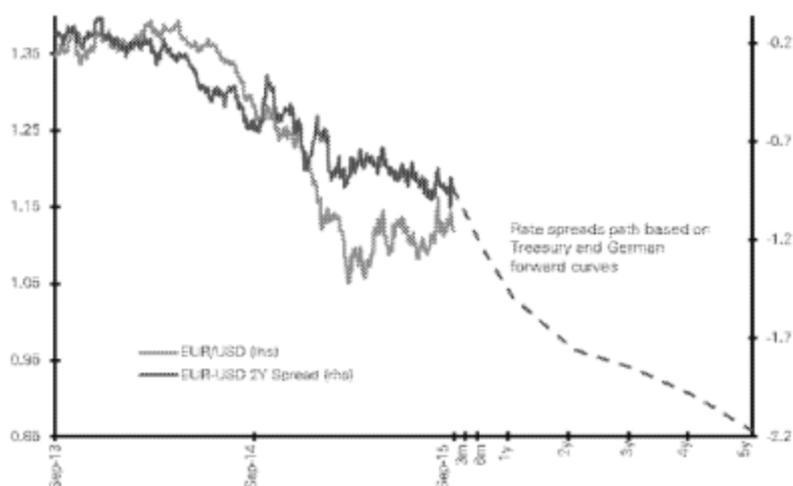




In Table 1 above we outline a framework for thinking about the USD, and the differentiation between different states of risk appetite. It is the different potential policy responses to risk appetite that have confused the picture on the majors recently.

State 1: This state is risk neutral/positive. The working assumption for much of the year was that the risk environment would not derail a Fed tightening cycle. In State 1, the data and risk appetite is constructive enough to allow for Fed tightening, while other G3 Central Banks are on hold. EUR/USD is then assumed to very roughly conform to the past response of going down ~10 big figures for every 100bp move in the 2yr USD – EUR spread. The forward curve is pricing in close to 100bps of additional spread adjustment in favor of the USD over the next 2 years, and the spread adjustment will likely go well beyond that once/if the Fed tightening cycle finally starts.

Figure 1: EUR/USD vs. EUR-USD 2Y yield spread - and what forward curves imply for the spread in the next 5 years



Source: Deutsche Bank, Datastream

State 2 has been the environment we have largely been operating in for the last few months. Here risk related to market volatility is such that it delays the Fed, but is not sufficient to get the ECB and BoJ to add to their respective QE programs. In this instance EUR/USD tracks essentially sideways in the recent 1.08 to 1.15 range. Wide daily ranges prevail, but longer-term weekly/monthly ranges for G4 currency pairs prove relatively narrow. State 2 is when the EUR is negatively correlated with risky assets (like equities), but this will not last a shift into State 1 or State 3. In contrast, Commodity and EM underperform all G4 majors, and display elevated volatility.

State 3 is when risk is consistently negative - enough that not only does it keep the Fed steady but it propels the ECB and BOJ into action with more QE accommodation. In this case EUR/USD tests the cycle low and probably extends to parity. Risk trades mostly negative, except immediately after the policy response. Note State 3 and State 2 may initially be difficult to separate. In State 3, the EUR is now hurt when risk is negative.

State 4 is if Risk Appetite turns exceedingly negative to the point where the Fed is driven to ease, quite possibly with QE4 and/or negative interest rates. The BOJ and ECB also ease. The probability of entering this state is still a low delta. This resembles aspects of 2008, where the USD initially does very well in the 'risk off' phase, then weakens sharply with the Fed policy response, especially if it includes negative rates. EM FX does the reverse of the USD. EUR/USD goes to parity then back up above 1.20, and FX vol for both G10 and EM goes crazy!