01 July 2013

Global FX Strategist

A fortnightly outlook for currencies

National Australia Bank

In this issue

Talking points

- After confirmation of the FOMC's stance on the withdrawal of monetary stimulus (data-dependent but potentially ending mid-2014), a succession of Fed speakers have sought to emphasise the importance of the data rather than the date.
- Panicky asset markets initially hit by indiscriminate selling amid position-liquidation have been to some extent calmed but the potential for further volatility spikes remains.
- Our long standing call for US Dollar strength in H2 2013 remains intact, driven by higher bond yields and US economic recovery.
- The Australian Dollar is in a "lose-lose" situation. Either the Fed tapers on strong US growth or global recovery proves so fragile that weak demand from China hurts the currency.
- Our view of fundamental NZ outperformance remains intact, and we expect further NZD appreciation on a TWI basis.
- ECB leaders are stressing that exit from unconventional monetary policy remains "distant". This should weigh on the euro through the Northern Hemisphere summer.
- UK GDP revisions show the scale of the task facing new BoE Governor Mark Carney.

Key trade themes

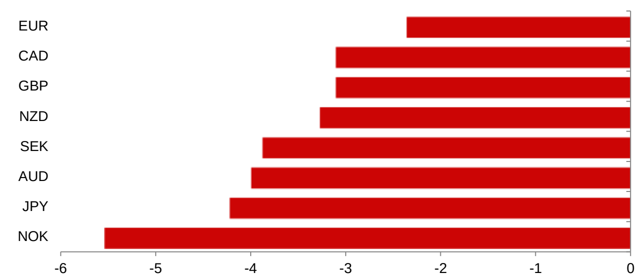
- We are short AUD/USD from 0.9210 but see declines as a multi-month process rather than an imminent collapse.
- We open a fresh short position in AUD/NZD at 1.1813 initially targeting 1.15 in Q3 but lower still in Q4.
- Our bias is to buy USD/JPY though the asset market reaction in the first data-heavy week of Q3 will be key to timing an entry point. Japanese Upper House elections on 21 July will soon come on to investors' radar screens.
- Should tentative signs of stabilization in the Eurozone prove short-lived, so too will the euro's stay at the top of the major FX performance table.

NAB FX Strategy Targets

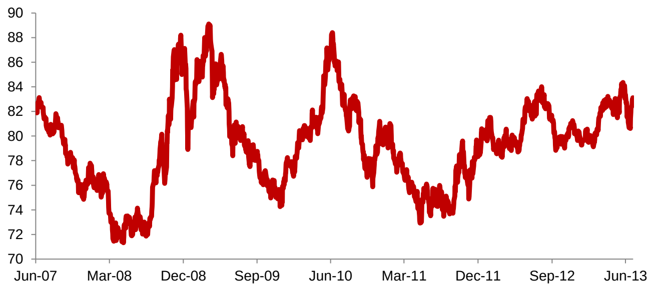
		1/07/2013	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14
Australian Dollar	AUD/USD	0.92	0.90	0.88	0.86	0.85	0.84	0.83
New Zealand Dollar	NZD/USD	0.78	0.78	0.78	0.76	0.75	0.74	0.73
Japanese yen	USD/JPY	99	104	105	107	110	111	112
Euro	EUR/USD	1.30	1.27	1.27	1.24	1.22	1.20	1.18
British Pound	GBP/USD	1.52	1.49	1.48	1.46	1.44	1.42	1.40
Swiss Franc	USD/CHF	0.95	0.98	0.97	1.00	1.02	1.04	1.06
Canadian Dollar	USD/CAD	1.05	1.03	1.02	1.03	1.02	1.02	1.01
Chinese New Yuan	USD/CNY	6.13	6.12	6.10	6.10	6.10	6.10	6.10
Crosses								
	AUD/NZD	1.18	1.15	1.13	1.13	1.13	1.14	1.14
	AUD/JPY	91	94	92	92	94	93	93
	AUD/EUR	0.70	0.71	0.69	0.69	0.70	0.70	0.70
	AUD/GBP	0.60	0.60	0.59	0.59	0.59	0.59	0.59
	AUD/CHF	0.87	0.88	0.85	0.86	0.87	0.87	0.88
	AUD/CAD	0.96	0.93	0.90	0.89	0.87	0.86	0.84
	AUD/SGD	1.16	1.15	1.14	1.13	1.12	1.12	1.11
	AUD/KRW	1043	1047	1034	1011	999	987	975
	AUD/CNY	5.62	5.51	5.37	5.25	5.19	5.12	5.06
Trade-Weighted Index	AUD TWI	71.40	71.11	69.80	69.00	68.99	68.77	67.59
	NZD/JPY	77.09	81.12	81.90	81.32	82.50	82.14	81.76
	NZD/EUR	0.60	0.61	0.61	0.61	0.61	0.62	0.62
	NZD/GBP	0.51	0.52	0.53	0.52	0.52	0.52	0.52
	NZD/CHF	0.73	0.76	0.76	0.76	0.77	0.77	0.77
	NZD/CAD	0.82	0.80	0.80	0.78	0.77	0.75	0.74
	EUR/GBP	0.86	0.85	0.86	0.85	0.85	0.85	0.84
	EUR/CHF	1.23	1.24	1.23	1.24	1.24	1.25	1.25
	USD index	83.15	86.01	86.09	86.09	86.09	86.09	86.09

FX performance over past fortnight

Percentage change versus USD



USD index (DXY)



Source: Bloomberg, National Australia Bank (c.o.b. 28 June 2013)

AUD Forecast Update – Lower Still

- **The asymmetric (downside) risks we alluded to in our previous AUD forecast update have eventuated and we are now make further downward revisions.**
- **The Fed's return to the (early stages) of policy normalcy in itself justifies an AUD/USD in the low 0.80s**
- **Terms of Trade headwinds from slower China growth and supply increases also a weight through 2014**

When we downgraded out forecast for the AUD earlier this month, we stressed that the risks around the new forecast track were asymmetric, meaning much more chance that the currency would fall further and faster than projected, than surprise to the upside. And in our latest Global FX Strategist published on 17 June, we said that these downside risks were eventuating and that our forecasts were under review for further downgrade. With AUD currently consolidating the 13% fall since mid-April we now formally revising our forecast, to suggest AUD/USD at 0.90 at the end of September, 0.88 by year end and down to the low 0.80's later next year.

Our NZD/USD forecasts are also revised lower but not by as much as for AUD/USD. The relative fundamental case for NZD outperformance versus AUD is becoming ever more compelling and while a stronger USD story means that highs for NZD/USD are now in, we expect in TWI terms NZD will be appreciating from here, albeit perhaps not as far or fast as the RBNZ assumes in its latest Monetary Policy Statement.

Current 'fair value' near 0.90

Reasonable people can disagree over whether or not US bonds markets overreacted to Ben Bernanke's post-FOMC press conference on 19 June, whether the tapering of its bond purchase programme will commence in September, later in 2013 or perhaps not until 2014 depending on how the economy evolves in H2 2013. But unless the US economy proves top have not yet reached escape velocity and incoming data reveals risk of it falling back into recessions and with inflation falling further (so validating FOMC dissenter James Bullard's protest against the decision to signal that the circumstances justifying tapering were expected to soon fall into place) the die looks cast for higher bond yields and a firmer USD. A straight read across from the back up in 10-year yields to the AUD/USD rate (Chart 2) suggests that the currency does not yet fully reflect the extent of the rise in bond yields. At a more sophisticated level, our preferred short term fair value model incorporating US rates adjusted for the impact of unconventional policy (the 'Shadow Short Rate' – currently near -3%) metals prices and risk appetite, suggests the AUD should be close to 0.90 (Chart 3). Other variants of fair value models we maintain suggest the currency should be somewhere between about 0.89 and 0.92. So in no sense do we regard the recent fall to just below 0.9200 as an overshoot.

US equity/bond combo key for USD

The recent steadier performance of the AUD/USD has coincided with a fall-back in currency volatility (alongside a quite rapid reversal of some key crosses - GBP and EUR in particular). A better showing by US equities after the sharp falls experienced in the wake of Mr Bernanke's press conference may be the common denominator here. If the USD is to rescale and extend its recent highs before too long, we will need to see the equity market maintain its steadier showing at the same time that US yields track steady to higher and meaning that QE tapering expectations do not yet dislodged. There is therefore little escape from the incoming US economic calendar as the primary guide to the USD's forward trajectory and in which regards the next couple of months' non-farm payrolls prints are top of the Tier-1 data list.

Table 1: FX Forecast Summary

		Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14
AUD/USD	New	0.90	0.88	0.86	0.85	0.84	0.83
	Old	0.94	0.93	0.92	0.90	0.88	0.87
AUD/EUR	New	0.71	0.69	0.69	0.70	0.70	0.70
	Old	0.77	0.77	0.75	0.74	0.74	0.74
AUD/JPY	New	94	92	92	94	93	93
	Old	98	98	98	99	98	97
AUD/GBP	New	0.60	0.59	0.59	0.59	0.59	0.59
	Old	0.63	0.63	0.63	0.63	0.62	0.62
AUD/NZD	New	1.15	1.13	1.13	1.13	1.14	1.14
	Old	1.15	1.12	1.12	1.13	1.11	1.10

Chart 2: AUD/USD versus 10-Yr Treasury yield

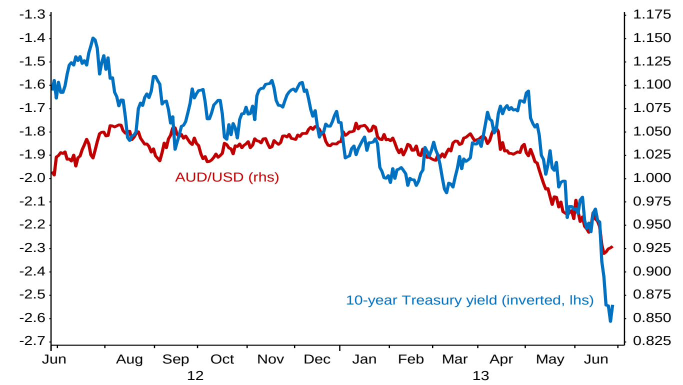
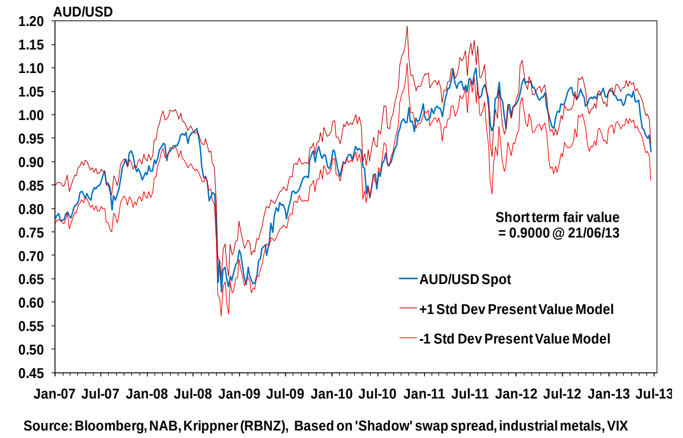


Chart 3: Short term fair-value currently near 0.90



Sources: Bloomberg, Reuters EcoWin Pro, National Australia Bank

AUD fair value to fall through 2014

In referencing an '80 cent' dollar is some our recent communications with clients, the key premise behind this claim is that at the point where the Fed's has dialled back its bond buying programme and bond yields have adjusted such that the effective short term US interest rate is near zero, this alone would justify an AUD/USD rate in the low 0.80s. Whether or not the RBA do see fit to further reduce the Cash Rate (we have one more cut pencilled in for this cycle, in Q4 20913) will have some, has much less bearing on our AUD view than what happened with implied US rates. If the RBA is not going to cut again, this is probably because the currency is falling further, so the causality here runs from the currency to rates, not vice-versa (i.e. rates inaction will hardly be supporting the currency).

At the same time, we project a further, albeit modest, decline in Australia's Terms of Trade though 2014 resulting from increased commodity supply that kicks in alongside a somewhat weaker Chinas growth profile than previously expected (we currently have 7.5% for 2014 but may revise lower after the Q2 GDP data next month). This should be an additional weight on the currency (we use the LME Metals Index as a terms of trade proxy in our model – Chart 5)) and underlies our forecast for AUD/USD at 0.83 at the end of 2014 and falling as low as 0.80 (still with some downside risk) in 2015 assuming the Fed is by then able to start raising the Fund Rate target.

Implications for key cross rates

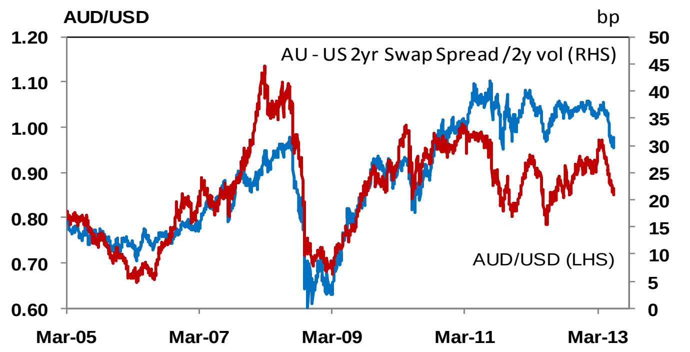
Our revised forecast track for AUD/USD is accompanied by downward revisions to our NZD/USD forecasts but do not detract from our high conviction view that the NZD will rally by at least 5% versus the AUD in coming quarters, with the RBNZ's assumptions for a rebound in the NZD TWI not too far off the mark (Chart 6). Incoming New Zealand activity data shows an economy clearly on the up, and BNZ's economists are highly sceptical that macro-prudential tools alone will suffice to deal with the housing market now officially described as overheated. Risk is that the RBNZ will be condemned to start the tightening cycle without the deference it is current displaying towards the exchange rate. Hence we can see at least a 5% fall in AUD/NZD in coming quarters.

AUD/CAD - In a stronger USD environment, we are not altering our view that CAD has much further to run in terms of outperformance versus AUD, and now project AUD/CAD sub-0.90 in 2014.

AUD/GBP - can at least maintain its recent 14% fall assuming incoming BoE Governor Carney does not push for an extension of QE.

AUD/EUR - is marked lower (0.69-0.70) in 2014 even though we expect EUR/USD to drop back well below 1.300 next year in conjunction with contrasting relative policy stances of the Fed and ECB.

Chart 4: Volatillity kills the attraction of the AUD carry trade



Source: **NAB**, Bloomberg

Chart 5: AUD TWI vs. LME Metals Index (our ToT proxy)

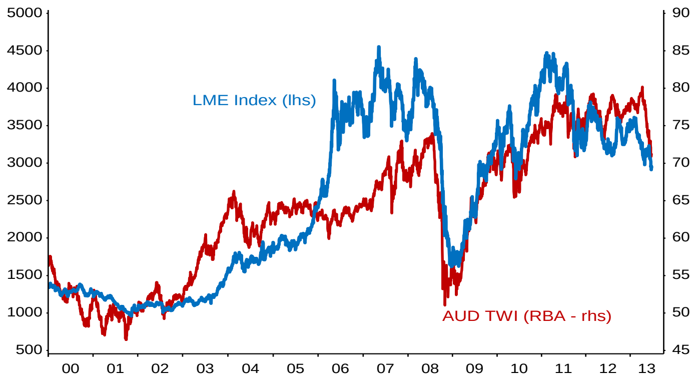
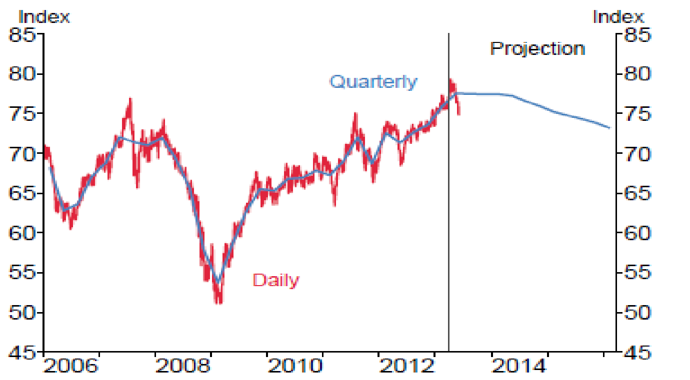


Chart 6: RBNZ NZD TWI projections



Sources: Bloomberg, Reuters EcoWin Pro, National Australia Bank

NZD: Factoring in the Fed

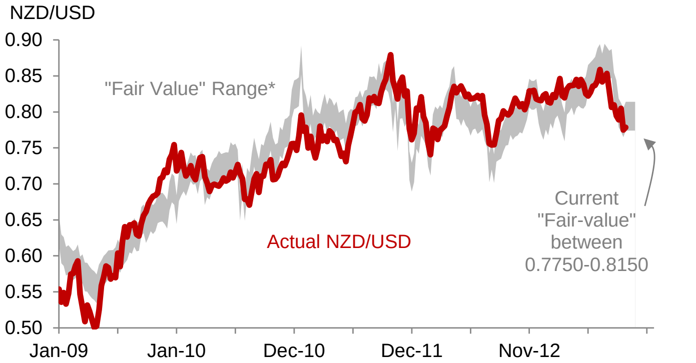
- **We've lowered our NZD/USD forecasts to take into account a stronger USD.**
- **But our view of fundamental NZ outperformance remains intact, meaning we expect further NZD appreciation on a TWI basis. The case for further depreciation in AUD/NZD is particularly compelling.**
- **Our new fundamental 'fair-value' NZD/USD model estimates a fair-value range of 0.7750-0.8150.**

Broadly speaking, we've taken on board the idea that the trend in the US economy and US dollar has turned (see AUD section). As a result, we have lowered our NZD/USD forecasts. We now see the NZD/USD at 0.7800 by year-end. The latest update of our new short-term valuation model shows the Fed has taken a fair old gouge out of the kiwi's fundamental 'fair-value'. Over the past month, the model's estimated fair-value range has declined 4 cents, to 0.7750-0.8150. Narrowing 'shadow-rate' differentials have done most of the work. The US 'shadow short rate' has jumped from -6.3% in April to -3% currently, as the market looks ahead to the end of QE.

Nonetheless, the fact the NZD/USD is now approaching the bottom-end of the model's fair-value range suggests we should exercise caution in expecting further sharp falls. The same can be said of the fact the speculative community, as indicated by the latest IMM data, is now extremely bearish on NZD and AUD. Against this background, we are quick to point out that while the NZD/USD may not spend much more time above 0.8000 this year, we don't believe we are in a downtrend. This remains a story for next year. First, the move higher in US bond yields and the USD has already been dramatic. And further topside progress may be harder won in an environment where Q2 growth looks shaky, USD positioning is becoming 'extreme', and the Fed wants to move cautiously and keep monetary policy loose for a "considerable" period. Second, domestic NZD 'fundamentals' remain supportive of the currency. NZ commodity export prices are holding up a little better than we've been expecting. And the outlook is for prices to ease, but only at a gradual pace. While the recent Chinese growth jitters have hit industrial metals prices hard, prices for 'soft' commodities are unlikely to be as negatively affected. We'll be keeping an eye on this week's ANZ commodity price index and GDT dairy price auction for a cross-check on this view. Meanwhile, recent economic data suggests the NZ recovery is both accelerating and broadening. Consumer spending is healthy, rising net migration is adding to the heat in the housing market, and business and consumer confidence remain at high levels. The prospect of the RBNZ making an early move to quell house price pressures via a higher OCR remains an upside risk to the NZD.

Still, the NZD/USD can have all the positive 'fundamentals' it likes, but in an environment of rising volatility and USD strength the currency isn't going to go anywhere but down. Implicit in our forecasts for the NZD/USD to hold up then, is a view that the current market turmoil settles down, and risk appetite returns to more normal levels. Under these circumstances, the NZD's superior economic fundamentals would be allowed to shine through. We're happy enough with this assumption for now. Particularly following recent signs of thaw in the Chinese interbank liquid squeeze. But with a stronger USD to contend with, our view of fundamental NZ outperformance is now more reflected in the TWI than in the NZD/USD. The case for NZD/AUD appreciation is particularly compelling given the ongoing underperformance of the Australian economy, weak industrial metals prices, and our forecast for another RBA rate cut.

Chart 1: NZD/USD relative to short-term 'fair-value'



*Fair-value is based on a regression model using NZ commodity prices, NZ-US 'Shadow' Rate Spreads, and Risk Appetite

Chart 2: Drviers of NZD/USD fair-value over the past month

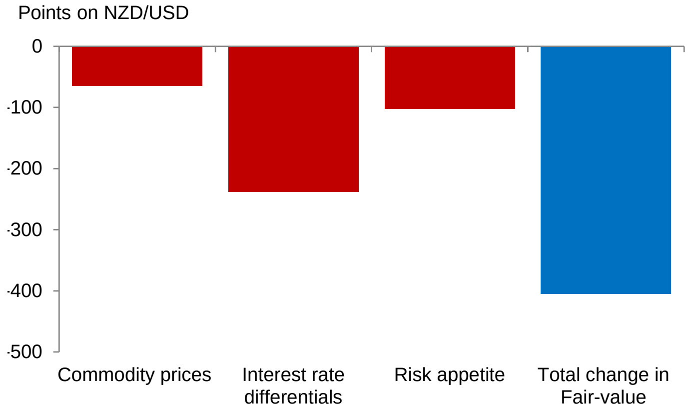


Chart 3: NZD & commodity prices

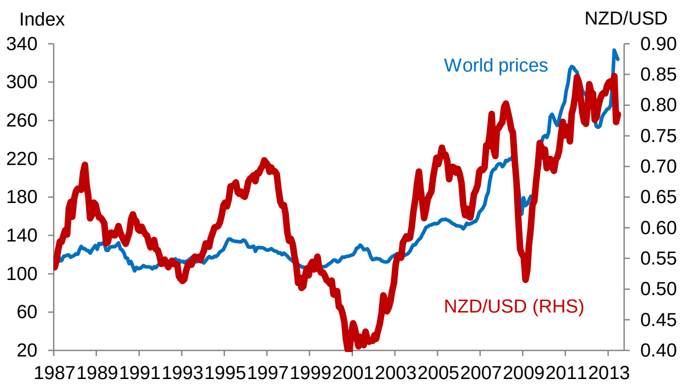
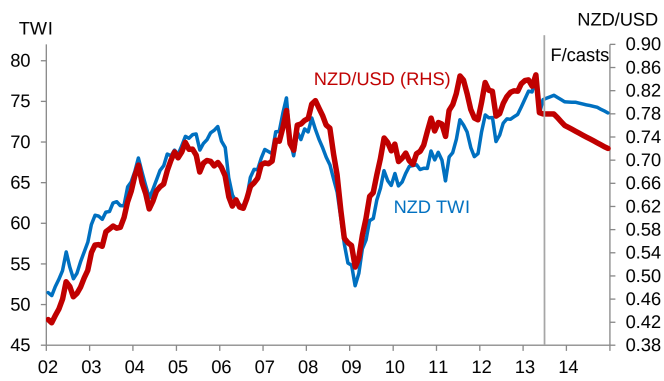


Chart 4: New Zealand Dollar



Source: BNZ, RBNZ, ANZ, Bloomberg, National Australia Bank

IMF Q1 COFER Update

- **Global FX reserves expanded by a further $136bn in Q1, but USD appreciation depressing the USD value of non-USD reserves means the FX-adjusted rise was larger than any quarter of 2012 - more like $253bn.**
- **China accounted for almost all of the Q1 rise.**
- **Reporting of AUD and CAD FX reserves for the first time shows they each represent about 1.6% of reserves – slightly less than we had expected.**
- **After several quarters of disposals, reserve managers were back buying EUR in Q1.**

Late IMF COFER (Composition of Foreign Exchange Reserves) data covering Q1 2013 revealed a rise in the value of global FX reserve of $135.8bn. This is less than each of the last three quarters of 2012, but really only because of the appreciation in the dollar against the Yen, Sterling, Euro and Swiss Franc and which has the effect of depressing the dollar value of reserve denominated in these currencies.

If we adjust for exchange rate change, and making our usual assumption that those central banks who do not report the composition of their reserves allocate in similar proportion to those that do, we estimate that global reserves rose by slightly more than $250bn. and which, in FX adjusted terms, is bigger than any quarter in 2012.

In short, central banks, in particular China who account for $131bn of the $135bn total rise, were continuing to accumulate large amounts of dollars in Q1 even in the face of dollar appreciation, and diversifying more than a third of these out of dollars into other currencies.

Of particular note here is that after several quarters of heavy disinvestment out of the Euro, reserve managers were back buying the single currency in Q1. Again, using the assumption about similar reserve allocations by those who don't report their composition as those that do, we estimate that after a $45bn sale of Euros in Q4 2012 (and $81bn in Q3) CBs were net buyers to the tune of $48bn in Q1. This of course follows the Draghi pledge to 'do whatever it takes' and which appears, with a lag, to have restored some faith in the Euro among reserve managers.

Also to note is that the sharp depreciation of the Yen in late 2012 and through Q1 2013 did not deter reserve managers from continuing to accumulate Yen. We estimate purchases in the order of $24bn, only slightly down on the prior two quarters. Sterling was also bought, and on a bigger scale that either of the prior two quarters.

The big and long-awaited news in the COFER report is the revelation of central bank holdings of AUD and CAD. At (US$) 98.7bn and 94.9bn respectively, these currencies each comprise about 1.6% of reserve holdings of those central banks revealing their breakdown. As Chart 1 shows, allocated reserve now account for 54.6% of the global total, so if unallocated reserves

Exhibit 1: Global FX Reserves – Q1 2013

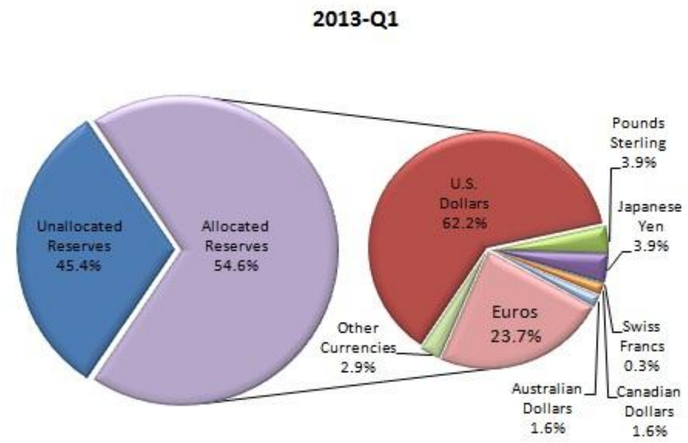
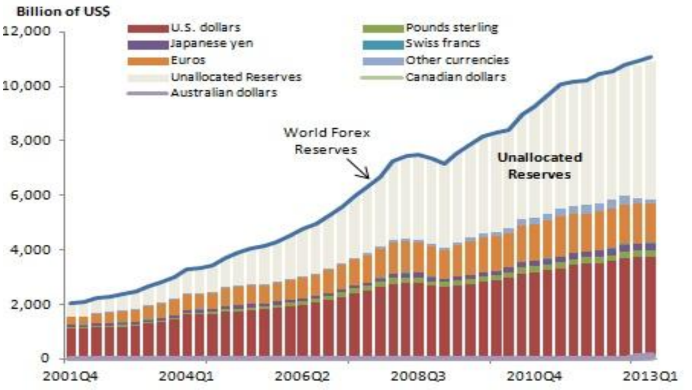


Exhibit 2: Compositon of FX Reserves



Source: IMF COFER

are similarly diversified, that would mean AUD and CAD holdings of some $180bn and $174bn respectively. We had been expecting something more like 2% (so at least $200bn for each).

Yet in the case of Australia, the lower number chimes better with what we know in terms of foreign ownership of the Commonwealth govt. bond market (it nevertheless still implies reserve managers must also own some Semis and/or SSA paper unless there are no ACGB holdings in private hands outside Australia – implausible).

Given global reserve accumulation likely ceased after Q1, the fact demand for AUD (and CAD) has not been quite as strong as believed can be viewed in a slightly positive light (the central bank demand vacuum is not quite so large). But since central banks did acquire some $9bn of AUD in Q1, that is still a sizeable loss of demand if FX reserves are no longer rising and diversification demand for AUD has now ceased.

Majors

- **Data-dependency is the watchword as FOMC signals intent to withdraw stimulus amid market volatility**
- **ECB and BoE keen to stress that their own exit from unconventional monetary policy remains 'distant'**
- **JPY to resume weakening trend as markets stabilise**

Fed Chairman Bernanke's public appearances have now become synonymous with extreme volatility across asset classes. The Q&A session after the Congressional Testimony in May triggered a collapse in the Japanese stock market and his post-FOMC Press Conference on June 19th did the same for sovereign and corporate debt, as well as giving global stocks another hefty nudge lower. Having previously mused publicly on the possible emergence of bubble-like conditions in certain financial products, some of the markets' reaction will not have been totally unwelcome. Better a mini-rout now, perhaps, than a bigger collapse at some future stage.

For all his academic brilliance and long experience as the world's most important policymaker at the time of the Global Financial Crisis, however, Mr Bernanke does not have a financial markets background. By signalling an admittedly data-dependent but time-specific path for the withdrawal of monetary stimulus, the impression was given that policy decisions would be enacted irrespective of the fall-out in asset markets. Indeed, this message was reinforced when Richard Fisher, President of the Dallas Federal Reserve said that the Fed had anticipated a "lively" market reaction to the announcement that it was considering scaling back its Asset Purchase Programme. Mr Fisher is a former hedge fund manager and when he went on to assert that "big money does organise itself somewhat like feral hogs", it appeared the Fed was readying itself for a fight.

Fortunately for investors, Narayana Kocherlakota, president of the Minneapolis Fed, said he was not particularly worried about the short-term market reaction to the Fed move, but would be concerned if it continued. "I think what we've seen so far is not a cause for concern but obviously if these higher yields were to harden over a longer period of time that would be restrictive to economic conditions, suppressing demand and thereby suppressing employment".

Clearly, to the extent that market movements are themselves an input into business and consumer sentiment, policymakers have to be mindful of positive or negative feedback loops across the whole economy. In so doing, a second-round reaction function is often created, where attempts to 'clarify' policy statements are aimed at mitigating unwanted consequences for asset prices and activity more broadly. Markets are not stupid, though (at least not always) and they in turn seek to anticipate and draw investment conclusions from such retrospective 'clarification'. Until market volatility eventually dissipates, we now witness a two-way process of second and even third-guessing the actions and intentions of the respective players which keeps day-to-day movements quite elevated. This could continue through the Northern Hemisphere summer, with more potentially large swings in equity, fixed income and foreign exchange markets.

Data-dependency is the new watchword. A yawning gap has opened between stocks and bond yields which the history of the last decade would suggest is more likely than not to be closed. Given strong economic data, the withdrawal of monetary stimulus should see long bond yields climb rapidly whilst equities are relatively (though not totally) unscathed. Stimulus withdrawal in the face of poor economic numbers, however, would lead to significantly less benign outcomes; plunging stock markets and a potentially huge negative impact on business and consumer confidence, investment and activity.

Chart 1: DXY has bounced impressively since the mid-May rout

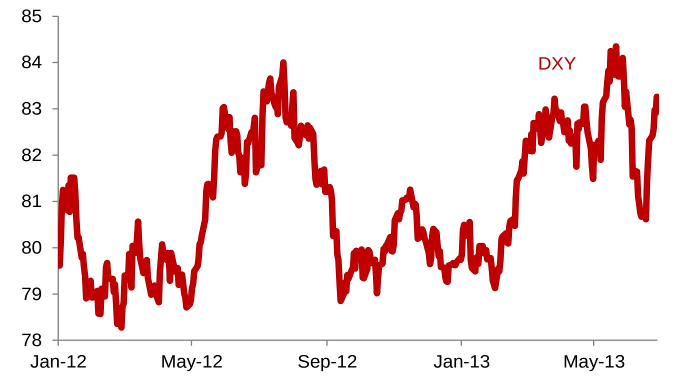


Chart 2: US 10y yields have helped lift the USD post-FOMC

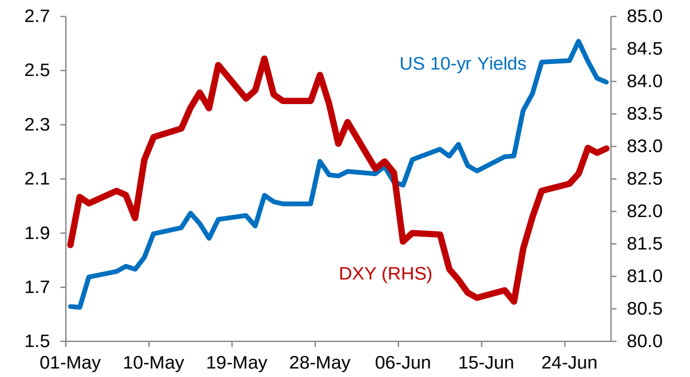


Chart 3: Volatility (VIX) surges but still below previous highs

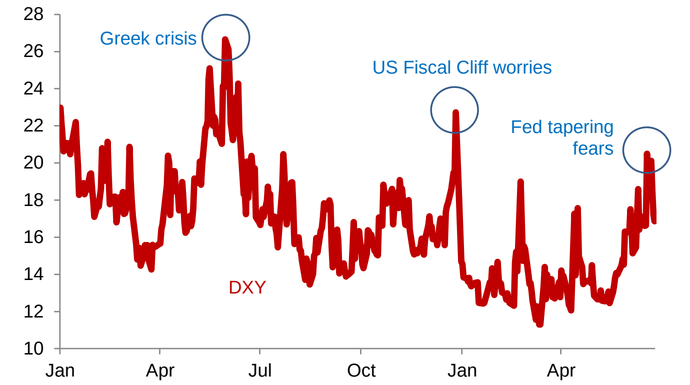
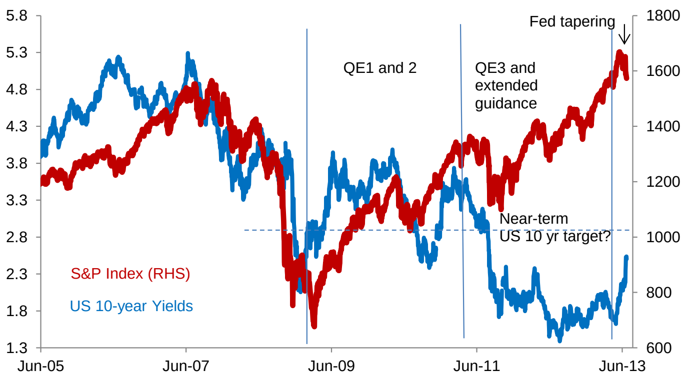


Chart 4: Closing the gap: which way will the re-connection come ?



Sources: Bloomberg, Reuters EcoWin Pro, National Australia Bank

For the US Dollar, the first of these outcomes is obviously preferable. Higher yields – both nominal and real – amidst greater activity and employment are unequivocally positive, especially against a background which has seen benchmark allocations to the currency systematically reduced over the past decade. Unfortunately, the volatility of the post-Testimony period since May 22nd and the unwinding of excessively long USD/JPY positions has thus far crimped investor appetite and may require the triptych of a fresh slate, strong data and a clear technical break before sizeable USD buying emerges.

Fortunately, with the horrors of Q2 now behind us, the first of these conditions may already have been met. “Tier 1” economic numbers are published this coming week (ISM and payrolls), whilst the recent closing high for the DXY of 84.35 is just 1.5% away. We’ve always forecast a stronger USD in H2 2013 and that second half starts today...

EUR

Across the Atlantic, the ECB President and his Executive Board colleague Benoit Coeure have gone to great lengths to stress that both the standard and non-standard monetary policy measures are in the ECB’s legal statutes and the overall economic outlook still warrants an accommodative stance. As Mr Draghi said, “I would say that OMT is even more essential now as we see potential changes in the monetary-policy stance with associated uncertainty in other jurisdictions of the integrated global economy". Mr Coeure said the ECB's loose monetary stance and non-standard measures will remain as long as needed and that “there should be no doubts that our ‘exit’ is distant” and these comments were repeated almost verbatim by Mr Draghi the following day. We believe that by deliberately and repeatedly highlighting the differences in the direction of monetary policy in the US and EU, the ECB is playing an active part in helping lower the value of the EUR exchange rate.

In this context, the July ECB Council Meeting on 4 July could be the opportunity to ram home the message to markets: OMT is there if necessary, negative interest rates have not been ruled out and the ECB’s policy is diametrically opposite to the Federal Reserve’s. With French consumer confidence falling below its GFC low, the European banking system again under scrutiny and the so-called ‘stabilisation’ of Eurozone economic activity a statistical illusion – the pace of decline has merely stopped accelerating, we believe the euro’s strong performance in Q2 will not be repeated.

EUR/USD1.30 may be a nice round number but the more important level is around 1.2910; the uptrend drawn off the July 2012 lows. We believe this will be broken in Q3 and re-iterate our forecasts (which have not been changed) for the euro to weaken to 1.27 as the US Dollar returns to favour.

GBP

As Mr Carney sits down to his first day in his new job, the latest – and very comprehensive – revisions to UK GDP data show the scale of the challenge he faces. Insofar as there is any good news, it is purely presentational: the “double-dip” recession in late 2011 and early 2012 has now been revised away. Beginning in Q4 2011, the series originally ran -0.1%, -0.1% and -0.4%; three consecutive quarters of negative growth. This has now been revised to show -0.1%, 0.0% and -0.5%. The net result is the same level of GDP by end Q2 2012 but a very slightly different profile with the middle quarter now showing zero. If a recession is defined as two consecutive quarters of negative growth then – hey presto! – the “double-dip” recession never happened.

But, if the UK economy did not have two consecutive quarters of negative growth, nor has it had two consecutive quarters of positive growth since Q3 2011. Since the middle of 2011, the

Chart 5: US yield curve steepens as 10y rises 83bp since May 1st

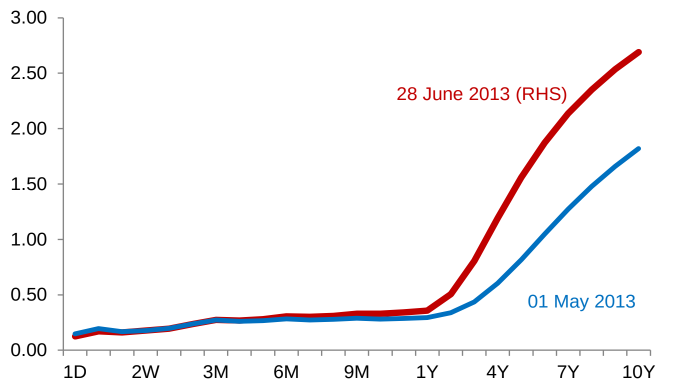


Chart 6:.Trade-weighted EUR only 15% off all-time high

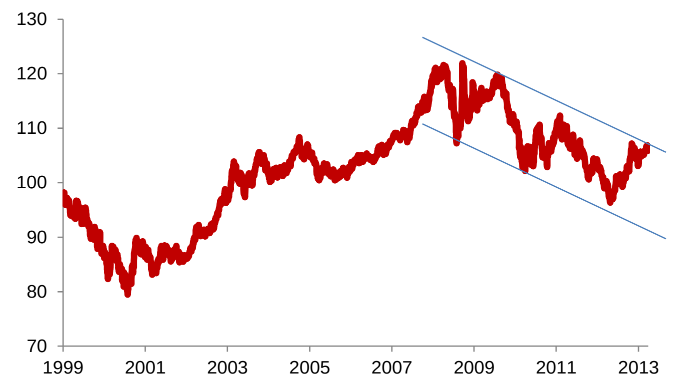


Chart 7: EUR/USD approaching trendline off July 2012 lows

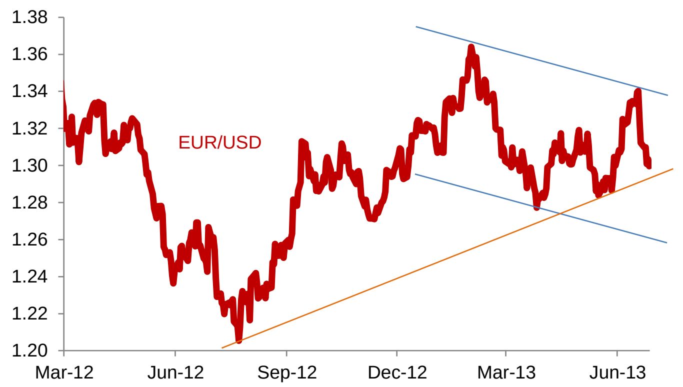
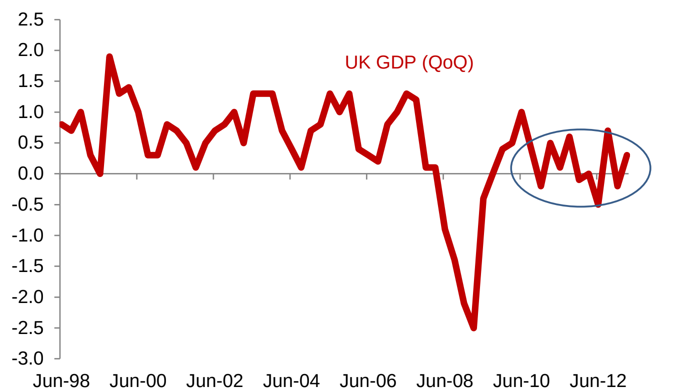


Chart 8: UK GDP still choppy; not yet reached escape velocity



Sources: Bloomberg, Reuters EcoWin Pro, National Australia Bank

series now reads +0.6%, -0.1%, 0.0%, -0.5%, +0.8%, -0.2% and +0.2%; the best we can say it that it is bumping along the bottom after a bigger drop than previously reported; the 6.3% loss of output from peak-to-trough has now been revised to a -7.2% decline. Mr Carney may still need to use a bigger shovel to dig the UK economy out of this hole.

Prior to the data revisions, we had thought the near-term risk might be for a downside break of the 15-week 0.84-0.86 range for EUR/GBP. This now appears less likely as GBP/USD has more than matched the euro's recent decline and we look for a continuation of this range well into the second half of the year.

CHF

Since our last edition the SNB's quarterly policy meeting has come and gone and without much in the way of notable news. We had expected the latest economic developments and movements in the exchange rate to allow the SNB – for the first time in eight quarters – to raise its key two-year inflation forecast back towards non-crisis territory. That was not to be and the two-year forecast has actually been pulled down one tenth to 0.3%. Even shorter-term CPI forecast have also been lowered a fraction. We suggest these CPI will come in on the high side of expectations going forward, aided by base-effects.

As we write there is once again brewing speculation that the CHF is on the verge of making a more sizeable decline. Back in May the EUR/CHF cross ramped from 1.22 to 1.2650 as investors suspected market conditions might be returning towards an environment where there would be less need for a safe-haven CHF. We have been a long-time supporter of this view and continue to hold a long EUR/CHF recommendation. However, the correction in markets generally since Fed chairman Bernanke's 22 May initial suggestions of tapering, have – via an unwinding of EM and other high yield trades – seen an unhelpful further round of flows into the CHF.

Once the bulk of these adjustments has washed through, however, and as markets adjust to a new less accommodative environment (at least with respect to the open-ended nature of Fed liquidity provision) and as global economic growth stabilises into 2014, we do expect the CHF to tumble and a return to 1.3 in EUR/CHF would not be out of the question. Timing this is fraught with difficulty – we may get lurches toward 1.27 initially. Looking at Swiss banks' foreign assets and balance sheet reduction (which have been CHF positive via repatriation), the pace of contraction has now slowed to 6-year low. It remains unclear just yet though if there will be an active return to building up more foreign assets in a generally capital-constrained environment.

JPY

After a brutal and volatile month of June, USD/JPY actually ended within 1.5% of its-end May level, having tumbled to a low of 93.79 amidst the equity market rout. Indeed, at one point, the Nikkei 225 index entered a technical bear market whilst still up 19.9% from the beginning of the year. The correlation between stocks and the currency remains very close but the causality, it seems, switches on a weekly – and sometimes a daily - basis. The 23 May equity rout drove USD/JPY lower but the USD rally off the low then lifted stocks. Most recently, we observed the somewhat counter-intuitive phenomenon of the Yen weakening after the publication of positive data on CPI and industrial production saw buyers return to equity market. Assuming the efforts of policymakers globally to calm investor nerves– from the US to China via the UK and Europe – are successful, we look for USD/JPY to return above 100 and to make fresh cycle highs in Q3. Initial disappointment that Mr Abe's "third arrow" (deregulation) would be delayed will dissipate as expectation builds through the Summer, whilst the Upper House Elections on 21 July should allow the LDP-New Komeito ruling bloc to end the divided Diet and cement the power of PM Shinzo Abe.

Chart 9: EUR/GBP to remain trapped in narrow range in H2 2013

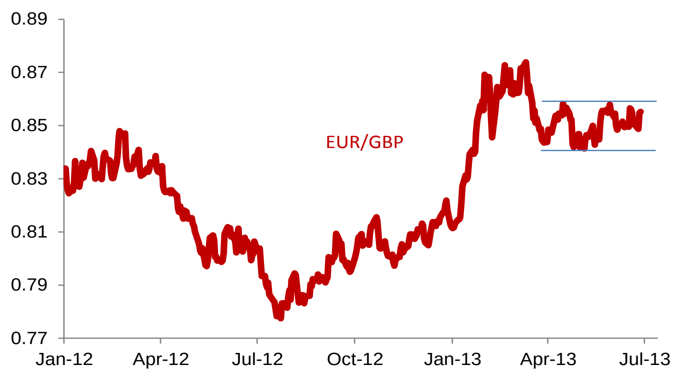


Chart 10: Swiss bank selling of foreign assets has stabilised

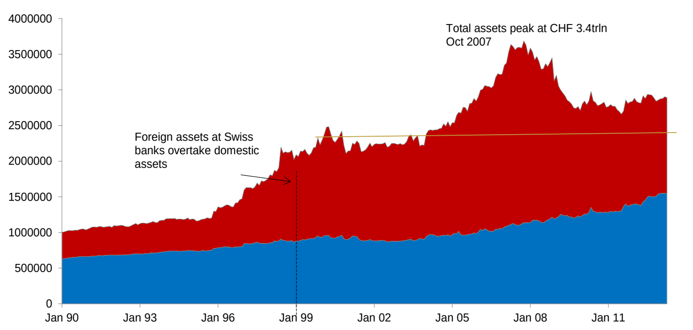


Chart 11: The 'safe-haven' TWI CHF could correct lower

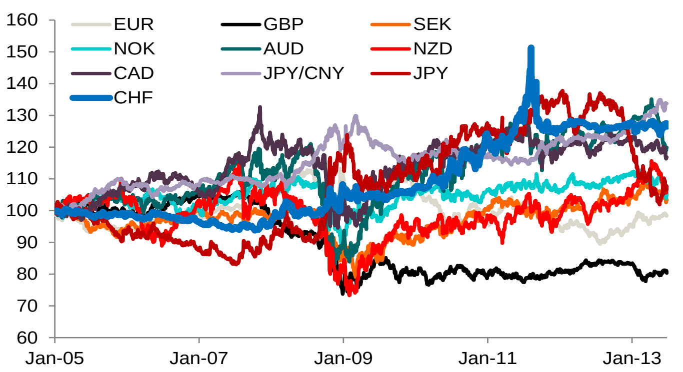
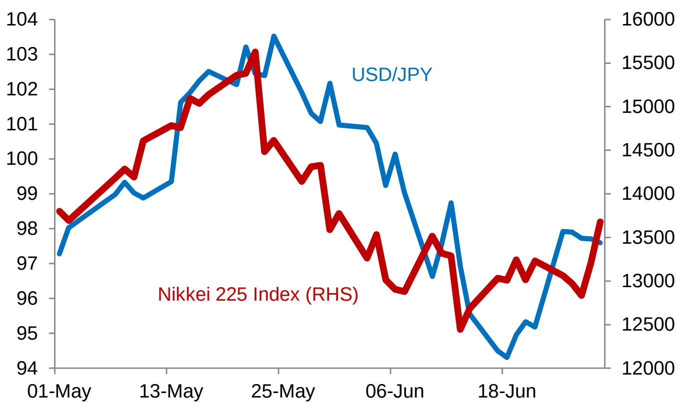


Chart 12: USD/JPY vs Nikkei – Correlation clear, causality less so...



Sources: Bloomberg, Reuters EcoWin Pro, National Australia Bank

US Federal Reserve

The distinction between tapering and tightening

After the relative clarity on US monetary policy offered by Fed Chairman Bernanke, markets are once again tying themselves in knots over the Fed's intentions. Comments from FOMC members Dudley and Powell last week have been taken by markets as 'dovish' and as part of a concerted effort by the Fed to push back on the idea the Fed is shifting to a less accommodative position.

Let's be clear what is happening here. Both Dudley and Powell (or any other FOMC members) are not out to change the message imparted by their boss Bernanke last week, that if the Fed's forecasts are met, then tapering can begin. As we go forward it is imperative we understand and don't confuse the distinctions Fed officials are making between tapering and tightening via changes to the Fed funds rate.

Dudley made the point that if the Fed misses its forecasts, QE may be prolonged. This should not surprise anyone and was absolutely explicit in Bernanke's Press conference, "If the incoming data are broadly consistent with this forecast, the committee currently anticipates that it would be appropriate to moderate the pace of purchases later this year." And, as he added, "if the subsequent data remain broadly aligned with our current expectations for the economy, we will continue to reduce the pace of purchases in measured steps through the first half of next year, ending purchases around mid-year."

The implication then is providing the Fed's forecasts are met, tapering can start later this year, potentially ending mid-2014, but that the Fed reserves the right to adjust this timeline guidance with the ebb and flow of the data. To emphasis the point Bernanke was asked at his press conference about past inaccuracy of the Fed's forecasts. Understandably, he confirmed that if the latest forecasts were not met then that would have to be factored in to policy adjustments.

When asked about changes to financial conditions via markets pushing up longer-term and thereby mortgage rates, he said that if conditions and longer-term yields rose 'for the right reasons' (because economic data and confidence and optimism was improving) that was 'a good thing'. But he also warned that markets could go too far and that would also have policy implications. "It is difficult to judge if markets are in sync or not but generally speaking and what I have seen from analysts and market participants is they are not widely out of line with what the FOMC is trying to communicate." That line of course was before the blow out in future implied rates as markets tumbled.

We should remind ourselves what Bernanke said on this (then potential phenomenon) on 19 June. "I think the most important thing I want to convey is it is important not to say this date, that date, this time (on tapering), but to understand our policies are economic dependent and in particular if financial conditions move away and to the extent they make this economic scenario unlikely, for example, then that would be a reason for us to adjust policy."

In light of the fact there has been a bringing forward of rate hike expectations (Dec 2014 Eurodollars implying a Fed funds rate of 0.4% in May to 0.8% on 24 June, while Dec 2015 moved from 0.8% to 1.6%). As Powell noted last week, "market adjustments are larger than that which would be justified by any reasonable assessment of the path of future Fed policy." At the same time he reiterated that if the economy grows as expected, bond buying could be scaled back later this year."

For his part New York Fed chief Dudley warned that "a rise in short-term rates is very likely a long way off... Let me emphasize, that such an expectation would be quite out of sync with both FOMC statements and the expectations of most FOMC participants". Dudley did reiterate that if the economy performs as he expects, the Fed believes it can moderate the pace of bond buying later this year.

So the message ought to be clear: Tapering can begin, providing labour market data perform as anticipated, but because that still leaves the Fed buying assets through to mid-2014 on the current baseline, there is no need to bring forward or raise rate hike expectations. The Fed has given markets a potential roadmap to when QE will end. The point markets appear to be missing is the 'extended' period of time between that date and eventual rate rises. Indeed, the Fed still doesn't see the economy at escape velocity by mid-2014: its latest central growth projections don't see GDP getting back up to a 3% to 3.5% range until Q4 2014.

The Fed does appear to be underestimating the turbulence and fallout that is inevitable when investors start to unwind a whole host of trades put on because of QE3 and the extended guidance. Chart 4 on page 4 shows the US 10 year government yield and the S&P 500. The two moved more or less in sync through QE1 and 2 mainly because markets and investors perceived (i) that policy accommodation would be successful and boost economic growth (ii) that QE would ultimately boost inflation (aiding commodity prices) and (iii) that there was a risk the Fed might lose control of inflation albeit temporarily.

However the positive correlation between the S&P 500 and 10-year yields broke down massively with the arrival of QE3, which followed a collapse in some assets as the US debt debacle of summer 2011 broke (leading to the US debt downgrade) and the Fed for the first time introduced its extended policy guidance (initially to 2013, but extended in early 2012 to 2015). The combination of the collapse in a broad array of asset prices in August 2011 (mainly EM as investors sold the 'good' to pay for the 'bad') and the Fed's extended guidance forced investors down the yield curve as yields collapsed alongside economic growth.

In addition accounting rules, solvency requirements and liquidity provisions compelled pension funds, insurance companies and banks to increase bond holdings, depressing yields further. The cutting of policy rates to the zero bound across major central banks (plus their own QE policies) and the fact the Fed then became the dominant purchaser of USTs out to the 10-year maturity had a magnified effect on depressing yields.

With investors forced down the quality curve, assets with higher dividend yields (which favoured globally exposed stocks such as those in the S&P 500, FTSE Eurofirst 300 and MSCI) ramped – aided hugely by the extended guidance. Because the economic backdrop has not been great, defensive sectors often lead major stock market gains, while billions of USDs also flooded into high yield and EM. It is possible that after seeing an initial explosion of position unwinds, we are over the worst and yields will steady, aided by the still uncertain economic backdrop and Fed 'calm down' rhetoric. Possible, but by no means guaranteed.

Unless the US economy really tanks, tapering looks to be on the way. Our best guess at this stage is the September 19th FOMC meeting which allows for three more NFP releases in the interim. Moreover, there is a Bernanke press conference on that date (there is not on either the 31 July and 29 Oct). And, if the Fed Chairman had meant the 18 December meeting, would he not have used the phrase 'late this year' instead of 'later this year'? We assume that so long as economic data perform as the Fed expects, US yields will grind up towards the 3% level, remaining in a broad 2.4% to 3% range, but NFP releases, as well as ISM Surveys and other "Tier One" economic data will see some violent swings within that range, pulling the USD in their wake.

Central Bank Policy Monitor

<table>
<tr><th></th><th>Current Rate</th><th>Last Change</th><th>Bias</th><th>Next Meeting</th><th>NAB Forecast</th><th>F'cast Rate End 2013</th></tr>
<tr><td>**Australia RBA**</td><td>2.75%</td><td>7 May 2013</td><td>Easing</td><td>2 Jul 2013</td><td>Unchanged</td><td>2.50%</td></tr>
<tr><td>Official Cash Rate</td><td></td><td>-25bps</td><td></td><td>6 Aug 2013</td><td>Unchanged</td><td></td></tr>
<tr><td colspan="7">The RBA statement following the June 'no change' was particularly terse, but the 'scope to ease' language was retained, so publicly an easing bias remains in place despite the fall in the exchange rate since May and which has significantly eased financial conditions. We very much doubt the RBA will cut this week (market odds of 20% seem about right) but given the RBA's evident hopes the currency will keep falling we doubt they will drop the public reference to retaining an easing bias.</td></tr>
<tr><td>**New Zealand RBNZ**</td><td>2.50%</td><td>10 Mar 2011</td><td>Neutral</td><td>25 Jul 2013</td><td>Unchanged</td><td>2.50%</td></tr>
<tr><td>Official Cash Rate</td><td></td><td>-50bps</td><td></td><td>12 Sep 2013</td><td>Unchanged</td><td></td></tr>
<tr><td colspan="7">The latest RBNZ meeting saw governor Wheeler re-state that rates were likely to remain at 2.5% at least through the end of 2013, with the OCR track in the MPS suggesting no rise until September 2014. Yet since the MPS also shows a forecast for the NZD TWI rising from 74 to above 77 this year, failure of this to materialise presumably implies risk that the leeway to raise rates earlier than expected is much greater.</td></tr>
<tr><td>**US Federal Reserve**</td><td>0.25%</td><td>16 Dec 2008</td><td>Easing</td><td>30 Jul 2013</td><td>Unchanged</td><td>0.25%</td></tr>
<tr><td>Fed Funds Rate</td><td></td><td>-75bps</td><td></td><td>17-18 Sep2013</td><td>Unchanged</td><td></td></tr>
<tr><td colspan="7">Bond yields have risen sharply on expectations that the Fed could start to taper its asset purchases from as early on as September. Bernanke has made it clear that if the economy continues to grow in line with expectations, the Fed would stop making new purchases in the middle of 2014, although we doubt that it would be selling its assets at that stage. We believe that the July meeting will be used to try to steer market expectations away from any imminent tightening.</td></tr>
<tr><td>**Eurozone ECB**</td><td>0.50</td><td>2 May 2013</td><td>Neutral</td><td>4 Jul 2013</td><td>Unchanged</td><td>0.75%</td></tr>
<tr><td>Refi Rate</td><td></td><td>-25bps</td><td></td><td>1 Aug 2013</td><td>Unchanged</td><td></td></tr>
<tr><td colspan="7">Following a spate of weak economic activity and price data, the ECB cut rates to a new record low of 0.5% in May. They also narrowed the corridor around the main refinancing rate in order to keep the reserve rate at 0.0%.Rates were left unchanged in June despite some speculation that a rate cut was possible given a weaker growth and inflation profile. ECB President Draghi gave little away in the Press Conference, which we suspect means that the ECB is happy to remain where it is as long as periphery debt markets do not come under too much pressure. We are at the limits of conventional monetary policy and splits within the Governing Council suggest that there are difficulties in launching unconventional policies such as loan guarantees.</td></tr>
<tr><td>**UK BoE**</td><td>0.50%</td><td>5 Mar 2009</td><td>On hold</td><td>4 Jul 2013</td><td>Unchanged</td><td>0.50%</td></tr>
<tr><td>Repo Rate</td><td></td><td>-50bps</td><td></td><td>1 Aug 2013</td><td>Unchanged</td><td></td></tr>
<tr><td colspan="7">Governor Carney starts in July, but only formally needs to give his view on the use of forward guidance in setting monetary policy in the August Inflation Report. However, there is some speculation that he could follow Governor King and vote for more QE at the July meeting even though he is unlikely to sway the rest of the Committee behind him for now. We suspect that the majority of the Committee are still happy to pursue credit easing, even though the rise in US yields shows that QE policies remain potent.</td></tr>
<tr><td>**Japan BoJ**</td><td>0.10%</td><td>19 Dec 2008</td><td>Easing</td><td>11 Jul 2013</td><td>Unchanged</td><td>0.10%</td></tr>
<tr><td>Overnight Call Rate</td><td></td><td>-0.2%</td><td></td><td>8 Aug 2013</td><td>Unchanged</td><td></td></tr>
<tr><td colspan="7">Latest utterances from BoJ officials suggest no inclination to add or subtract from the roll out of the existing policy intended to double the monetary base by the end of next year while extending the duration of its JGB portfolio. With the JGB market behaving in a more stable fashion, and the Yen no longer appreciating, there is little reason to expect policy tweaks for the time being.</td></tr>
<tr><td>**Switzerland SNB**</td><td>0.25%</td><td>12 Mar 2009</td><td>Easing</td><td>19 Sep 2013</td><td>Unchanged</td><td>0.25%</td></tr>
<tr><td>3mth Libor Target range</td><td></td><td>-25bps</td><td></td><td>12 Dec 2013</td><td>Unchanged</td><td></td></tr>
<tr><td colspan="7">SNB set a EUR/CHF floor on 15 Sep 2011 at 1.20. Notwithstanding recent asset market volatility, we believe the CHF will be under less upward pressure and we still expect EUR/CHF to rally to 1.27 to 1.30 over time.</td></tr>
<tr><td>**Canada BoC**</td><td>1.00%</td><td>8 Sep 2010</td><td>On hold</td><td>18 Jul 2013</td><td>Unchanged</td><td>1.00%</td></tr>
<tr><td>Overnight Lending Rate</td><td></td><td>+25bps</td><td></td><td>05 Sep 2013</td><td>Unchanged</td><td></td></tr>
<tr><td colspan="7">Outgoing BoC Governor Mark Carney's swansong meeting on May 29 pretty much repeated the April (and earlier) meetings message; the 1% policy rate is likely to be appropriate for 'a period of time' but a rate hike will be necessary sometime. In all likelihood the BoC is on hold for at least the rest of this calendar year; current market pricing for a roughly 50% chance of +25bp within a year looks reasonable.</td></tr>
<tr><td>**Norway Norges Bank**</td><td>1.50%</td><td>14 Mar 2012</td><td>On hold</td><td>19 Sep 2013</td><td>Unchanged</td><td>1.50%</td></tr>
<tr><td>Deposit Rate</td><td></td><td>-25bps</td><td></td><td>24 Oct 2013</td><td>Unchanged</td><td></td></tr>
<tr><td colspan="7">Unless the Norwegian economy is exposed to new major shocks, Norges Bank is very comfortable holding rates at today's level towards the end of 2013 and possibly beyond as "the expected upward shift in interest rates abroad has been deferred further ahead"</td></tr>
<tr><td>**Sweden Riksbank**</td><td>1.00%</td><td>18 Dec 2012</td><td>Neutral</td><td>3 Jul 2013</td><td>Unchanged</td><td>1.00%</td></tr>
<tr><td>Repo Rate</td><td></td><td>-25bps</td><td></td><td>5 Sep 2013</td><td>Unchanged</td><td></td></tr>
<tr><td colspan="7">Low inflation and a generally weak economy have led the Riksbank to favour an expansionary monetary policy to support the recovery. Having cut rates by 25bps in its December meeting, the central bank left the repo rate unchanged in February despite dissent from one board member wanting a 25bps rate cut. We look for rates to be left on hold through 2013.</td></tr>
<tr><td>**China PBoC**</td><td>6.00%</td><td>5 Jul 2012</td><td>Neutral</td><td>n/a</td><td>Unchanged</td><td>6.00%</td></tr>
<tr><td>1 Year Rate</td><td></td><td>-31bps</td><td></td><td></td><td></td><td></td></tr>
<tr><td colspan="7">The Chinese authorities appear willing to stick to their calls of short time pain for long term gain. For PBoC policy this means we are likely to see monetary conditions remain tighter than at the start of the year, which is likely to result in significantly slower credit growth. 'Prudent' monetary policy will remain the watchword, and should mean that policy rates and the RRR remain where they are through 2013.</td></tr>
</table>

Trade Recommendations

Entry date	Currency pair	Recommendation	Opening level	Target	Closing rate	Comment	*P/L (%)
Sep 12 2011	EUR/CHF	Buy	1.2030	1.3	1.244	Closed May 15 2013	+3.41
Oct 25 2012	EUR/GBP	Buy	0.8061	0.82	0.7995	Closed Nov 5	-0.82
Nov 26	USD/JPY	Buy	82.35		87.72	Closed Jan 7	+6.52
Nov 27	EUR/GBP	Buy	0.8080		0.8496	Closed Jan 25	+5.15
Dec 20	EUR/JPY	Buy	110.65		118	Closed Jan 22	+6.64
Dec 20	INR/JPY	Buy	1.5320		1.651	Closed Jan 22	+7.77
Jan 7	GBP/USD	Sell	1.6040		1.6135	Closed Jan 9	-0.59
Jan 25	EUR/GBP	Buy	0.8520		0.8611	Closed Feb 1	+1.07
Feb 11	AUD/NZD	Sell	1.2350		1.254	Closed Mar 14	-1.54
Feb 25	GBP/USD	Sell	1.5136	1.47	1.5198	Closed May 14	-0.41
Feb 25	NZD/USD	Buy	0.8280		0.828	Closed Mar 13	+0.00
Feb 26	EUR/USD	Buy	1.3065		1.307	Closed Mar 1	+0.04
Feb 26	EUR/JPY	Buy	120.08		120.8	Closed Mar 1	+0.60
Mar 14	AUD/USD	Sell	1.0330		1.0448	Closed Mar 25	-1.14
Mar 25	USD/JPY	Buy	94.40	105	102.01	Closed May13	+8.06
Mar 25	AUD/NZD	Sell	1.2525	1.20	1.2058	Closed May 3	+3.73
Mar 27	US DXY	Buy	83.21	86.00	81.8	Closed Apr 16	-1.69
Apr 15	AUD/CAD	Sell	1.0635	1.00	1.0078	Closed May 13	+5.24
May 20	AUD/NZD	Sell	1.2000			Recommendation	
May 20	USD/JPY	Buy	101.80		101.45	Closed May 24	-0.34
May 20	EUR/CHF	Buy	1.2450			Open Position	
Jun 24	AUD/USD	Sell	0.9210			Open Position	
July 1	AUD/NZD	Sell	1.1813			New position	

+ = Profit - = Loss

* These trade recommendations reflect the views of the FX Strategy team, not actual investments

** Profit and Loss does not take into account the cost of funding.

** All trades are entered and exited at specified levels

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