export revenues** from the petroleum sector while a growing proportion of those falling oil revenues were pored into the economy (through the government budget because of the spending rule) resulting in a **surging mainland trade deficit**.

This has created a situation where trade with the rest of the world today is **roughly on balance** => The large trade surpluses of the past 15 years are gone.

When trade surpluses peaked in 2005 the NOK was much stronger than today. However, most of the impact on the krone from large export revenues related to the petroleum sector were neutralized by the setup with the oil fund and the spending rule. At the time **most of the oil revenues were therefore invested outside the country** => large portfolio outflows offsetting the trade surplus.

Because of the spending rule and a sharp rise in the valued of the GPFG government oil revenues are today fully used in the government budget.





NOK: Average FX purchases at NOK 900mn

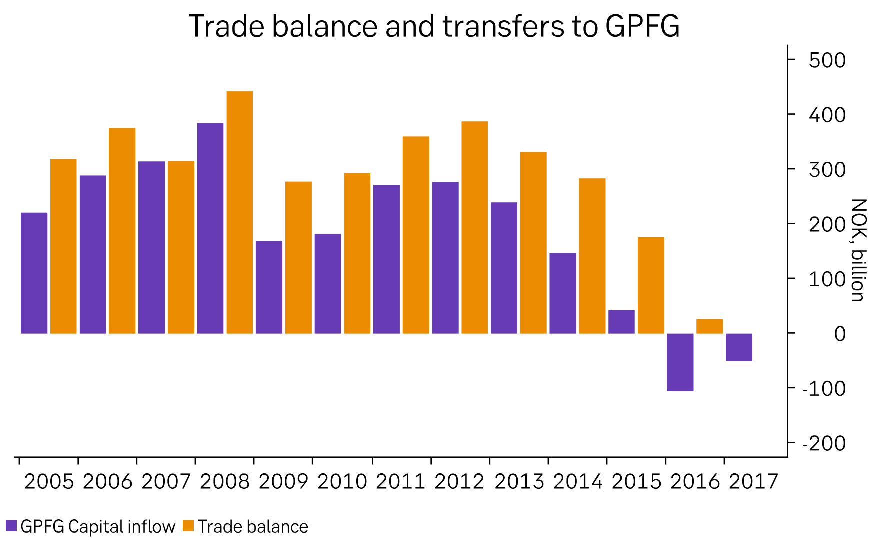
Consequently trade statistics and current account statistics are today much more accurate in reflecting the flows that would have an impact on the NOK exchange rate. However, being close to balance the impact on the exchange rate should remain limited.

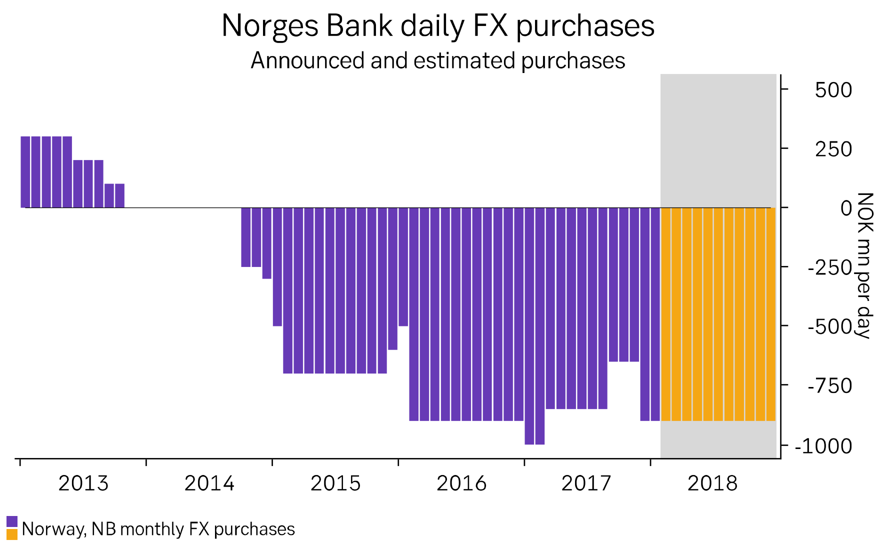
NORGES BANK FX PURCHASES

Daily NOK-purchases by Norges Bank depend on the combination of how much of oil revenues that are used in the government budget (the non-oil budget deficit), FX-revenues in SDFI (Petoro) and tax revenues in NOK.
At the end of the day it is in fact the size of the non-oil budget deficit which determines the size of total net capital flows related to petroleum exports.

According to the 2018 government budget the non-oil budget deficit is estimated to grow to NOK 255bn from NOK 220bn last year. It suggests that net capital inflows will grow a little further in 2018. With government net petroleum revenues estimated to NOK 183bn, part of the return of the oil fund will have to be used to cover the budget deficit.

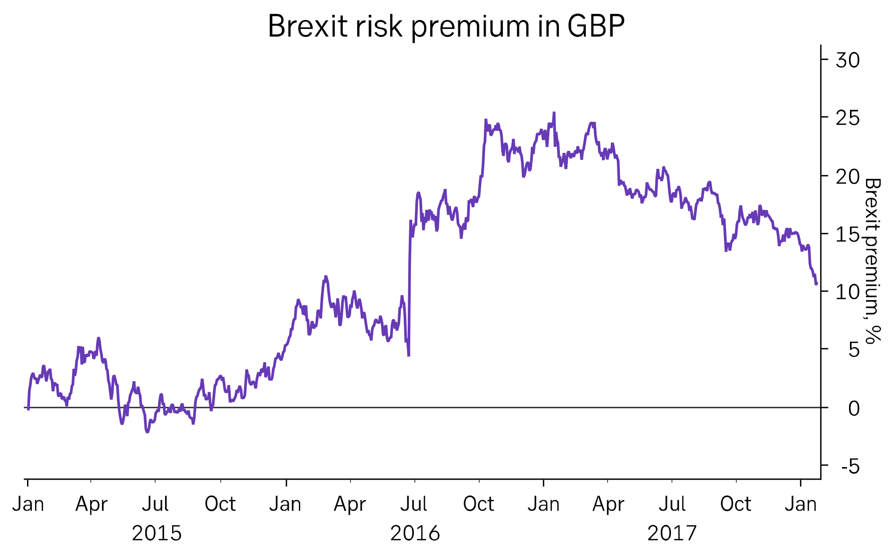
Based on these assumptions our calculations suggest that **daily FX purchases will on average be NOK 950mn in 2018, which is close to the NOK 900mn per day announced by NB for January.**

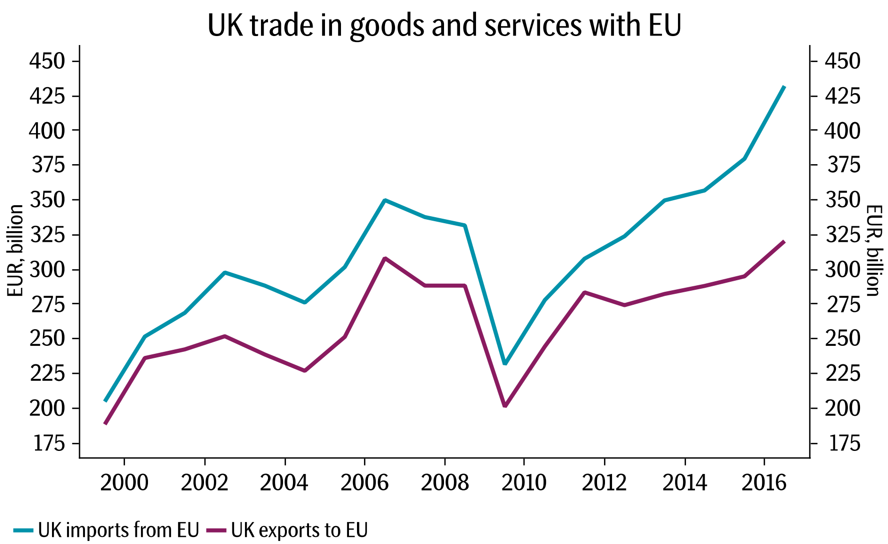




Brexit remains key for the GBP

- Since the GBP began to fall in late 2015 we have attributed much of its weakness to uncertainty caused by the UK's decision to withdraw from the EU – i.e. a Brexit risk premium.
- Today we estimate this risk premium has dropped to around 10%, which means that if the UK decided to remain in the EU (however unlikely this may be) we would expect the GBP to appreciate by a similar amount.
- Our main scenario for Brexit negotiations has for a long time been skewed to the optimistic side, believing the UK will leave the EU with a trade deal and a transitional agreement delaying the full withdrawal until 2021. Our main reason for this optimism is simply that we expect a no-deal exit to be accompanied by substantial wealth losses in both the UK and EU.
- The total value of trade in goods and services between the EU and UK continued to rise sharply in 2016. Total imports to the UK from EU countries grew by 14% to EUR 432bn (+52bn) while British exports to the EU increased by almost 9% to EUR 320bn (+25bn). The UK trade deficit with the EU widened to EUR 110bn in 2016.
- Last year Brexit negotiations on the divorce phase played out a little bit differently than expected, with only very limited signs of progress until the very end in December. Nevertheless a deal on this phase was eventually sealed.
- Political negotiations of this kind are often conducted in such a way, with last-minute talks enabling each side to justify the outcome while arguing they did everything possible to reach the best possible deal. Most likely this will be the case again when negotiations on a trade deal begins in March.

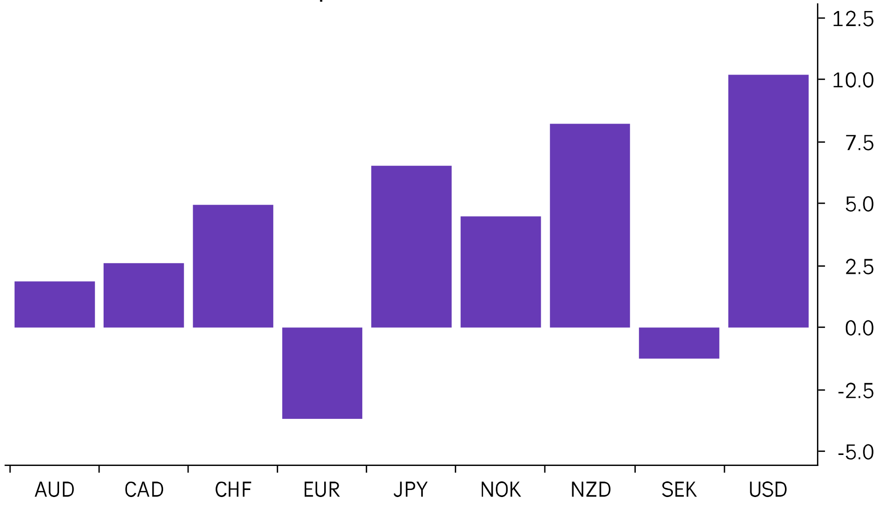




SEB

Brexit and the GBP

GBP performance 2017, %



EUR/GBP with and without Brexit risk premium

- Although we remain optimistic that politicians on both sides will eventually look beyond their own narrow political interests, focus on the best deal for both parties, and make concessions that eventually enable agreements to be made on future trade and transitional arrangements just as on the divorce.
- Last year the GBP lost ground against the euro, although its Brexit risk premium has decreased. However, the GBP has outperformed most other currencies - i.e. the GBP has not so much been weak against the euro but rather the euro has been strong against the GBP.
- Given the size of the estimated risk premium, a trade deal in October would most likely trigger a stronger GBP. Partly, this was the case after the divorce deal in December last year but .
- One risk is of course that negotiations may remain deadlocked, and it then becomes clear that the UK will withdraw from the EU without a deal. In such a case, the present risk premium would not prevent the GBP from falling further.
- A second risk is that the British government break up or that PM Theresa May has to step down, which would make a deal with the EU much more complicated given how little time is left.
- In a more positive scenario we expect EUR/GBP to fall to 0.85 by the end of this year and continue lower next year. However, near-term the risk remains on the upside as negotiations are unlikely to show much progress on a new trade deal until after summer.

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