



Theme #1: Hoiler for dollars

- We expect the Fed and a recovery in US equity inflows to be the two main pillars of support for the dollar in 2014. Buy USD vs. NZD, CHF and SGD on cycle and extreme valuation.
- The Euro-area current account remains supportive for the euro, but tight liquidity is fully priced, the risk of negative rates is material, portfolio inflows are peaking and we are reaching the 20% FX over-valuation bound. Buy 12m EUR/USD 1.40/1.31 risk reversals for zero cost.

Don't Rely on Fed Dovishness

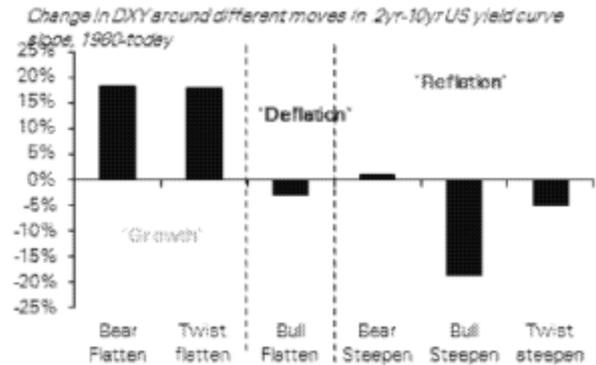
Last year was all about pricing out QE, even though tapering is just beginning. The overwhelming message is that the market front-runs major events, and that the timing of re-pricings is very unpredictable. Just as 2013 was about QE unwinds and higher long-end yields, we think this year will be about the re-pricing of "low for long" and higher short-end yields.

First, US short-end expectations are exceptionally benign. The market is not pricing the first rate hike until Q3 2015, just in line with FOMC projections, and by which time a simple linear extrapolation of the US unemployment rate takes us well below 6%. Second, the US yield curve is close to all-time steepness extremes. On the one hand, this means that the risks are skewed towards flattening, historically one of the most supportive yield curve environments (chart 1). On the other hand, the forwards are extremely high, suggesting that even if these are realized, the US dollar will climb up the carry ladder and drop-out of the bottom-3 yield ranking by year-end.

Foreigners to Come Late to the Party

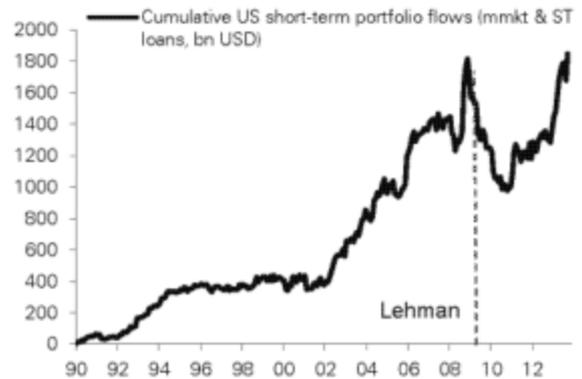
The second building block to our bullish USD view is our positive outlook on growth and by extension US equity inflows. 2013 stood out for large dollar cash accumulation, on the back of UST liquidation and an adjustment of USD hedge ratios (chart 2). The year has also stood out for record outflows from US equities as Americans have invested large amounts offshore and foreigners have refused to engage in the S&P 500 rally. But looking at relative valuations, outflows have overshoot what is a relatively benign valuation picture for US stocks. Using the average P/E ratio of Hong Kong and UK stocks as a global proxy, we find that valuations are close to the medium-term average (chart 3). The odds therefore seem skewed towards higher equity inflows into the US, which combined with a flatter US curve should see an improvement in portfolio flows that was lagging this year.

Curve Flattening Very Bullish USD



Source: Deutsche Bank, IMF

UST Selling Last Year Offset By Cash and Hedging



Source: Deutsche Bank, Bloomberg Finance LP, Datastream

Equity Valuations Not Extreme, Inflows Should Recover



Source: Deutsche Bank, Bloomberg Finance LP, \*we proxy world by the FTSE and Hang Seng