



## Overview

Asia, not the US, has provided the biggest surprises of 2013 so far. Chinese FX reserve accumulation has grown at a pace not seen since 2010. Much seems to be due to speculative dollar sales, but whatever the reason, the likely rebalancing has provided support for non-dollar reserve currencies such as the euro and Australian dollar. The other surprise has been the scale of the Japan "shock" with Abenomics proving to be the most radical set of policies since the depression-era. The yen has fallen markedly; competitor nations such as Korea have seen their currencies weaken, while suppliers to Japan such as Thailand and Malaysia have seen their currencies strengthen. Through all of this the dollar has marched higher even with the market wavering over an early move to tapering by the Fed and still absent equity re-allocations to the US.

### Dollar Break-Out Time

The resilience of the dollar should be taken as a signal that the dollar is in the midst of a major uptrend. Over the coming months, economic data will likely improve after a soft patch, which should keep real yields well supported. More importantly, despite continued US equity market outperformance, international investors have still favoured the Euro-area, Japan and EM Asia over the US in terms of flows. This is unlikely to continue. Chinese reserve accumulation should also slow down, not least because of measures by authorities to clamp down on speculative inflows. The euro will no doubt lose out with such a backdrop. Additionally, the ECB has re-opened discussions of easing, while the Fed is contemplating how to wind down easing. On the flow side, lower euro risk premia should see much less repatriation, and if anything a greater allocation to foreign assets by Euro-area investors. We go long the dollar trade-weighted index and short EUR/USD.

### Japan Shock

Though many want to fight the trend, we continue to stick resolutely to a bearish yen view. The next three to four months should see a wave of events and announcements that will reinforce the potency of Abenomics, whether through elections, structural reforms or monetary policy. Expectations will remain one of the key channels through which Abenomics will influence the direction of the economy. The flow picture also remains negative for the yen thanks to M&A outflows and the potential for further unwinds in past inflows to short-term Japanese instruments. We stay short the yen against the dollar.

### GBP, CHF: Nowhere To Hide

Two other currencies should lose out to an unwind of safe-haven inflows: sterling and the Swiss franc. The negative sterling picture is aggravated by the fact that recent strong data will not change BoE policy, while the negative net investment income balance points to

an extremely negative current account deficit dynamic. The franc meanwhile will suffer from a resumption of portfolio outflows from Swiss-based investors. We sell both GBP and CHF (vs EUR and USD).

### Rest of G10

Swedish disinflation and Norwegian household debt issues should lead to central bank biases that support a long NOK/SEK trade. Finally in G10, we like to go long CAD against the JPY and NZD on the back of Canadian growth catching up to US growth, a stabilisation in the housing market and an upturn in natural gas prices. We are neutral on the Australian dollar, but given the recent sharp decline would consider buying AUD upside options, which appear cheap making the risk-return look attractive.

### Asia = China+ Japan

The yen-centric Asia FX trade, short Korean won and long Malaysian ringgit, should continue to perform well. As well as competition from Japanese companies, Korea will likely suffer from portfolio re-allocations to Japan. Malaysia meanwhile should benefit from a pick-up in bond and equity inflows after the recent election. As for CNY, at annualized appreciation pace of 12%, we are concerned. The state of the economy does not justify that, and measures to clamp down on speculative inflows should reduce the appreciation pressure. Moreover, a band-widening should, if anything, lead to CNY weakness. We like to sell CNY via options.

### Rest of EM

Of the remaining currencies, we find the Brazilian real attractive thanks to its carry and policy support for a range in the currency. We go tactically neutral on the Mexican peso. Big picture the currency looks attractive, but positioning is crowded. In EMEA, we look for additional strength in the Israeli shekel after its recent sell-off on the back of a strong economy. We remain negative on the Hungarian forint and South African rand, and positive on the Turkish lira. We enter option-based trades to express those views.

### How We Did

Turning to how our trades performed from January's blueprint, it is clear that our weaker yen and stronger euro calls were key factors behind our overall return of +3.8%. Carry trades also performed well. Our biggest winner was long USD/JPY (up 17%) while our biggest loser was short a 1 year USD/PHP NDF (-1.5%). The trades made 3.8% on average with a hit ratio of 78%.<sup>1</sup>

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<sup>1</sup> Past performance is not indicative of future performance.