

Foreign Exchange Forecasts

August 2012

- USD relative strength, despite better risk appetite and position unwinds, suggests underlying fundamental support. We forecast further USD upside medium term
- EUR should be weak across the board medium term assuming Grexit, volatile and wide bond yield spreads between core and periphery, weak EMU growth, further ECB rate cuts and additional LTROs. But near term, we may see some stability given the sharp move lower recently and very negative positioning
- In Europe, SEK and NOK should appreciate further versus the single currency in the medium term. However, in the short run, they might give back some of their recent gains if EUR/USD consolidates. Sterling range trades versus the euro over the forecast horizon
- We continue to expect the EUR/CHF peg to hold, so long as inflation in Switzerland is contained and EMU pressures remain manageable
- Within EM, CEEMEA is the big loser medium term. LATAM gains near term and then loses further out. Asia is relatively stable reflecting the pivotal USD/CNY

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Figure 1. DM & EM – Forecasts Paths

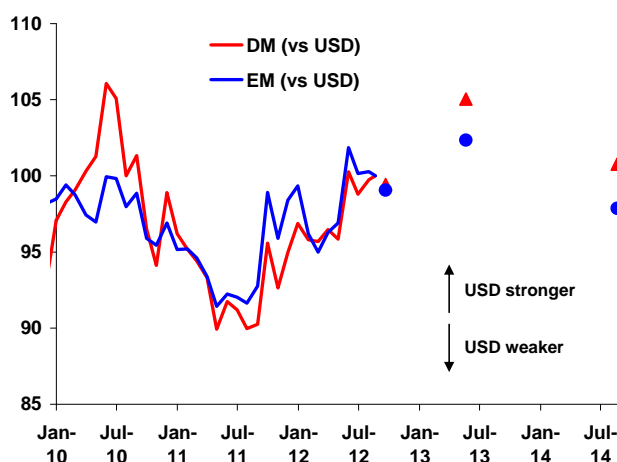


Chart shows GDP weighted baskets. Today = 100
Sources: Citi Research and Bloomberg

Figure 2. EM Regions – Forecasts Paths

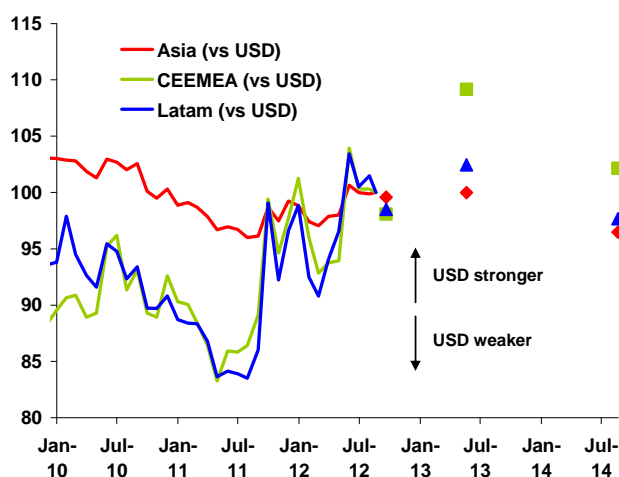


Chart shows GDP weighted baskets. Today = 100
Source: Citi Research and Bloomberg

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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Foreign Exchange Forecasts

Figure 3. Citi Foreign Exchange Forecasts

		Market data			Forecasts			Returns**	
		spot	3m Fwd	12m Fwd	0-3 mos	6-12 mos	long-term	3 mos rtn	12 mos rtn
G10									
Euro	EURUSD	1.23	1.23	1.24	1.25	1.15	1.25	1.4%	-7.2%
Japanese yen	USDJPY	80	79	79	81	80	84	2.0%	1.2%
British Pound	GBPUSD	1.57	1.57	1.57	1.58	1.50	1.58	0.9%	-4.1%
Swiss Franc	USDCHF	0.97	0.97	0.97	0.96	1.04	0.96	-1.4%	8.1%
Australian Dollar	AUDUSD	1.05	1.04	1.01	1.05	0.98	0.95	1.3%	-3.2%
New Zealand Dollar	NZDUSD	0.81	0.80	0.79	0.82	0.75	0.69	2.0%	-5.0%
Canadian Dollar	USDCAD	0.99	0.99	1.00	0.98	1.00	0.97	-1.0%	0.2%
Dollar Index*	DXY	82.57	82.57	82.37	81.93	86.91	82.22	-0.8%	5.5%
G10 Crosses									
Japanese yen	EURJPY	98	98	98	101	92	105	3.4%	-6.1%
Swiss Franc	EURCHF	1.20	1.20	1.20	1.20	1.20	1.20	0.0%	0.3%
British Pound	EURGBP	0.79	0.79	0.79	0.79	0.77	0.79	0.5%	-3.2%
Swedish Krona	EURSEK	8.22	8.26	8.37	8.35	8.00	8.25	1.1%	-4.4%
Norwegian Krone	EURNOK	7.31	7.35	7.45	7.45	7.15	7.30	1.4%	-4.0%
Norwegian Krone	NOKSEK	1.12	1.12	1.12	1.12	1.12	1.13	-0.3%	-0.4%
Australian Dollar	AUDNZD	1.29	1.29	1.28	1.28	1.31	1.38	-0.6%	1.9%
Australian Dollar	AUDJPY	83	82	80	85	78	80	3.3%	-2.1%
Asia									
Chinese Renminbi	USDCNY	6.36	6.38	6.45	6.36	6.30	6.15	-0.3%	-2.4%
Hong Kong Dollar	USDHKD	7.76	7.75	7.75	7.76	7.76	7.75	0.1%	0.1%
Indonesian Rupiah	USDIDR	9517	9669	10122	9450	9750	9649	-2.3%	-3.7%
Indian Rupee	USDINR	55.7	56.8	59.4	55.0	56.0	52.3	-3.2%	-5.7%
Korean Won	USDKRW	1136	1142	1154	1120	1140	1080	-1.9%	-1.2%
Malaysian Ringgit	USDMYR	3.13	3.15	3.19	3.10	3.23	3.11	-1.6%	1.4%
Philippine Peso	USDPHP	42.4	42.6	42.9	42.5	43.0	40.8	-0.2%	0.3%
Singapore Dollar	USDSGD	1.25	1.25	1.25	1.25	1.28	1.23	-0.3%	2.3%
Thai Baht	USDTHB	31.5	31.7	32.1	31.4	32.0	29.9	-0.9%	-0.4%
Taiwan Dollar	USDTWD	30.0	30.0	29.7	29.7	30.5	28.5	-1.0%	2.5%
EMEA									
Czech Koruna	EURCZK	24.9	25.0	25.0	24.7	26.0	24.5	-1.0%	3.8%
Hungarian Forint	EURHUF	278	282	292	275	290	290	-2.5%	-0.7%
Polish Zloty	EURPLN	4.07	4.12	4.25	4.00	4.40	3.90	-2.9%	3.5%
Israeli Shekel	USDILS	4.03	4.05	4.08	4.00	4.20	4.00	-1.2%	3.0%
Russian Ruble	USDRUB	32.1	32.6	34.1	31.5	35.4	33.7	-3.5%	3.9%
Russian Ruble Basket		35.4	36.0	37.8	35.0	37.8	37.5	-2.8%	0.1%
Turkish Lira	USDTRY	1.80	1.83	1.90	1.77	1.88	1.85	-3.1%	-1.3%
South African Rand	USDZAR	8.31	8.43	8.73	8.25	8.70	8.72	-2.1%	-0.3%
LATAM									
Brazilian Real	USDBRL	2.02	2.05	2.13	1.99	2.06	2.00	-2.8%	-3.1%
Chilean Peso	USDCLP	483	490	505	495	510	490	1.0%	1.0%
Mexican Peso	USDMXN	13.1	13.2	13.5	12.7	13.4	12.2	-3.9%	-0.9%
Colombian Peso	USDCOP	1820	1847	1893	1820	1865	1850	-1.5%	-1.5%

* The DXY forecasts are implied from the forecasts of the constituent crosses.

** Returns are relative to forwards

Source: Citi Research and Bloomberg

Overview

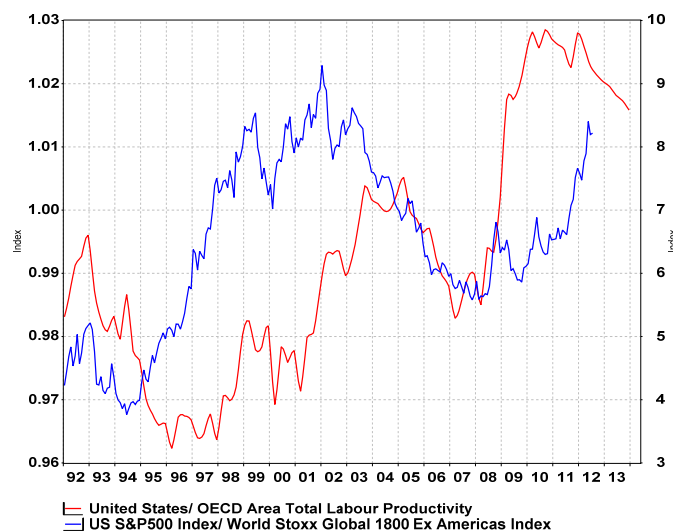
Medium term, our forecasts remain resolutely USD bullish, with an appreciation of around 5% priced vs. other G10 currencies over 6-12m and 4% globally. This is turn reflects likely US cyclical outperformance. FX investors are likely to believe that the US economy may be sub-par but that it is still likely to better other regions. Equity market outperformance, and bond market underperformance on trend suggest similar expectations are in other asset markets. These factors are likely to drive USD appreciation over the medium term, absent US policy disasters. As such, investors in US asset markets will likely outperform via either asset market or currency (Figure 4).

The EUR is expected to be the weakest major currency over the same medium term horizon, undermined by high risk premia, relatively aggressive ECB monetary easing/ balance sheet expansion and tight fiscal policies/ subdued cyclical performance. In the EM world, we expect USD/ CNY to be broadly stable implying some Chinese appreciation against other blocs. LATAM currencies may perform relatively well short term but give back some gains medium term. CEEMEA performance will be varied but generally weak, held back by association with EUR weakness.

Short term, however, the correction weaker in USD since early June may extend further and this is reflected in our 0-3m forecasts. For one thing, USD remains a risk-on/ risk off currency however much we may all wish it was not so (Figure 5). Given the extent of current Central Bank liquidity support to markets, and receding concerns about tail risks in Europe, this points to some scope for the USD to fall near term. For another, apparent speculative positioning in USD based on CFTC and Citi platform indicators suggests that markets are positioned for USD upside and some unwind may need to occur near term, again pushing USD lower.

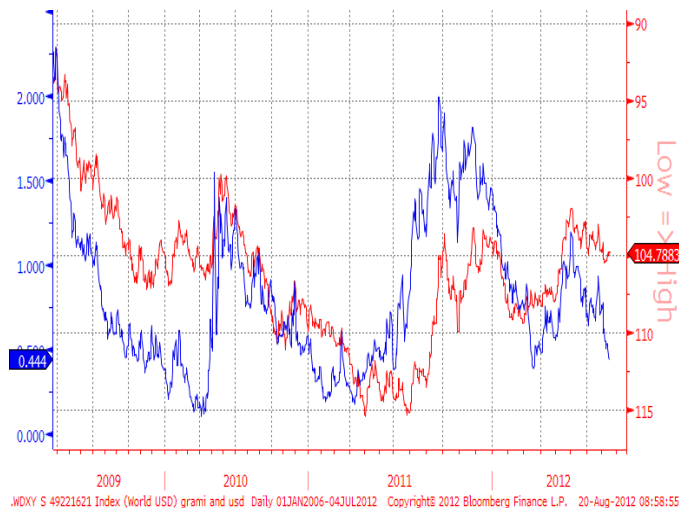
All in all, while Citi forecasts anticipate further USD gains medium term, especially relative to G10 majors with EUR/USD falling towards 1.15, our near term outlook sees some USD weakness for so long as risk appetite remains robust.

Figure 4. US / Total OECD Area Productivity (Red) and Relative Equity Market Performance (US/ World in USD – Blue)



Sources: Citi Research and Reuters EcoWin

Figure 5. GRAMI (Blue) vs. World USD Index (Red) — Higher = Greater Risk Aversion and Stronger USD Respectively



Source: Citi Research and Bloomberg

World USD = Average of 4 evenly weighted regional indices (Higher = USD Weaker)

G10 Exchange Rates

EUR/USD — Downward Pressures Remain

Our medium term forecasts assume further downwards pressure on EUR/USD with our 6-12m projection unchanged from last month at 1.15.

Expected negatives for the EUR include a continuing trend lower in shorter term interest rate differentials between EUR and USD (Figure 6) and a further increase in the size of the ECB balance sheet relative to that of the Fed (Figure 7). With additional LTROs, policy rate cuts and bond purchases via the SMP all likely to occur over the 6-12 months horizon, it would take a gargantuan recovery in EMU risk premia, or an unlikely even bigger monetary expansion via by the Fed, to prevent further EUR/USD downside in the face of this relative monetary ease.

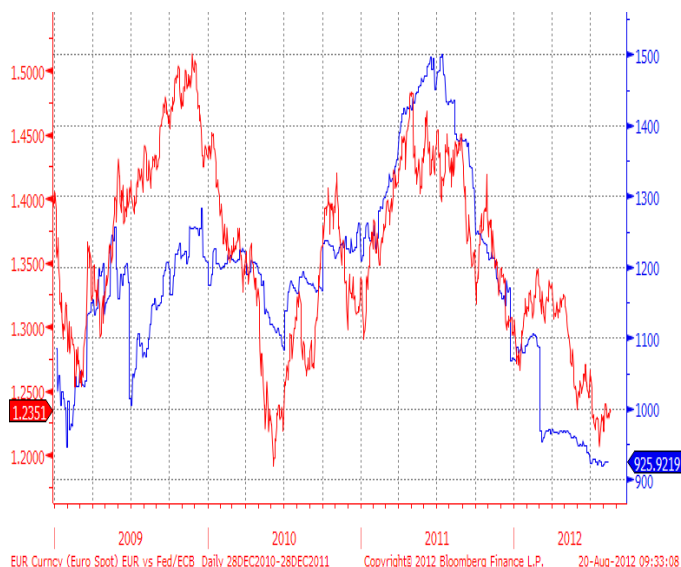
Instead, with Citi economists now anticipating GREXIT in the baseline forecast by December/ January (with a smaller chance of this coming even earlier), initial contagion fears from such an event may even push risk premia higher. Additional uncertainties come from the decision of the German Constitutional Court regarding German participation in the ESM; this may drag on for another few months, increasing uncertainty.

Figure 6. EUR/USD (Red) vs. EUR Less USD 2y Swap Rate Differentials (Black)



Source: Citi Research and Reuters EcoWin

Figure 7. EUR/USD (Red) vs. Relative Balance Sheet of Fed/ECB (Blue)



Source: Citi Research and Bloomberg

Another factor that may undermine the EUR more than before relates to reserve manager and diversification flows. Our own modelling of the EUR has found that, in the past, higher oil prices have been positively correlated with EUR/USD. There are several possible explanations for this but the most credible has been actual and expected diversification by Reserve Managers out of USD and into EUR. The latest surge in oil prices has not had a positive impact on the single currency, however, and other evidence suggests too that reserve managers may either choose not to buy EUR given uncertainty or may be lacking firepower.

In the case of China, for example, the current account surplus was 10% of GDP as recently as 2007 but will be around 1.5% of GDP next year. This has contributed to a much slower FX reserve build up as downwards pressures on USD/CNY have waned. As Figure 8 shows, this may in turn lead to less pressure to buy EUR as diversification out of USD and therefore a reduced support for the single currency in times when fundamentals are unhelpful.

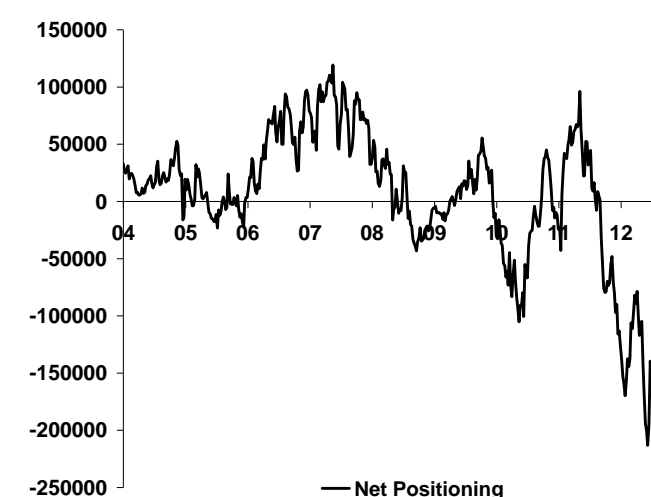
While medium term pressures seem likely to take EUR/USD lower unless the Fed also expands the money base rapidly, the short term forecast is for some consolidation or a small rally in EUR. This is because risk appetite continues to recover on the back of extremely easy developed Central Bank monetary policy. Extended periods of “risk-on” tend to be USD negative pretty much across the board. Since USD positions are extended still (see Overview section above) and EUR shorts are high (Figure 9), this may also lead to EUR/USD moving higher temporarily, possibly towards the upper end of its downwards sloping trading range which we put at about 1.25-1.26.

Figure 8. Chinese FX Reserves Growth (Blue) vs. EUR/USD (Red)



Source: Citi Research and Reuters EcoWin

Figure 9. EUR Short Positions CFTC Non Commercial Futures and Options



Source: Citi Research, Bloomberg and CFTC

USD/JPY — Sideways

USD/JPY continues to trade mainly sideways, broadly within a range bounded by 75-85. Our forecasts essentially see this continuing with a slight upwards bias in the exchange rate in both short and medium terms.

Short term, USD/JPY probably moves higher mainly on better risk appetite and the likely associated modest upwards movement in US yields, often a USD/JPY driver (Figure 10). Since the most likely outcome is for a limited movement in US front end yields and some bear steepening, however, it is less clear that USD/JPY will have significant support from this source and our forecasts reflect this.

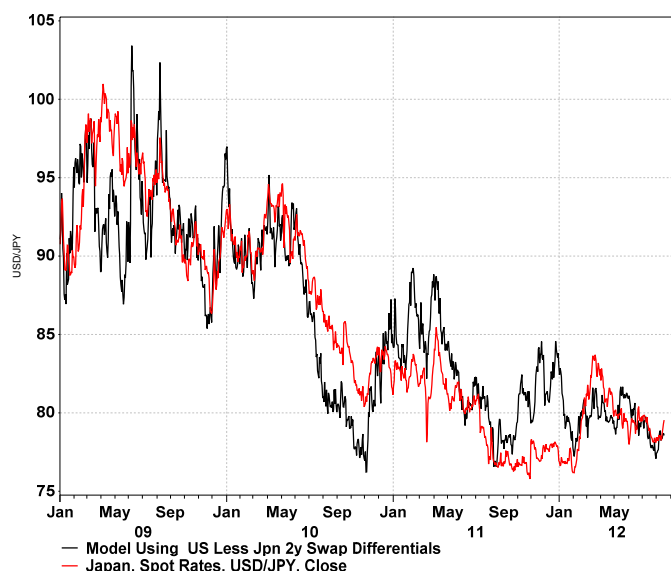
More medium term, we expect risk aversion to rise again but think USD/JPY may be broadly stable. This is partly because we think the USD will be supported by cyclical outperformance and partly because we think Japan specific factors may become somewhat less positive for JPY.

One such factor may be an at least partial loss of the perceived safe haven status on JPY. The recent Upper House confirmation of the two stage sales tax hike (5% to 8% in April 2014 and then to 10% in October 2015) has helped improve confidence in markets that Japan's large fiscal deficit/ debt can be contained. However, Citi economists see a high probability that spending surges before the first hike and slumps thereafter, making the second stage difficult to implement. And, more

generally, the ageing of Japan's population brings with it a declining savings surplus and slow reduction/ elimination of the current account surplus. As this happens, Japan will rely more on foreign capital which may mean that either higher rates or a less robust currency will be required to attract investors.

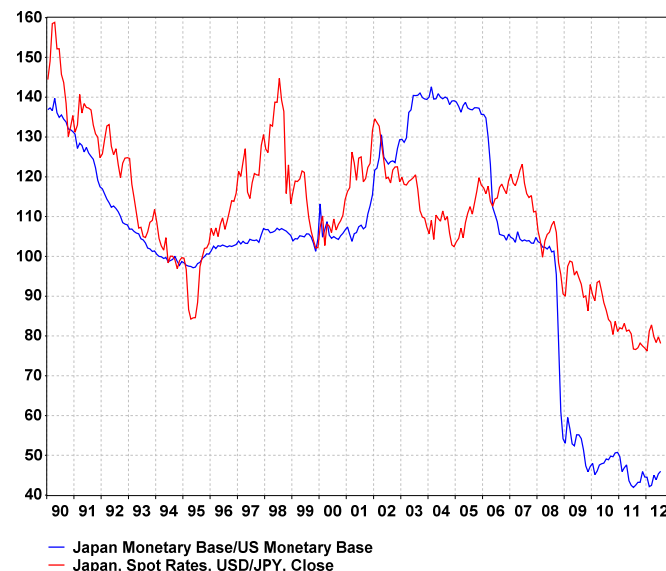
That said, these are slow moving changes. In the medium term, relative monetary policies have a big influence and we continue to expect the BoJ to remain fairly conservative in terms of balance sheet expansion compared with the Fed and, even more so, the ECB (Figure 11). As a result, our 6-12m and long term USD/JPY forecasts show only modest upside

Figure 10. USD/JPY vs. A Model Based on 2y Swap Rate Differentials



Sources: Citi Research and Reuters EcoWin

Figure 11. USD/JPY vs. Relative Monetary Base



Sources: Citi Research and Reuters EcoWin

Dollar Bloc — CAD Outperforms Longer Term

Our forecasts for the \$-bloc currencies are for range trading/ moderate appreciation near term but with some tendency to weaken against a strong USD over the medium term. However: (i) all \$ bloc currencies outperform the EUR medium term; and (ii) within the bloc, we believe that CAD may be the outperformer longer term reflecting better valuation and less exposure to a weakening economy in China.

AUD is still trading at levels that are way above both long term valuation (WERM at 0.90) and fitted fair value in models that use market drivers. For example, Figure 12 uses Asian currencies, carry, terms of trade and risk appetite proxies and still finds that AUD is about 8% too high. The divergence from key commodity prices is especially striking (Figure 13). Two factors may be holding up AUD.

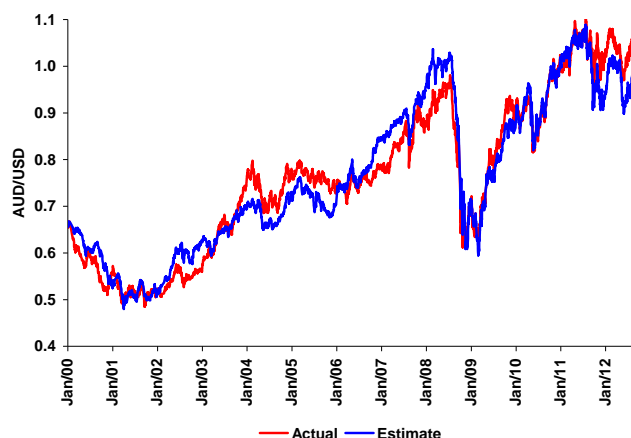
First, global investors face great uncertainty in Europe, the US and China and the pool of AAA asset markets is shrinking when they look for safety. With interest rates/ yields near zero in old world core bond markets, even a reduced spread on A\$ assets offers increased attraction so long as Australia is growing and looks to have public solvency. In fact, Australian budget plans look for an apparently severe tightening of 3.1% of GDP between FY 2012 and 2013 though our economists reckon that the true drag is probably less than half of this. By making investors feel more secure in Aussie government paper, this fiscal tightening may, in the current circumstance, support AUD even if, at the margin, the RBA sees this as a reason to

lower rates/ delay tightening. This is not how we have tended to see the world in the past because, traditionally, tight fiscal policy and easy money are not currency friendly. But the world is not normal currently and some things are being turned on their head – see also the strength of GBP with a similar, but more extreme, policy mix.

The second support is related. Official Reserve managers have to own something and generally believe themselves overweight USD. Traditionally, this has led to diversification into other currencies in size broadly proportionately to liquidity. But the EMU crisis has made RMs reluctant to buy EUR and has meant that flows into AAA type government paper elsewhere may have been larger than normal. AUD, NOK and SEK may all have benefited from this flow. What this means, in effect, is that some kinds of “risk off”, especially European related ones, may be less negative AUD than before.

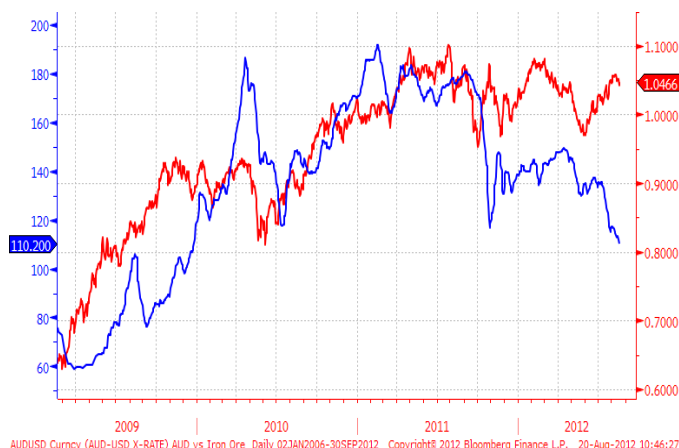
We have somewhat revised our forecast path to reflect this with spot higher near term in a favourable risk on environment anyway and then falling less medium term. Since we remain concerned about not just European risks, but Chinese ones too, we still expect AUD/USD lower over 6-12m.

Figure 12. AUD/USD vs. Model Based on Terms of Trade, GRAMI, Carry and ADXY



Source: Citi Research and Bloomberg

Figure 13. AUD/USD vs. Iron Ore Spot Prices



Source: Citi Research and Bloomberg

Medium term, we expect AUD to continue to outperform NZD. Carry is slightly better on AUD, growth is more robust and unemployment lower in Australia, the NZ current account deficit is bigger and widening faster and the first RBNZ rate hike keeps getting pushed further into the future by very favourable (low) inflation readings. All this will likely see AUD/NZD push higher towards our WERM fair value estimate at 1.39 over the longer term.

Near term, however, rising food related commodity prices likely benefit NZ more than Australia and the latter's exposure to China becomes at least a short term negative. As a result, over 0-3m we see NZD outperforming, rising to NZD/USD 0.82 before falling back further out to 0.75 over 6-12m.

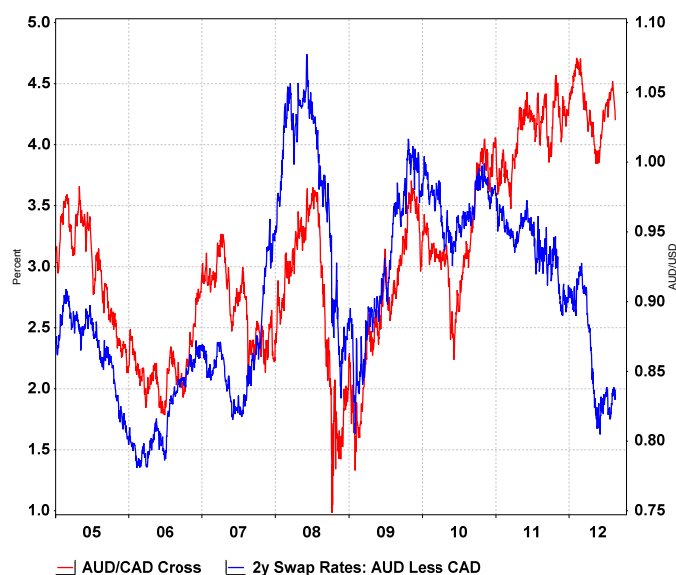
CAD remains relatively low beta but is supported in our view by valuation and fundamentals relative to AUD and NZD over the medium term. One of the key factors is the monetary policy stance of the BoC. Our economists still expect a relatively early normalisation of rates in Canada based on: (i) somewhat better

control of the downside tail risks in Europe; (ii) local growth holding up well and being helped by somewhat better news recently in the US; and (iii) existing policy settings being viewed by BoC as super accommodative.

Citi forecasts show rates rising in March 2013, clearly very early in the cycle compared with other major Central Banks. Short term, low inflation will provide nothing for officials to hang an earlier rate move on, while it would take a considerable downside shock to the global economy for any further easing to be considered. Given that even existing rate differentials appear to favour CAD over, for example, AUD (Figure 14), a BoC rate hike within the 6-12m horizon should significantly limit CAD setbacks compared with other \$ bloc currencies.

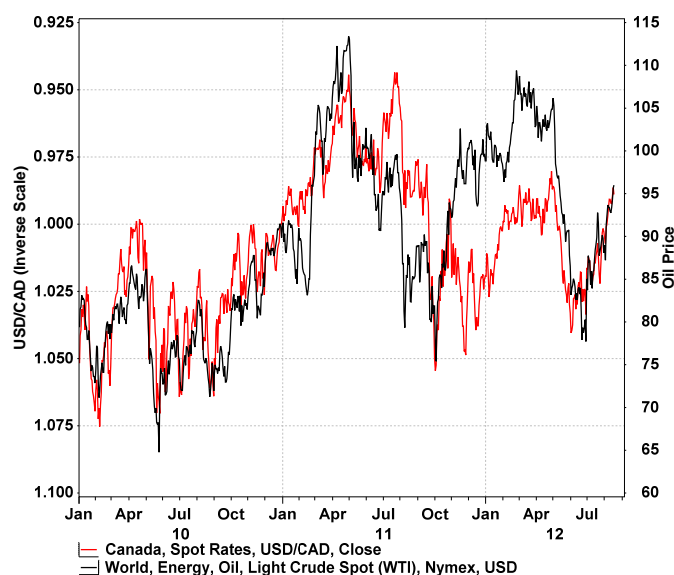
Our forecasts assume some near term modest further CAD gains as risk assets rally and oil prices remain firm (Figure 15) followed by a setback over 6-12m back to parity but with CAD outperforming AUD and NZD.

Figure 14. AUD/CAD and 2y Swap Rate Differentials



Source: Citi Research and Reuters EcoWin

Figure 15. USD/CAD (Inverted) vs. Oil Prices



Source: Citi Research and Reuters EcoWin

European Crosses

GBP — Range Trading vs. Euro

Sterling continues to appreciate against both the euro and the greenback. After breaking out of its range versus a 50:50 basket of EUR and USD, sterling now seems to be trading in an upwards sloping channel (Figure 16).

However, data continues to disappoint and Citi's UK ESI remains firmly in negative territory. Citi economists have further downgraded their growth outlook this month and with inflation falling and likely to undershoot the MPCs target, more QE is also expected. Citi's economists envisage a further expansion in November and expect the total QE program to reach £500bn. All else equal, this is a sterling negative vs. USD, and with risk appetite likely less supportive in the medium term, our forecasts see cable at 1.50 in 6-12 months. Over this time period, EUR/USD also has a further leg lower, so EUR/GBP edges down, with our 6-12 month point forecast at 0.77.

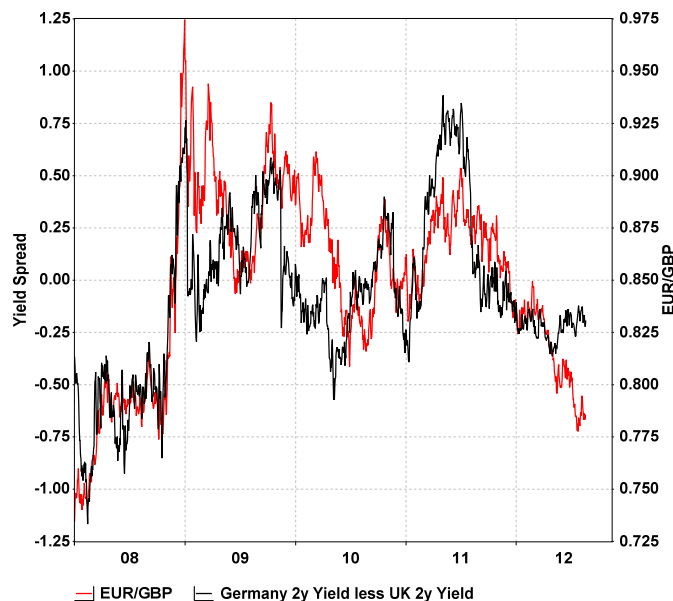
In contrast, the short term forecasts assume risk appetite to remain firm. In such an environment, GBP will likely appreciate vs. the USD and our forecasts see 1.58 in 0-3 months. As for other European crosses, however, the expectation of a bounce in EUR/USD, means sterling range trades close to current spot against the single currency. Also note that EUR/GBP has already overshot its rate differential relationship slightly (Figure 17). We forecasts EUR/GBP at 0.79 in 0-3 months.

Figure 16. GBP vs. Average of USD and EUR (Higher = Stronger GBP)



Source: Citi Research and Reuters EcoWin

Figure 17. EUR/GBP vs. Rate Differential



Source: Citi Research and Reuters EcoWin

Scandis — Stay Strong In The Medium Term

The Swedish Krona continued to appreciate strongly vs. the EUR since our last *Forecasts*. After breaking the 8.75-8.95 range it held for most of the previous seven months, EUR/SEK has fallen to a low below 8.20 in recent trading sessions, even breaking below our WERM long term fair value model.

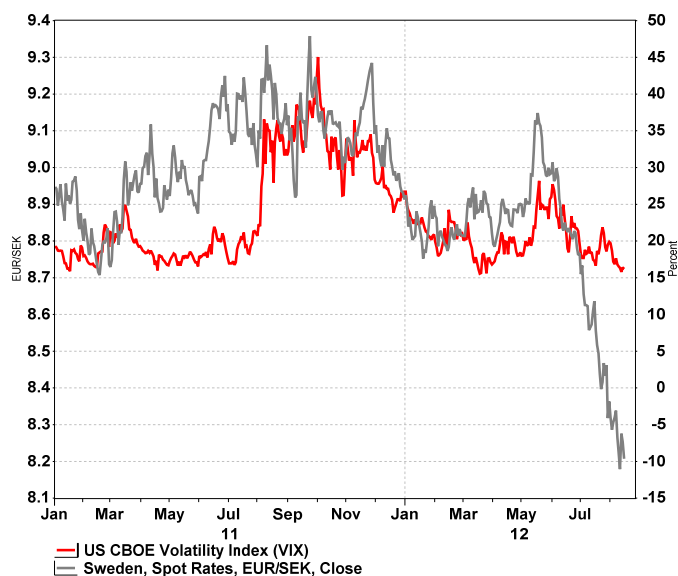
Recent stronger macro data has been supportive – Citi's Swedish ESI is close to all time highs for example. Citi economists have also upgraded the growth outlook, with Swedish GDP growth now expected at 1.0% in 2012. Whilst this is still down from 4.0% a year earlier, the economy is clearly outperforming the Euro Area. Strong fiscal and external balances also continue to be a SEK positive.

However, as with AUD (see above) and some other European currencies (e.g. NOK) the sharp move higher in SEK is probably hard to explain using traditional fundamentals alone and is suggestive of Official Reserve Manager activity. With a shrinking pool of AAA rated fixed income assets/ currencies, currencies such as SEK may well trade rich compared with traditional metrics in the current environment. With EUR/USD coming under renewed pressure further out, we see EUR/SEK falling to new lows near 8.00 in 6-12 months.

In the near term, recent sharp moves look overdone however. Having traded in-line with implied equity volatility for example (i.e. SEK appreciated in risk-on when VIX declined), the relationship has broken down completely — current EUR/SEK spot is historically consistent with VIX at -10%, a level it has obviously never traded at before (Figure 18).

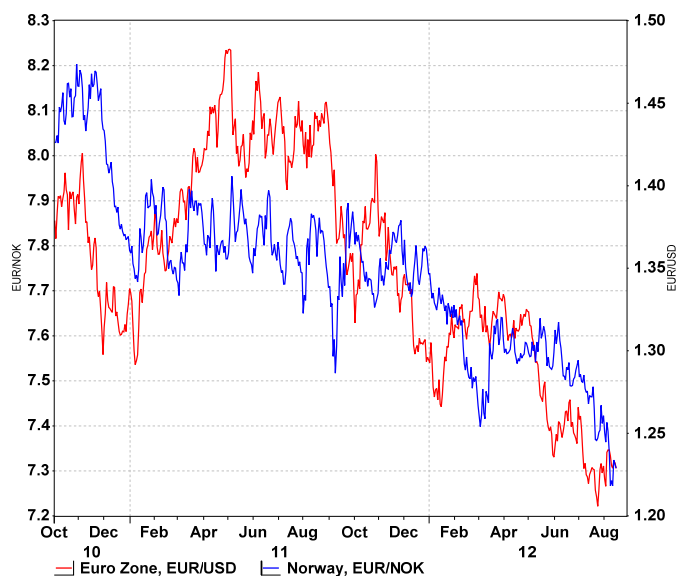
If, as we expect, risk appetite remains firm, SEK will likely continue its appreciation vs. the USD in the short run. However, we expect the bounce in EUR/USD to outweigh further SEK strength in the next months. As such, EUR/SEK is expected to retrace somewhat and our 0-3m forecasts see 8.35 for the cross.

Figure 18. EUR/SEK vs. VIX – Relationship Decoupled



Source: Citi Research and Reuters EcoWin

Figure 19. EUR/NOK and EUR/USD



Source: Citi Research and Reuters EcoWin

The Norwegian Krone has also appreciated strongly vs. the single currency since our last *Forecasts*, with current EUR/NOK spot trading near a decade low. Nonetheless, appreciation has been less than for the Swedish Krona, and as a result NOK/SEK continues to fall.

In terms of growth, Citi economists continue to expect Norway to markedly outperform most other European economies this and next year, in part due to the stabilizing effect of the petroleum industry. Citi economists thus see the Norges Bank to be on hold for the foreseeable future. With further ECB rate cuts in the pipeline, this increase in carry should lend support to the Norwegian Krone.

In the medium term, we forecast NOK to appreciate further versus the single currency, especially as EUR/USD is expected to lose further ground (Figure 19). We forecast EUR/NOK at 7.15 in 6-12 months.

As with its Swedish counterpart, the expectation of a short term bounce in EUR/USD means EUR/NOK is likely to retrace somewhat. We forecast 7.45 in 0-3 months as a result.

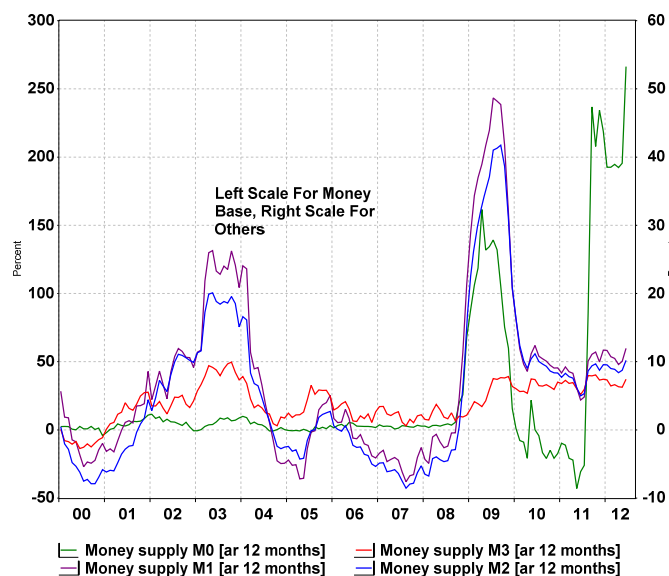
CHF — Peg Holds Unless Inflation Becomes A Problem

The Swiss Franc peg is unchanged and EUR/CHF continues to trade in close proximity to the 1.20 level, while in the meantime, realised volatility has remained at extraordinarily low levels. We doubt this pattern will be disturbed in the near to medium term, and as such our point forecasts remain unchanged at 1.20 over the forecast horizon.

Recent interventions have seen the SNB's balance sheet expand to record levels, while foreign exchange reserves rose a third consecutive month in July to CHF 406bn. Nonetheless, in the face of continued weak inflation pressures – Citi economist expect negative CPI inflation in the coming years – the SNB will likely continue to print as many CHF as it takes to absorb sales of EUR. This holds true despite the fact that Q2 GDP surprised to the upside and Citi economists have revised their growth outlook higher. The peg will likely hold in the short to medium term in other words.

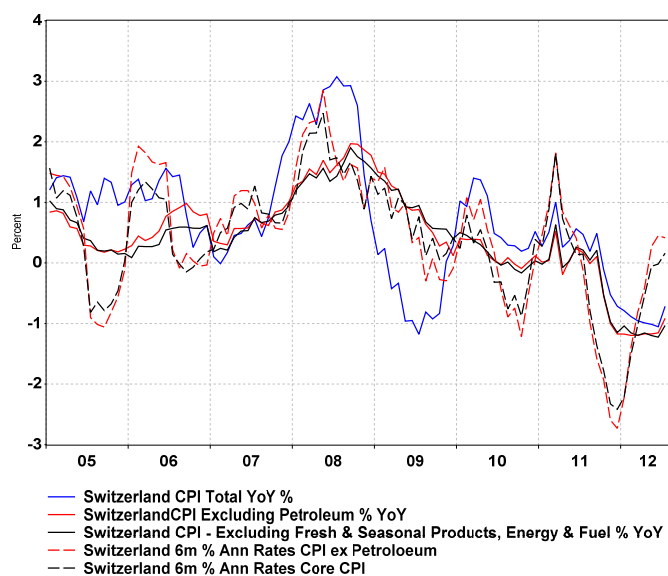
Further out, there are two main risks to the peg. Firstly, inflation – base money growth has already been explosive (Figure 20) and this rapid growth in local liquidity risks asset price, and eventually, CPI inflation. Indeed, headline inflation rates already appear to be bottoming out and (unadjusted) annualised rates have crept back into positive territory (Figure 21). The second risk stems from the euro zone crisis. EMU pressures building strongly could cause CHF safe haven inflows to overwhelm the SNB. As a result the downside in EUR/CHF may well be tested in the long term.

Figure 20. Swiss Base Money Growth is Rapid...



Source: Citi Research and Reuters EcoWin

Figure 21. ...Causing Swiss Inflation To Bottom Out



Source: Citi Research and Reuters EcoWin

EM Exchange Rates

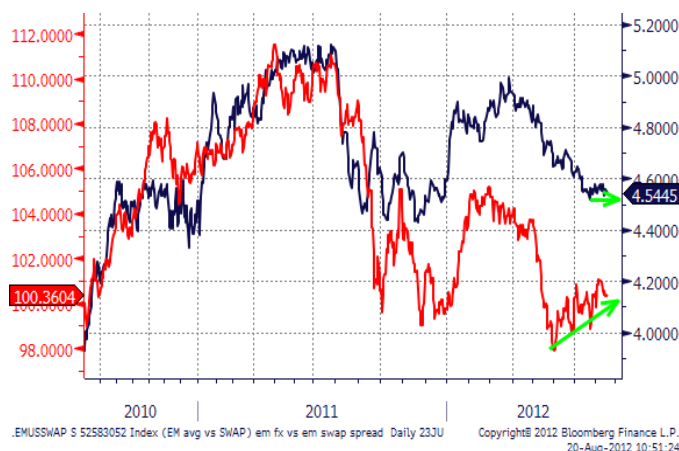
Weighty medium-term risks described in the opening section above lead us to expect risk assets lower and the dollar higher over the 6-12 month time-frame. EM currencies are forecast to be generally weak in this period, with ultra-sensitive CEEMEA currencies weakening the most vs. the USD and Asian FX, which has also been historically more stable, softening the least.

The near term looks different however. Risk appetite is improving and EM currencies have in toto performed better against the dollar, and more so than metrics like swap rate differentials would have suggested, though this is in part a catch up given earlier divergence (Figure 22). The arguments for catch up are particularly compelling in more bombed out currency blocs/crosses – like CEEMEA, for example, which as a group has conspicuously underperformed other currency regions (Figure 23).

Our forecasts show CEEMEA FX strengthening the most vs. the USD in the next couple of months – it is expected to be high beta in both directions over the forecast horizon, in other words. This behaviour is consistent with recent historical patterns, where CEEMEA has tended to strengthen more than Latam, Asia or other G10 against the USD in risk on, but also weakens more dramatically in risk off.

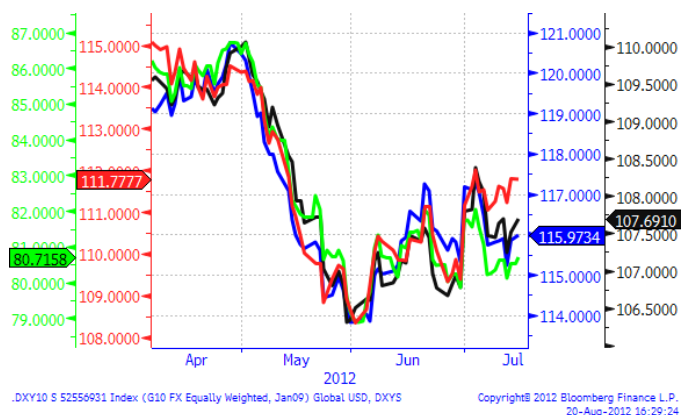
The higher beta Latam crosses are also forecast to do well near term, but unlike CEEMEA are also expected to hold up better in the medium term. Asia is, on average, forecast to stay lower beta to the risk cycle over the next year or so in both directions.

Figure 22. EM FX vs. USD (Red)* and Avg. 2y EM Swap Rates vs. US 2y Rate (Blue)



Source: Citi Research and Bloomberg
*higher = Local currency stronger/USD weaker

Figure 23. Equally Weighted Regional Currency Baskets*



Sources: Citi Research and Bloomberg
*Blue: G10, Green: CEEMEA; Red: Latam; Black: Asia

EM Asia — Lower Beta Pegs

The general direction of our Asian forecasts this month is for stronger currencies in the near term and weakness further out. On average, moves are less obvious than other EM regions in both directions and time frames considered, in line with recent experience.

The chief anchors to our EM Asian forecasts is a flat-lining CNY. For the region overall in the near term, relative swap rate differentials should also provide support for stronger Asian FX (Figure 24).

The general pattern so far this year has been for USD/CNY spot and 12 month NDFs to drift gently higher (Figure 25). We forecast USD/CNY to stay broadly flat over the forecast horizon. Our forecast for stability is partly due to political “handovers” in both the US and China in the next few months, which makes the USD/CNY fixing even more fraught with sensitivity than usual. We see very little room for any CNY appreciation in coming months: recent policy easing is unlikely to lift growth until next year, given the typical time lags involved, and in the meantime, growth, including in trade and leading money and credit data, has stayed weak or even weakened further.

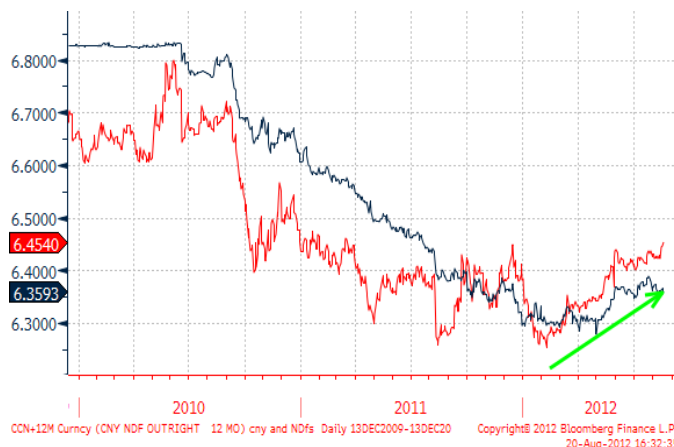
A slower Chinese economy and flat yuan has important implications for export/China-led Asian FX. Korea, Taiwan and Malaysia are probably most exposed: they are very open economies, with large shares of exports to China and are high beta to China’s own exports. All three currencies are forecast to strengthen over the next three months by between 1 and 1.5% against the USD relative to current spot. Further out, performance is more mixed, with KRW giving back much less than MYR, TWD and indeed most other regional pairs.

Figure 24. Asia 2y Swap Rates less US (Red) and Equally Weighted Asia FX (Blue)*



Sources: Citi Research and Bloomberg
*stronger is local currency higher/dollar weaker

Figure 25. USD/CNY (Blue) and 12m NDFs (Red) Drifting Higher all Year



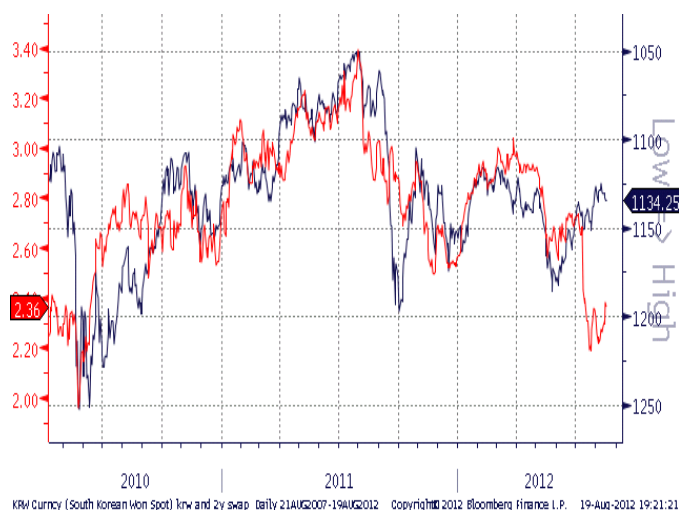
Sources: Citi Research and Bloomberg

Our forecast for USD/KRW to pull back in to the lower range of March and April this year balances several conflicting factors. On the one hand, relative rate differentials that have historically moved in tandem with the currency point to considerable upside for USD/KRW (scale inverted, Figure 26). A weaker won could also be desirable from a local policy perspective, with crucial exports falling at 8.8% in yearly terms in July, the steepest fall since September 2009. On the other hand, KRW seems to have held its own despite this, shrugging off bad news and outperforming its peers (Figure 27) as foreign inflows, particularly into local bonds, have continued apace. We forecast USD/KRW falling back to recent support at 1120 in short term risk on, and rising towards 1140, the upper end of its March trading range, in risk off further out.

The Taiwanese dollar has moved very differently to the won, and has caught up with earlier weakness in Asia (Figure 27). It has been one of the worse performers against the dollar since early May, and over the medium term we expect this to continue, with USD/TWD forecast at 30.5 in 6-12 months.

Perceptibly better recent data than expected from Malaysia has already boosted MYR which has outperformed other Asian currencies since early June. The two factors which help MYR in risk on – a foreign investor friendly bond market, of which around 40% is externally owned, and exposure to commodity prices – also weigh heavily against it in risk off. Our forecasts have USD/MYR at 3.10 in the near term, and 3.23 in 6-12 months' time.

Figure 26. Korea 2y Swap Rates less US Rates (Red) and USD/KRW (Inv., Blue)*



Sources: Citi Research and Bloomberg
*stronger is local currency higher/dollar weaker

Figure 27. USD/KRW (Blue), USD/TWD (Green) and Equally Wtd Asia (Orange)*



Sources: Citi Research and Bloomberg
*all vs. US dollar, lower = local FX stronger except for equally weighted index

At the other end of the spectrum remain INR and IDR, which stood out for being driven by more idiosyncratic forces than the rest of Asia. This includes very recently, when other regional Asian crosses have moved lower then higher against the US dollar but USD/IDR and USD/INR barely took note and continued to trend higher.

In macro terms, India and Indonesia are set apart from the Asian region in two important ways. First, both have twin deficits on current and fiscal accounts, an unusual feature in Asia that is flush with current account surpluses. Second, they are far less China-sensitive/and the most domestic demand driven economies in EM Asia. The former argues for local currency weakness in the medium term and the latter perhaps for relative strength.

Relative to current spot, we forecast some appreciation in both exchange rates in the very near term in a better risk setting. INR is expected to firm up to 55 against the dollar, and IDR to around 9450 over the next three months. Further out, we forecast USD/INR at around 56, and IDR at around 9750.

CEEMEA — High Beta in Both Directions

A likely exit of Greece from the Eurozone by January 2013, and our related forecast for EUR/USD at 1.15 in 6-12 months – has very significant implications for CEEMEA FX. To be sure, traditional relationships with, e.g., currency moves and short end swap rate differentials were overwhelmed by risk premia from the EA crisis over a year ago (Figure 28), and much more so than in other regions. Reflecting our scepticism that the eurozone debacle is resolved smoothly, we anticipate sharp currency depreciations across the region over the medium term.

In the more immediate future, however, absent any significant negative shocks from Europe, CEEMEA currencies should outperform. As discussed in the EM Overview, CEEMEA FX (unlike Latam FX) tends to be high beta in both directions – rising strongly in risk on but falling sharply in risk off. Recent price action has created room for catch up, and positioning on Citi's platform based indicator appears to be relatively light vs. other EM (Figure 29).

Within CEEMEA, currencies with the highest beta – the rouble, zloty and lira – that also have the deepest/most liquid FX markets are forecast to outperform near term, appreciating roughly 2% (RUB) and 4% (PLN) relative to current dollar spot rates in the next three months. Of these, PLN, RUB (and HUF) are expected then to give back the most in 6-12 months' time against the US dollar.

The rouble basket is forecast at 35 in the next three months and 37.8 over the medium term, i.e., initially moving sharply higher vs. both the dollar and euro and then much lower further out. The same factors which point to rouble outperformance in the near term – an unusually close relationship with risk (Figure 30) and indeed with oil prices – also pose the greatest headwinds further out.

PLN too has tended to be very sensitive to risk appetite, not least because as the largest economy in its CEE cohort with the deepest and most liquid markets it tends to be used as a play for the wider region. We forecast PLN to break through recent support at 4.04-5 vs the EUR in a more risk friendly setting, taking it back to levels seen this time last year. Cleaner positioning on Citi's platform based data would seem to support this (Figure 31). However, along with rouble, the zloty is expected to encounter the sharpest medium-term reversal, and our forecasts show EUR/PLN at 4.40 in 6-12 months.

Figure 28. CEEMEA FX (Blue)* and 2y Swap Rates less US Rates (Red)



Sources: Citi Research and Bloomberg

*Equally Weighted CEEMEA FX - higher is local currency stronger/USD weaker

Figure 29. Investor Positioning on Citi's Platform-Based Indicators*



Source: Citi Research and Bloomberg

Red – Commodity FX; Green – EM FX; Black – CEEMEA FX

*Measures positioning of active profit-seeking FX traders. Aggregate positions are shown in multiples of their own past absolute averages, capped between -3 and +3

We forecast USD/TRY lower in 0-3 months at 1.77-78, i.e. back to end-July lows. With inflation still high at above 9%, and the central bank's recent policy of using the exchange rate to manage local monetary conditions (despite its inflation target), TRY should find support in risk on market conditions. In the medium term, we expect TRY to give back some of these gains: a key consequence of unconventional policies has been that the capital account offsets to the large (7-7.5%) current account deficit are increasingly dubious hot money and banking flows, both of which tend to be negative forces for currency performance over longer periods. Our 6-12 month forecasts have USD/TRY back at early the June highs of 1.88-1.90.

The rest of the region is split into higher beta currencies like CZK and HUF that are linked most intimately to the EA crisis and are expected to underperform the USD sharply in the medium term, and relatively less directly sensitive currencies like ZAR and ILS, that are expected to sell off by less.

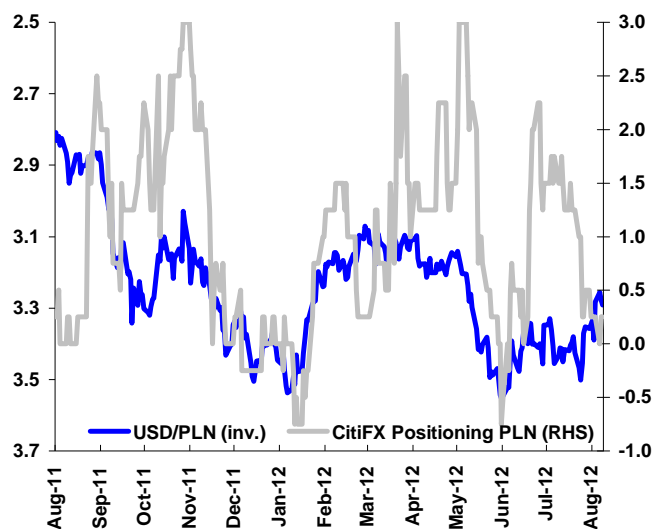
In both Hungary and the Czech Republic, domestic growth and monetary policy backdrops are also expected to turn less supportive over the medium term, and we forecast both EUR/HUF and EUR/CZK around 4-5% higher than current spot in 6-12 months' time. In the next three months, EUR/HUF is expected to stay around current spot: the cross has already retraced 75% of its June 2011 to early January 2012 move higher, and significant downside domestic risks (the ongoing IMF/EU loan negotiations in particular) are likely to constrain further HUF strengthening.

Figure 30. GRAMI (20d lead) and USD/RUB



Sources: Citi Research and Bloomberg
Blue – GRAMI; Orange – USD/RUB

Figure 31. Poland's Zloty and Positioning on Citi's Platform-Based Indicators*



Source: Citi Research and Bloomberg
*Measures positioning of active profit-seeking FX traders. Aggregate positions are shown in multiples of their own past absolute averages, capped between -3 and +3.

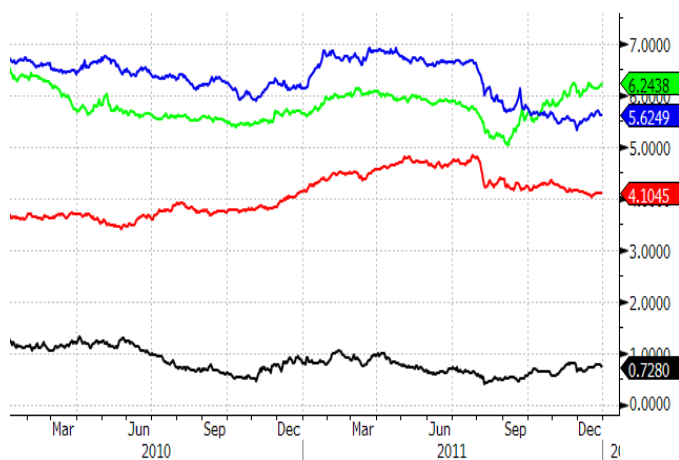
Finally it is worth noting that the relationship between USD/ZAR and gold prices, which appeared to have broken down this time last year, seems to have tightened up again in recent months. We forecast USD/ZAR at 8.25 and 8.70 in the short and medium term respectively. Gold correlates highly with central bank balance sheet expansion, and this in turn may mean ZAR falls by less than usual when markets turn risk off.

Latam FX — It's Complicated

As discussed in the Overview, Latam FX in aggregate has tended to be higher beta in early stages of risk on, and somewhat lower beta in risk off – an important distinction with CEEMEA currencies that are high beta in both directions. Both trends are expected to stay intact, with Latam FX projected to be amongst the better performers in both near term risk on and medium term risk off.

Historically, part of the reason for relative outperformance in risk off has been significantly higher interest/swap rates than elsewhere that made Latam FX an expensive short – although as Figure 32 illustrates this “premium” is no longer ubiquitous. More important in risk off may be very distinct sensitivities for various Latam economies/currencies, which mean that moves in individual crosses often cancel each other out. In risk on, by contrast, carry allure and relatively deep and liquid foreign exchange markets tend to lead to generally strong performances. Put differently: it's complicated.

Figure 32. 2y Swaps Compared



Sources: Citi Research and Bloomberg
Black – US; Red – Asia; Green – CEEMEA; Blue Latam

Figure 33. Copper a Key Reason to Expect Weaker CLP



Source: Citi Research and Bloomberg
Black – USD/COP, Orange – Copper Spot (Inverted)

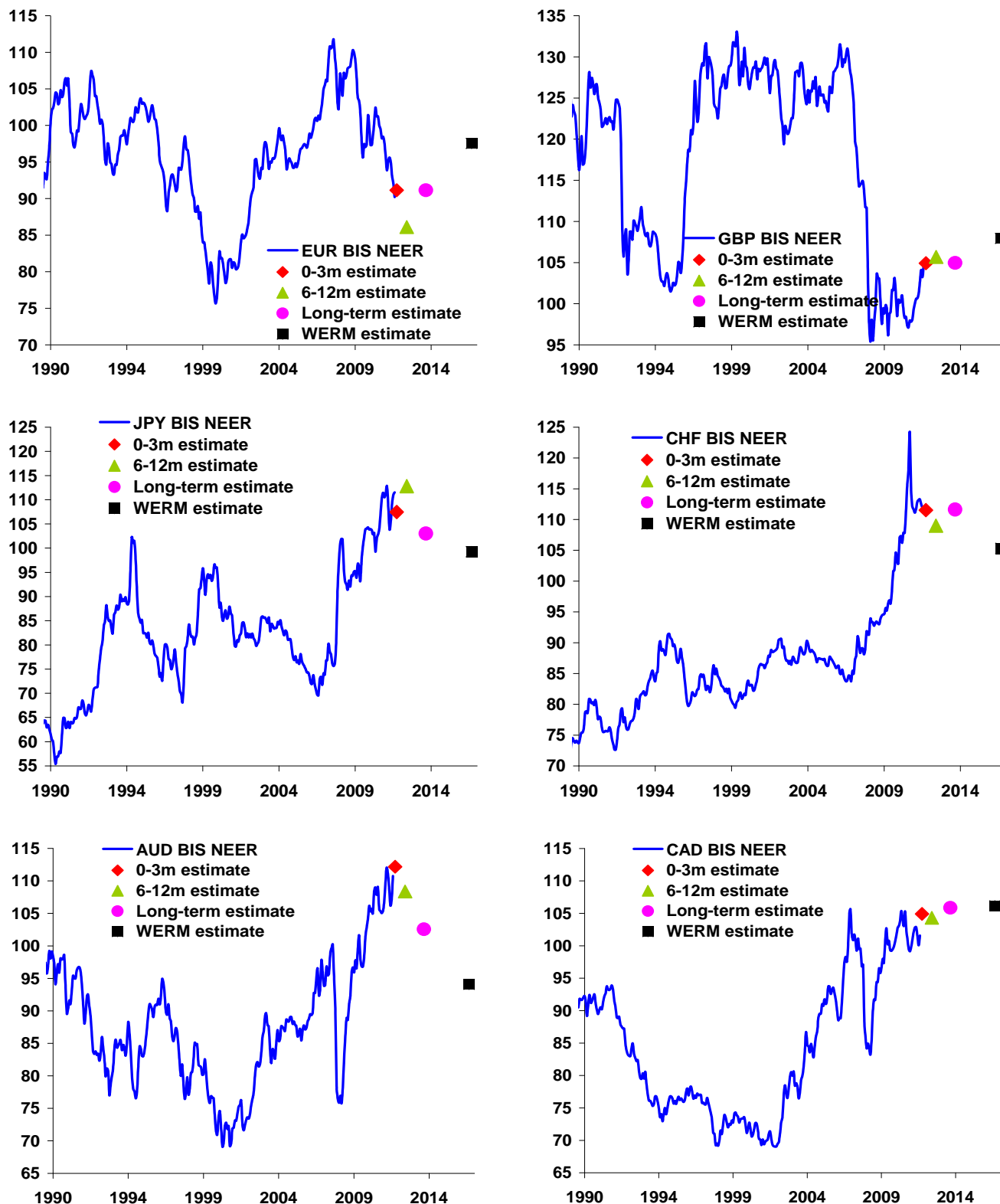
Brazil's real stands out for being a particularly “bombed out” EM currency, having shed nearly a quarter its value vs. the USD in the last year (and making it the worst performing EM currency over this period). Strong historical relationships of USD/BRL with various variables including investor positioning, terms of trade, and indeed, relative rates all point to the real stronger than spot in the short run. A central bank that is intervening to buy the currency at 2.10 is an added positive. Our forecasts have USD/BRL at 1.99 in 0-3 months and 2.06 6-12 months out.

MXN, meanwhile, has gained considerably in recent months and at the time of writing had retraced around 75% of the mid-March to early June sell off. It has recently consolidated some of these gains, but, should risk appetite stay reasonably firm as we expect near term, we think USD/MXN could retrace all the way to around 12.7, which is our 0-3 month forecast. Various factors support near term MXN strength, including a tight historical relationship with our GRAMI measure of risk aversion that points to USD/MXN around 12.7. There are also fundamental grounds to see MXN higher, including recently better macro data and proximity to the US, where earlier improvements in IP for example have yet to feed through to Mexico.

CLP by contrast is forecast to weaken in both the short and medium term. Our forecasts are for USD/CLP at 495 in 0-3 months and 510 further out. Part of our bearishness reflects some catch up with a weaker Chinese economy/sharply lower copper prices (Figure 33), where a tight historical relationship points to CLP at between 510 and 520, i.e., back to levels seen earlier this year. Domestic data has also been weak, and Citi economists' expectation of rate cuts soon should help keep the currency soft.

COP is expected to stay flat at around current spot in the near term and weaken in line with the rest of the region further out. As highlighted in previous forecasts, the general outperformance of COP vs. the rest of Latam, despite central bank/MoF intervention to weaken COP has been striking – and with the authorities stepping up both action and rhetoric it should underperform currencies like BRL and MXN in a risk on move. The recent pattern of higher lows and higher highs in USD/COP since July points to USD/COP at around 1865 in coming months, which is our medium term forecast.

Figure 34. Implied Path – BIS Nominal Exchange Rates



Source: Citi Research, BIS and Bloomberg

Figure 35. Quarterly Interpolated Forecasts

Quarterly Interpolated Forecasts

	Currency	Spot	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14
G10-US Dollar											
Euro	EURUSD	1.23	1.25	1.21	1.17	1.16	1.18	1.20	1.22	1.24	1.25
Japanese yen	USDJPY	80	81	81	80	80	81	82	83	84	84
British Pound	GBPUSD	1.57	1.58	1.55	1.52	1.51	1.53	1.54	1.56	1.57	1.59
Swiss Franc	USDCHF	0.97	0.96	1.00	1.03	1.04	1.02	1.00	0.99	0.97	0.96
Australian Dollar	AUDUSD	1.05	1.05	1.02	0.99	0.98	0.97	0.97	0.96	0.95	0.95
New Zealand Dollar	NZDUSD	0.81	0.82	0.79	0.76	0.74	0.73	0.72	0.71	0.70	0.69
Canadian Dollar	USDCAD	0.99	0.98	0.99	1.00	1.00	0.99	0.99	0.98	0.97	0.97
Dollar Index*	DXY	82.57	82.12	83.95	85.82	86.46	85.48	84.52	83.61	82.71	81.99
G10 Crosses											
Japanese yen	EURJPY	98	101	97	94	93	96	98	101	104	105
Swiss Franc	EURCHF	1.20	1.20	1.20	1.20	1.20	1.20	1.20	1.20	1.20	1.20
British Pound	EURGBP	0.79	0.79	0.78	0.77	0.77	0.77	0.78	0.78	0.79	0.79
Swedish Krona	EURSEK	8.22	8.34	8.20	8.07	8.02	8.07	8.12	8.17	8.22	8.26
Norwegian Krone	EURNOK	7.31	7.44	7.32	7.21	7.16	7.19	7.22	7.25	7.28	7.30
Norwegian Krone	NOKSEK	1.12	1.12	1.12	1.12	1.12	1.12	1.12	1.13	1.13	1.13
Australian Dollar	AUDNZD	1.29	1.28	1.29	1.30	1.31	1.33	1.34	1.36	1.37	1.38
Australian Dollar	AUDJPY	83.1	84.8	82.2	79.8	78.5	78.8	79.1	79.4	79.6	79.6
EM Asia											
Chinese Renminbi	USDCNY	6.36	6.36	6.33	6.31	6.29	6.26	6.23	6.20	6.17	6.15
Hong Kong Dollar	USDHKD	7.76	7.76	7.76	7.76	7.76	7.76	7.76	7.75	7.75	7.75
Indonesian Rupiah	USDIDR	9517	9462	9576	9688	9741	9721	9700	9680	9660	9643
Indian Rupee	USDINR	55.7	55.0	55.4	55.8	55.7	54.9	54.2	53.4	52.7	52.2
Korean Won	USDKRW	1136	1121	1128	1136	1135	1123	1110	1099	1087	1077
Malaysian Ringgit	USDMYR	3.13	3.11	3.15	3.20	3.22	3.20	3.17	3.15	3.12	3.10
Philippine Peso	USDPHP	42.4	42.5	42.7	42.9	42.8	42.4	41.9	41.5	41.0	40.8
Singapore Dollar	USDSGD	1.25	1.25	1.26	1.27	1.28	1.27	1.26	1.25	1.24	1.23
Thai Baht	USDTHB	31.5	31.4	31.7	31.9	31.8	31.4	31.0	30.6	30.1	29.9
Taiwan Dollar	USDTWD	30.0	29.7	30.0	30.3	30.3	29.9	29.5	29.1	28.7	28.5
EM Europe											
Czech Koruna	EURCZK	24.92	24.75	25.25	25.73	25.87	25.56	25.26	24.97	24.67	24.41
Hungarian Forint	EURHUF	278	276	281	287	290	290	290	290	290	290
Polish Zloty	EURPLN	4.07	4.02	4.17	4.32	4.36	4.25	4.15	4.06	3.96	3.90
Israeli Shekel	USDILS	4.03	4.01	4.08	4.16	4.18	4.14	4.10	4.06	4.02	3.98
Russian Ruble	USD RUB	32.1	31.6	33.1	34.6	35.3	34.9	34.6	34.2	33.9	33.6
Russian Ruble Basket	RUB	35.4	35.1	36.2	37.2	37.8	37.7	37.7	37.6	37.5	37.5
Turkish Lira	USDTRY	1.80	1.77	1.82	1.86	1.88	1.87	1.87	1.86	1.85	1.85
South African Rand	USDZAR	8.31	8.27	8.44	8.61	8.70	8.71	8.71	8.71	8.72	8.77
EM Latam											
Brazilian Real	USDBRL	2.02	1.99	2.02	2.05	2.05	2.04	2.03	2.02	2.01	1.99
Chilean Peso	USDCLP	483	496	501	507	508	504	500	496	492	490
Mexican Peso	USDMXN	13.1	12.7	13.0	13.3	13.3	13.1	12.8	12.6	12.3	12.2
Colombian Peso	USDCOP	1820	1822	1839	1856	1864	1861	1858	1855	1852	1854

* The DXY forecasts are implied from the forecasts of the constituent crosses.

Source: Citi Research and Bloomberg

Figure 36. Annual Forecasts

Annual Forecasts							
	Currency	Spot	2012*	2013*	2014*	2015*	2016*
G10-US Dollar							
Euro	EURUSD	1.23	1.26	1.18	1.24	1.29	1.33
Japanese yen	USDJPY	80	81	81	84	84	84
British Pound	GBPUSD	1.57	1.57	1.52	1.58	1.63	1.68
Swiss Franc	USDCHF	0.97	0.95	1.02	0.97	0.96	0.95
Australian Dollar	AUDUSD	1.05	1.03	0.98	0.95	0.93	0.91
New Zealand Dollar	NZDUSD	0.81	0.81	0.74	0.69	0.68	0.66
Canadian Dollar	USDCAD	0.99	1.00	0.99	0.97	0.96	0.96
Dollar Index**	DXY	82.57	81.60	85.57	82.44	80.30	78.46
G10 Crosses							
Japanese yen	EURJPY	98	102	95	104	109	112
Swiss Franc	EURCHF	1.20	1.20	1.20	1.20	1.23	1.27
British Pound	EURGBP	0.79	0.80	0.77	0.79	0.79	0.79
Swedish Krona	EURSEK	8.22	8.53	8.07	8.23	8.33	8.41
Norwegian Krone	EURNOK	7.31	7.48	7.20	7.28	7.30	7.31
Norwegian Krone	NOKSEK	1.12	1.14	1.12	1.13	1.14	1.15
Australian Dollar	AUDNZD	1.29	1.28	1.32	1.37	1.38	1.39
Australian Dollar	AUDJPY	83.1	83.6	79.0	79.5	78.4	77.1
EM Asia							
Chinese Renminbi	USDCNY	6.36	6.34	6.27	6.16	6.12	6.09
Hong Kong Dollar	USDHKD	7.76	7.76	7.76	7.75	7.75	7.75
Indonesian Rupiah	USDIDR	9517	9404	9712	9654	9600	9550
Indian Rupee	USDINR	55.7	54.2	55.1	52.6	51.5	50.8
Korean Won	USDKRW	1136	1132	1126	1083	1050	1019
Malaysian Ringgit	USDMYR	3.13	3.13	3.20	3.12	3.06	3.01
Philippine Peso	USDPHP	42.4	42.6	42.5	41.0	40.5	40.3
Singapore Dollar	USDSGD	1.25	1.26	1.27	1.23	1.22	1.20
Thai Baht	USDTHB	31.5	31.4	31.5	30.1	29.6	29.3
Taiwan Dollar	USDTWD	30.0	29.8	30.0	28.7	28.4	28.3
EM Europe							
Czech Koruna	EURCZK	24.92	25.08	25.61	24.56	23.71	22.91
Hungarian Forint	EURHUF	278	284	289	290	287	283
Polish Zloty	EURPLN	4.07	4.14	4.27	3.95	3.90	3.90
Israeli Shekel	USDILS	4.03	3.93	4.15	4.00	3.80	3.60
Russian Ruble	USDRUB	32.1	31.6	34.8	33.7	32.5	31.3
Russian Ruble Bask RUB		35.4	35.3	37.6	37.5	37.3	37.2
Turkish Lira	USDTRY	1.80	1.80	1.87	1.86	1.88	1.91
South African Rand	USDZAR	8.31	8.14	8.68	8.77	9.12	9.54
EM Latam							
Brazilian Real	USDBRL	2.02	1.96	2.04	2.00	1.93	1.87
Chilean Peso	USDCLP	483	497	505	492	490	490
Mexican Peso	USDMXN	13.1	13.0	13.1	12.4	12.5	12.7
Colombian Peso	USDCOP	1820	1808	1859	1856	1883	1916

*Averages of end-quarter data shown in quarterly interpolation table.

** The DXY forecasts are implied from the forecasts of the constituent crosses.

Source: Citi Research and Bloomberg

Figure 37. Citi Foreign Exchange Forecasts Contributors

For informational purposes only

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