



Overview

Forever young FX market

This year's Blueprint title is not intended to argue against the grimness with which risk assets have started 2016. Instead, it is an expression of confidence in a trend that has proved remarkably resilient since the end of the financial crisis: the ongoing strength of the dollar. Albeit maturing and far from young, we still believe there's vigor left to the dollar in 2016. There are plenty of fresher themes in this year's Blueprint too. First, we see scope for more weakness in those currencies that have lagged the dollar upcycle. This makes us particularly bearish on GBP but less so on the JPY. Second, we have a particularly negative bias on Asia. Not only have the region's currencies lagged overall dollar appreciation, but internal vulnerabilities are high and rising. China's currency adjustment has much more to go. Third, we have a lesser focus on RV and intra-regional opportunities compared to last year. In a world of high volatility and low liquidity, we mostly stick with big picture macro drivers in FX: a market that remains "forever young" in both its themes and trading opportunities for 2016!

Euro to break parity

We remain euro bears and target a move down to 95cents by the end of this year. The key difference from last year is that the dollar will have to do more legwork. This is why we also like buying the trade-weighted dollar. The USD should be helped by its move into the ranks of a high-yielding currency by year-end, large-scale repatriation of American capital, and the record run of negative US data surprises that poses upside risks versus expectations. Europe can't be forgotten either, however. There remain persistent risks of additional easing from the ECB, but we show that even a potential (hawkish) repricing of ECB QE expectations later in the year will not matter that much for EUR/USD compared to the Fed.

It's not over for the Renminbi

We believe yuan weakness will continue over 2016. Further unwinds of carry trades, FX liability hedging due to poor fundamentals and higher credit risk, and higher tolerance for currency depreciation by Chinese authorities should all help. More broadly, Asia stands out among EM FX as the region which has the most to adjust from post financial crisis imbalances. Output gaps, domestic indebtedness and demographics are all likely to be exposed to widening rate differentials versus the US in 2016. We expect persistent currency weakness in CNH, KRW, THB and TWD.

We're not turning bullish JPY yet

Consensus is becoming bullish on the yen, but we think it's too early. The BoJ is unlikely to tolerate additional FX strength, while Japan Inc's support for

USD/JPY is also likely to stay strong. The balance of payments doesn't point to JPY strength either. The current account has been improving, but this has been more than offset by persistent FDI and portfolio outflows. We thus like buying USD/JPY.

Watch out Britannia

The UK will undergo the largest fiscal tightening of any major economy this year. Add to that a stretched current account deficit and likely referendum on the country's future in the EU, and a big fall may be on the cards. We stick with our bearish GBP/USD recommendation entered into at the start of November. By contrast, long-awaited Swedish krona strength should materialize this year. Near-term, though, the Riksbank will be reluctant to tolerate more appreciation given wage negotiations in the first quarter. We couple a medium term short GBP/SEK trade with a tactical recommendation to buy a 3m EUR/SEK risk reversal. We also like re-entering CHF shorts against euro and yen based on renewed outflows and light positioning.

Diverging commodities bloc

AUD and NZD have little to cheer about this year. China FX weakness impacts both disproportionately given their trade-weights, but it also supports domestic commodity production in China by pushing commodity breakeven prices lower. Combined with challenging balance of payments dynamics and FX that has lagged the overall rally in the dollar we are bearish on both the Antipodes. We are less negative on CAD given the magnitude of the adjustment and closer ties to the US business cycle and would buy against NOK.

Rest of EM FX

In the rest of EM we retain our long-standing bearishness in ZAR as there are few signs of the required external adjustments and SA remains particularly exposed to China. We see scope for PLN outperformance versus HUF given divergent growth and monetary policy and are also bearish ILS. In LatAm we like to buy MXN/COP on fundamental divergence, greater Banxico FX tolerance and undervaluation versus oil. We also like buying PEN/CLP and argue that EUR/EM volatility is underpriced.

Last year's Blueprint trades

Our three FX Blueprints generated a combined return of 4.2% last year with a hit rate of 55%. The best-performing trade from the September Blueprint was long USD/ZAR (+14%) and the worst-performing was long AUD/NZD (-5%). See detailed returns on p. 31. On to 2016!

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