FX Strategy: Plenty of run left in the USD upswing

- The multi-year strong USD cycle should extend for at least another two years, with a further 10% appreciation in the real broad USD TWI.
- 2016 year-end forecasts are largely unchanged, with EUR/USD, USD/JPY and GBP/USD seen at 0.90, 128 and 1.27 respectively. We anticipate extremes in the likes of AUD/USD, NZD/USD and USD/CAD at 0.62, 0.53 and 1.40 respectively.
- In macro terms, how 2016 shapes up will be heavily influenced by whether the main macro driver is the Fed or China. If the Fed is the driver, USD gains are seen as likely to be slow and broad-based, spread fairly evenly between G4, commodity FX and EM FX. If on the other hand, China, particularly China FX policy, becomes a source of instability, USD gains will likely be heavily concentrated in commodity and EM FX, while the G4 majors all outperform.

The USD continues to conform to the multi-year cycle big USD cycles of the past. Since the fall of Bretton Woods, big USD down cycles of 9-10 years have been followed by big USD upswings of 6-7 years. While all cycles are different, the macro backdrop conforms to a view that we are about 2/3rds the way through the big USD up cycle, with the real broad index some 50 months into an upswing. In the same vein, the real Broad TWI has in past cycles largely retraced any prior cycle losses, and increased by 53% and 33% in the 1978 - 1985 and 1995 – 2002 upswings respectively. In the last downswing the USD real broad TWI fell by 28%. We expect that the USD will at a minimum fully retrace these losses, fitting with further real broad TWI gains in the order of 10%. In magnitude terms we are then also likely to be a little over 2/3rds the way through the USD cycle, with USD gains henceforth likely to come at a slightly slower pace.

The main departure in this cycle relative to past cycles is that the USD gains before the Fed starts hiking rates have been substantially larger than anything we have seen in any fed hiking cycle. This front-loading of USD gains fits with more modest USD gains to come.

It would however be premature to think that we are close to a USD top. This cycle is also likely to be unique in a couple of respects that are very positive for the USD:

(1) In this cycle, at least for the coming year the Fed, and perhaps the BOE are the only G10 Central Banks that are likely to tighten. This is in contrast to most Fed tightening cycles, when many G10 Central Banks are typically tightening. In the last Fed tightening cycle, all G10 Central Banks tightened.

(ii) In addition, in this cycle many Central Banks are still leaning toward further accommodation, including not least in encouraging their own currency weakness. The US is one of the few countries willing to tolerate currency strength.

iii) Some of the most important rate spreads for currencies, notably the 2yr US Treasury - Bund yield spread are seen moving in favor of the USD for the next 5 years, if the respective forward curves prove correct. We expect that some of the likely rate spread adjustment will also end up being front-loaded into the next two years.

Figure 1: USD real BROAD TWI performance during USD upward cycles

Cycle	Upswing gain (%)	Prior cycle loss (%)	Months of upswing	Average gain per month
78-85	52.7	-21.8	78.0	0.7
95-2002	33.1	-34.0	83.0	0.4
2011	20.9	-28.2	50.0	0.4

Source: Datastream, Deutsche Bank Research

Figure 2: FX forecasts

	Q1-16F	Q2-16F	Q4-16F	2015F	2016F	2017F
EUR/USD	1.01	0.97	0.90	1.05	0.90	0.85
USD/JPY	127	128	128	125	128	120
GBP/USD	1.42	1.37	1.27	1.47	1.27	1.15

Source: Datastream, Deutsche Bank Research

Figure 3: EUR/USD performance months prior start of FED hike cycle

	t-24	t-12	t-6	t-3
Median	-5%	-2%	1%	-1%
Latest	-22%	-15%	-4%	-6%

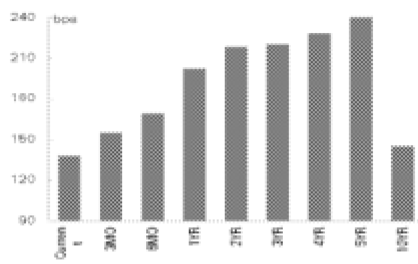
Source: Datastream, Deutsche Bank Research

Figure 4: G10 rate hike cycles

	Nov 78-May 81	Nov 82-Aug 84	Aug 86-May 89	Sep 93-Feb 95	Nov 98-May 00	Jun 03-Jun 06	2016
JPN	yes	no	yes	no	no	yes	No, + easing
EU*	yes	yes	yes	no	yes	yes	No, + easing
CAN	yes	yes	yes	yes	yes	yes	No
GBR	yes	yes	yes	yes	no	yes	Maybe yes
CHE	yes	no	yes	no	yes	yes	No
AUD	yes	yes	yes	yes	yes	yes	No
NZL**	N/A	N/A	N/A	yes	yes	yes	No, + easing
SWE	yes	yes	yes	yes	yes	yes	No
NOR	yes	yes	yes	no	yes	yes	No, + easing
Total	8	6	8	5	7	9	1

Bundesbank until 1992,ECB onwards.data available from 1988 onwards Source: Deutsche Bank Research, Datastream*

Figure 5: 2y US-German spread forward curve



Source: Datastream, Deutsche Bank Research