17 September 2012 | 25 pages

Global

Foreign Exchange Forecasts

September 2012

- Fed QE3, plus extended guidance and Twist, are risk positive but USD negative. We forecast near across the board USD depreciation over 0-3m. Longer term, this may reverse as GREXIT and other significant concerns return to hurt risk appetite
- We expect EUR/USD in a 1.30-1.35 range in 0-3m. USD/JPY is likely to be stable, then lower later. CAD will be the $ bloc outperformer but NZD should start to beat AUD
- In Europe, SEK and NOK should do well versus the single currency in the medium term, and especially NOK is expected to outperform. However, in the short run, they are likely to give back some ground if EUR/USD rallies more. Sterling is similarly 'EUR dependant'
- We continue to expect the EUR/CHF peg to hold, so long as inflation in Switzerland is contained and especially since EMU pressures seem to be fading for now
- Within EM, CEEMEA currencies are weakest medium term, while LATAM and Asia hold up better. In the near term, EM currencies should broadly strengthen vs. a weak USD

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Figure 1. DM & EM – Forecasts Paths

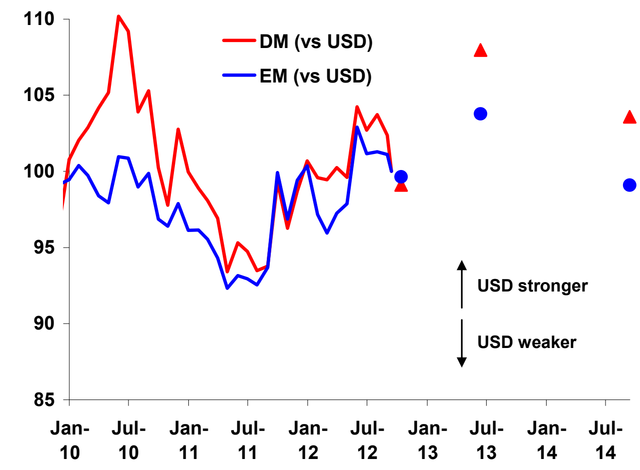


Chart shows GDP weighted baskets. Today = 100

Sources: Citi Research and Bloomberg

Figure 2. EM Regions – Forecasts Paths

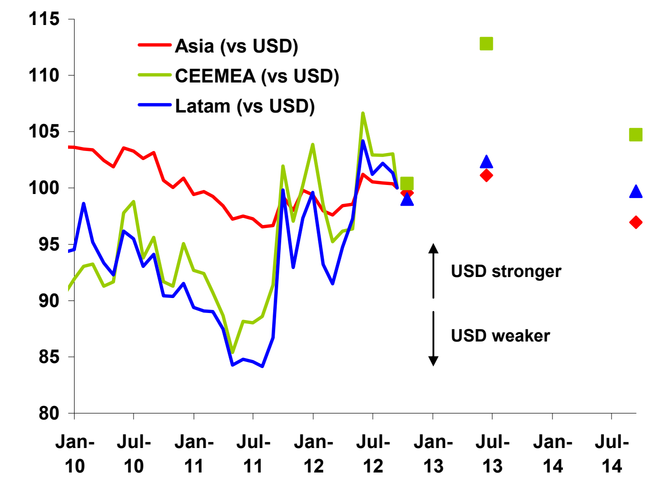


Chart shows GDP weighted baskets. Today = 100

Source: Citi Research and Bloomberg

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	1.31	1.30	1.31	1.32	1.15	1.25	1.2%	-12.1%
Japanese yen	USDJPY	78	78	77	78	76	80	0.4%	-1.8%
British Pound	GBPUSD	1.62	1.62	1.62	1.63	1.51	1.58	0.7%	-6.3%
Swiss Franc	USDCHF	0.93	0.93	0.93	0.91	1.04	0.96	-2.4%	12.6%
Australian Dollar	AUDUSD	1.06	1.05	1.03	1.05	0.96	0.95	0.0%	-6.5%
New Zealand Dollar	NZDUSD	0.83	0.83	0.81	0.83	0.79	0.69	0.0%	-3.0%
Canadian Dollar	USDCAD	0.97	0.97	0.98	0.95	0.98	0.97	-1.9%	0.4%
Dollar Index**	DXY	78.81	79.06	78.99	78.31	86.23	81.69	-0.9%	9.2%
G10 Crosses									
Japanese yen	EURJPY	103	101	101	103	87	100	1.6%	-13.7%
Swiss Franc	EURCHF	1.22	1.22	1.21	1.20	1.20	1.20	-1.2%	-1.0%
British Pound	EURGBP	0.81	0.81	0.81	0.81	0.76	0.79	0.5%	-6.1%
Swedish Krona	EURSEK	8.61	8.62	8.71	8.75	8.35	8.30	1.5%	-4.1%
Norwegian Krone	EURNOK	7.46	7.46	7.56	7.45	7.20	7.30	-0.1%	-4.7%
Norwegian Krone	NOKSEK	1.15	1.16	1.15	1.17	1.16	1.14	1.6%	0.7%
Australian Dollar	AUDNZD	1.27	1.27	1.26	1.27	1.22	1.38	0.0%	-3.6%
Australian Dollar	AUDJPY	83	82	79	82	73	76	0.4%	-8.2%
Asia									
Chinese Renminbi	USDCNY	6.32	6.35	6.40	6.31	6.36	6.15	-0.6%	-0.7%
Hong Kong Dollar	USDHKD	7.75	7.75	7.75	7.75	7.76	7.75	0.0%	0.1%
Indonesian Rupiah	USDIDR	9520	9602	9976	9600	9850	9660	0.0%	-1.3%
Indian Rupee	USDINR	54.3	55.4	57.7	54.6	56.0	52.3	-1.4%	-2.9%
Korean Won	USDKRW	1117	1124	1136	1120	1140	1070	-0.3%	0.4%
Malaysian Ringgit	USDMYR	3.04	3.06	3.11	3.05	3.13	3.11	-0.5%	0.8%
Philippine Peso	USDPHP	41.4	41.4	41.7	41.1	43.0	40.8	-0.8%	3.2%
Singapore Dollar	USDSGD	1.22	1.22	1.22	1.24	1.27	1.24	1.5%	4.0%
Thai Baht	USDTHB	30.8	30.9	31.4	30.4	32.0	29.9	-1.7%	2.0%
Taiwan Dollar	USDTWD	29.4	29.3	29.1	29.7	30.5	28.5	1.2%	5.0%
EMEA									
Czech Koruna	EURCZK	24.3	24.4	24.4	24.7	25.9	24.5	1.1%	6.0%
Hungarian Forint	EURHUF	282	285	295	290	310	290	1.6%	5.2%
Polish Zloty	EURPLN	4.07	4.10	4.22	4.11	4.40	3.90	0.1%	4.3%
Israeli Shekel	USDILS	3.89	3.93	3.96	4.00	4.20	4.00	1.9%	6.0%
Russian Ruble	USDRUB	30.5	31.3	32.7	30.8	35.4	33.7	-1.7%	8.1%
Russian Ruble Basket		34.7	35.6	37.3	35.2	37.8	37.5	-1.1%	1.4%
Turkish Lira	USDTRY	1.80	1.82	1.89	1.80	1.92	1.85	-1.0%	1.6%
South African Rand	USDZAR	8.23	8.35	8.65	8.40	8.70	8.72	0.6%	0.5%
LATAM									
Brazilian Real	USDBRL	2.02	2.05	2.13	2.00	2.05	2.05	-2.4%	-3.9%
Chilean Peso	USDCLP	471	480	495	480	510	490	0.0%	3.0%
Mexican Peso	USDMXN	12.7	12.9	13.2	12.5	13.2	12.2	-3.1%	-0.2%
Colombian Peso	USDCOP	1791	1815	1861	1820	1850	1850	0.3%	-0.6%

Source: Citi Research and Bloomberg; *Market data including spot as of 6.09PM London time on 14 September 2012; **The DXY forecasts are implied from the forecasts of the constituent crosses; *** Returns are relative to forwards.

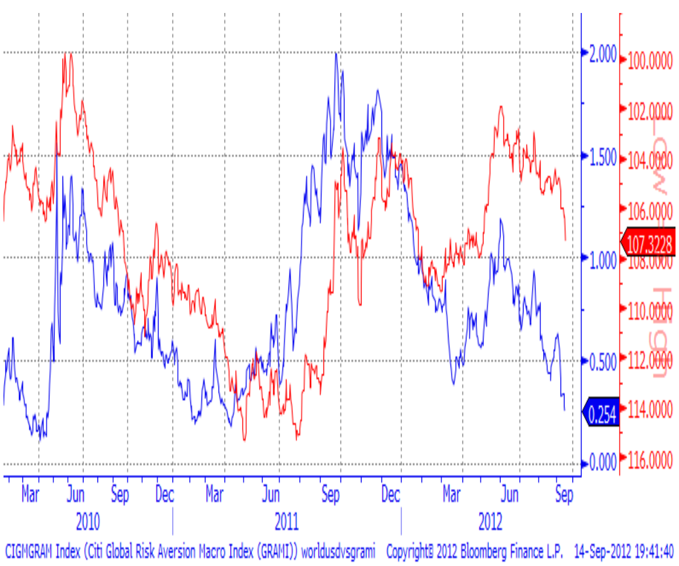
Overview: Risk On, USD Lower

Risk appetite continues to improve following a series of favourable policy interventions. The ECB meeting on 6 September outlined details of the new OMT programme and eased collateral requirements while Citi economists continue to expect this to be followed by depo/ refi rate cuts and additional LTROs, albeit the latter may only come in the event of a crisis around GREXIT. Meanwhile, the SNB and BoE continue to expand their balance sheets via exchange rate intervention and gilt purchases respectively. And the Fed announced QE3, extended Twist and extended guidance at the 13 September FOMC.

We have highlighted before how better risk appetite tends to be associated with a lower USD and this is especially true when better risk appetite comes from Fed quantitative easing. While USD losses may be less than the historic beta suggests (see Figure 4) mainly because the US still seems likely to be the cyclical outperformer (Figure 5), some further downside does seem likely. Meanwhile, after a long period in which speculative and hedging positions have been short EUR, the unwind of these exposures in the face of reduced near term EMU tail risks and lower risk premia means that the pivotal EUR/USD probably has further upside over 0-3m (see below). Overall, we expect USD to lose a further 0.5-1.0% vs. world currencies over 0-3m.

Medium term, our forecasts are USD bullish, with an appreciation of around 9% priced vs. other G10 currencies over 6-12m and 7% globally. This is turn reflects likely US cyclical outperformance plus a return to impaired risk appetite as a number of adverse developments hit markets, possibly including GREXIT and a much a more prolonged/ deeper slowdown than expected in China. Medium term, 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.

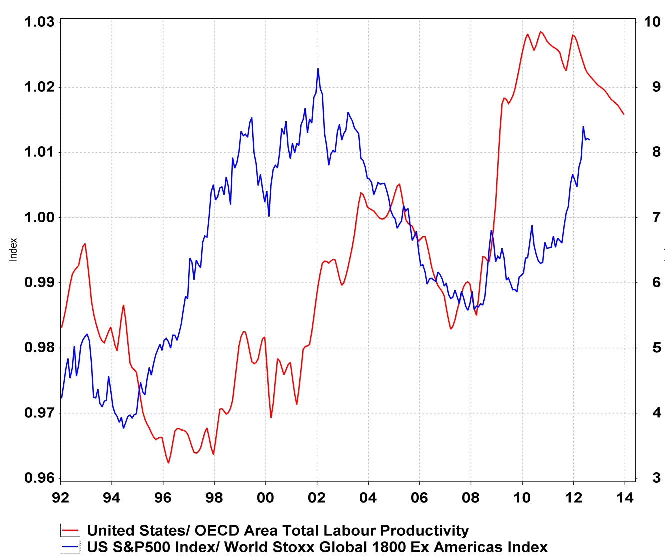
Figure 4. GRAMI (Blue) vs. World USD Index (Red) — Higher = Greater Risk Aversion and Stronger USD Respectively



Sources: Citi Research and Bloomberg

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

Figure 5. US / Total OECD Area Productivity (Red) and Relative Equity Market Performance (US/ World in USD – Blue)



Source: Citi Research and Reuters EcoWin

G10 Exchange Rates

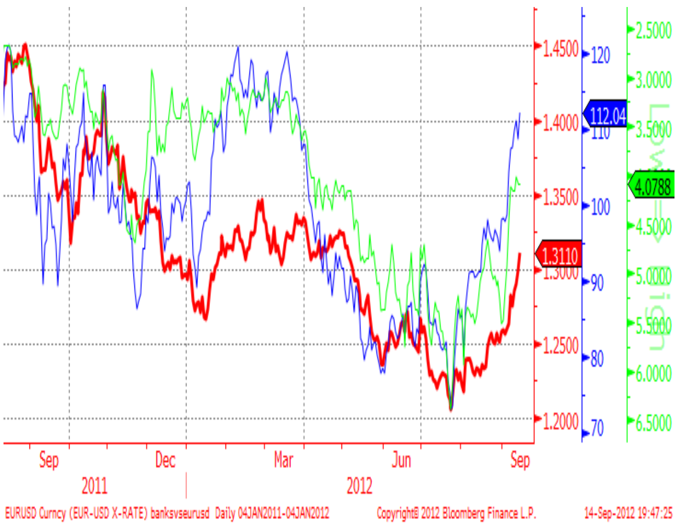
EUR/USD — Further Upside Near Term

Our 0-3m EUR/USD forecast has been raised from 1.25 to 1.32. While we anticipated a bounce in EUR/USD in our last short term projection, spot has already exceeded this level and we think could go further still as risk premia on EMU assets fall (Figure 6).

Along with generalised easy money / liquidity, and continued signs of stronger risk appetite in other asset classes, the strong statement from the ECB and near unanimity of the decision to instigate the OMT programme are likely to lead to further unwinds of short EUR speculative and hedging positions (Figure 7). This assumes that lower risk premia outweigh, at least for now, relatively lower EUR returns/ higher supply evident in rate differentials and money growth (see below).

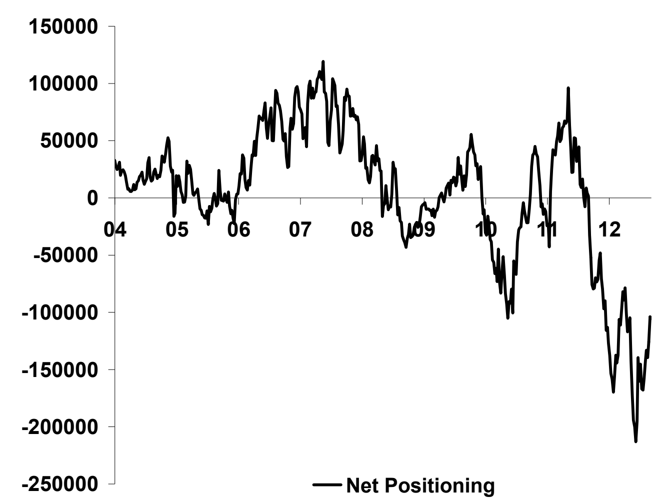
Since exchange rates are relative prices, help for EUR also comes from Fed balance sheet expansion as outlined at the September FOMC.

Figure 6. EUR/USD (Red) vs. SX7E (EUR Bank Stocks – Blue) and Spanish Less German 10y Bond Differentials (Inverse - Black)



Source: Citi Research and Bloomberg

Figure 7. EUR Short Positions CFTC Non Commercial Futures and Options

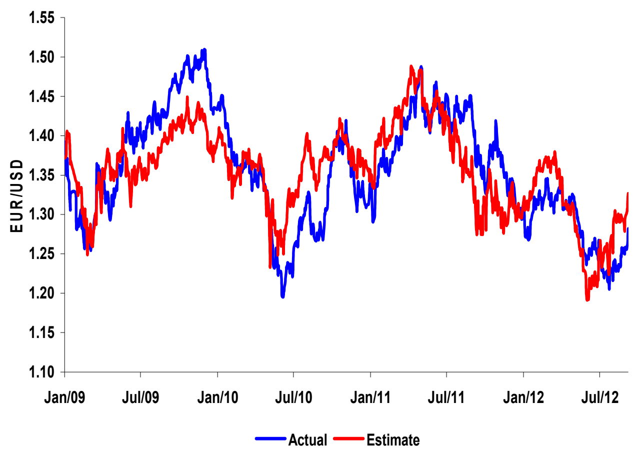


Source: Citi Research, CFTC and Bloomberg

Medium term, though, we are less constructive on EUR. For one thing, we doubt that EMU countries as a whole would welcome too significant an appreciation of EUR since a weak EUR at least helps ameliorate the European recession. For another, while our short term models combining both risk premia and relative returns point to further EUR upside (Figure 8), the longer term may see relative rates and base money growth again being the critical driver of a lower EUR/USD rate as has been the case often since mid-2010 (Figure 9).

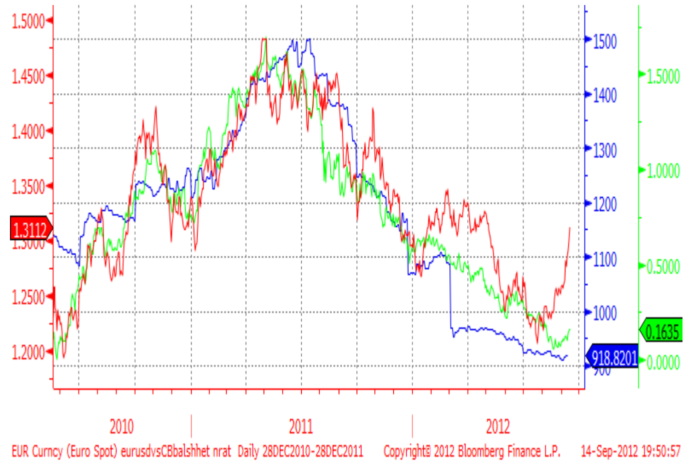
If we take Citi economists' base case that GREXIT is highly likely over 6-12m, that programmes for Spain and Italy will be needed and, maybe, debt restructuring will ultimately reach Tier 2 markets, it seems likely that the current lower risk premia in EMU will be hard to sustain. Meanwhile, likely further ECB rate cuts and additional liquidity provision both through the OMT and LTROs should drive that side of our model to weaker levels. Over 6-12m, our forecast is unchanged at 1.15.

Figure 8. EUR/USD Model Based on Market Drivers (Combines Risk Premia and Rate Differentials)



Source: Citi Research and Reuters EcoWin

Figure 9. EUR/USD (Red) vs EUR Less USD 2y Swap Rates (Green) and the Ratio of the Fed to the ECB Balance Sheet (Blue)



Source: Citi Research and Bloomberg

USD/JPY — Staying Strong

The performance of the JPY since our last forecast has been something of a surprise. Although we anticipated generalised USD weakness, the normal pattern when risk rallies, is for USD/JPY to move a little higher. The driver in this relationship is, however, usually from higher US interest rates, with 2y rates the key point on the curve. Since US yields have barely budged in the face of higher equities recently, there has been no upwards pressure on USD/JPY from this source. Our models based on rate differentials suggest there could even be slight further downside for the exchange rate (Figure 10) and this is reflected in our 0-3m forecast of 78.

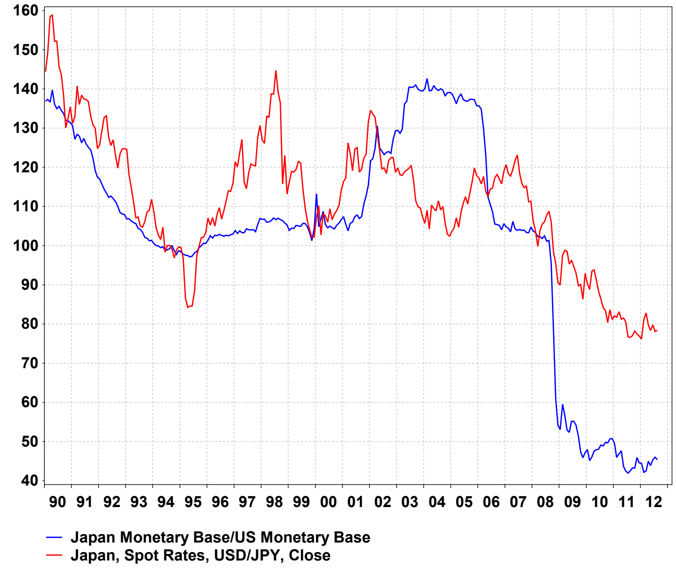
More medium term, we expect risk aversion to rise again reflecting GREXIT, China concerns and so on. This is likely to be a helpful environment for JPY as core rates elsewhere head lower again. Furthermore, the extension of the Fed's balance sheet in response to risk aversion and a sub par recovery in the US economy will very likely continue to be more aggressive than that by the BoJ. Longer term, the relatively greater ease by the Fed is likely to be a driver taking USD/JPY lower as Figure 11 highlights.

Thus we expect JPY bears to continue to be frustrated even over longer horizons. Despite a large fiscal deficit and high public debt mix, Japan continues to run a current account surplus and our economists do not see this disappearing over the next year or so. Medium term concerns on Japan's sovereign solvency, and the associated need for higher rates or a lower currency, will likely be postponed for a while longer. We forecasts USD/JPY over 6-12m at 76.

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

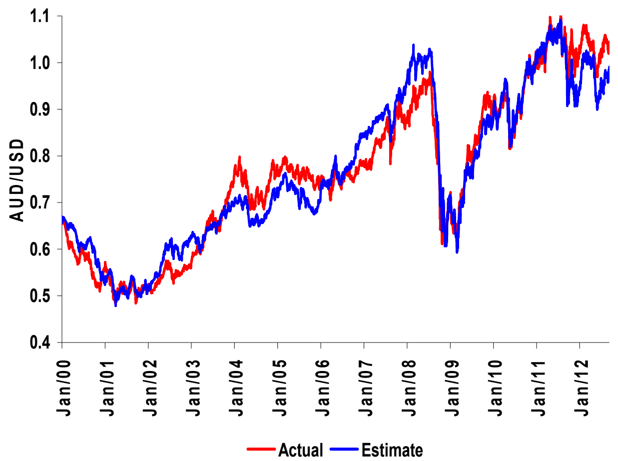
CAD has appreciated sharply and almost without interruption since early June. Given a bullish outlook near term for risk appetite and our expectation of generalised USD weakness over 0-3m, we see little reason for this trend to change near term. We forecast a re-test of the April/ July lows around 0.95.

Helping the CAD both short and medium term are terms of trade gains from relatively buoyant oil prices (even if they pull back some), less exposure to China than, say, AUD and the expectation of higher policy rates (albeit small) priced into forwards. On the latter, Citi economists still expect the BoC to be relatively early in removing monetary accommodation. Furthermore, at 0.95, CAD is only at fair value in WERM terms unlike the over-valued NZD and AUD. As a result, even in the medium term, when USD appreciation is likely in a less risk friendly setting, we see CAD trading in a 0.95-0.98 range.

AUD is still trading at levels that are above both long term valuation (WERM at 0.92) 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 5% too high. The divergence from key commodity prices is striking (Figure 13). We think the AUD is especially vulnerable longer term to the slowdown underway in China, but this is unlikely to become evident short term with the major Central Banks in super easy policy mode. Over 0-3m, we expect AUD/USD 1.05.

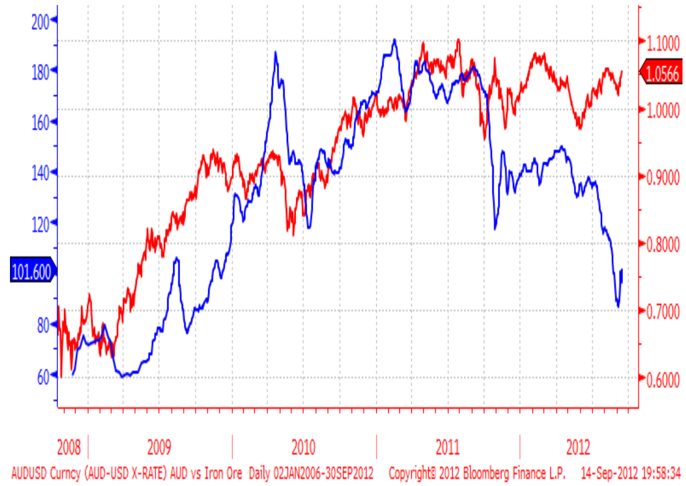
Longer term, concerns are increasing in Australia that the economy has become so bifurcated that growth is extremely vulnerable if China gives a negative surprise. We expect a move back through parity over 6-12m.

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



Source: Citi Research and Bloomberg

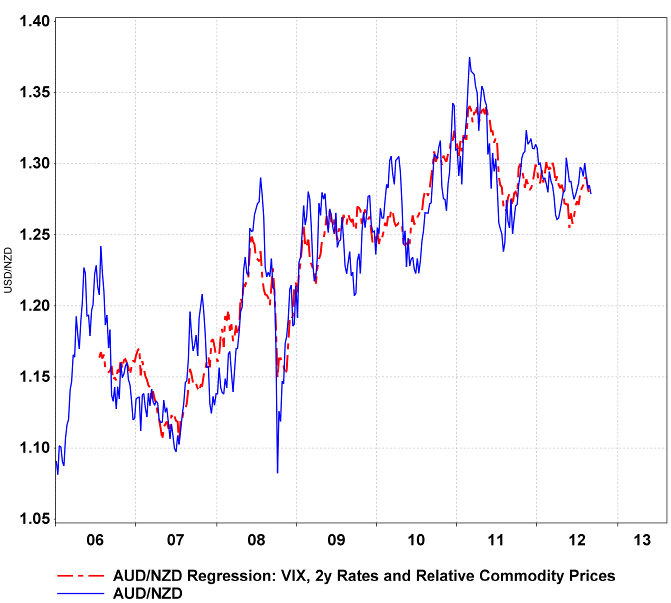
Figure 13. AUD/USD (Red) vs. Iron Ore Spot Prices (Blue)



Source: Citi Research and Bloomberg

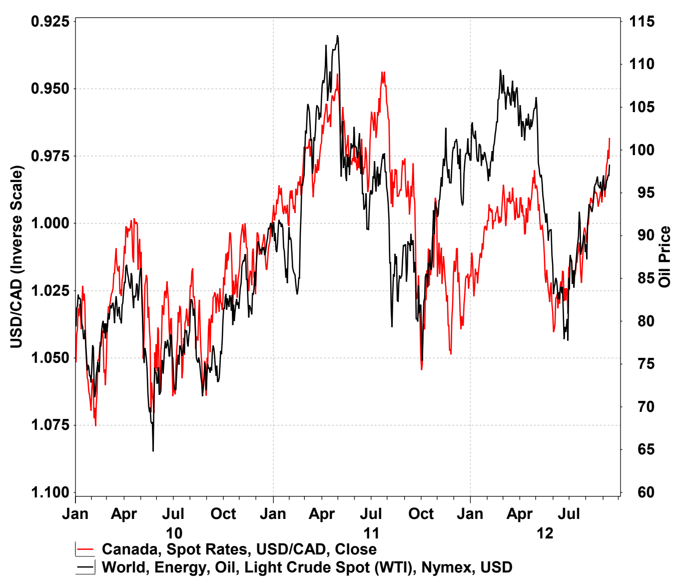
Medium term, we now think that the outperformance of AUD over NZD since 2006 may be drawing to a close. Figure 14 reports a regression of the cross on 2y swap rate differentials and relative commodity prices (GSCI metals/ ags). Our bias is to expect further underperformance of base metals and ores in the commodity space medium term given our bearish China outlook. And our economists also expect New Zealand to raise rates ahead of the RBA in 2013. So both inputs suggest the upside for AUD/NZD is limited from here. We reflect this in the forecasts which show AUD/NZD falling back to 1.22 over 6-12m and has NZD/USD at 0.83 over 0-3m and 0.79 over 6-12m.

Figure 14. AUD/NZD vs. Model Based on Rates and Commodity Prices



Source: Citi Research and Reuters EcoWin

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



Source: Citi Research and Reuters EcoWin

GBP — Driven By Euro Outlook

After breaking out of its multi-month range versus a 50:50 basket of EUR and USD, sterling seems to be trading in a strengthening channel (Figure 16). However, since our last *Forecasts*, sterling strength has been driven primarily by cable rather then versus the single currency.

In fact, improving risk appetite has buoyed GBP/USD to above the 1.60 level for the first time in four months. The rally of EUR/USD has outweighed this however, and thus EUR/GBP has actually edged higher in recent weeks.

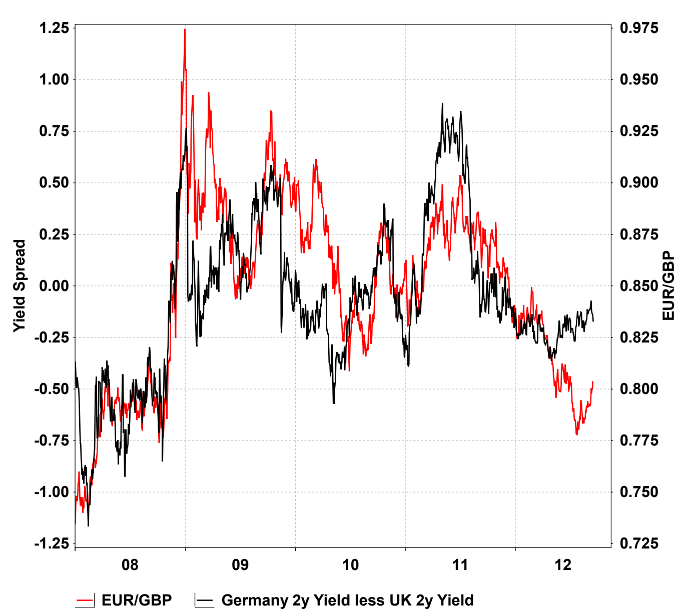
We think this recent dynamic of ‘EUR dependence’ could likely persist for sterling. So while we have pencilled in some modest further gains for cable on the back of better risk appetite, expecting 1.63 in 0-3 months, EUR/GBP is dragged higher still along with our EUR/USD forecasts. We see 0.81 tested in 0-3 months. The recent overshoot to rate differentials also argues for a higher EUR/GBP exchange rate (Figure 17).

Further out, renewed risk aversion and resurfacing EMU pressures will likely cause a mirror image of these shorter term expectations. In other words, while cable comes under pressure during risk-off, the expectation that the single currency tests new cyclical lows versus the USD, results in EUR/GBP also testing fresh lows. Our 6-12 month forecasts see cable at 1.51 and by implication EUR/GBP at 0.76.

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

Source: Citi Research and Reuters EcoWin

Figure 17. EUR/GBP vs. Rate Differential



Source: Citi Research and Reuters EcoWin

Scandis — NOK Outperformance in the Medium Term

Both the Swedish Krona and the Norwegian Krone gave back some strength versus the single currency since our last *Forecasts*. Indeed, as we had highlighted, the strong rally in Scandi currencies seemed to have been *too fast, too furious*. While outperformance in risk-on is expected, both currencies broke through their WERM fair value estimates and the EUR/SEK move to 8.20 was historically consistent with VIX at -10%, a level it has obviously never traded at.

With 'EMU risk premia' continuing to recede in our short term assumptions, we are expecting both EUR/SEK and EUR/NOK to unwind a bit further still with EUR/USD rallying. Macro data also support this short term view, with Citi's ESIs showing improving data in the Eurozone, whereas both the SEK and NOK ESIs are tipping over (Figure 18).

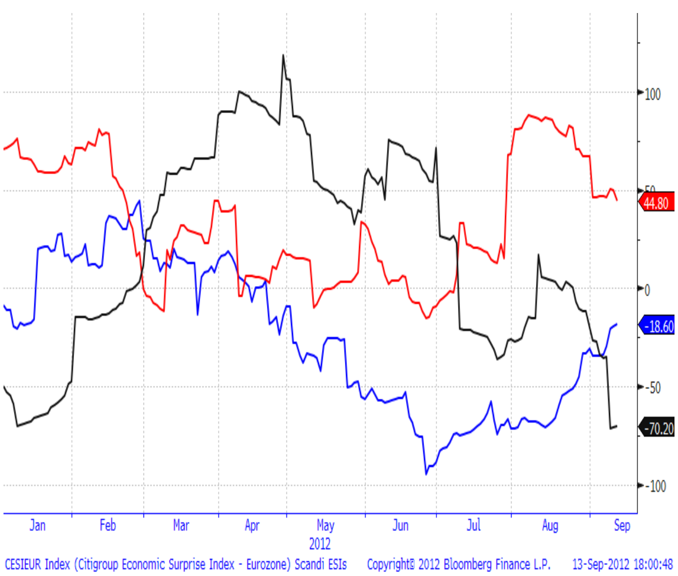
Our short term forecasts see EUR/SEK at 8.75 and EUR/NOK at 7.45 in 0-3 months.

Further out, with the short term euro bounce fading, we expect Scandi strength to resume. Both economies are set to outperform the Euro Area in terms of growth prospects, and as such, their AAA rated fixed income assets will likely remain bid, providing support to their currencies in the medium term.

Norway in particular, is set markedly to outperform most other European economies in terms of growth this and next year, in part due to the stabilizing effect of the petroleum industry. Citi economists also see the Norges Bank hiking policy rates in 1Q 2013, which should lend support to the Norwegian Krone.

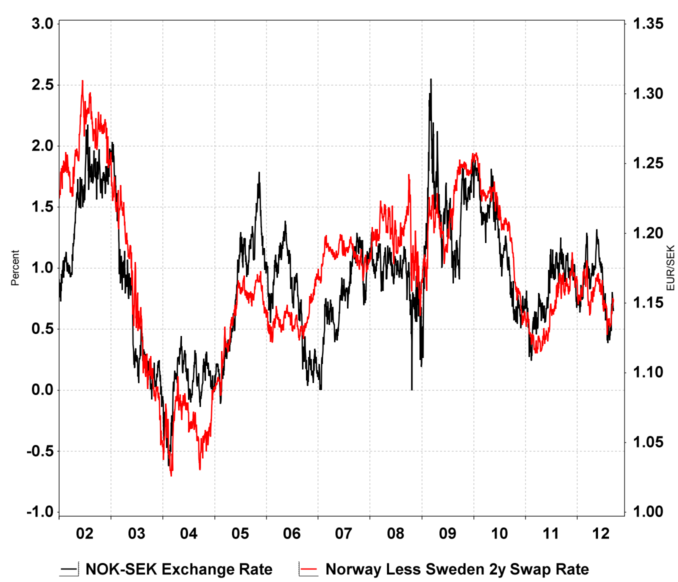
With NOK/SEK highly driven by rate differentials, we expect NOK to outperform SEK over the forecast horizon (Figure 18).

Figure 18. ESIs – Europe (Blue), Sweden (Red) and Norway (Black)



Source: Citi Research and Bloomberg

Figure 19. NOK/SEK vs. 2y Swap Rate Differential



Source: Citi Research and Reuters EcoWin

CHF — Improving 'EMU Risk Premia' = Lower Risks to Peg

Having surpassed its 1st anniversary, the Swiss Franc peg continues to hold. In fact, having traded with hardly any realised volatility in recent months, price action has actually been to the upside in recent trading sessions, pushing EUR/CHF to above 1.21 for the first time since March.

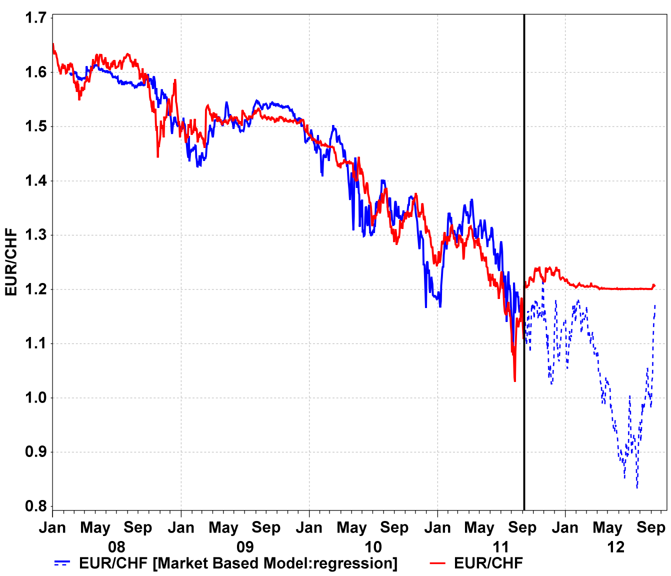
Speculation around the SNB raising the peg level, and the recent improvement in 'EMU risk premia' and risk appetite more broadly, have both played a role. In fact, as shown in Figure 20, a market variable based regression for EUR/CHF has rebounded strongly, and currently points to 'fair value' just under the 1.20 floor. This suggests that downside pressures on the peg are diminishing, for now at least.

In the meantime, the 13th September SNB meeting wasn't accompanied by a peg change. Nonetheless, the SNB reiterated their "utmost determination" to prevent CHF appreciation by pledging to intervene in "unlimited quantities".

We continue to expect the Swiss Franc peg to hold throughout the forecast horizon.

As we have highlighted before, the biggest risk to the peg stems from inflation. Base money growth is already explosive, and this rapid growth in local liquidity risks asset price, and eventually, CPI inflation. While headline inflation rates already appear to be bottoming out (Figure 21), inflation risks remain minimal for now.

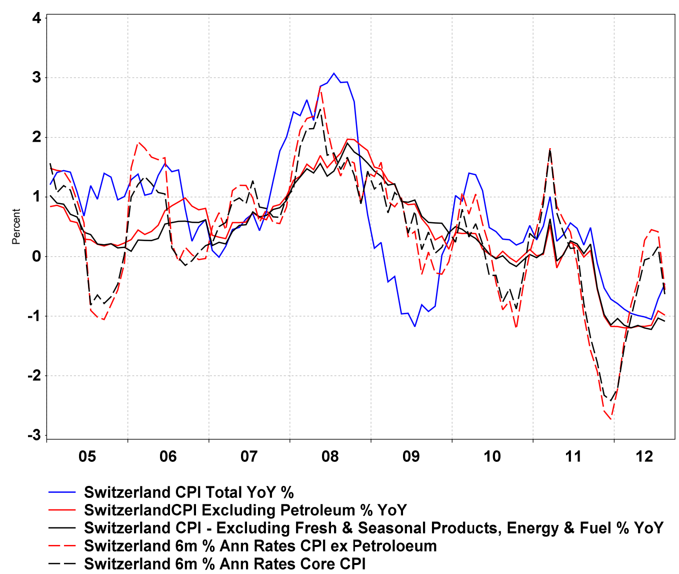
Figure 20. Improving 'EMU Risk Premia' Boosts EUR/CHF Fair Value*



Source: Citi Research and Reuters EcoWin

* Market based model estimated from 2008 to August 2011 (when peg was introduced). Fair-value since then is out of sample estimate.
Market drivers are 2y swap rate differentials, Spanish 5y CDS, EuroZone Bank stocks and VIX

Figure 21. Bottoming Out Inflation Poses A Risk To The Peg



Source: Citi Research and Reuters EcoWin

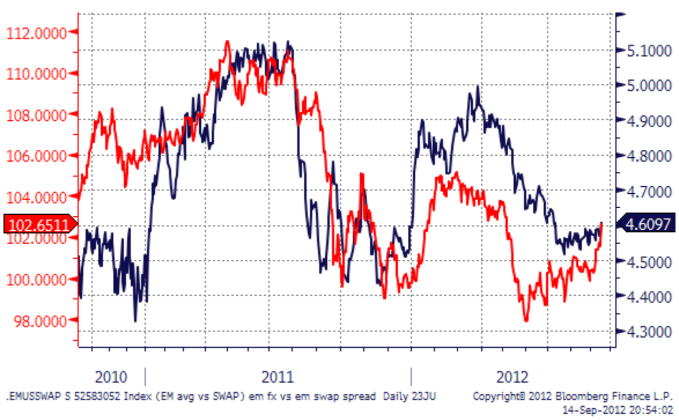
EM Exchange Rates

Medium term, we think the USD will be stronger against all currencies including EM, assuming risk appetite is impaired again by GREXIT and other events. The CEE part of CEEMEA is forecast to fall most against the US dollar over this period, reflecting both wider Euro Area concerns (and our EUR forecast of 1.15) and strong local idiosyncrasies that are expected to play out over this period. The CEE-3 currencies weaken by between 20 and 25% over the medium term based on our forecasts. Reflecting this, CEEMEA as a whole is forecast to be the worst performing bloc (vs. the USD) in EM over the medium term. Latam is expected to suffer much less, in line with historical experience where it tends to be high beta in upswings but low beta in downswings. Asia holds up best.

The near term looks quite different, however, with large doses of easy money a potent headwind for the dollar and a tailwind for risky assets more generally. To be sure, as shown in Figure 22, the gap between EM and US swap rate differentials and relative FX moves has closed up significantly in recent weeks. In aggressive risk on stimulated by the Fed, EM currencies may continue to strengthen beyond what relative rate differentials current suggest (Figure 23).

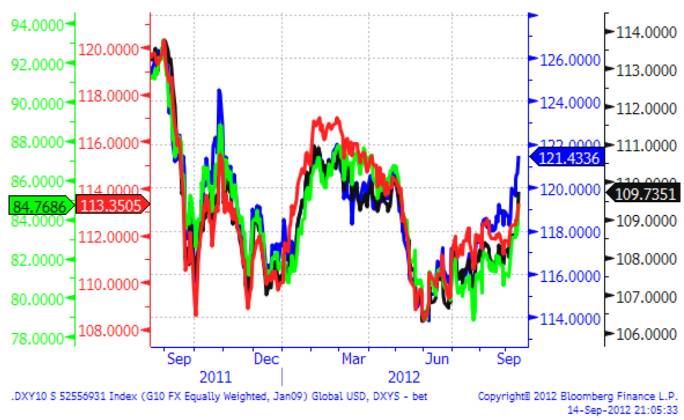
As such, we forecast both Latam and Asia flat to slightly stronger in the next three months. CEEMEA is expected to weaken vs. the USD in aggregate – although the divergence between individual crosses is significant.

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 — The China Factor

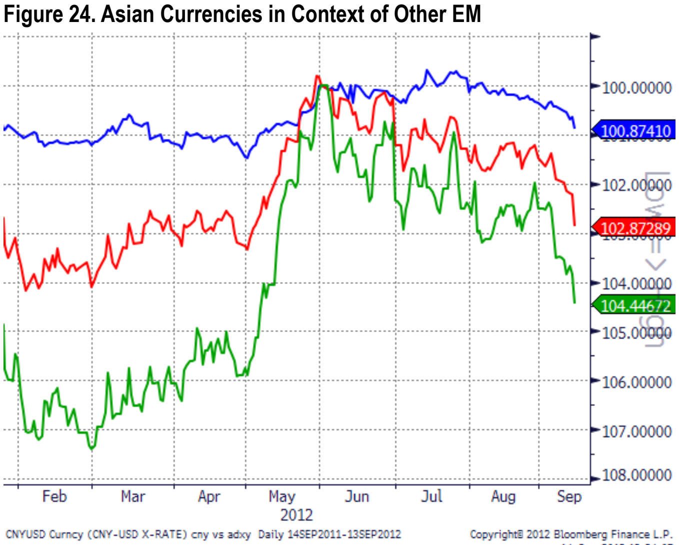
We forecast Asian currencies weaker in the medium term, reflecting both external and local factors. Externally, our expectation of broad-based dollar strength over this period *de facto* implies weaker domestic currency. Locally, mounting concerns around the Chinese growth story lead us to project USD/CNY flat over the forecast horizon and this has powerful implications for export-oriented Asian currencies.

In the shorter, 0-3 month time frame, most currencies are forecast to stay flat against the dollar, with only a handful of exceptions like SGD where the currency acts as a monetary policy variable and is being targeted weaker, and TWD where recent currency strength seems excessive in the context of a sharply weaker economy.

Since late July, CNY has appreciated by just over 1% against the dollar, lagging moves in other Asian currencies (and indeed, other EM) in both timing and in size (Figure 24). The general trend so far this year, however, has been one of USD/CNY flat-lining, and our forecasts suggest this is sustained over the twelve month horizon. With growth in trade and property investment staying very weak indeed, and leading data like PMIs, money and credit pointing to more weakness forthcoming, a flat and perhaps even slightly weaker CNY (as suggested by 12 month CNY NDFs, for example) is expected over the next twelve months.

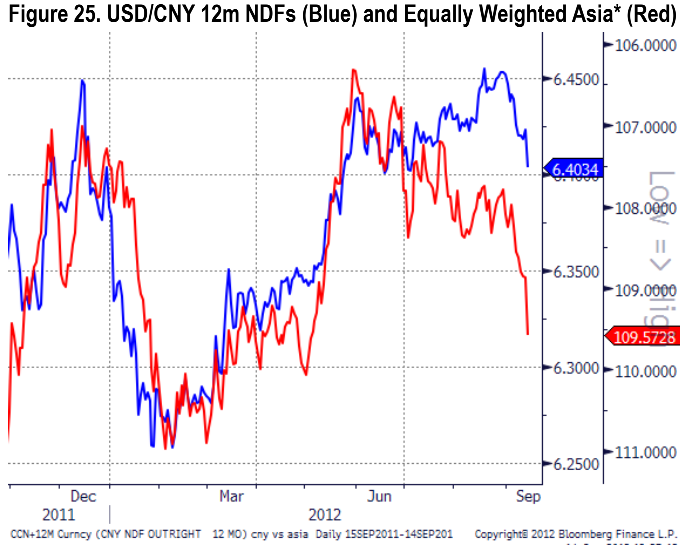
A slower Chinese economy and flat yuan continues to have important implications for export/China-led Asian currencies that have strengthened ahead of CNY (Figure 25) and are ultra sensitive to the ongoing Chinese economic slowdown. This is especially the case in countries where domestic data has slowed sharply and ahead of other regions, if less so than in China. Both Taiwan and Korea fall into this cohort: as we have pointed out before, both are very open economies, with large shares of exports to China and are high beta to China's own exports.

Figure 24. Asian Currencies in Context of Other EM



Sources: Citi Research and Bloomberg
Green – Equally weighted EM; Red – Equally Weighted Asia; Blue USD/CNY
*Lower in chart shows USD falling, local currency rising. June 1 2012=100 for all

Figure 25. USD/CNY 12m NDFs (Blue) and Equally Weighted Asia* (Red)



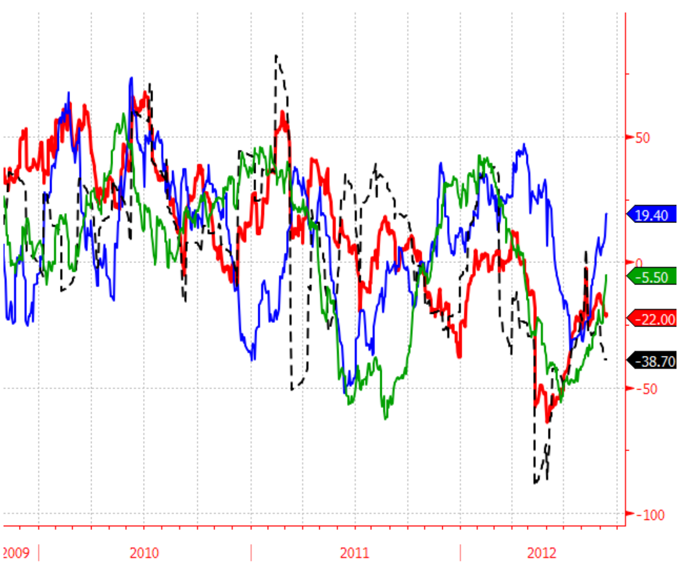
Sources: Citi Research and Bloomberg
*Lower in chart is USD weaker

The Taiwanese dollar is forecast to be weaker against the US dollar in both the next three months and six months, one of the few EM currencies where we expect this to be the case. Our bearishness reflects a number of factors: data that are weakening sharply and ahead of other countries, and a central bank that has tended to be more interventionist than most in the past. Sensitivity about the exchange rates comes with good reason: of all the EMs considered in this forecast, Taiwan is amongst the most open, trade-reliant, and China-sensitive economies around. Our forecasts are for USD/TWD at 29.7 in the next three months, and 30.5 in the medium term.

Weakness in KRW, meanwhile, occurs in the second half of our forecasts, i.e., 6-12 months out, where we forecast USD/KRW at 1140. As mentioned above, Korea is very exposed to a slowing China, with the beta of Korean exports to Chinese exports above unity. Even excluding the “China factor” Korea (along with Taiwan) also ranks amongst the most sensitive EMs to a broader external shock according to Citi Economists, based on the share of exports in GDP and expected growth contribution of exports to 2012 growth (Figure 27). Near term, it USD/KRW is forecast flat around current spot, held up by the latest ratings upgrade and expected strong inflows into local bonds especially following QE3.

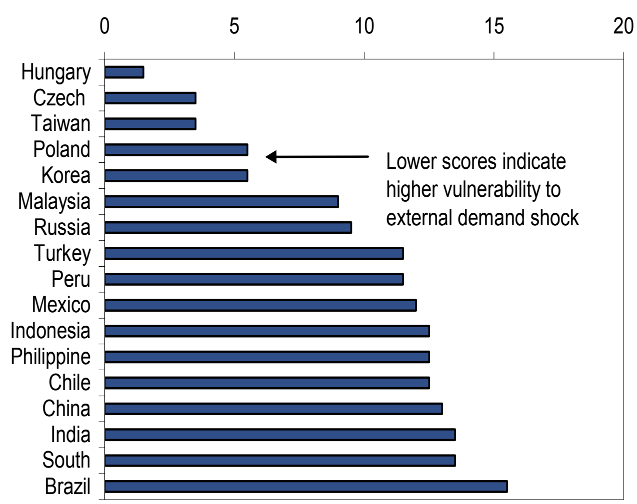
Malaysia’s better economic performance – GDP and imports data were both perceptibly better than expected for example – has already boosted MYR which has been by far the best performing Asian currency since early July. We forecast USD/MYR to hold its ground at around 3.05 in the next three months, which has been something of a support/resistance line in recent years. Further out, we expect it to give back some of these gains as the twin factors which help MYR in risk on – an open and liquid bond market and exposure to commodity prices – also weigh heavily against it in risk off.

Figure 26. Asian Economic Surprise Indices in Context



Sources: Citi Research and Bloomberg
Red – Asia Pac ESI; Black dotted – CNY; Blue – Latam; Green – G10

Figure 27. Citi’s Ranking of Countries' Vulnerability to External Shock.



Sources: Citi Research and Bloomberg
* Each score averages the export share of GDP and net exports' contribution to GDP growth in 2012.

Both INR and IDR should remain generally weak throughout the forecast horizon, perhaps ironically given that they are the most trade/China insulated economies in the Asia bloc. As before, these forecasts are driven by more idiosyncratic forces than the rest of Asia.

Recent price action in the Indonesian rupiah is striking: it is the only EM currency other than the Argentine peso to have actually *weakened* against a weakening dollar since June. To some extent this likely reflects poor (and especially currency unfriendly) fundamentals, including sizeable twin deficits on the current and fiscal accounts. But it probably mostly reflects an express desire of the authorities to depreciate the exchange rate: Citi economists believe that the IDR will continue to be managed weaker as policy makers try to soften imports to cull the current account deficit. We forecast USD/IDR at 9600 in the next three months and 9850 over the medium term.

Finally, INR, which continues to be plagued by a potent economic slowdown and (at least so far) impotent policy. With data continuing to surprise to the downside, inflation once again surprising to the upside, and persistently large fiscal deficits, India's Reserve Bank is trapped in a nasty stage in the economic cycle. Unlike IDR, however, we see no reason for INR to weaken in a risk on environment. We forecast INR to hold ground at current spot in three months – and weaken back to recent resistance at 56, which is our 6-12 month forecast.

CEEMEA — CEE vs. MEA

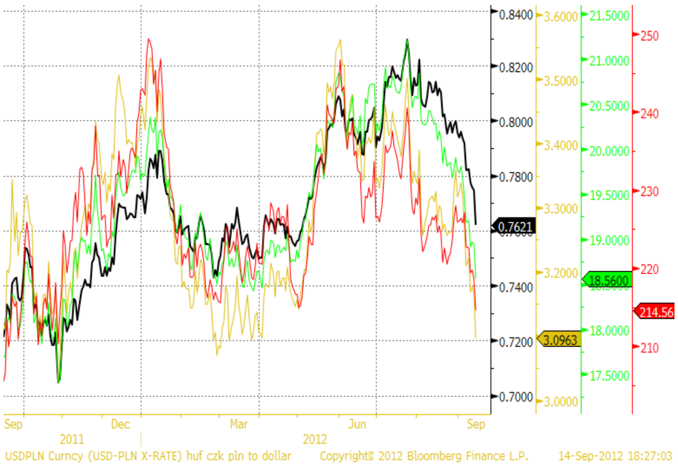
Our short-term core theme for CEEMEA markets centres on a weaker dollar and the outperformance of high beta Eastern European currencies. With open ended QE and supportive macroeconomic indicators we reckon recent dollar weakness has further to run. Relative to the euro, in comparison, we think that outperformance has gone so far that it may have almost run its course.

Beyond 3 months, however, we think that Euro structural issues start to reassert themselves. We think many of the current currency gains will be undone in this period and that much of the potential appreciation versus the Euro has already occurred.

The other major trend we've seen in CEEMEA is the deliberately targeting of a weaker currency for political expediency. This is the basis of our forecasts for ILS and TRY, and to some extent, ZAR.

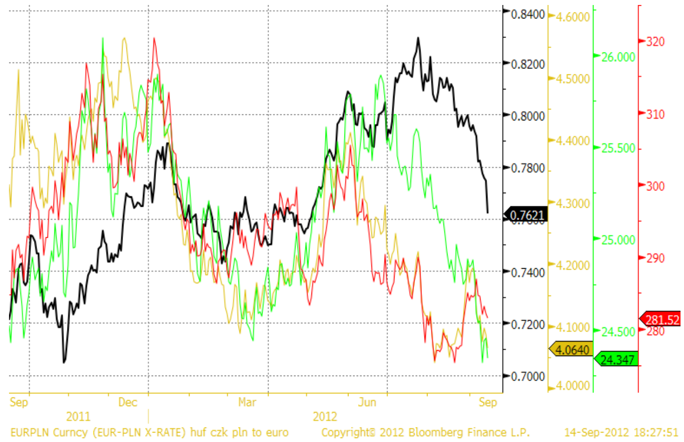
But first, the high beta Eastern European currencies. Figure 28 illustrates how the zloty remains the highest beta currency, outperforming in rallies and underperforming in sell-offs, with the Hungarian forint slightly behind that. In contrast, Figure 29 illustrates how far euro outperformance has come already, and underpins our view that most of the gains are baked in already, with EURHUF and EURCZK already showing signs of weakening.

Figure 28. High Beta Outperformance Relative to Dollar May Continue…



Source: Bloomberg
Black USDEUR, Red USDHUF, Green USDCZK, Gold USDPLN

Figure 29. …But May Have Run Its Course Relative to Euro



Source: Bloomberg
Black USDEUR, Red EURHUF, Green EURCZK, Gold EURPLN

The HUF has been the best performing CEEMEA cross year to date we expect it to give a lot of this back, for a several reasons. First, political/headline risk is rising fast with PM Orban rejecting IMF loan conditions earlier this month. Hungary needs this loan to meet debt redemptions so negotiations are crucial in this regard. Citi Economists reckon that March 2013 as the furthest that the government can go without an IMF loan. Second, the central bank is cutting rates again, and this should remove further support from HUF. And finally, as discussed before, fundamentals are very soft indeed. Reflecting this potent combination, we expect Hungary's forint to be by far the worst performing EM currency in the medium term, at 310 vs. the euro.

For PLN, meanwhile, our forecasts are neutral for the next three months, with (acute) weakness forecast thereafter. On the one hand, the National Bank of Poland looks almost certain to reverse its May rate hike, which could argue for PLN weaker near term especially given significant strengthening since early June. But on the other hand, it remains one of the stronger links in CEEMEA and should stay supported in risk on. Our forecasts have EUR/PLN at 4.11 and 4.40 in the short and medium term respectively.

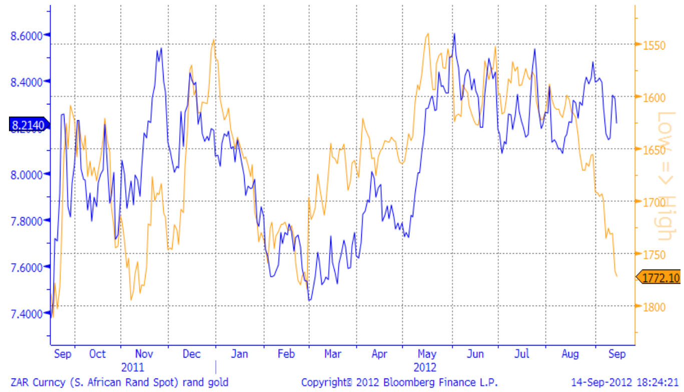
We remain bearish on Israeli Shekel too, but for different reasons. Our forecasts here continue to be dominated by two major factors. Firstly, fears over Iran's nuclear ambitions, which seem unlikely to get worse before they get better. This is illustrated by Figure 30 where we see the Shekel decouple from risk assets towards the end of 2011 when the nuclear inspections broke down. Secondly, and in this context, we think that the apparent desire of the central bank to continue cutting interest rates *and* keep the shekel weak is likely to work, at least over the medium-term. Figure 30 illustrates policy rate inflection point in 2011 and the series of cuts since then help to explain our forecast of a further weakness to around 4.20, i.e., close to the 2009 lows, over 6-12 months.

Figure 30. Geopolitical Concerns and a Deliberate Economic Policy of Shekel Weakness is Set to Continue

Source: Bloomberg

Red: USDILS, Gold: SPX (inv), Green: Policy Rates

Figure 31. Political and Structural Concerns Will Keep the Rand (Blue) Decoupled from Gold



Source: Bloomberg

Politics is also the key factor in our bearish outlook for the South African rand. Figure 31 illustrates the extent to which it has decoupled from gold prices, reflecting we think deepening concerns. Potential army involvement in the miners' strike and machinations of ousted youth leader Malema speak to continued political weakness at a time when structural issues on poverty, social housing and welfare need to be addressed. With such concerns, it seems unlikely that action will be taken to stem the widening deficit and the SARB seems comfortable with a weaker currency as a factor adjusting the current account. In such an environment we forecast ZAR to weaken to 8.70 over a 12 month period.

There is a similar, if more overt, desire for Turkish Lira weakness from the central bank, which is an important factor in our forecast. To be sure, our earlier bullishness was underpinned by the fact that the central bank was using the TRY in the opposite direction, to tighten local monetary conditions. With the carry gains for TRY significantly diminished, deep structural concerns especially in the balance of payments, and policy no longer on side, we see TRY weaker at 1.82 in the next 3 months and 1.92 in 6 to 12 months' ahead.

The Russian rouble looks bullish on a short term stance, on the back of oil strength, recently higher interest rates and generally better global risk appetite. But on balance, longer term we think that risks remains to the downside: Russia, in essence, remains chiefly an oil and gas story, and we doubt that oil prices will hold up in our more bearish medium term global outlook. Our forecasts for the rouble basket are 35.2 and 37.8 in the short and medium term respectively.

Latam FX — It's (Still) Complicated

As discussed in our last *FX Forecast*, Latam FX in aggregate has tended to be higher beta in risk on, and somewhat lower beta in risk off. Both trends are expected to stay intact, with Latam FX projected to be amongst the better EM performers in both near term risk on and medium term risk off.

There are two main reasons for this behaviour of the Latam bloc. First, in risk off, distinct sensitivities for various Latam economies/currencies often 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.

Figure 32. A New Range for BRL

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

Figure 33. Better Risk Appetite, A Stronger MXN

Source: Citi Research and Bloomberg
Blue – GRAMI with a 30 day lead; Orange – USD/MXN Spot

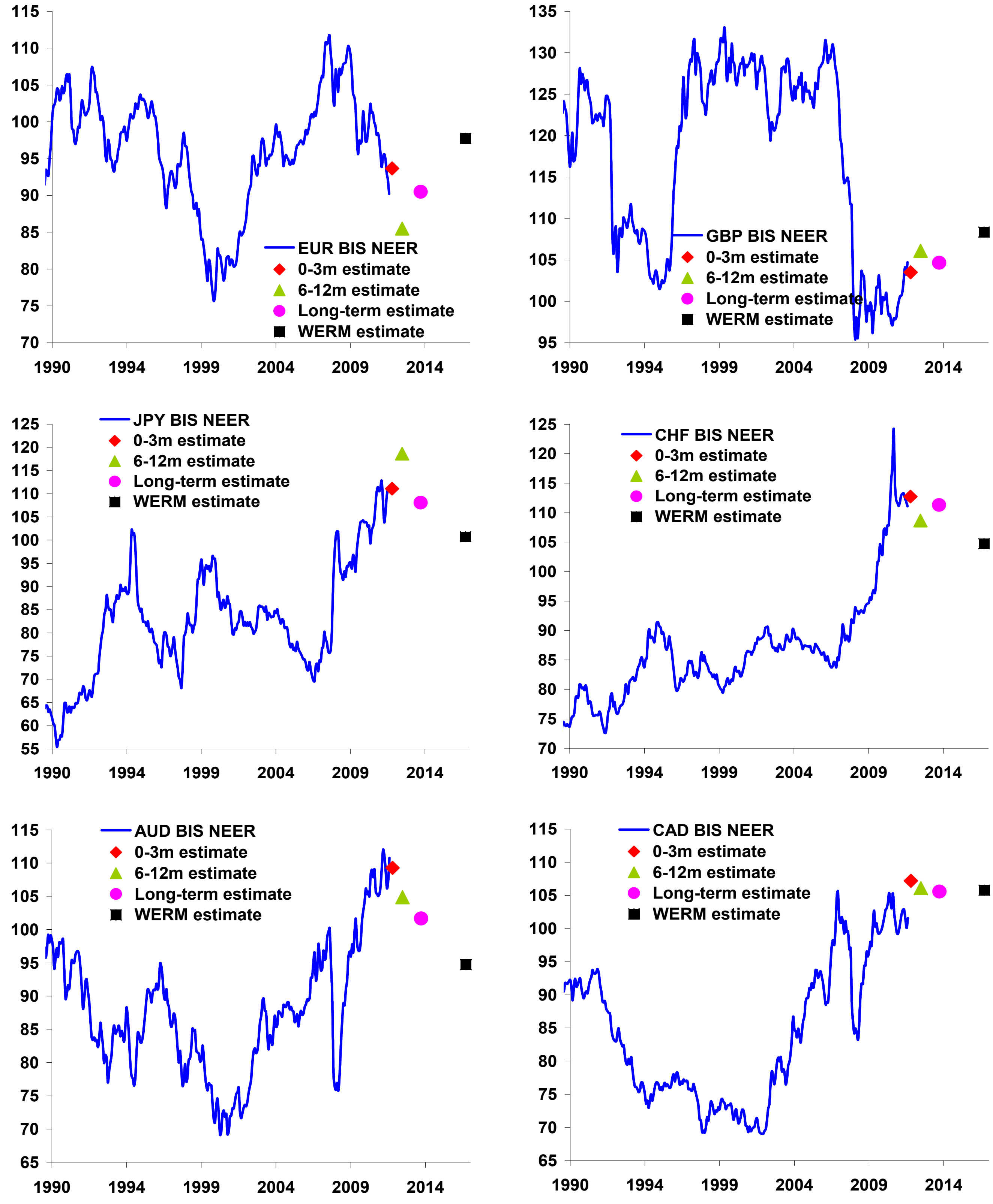
Recent price action in USD/BRL has been characterized by ultra-low volatility (Figure 32). This is of course the desired outcome for policy makers: the Brazilian central bank has been intervening in both directions, stemming real strength at around 2 and capping weakness near 2.05. This is a significant departure from their earlier strategy – which was to intervene to lower USD/BRL at about 2.10 and to "tolerate strength" up to 1.90. The new range established since early July as a result of these policies is much narrower than the previous range and forms the upper and lower bounds for our forecasts over the next twelve months.

MXN, by contrast, is the most flexible exchange rate in its Latam cohort and has been the darling of EM investors in the latest spate of US dollar weakness. Our forecasts are for this to continue. We expect USD/MXN to fall back to the lows of earlier this year of around 12.5, which has also been an important support in the last twelve months or so, and then rise back to around 13.2 over the medium term. Fresh easing from major global central banks should be particularly supportive for MXN, which shares amongst the closest relationships in EM with the global risk cycle (Figure 33). The economy is intimately linked to the US and has yet to reflect recent improvements there; it also has very little exposure to China, an important difference with Chile and Brazil.

Somewhat surprisingly, CLP has continued to strengthen despite close links with China/base metals and Citi Economists' generally bearish views on the economy. Notably the peso began to strengthen even as copper prices were falling in early June, although the September rally in copper seems to have helped USD/CLP lower. Reflecting this resilience in risk on, we have shaved our forecasts for USD/CLP down to 480 0-3 months, while sticking to our view of weakness to around 510 further out, making it the weakest currency in Latam on a one year view.

Despite breaking through its upward sloping channel of July-August, USD/COP has maintained a relatively clear pattern of higher local lows since May. We expect this to be maintained, with COP performing in line with CLP in the near term, albeit for different reasons. First, because it has had a stellar run compared with the rest of Latam, really since this time last year, and so may gain somewhat less in risk on. Second, and more importantly, Citi economists expect forceful intervention by both the Central Bank and the Ministry of Finance after the latest bout of Fed easing, and this should put a lid on how much it strengthens now. We forecast USD/COP at 1820 in the next three months and 1850 over the medium term.

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	1.31	1.32	1.27	1.20	1.15	1.17	1.19	1.21	1.23	1.25
Japanese yen	USDJPY	78	78	77	77	76	77	78	79	79	80
British Pound	GBPUSD	1.62	1.63	1.59	1.55	1.52	1.53	1.54	1.56	1.57	1.58
Swiss Franc	USDCHF	0.93	0.92	0.95	1.00	1.04	1.02	1.01	0.99	0.97	0.96
Australian Dollar	AUDUSD	1.06	1.05	1.02	0.99	0.96	0.96	0.96	0.95	0.95	0.95
New Zealand Dollar	NZDUSD	0.83	0.83	0.82	0.80	0.79	0.77	0.75	0.73	0.71	0.69
Canadian Dollar	USDCAD	0.97	0.96	0.96	0.97	0.98	0.98	0.98	0.97	0.97	0.97
Dollar Index*	DXY	78.81	78.57	80.67	83.60	86.06	85.11	84.17	83.29	82.41	81.59
G10 Crosses											
Japanese yen	EURJPY	103	103	98	92	88	90	93	95	98	100
Swiss Franc	EURCHF	1.22	1.21	1.20	1.20	1.20	1.20	1.20	1.20	1.20	1.20
British Pound	EURGBP	0.81	0.81	0.79	0.78	0.76	0.77	0.77	0.78	0.79	0.79
Swedish Krona	EURSEK	8.61	8.68	8.62	8.47	8.35	8.34	8.33	8.32	8.31	8.30
Norwegian Krone	EURNOK	7.46	7.46	7.37	7.28	7.20	7.22	7.24	7.26	7.28	7.30
Norwegian Krone	NOKSEK	1.15	1.16	1.17	1.16	1.16	1.15	1.15	1.15	1.14	1.14
Australian Dollar	AUDNZD	1.27	1.27	1.25	1.23	1.22	1.25	1.29	1.32	1.35	1.38
Australian Dollar	AUDJPY	82.7	82.3	79.0	75.7	73.1	73.7	74.3	74.9	75.5	76.0
EM Asia											
Chinese Renminbi	USDCNY	6.32	6.31	6.33	6.34	6.35	6.31	6.27	6.23	6.18	6.15
Hong Kong Dollar	USDHKD	7.75	7.75	7.75	7.76	7.76	7.76	7.76	7.75	7.75	7.75
Indonesian Rupiah	USDIDR	9520	9563	9680	9773	9843	9805	9767	9729	9692	9658
Indian Rupee	USDINR	54.3	54.5	55.0	55.6	55.9	55.1	54.4	53.7	52.9	52.3
Korean Won	USDKRW	1117	1119	1126	1134	1138	1123	1109	1096	1082	1069
Malaysian Ringgit	USDMYR	3.04	3.05	3.08	3.11	3.13	3.13	3.12	3.12	3.11	3.11
Philippine Peso	USDPHP	41.4	41.2	41.7	42.4	42.9	42.5	42.0	41.6	41.2	40.8
Singapore Dollar	USDSGD	1.22	1.23	1.25	1.26	1.27	1.26	1.26	1.25	1.24	1.24
Thai Baht	USDTHB	30.8	30.6	30.9	31.5	31.9	31.5	31.1	30.7	30.2	29.9
Taiwan Dollar	USDTWD	29.4	29.6	30.0	30.3	30.4	30.0	29.6	29.2	28.8	28.5
EM Europe											
Czech Koruna	EURCZK	24.35	24.54	25.09	25.53	25.85	25.57	25.29	25.01	24.73	24.46
Hungarian Forint	EURHUF	282	286	296	304	309	305	301	297	293	290
Polish Zloty	EURPLN	4.07	4.09	4.20	4.31	4.38	4.28	4.18	4.08	3.98	3.90
Israeli Shekel	USDILS	3.89	3.95	4.06	4.14	4.19	4.15	4.11	4.07	4.03	3.99
Russian Ruble	USDRUB	30.5	30.6	32.3	34.0	35.4	35.0	34.7	34.3	34.0	33.7
Russian Ruble Basket	RUB	34.7	35.0	36.0	37.0	37.8	37.7	37.7	37.6	37.5	37.5
Turkish Lira	USDTRY	1.80	1.80	1.84	1.88	1.92	1.90	1.89	1.88	1.86	1.85
South African Rand	USDZAR	8.23	8.32	8.50	8.61	8.70	8.70	8.71	8.71	8.72	8.74
EM Latam											
Brazilian Real	USDBRL	2.02	2.01	2.02	2.03	2.05	2.05	2.05	2.05	2.05	2.05
Chilean Peso	USDCLP	471	476	490	501	509	505	501	497	493	490
Mexican Peso	USDMXN	12.7	12.6	12.7	13.0	13.2	13.0	12.8	12.6	12.4	12.2
Colombian Peso	USDCOP	1791	1806	1830	1841	1850	1850	1850	1850	1850	1851

* 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	1.31	1.30	1.18	1.24	1.29	1.34
Japanese yen	USDJPY	78	80	77	80	81	81
British Pound	GBPUSD	1.62	1.60	1.53	1.58	1.64	1.70
Swiss Franc	USDCHF	0.93	0.93	1.02	0.97	0.95	0.95
Australian Dollar	AUDUSD	1.06	1.03	0.97	0.95	0.94	0.93
New Zealand Dollar	NZDUSD	0.83	0.82	0.78	0.70	0.68	0.67
Canadian Dollar	USDCAD	0.97	0.98	0.98	0.97	0.96	0.96
Dollar Index**	DXY	78.81	79.93	84.72	82.07	79.67	77.59
G10 Crosses							
Japanese yen	EURJPY	103	103	91	99	105	109
Swiss Franc	EURCHF	1.22	1.20	1.20	1.20	1.23	1.27
British Pound	EURGBP	0.81	0.81	0.77	0.79	0.79	0.79
Swedish Krona	EURSEK	8.61	8.72	8.37	8.31	8.35	8.40
Norwegian Krone	EURNOK	7.46	7.49	7.24	7.29	7.29	7.29
Norwegian Krone	NOKSEK	1.15	1.16	1.16	1.14	1.14	1.15
Australian Dollar	AUDNZD	1.27	1.26	1.25	1.36	1.38	1.39
Australian Dollar	AUDJPY	82.7	82.2	74.2	75.6	75.8	75.6
EM Asia							
Chinese Renminbi	USDCNY	6.32	6.32	6.32	6.18	6.12	6.09
Hong Kong Dollar	USDHKD	7.75	7.76	7.76	7.75	7.75	7.75
Indonesian Rupiah	USDIDR	9520	9455	9797	9681	9611	9558
Indian Rupee	USDINR	54.3	54.0	55.2	52.7	51.6	50.8
Korean Won	USDKRW	1117	1131	1126	1077	1045	1018
Malaysian Ringgit	USDMYR	3.04	3.09	3.12	3.11	3.06	3.01
Philippine Peso	USDPHP	41.4	42.0	42.5	41.1	40.6	40.3
Singapore Dollar	USDSGD	1.22	1.25	1.26	1.24	1.22	1.21
Thai Baht	USDTHB	30.8	31.0	31.5	30.2	29.6	29.3
Taiwan Dollar	USDTWD	29.4	29.7	30.1	28.8	28.4	28.3
EM Europe							
Czech Koruna	EURCZK	24.35	24.99	25.56	24.62	23.77	22.96
Hungarian Forint	EURHUF	282	291	305	292	287	284
Polish Zloty	EURPLN	4.07	4.17	4.29	3.97	3.90	3.90
Israeli Shekel	USDILS	3.89	3.91	4.15	4.01	3.82	3.62
Russian Ruble	USDRUB	30.5	31.2	34.8	33.8	32.6	31.4
Russian Ruble Baske	RUB	34.7	35.3	37.5	37.5	37.3	37.2
Turkish Lira	USDTRY	1.80	1.81	1.90	1.86	1.87	1.89
South African Rand	USDZAR	8.23	8.16	8.68	8.75	9.10	9.51
EM Latam							
Brazilian Real	USDBRL	2.02	1.97	2.05	2.04	1.97	1.89
Chilean Peso	USDCLP	471	489	504	493	490	490
Mexican Peso	USDMXN	12.7	12.9	13.0	12.4	12.4	12.7
Colombian Peso	USDCOP	1791	1802	1848	1853	1881	1914

*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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