26 May 2016

Moves overdone

Georgette Boele
Co-ordinator FX & Precious Metals Strategy
Tel: +31 20 629 7789
georgette.boele@nl.abnamro.com

Roy Teo
Senior FX Strategist
Tel: +65 6597 8616
roy.teo@sg.abnamro.com

- **US dollar rally to be temporary…**
- **…as well as the strengthening of sterling**
- **Firmer oil prices support currencies of oil exporting countries**
- **Weaker iron ore prices weigh on AUD; RBNZ to pause in June?**
- **Resilient Japanese yen and Chinese yuan**

Dollar has recovered since the end of April …

The US dollar weakened by around 8.5% from February 2016 up to the end of April 2016. It will not come as a surprise that commodity prices and emerging market currencies rallied strongly during this period. However, since the end of April, the dollar has been on a recovery path (+3%) and emerging market currencies and commodity prices (especially metals) have fallen considerably. Precious metal prices have retraced by 4 to 12%. However, oil prices have remained resilient. The upward adjustment in Fed interest rate expectations since 12 May and better-than-expected US data have played crucial roles in this market behaviour.

Long term dollar trend

Calculated effective exchange rate US

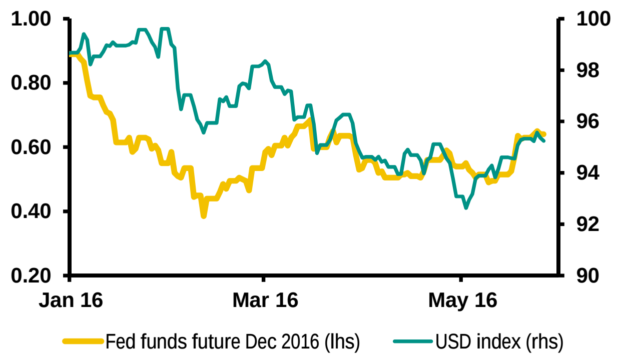
Source: Bloomberg, Bank of England

… but this is expected to be a temporary recovery

Is this a re-start of the US dollar rally? In short, no. We see this movement mainly as a short-term US dollar recovery. We continue to hold the view that the multi-year dollar uptrend is over and has turned negative. Short-term waves of strengthening do not change this overall outlook as long as the US dollar does not break above the 200-days moving average. In addition, if the Fed were to hike rates this year (not our base case), it will be gradual. A 25bp rate hike by the Fed this year is now roughly priced in by financial markets. In addition, US real yields (taking into account inflation expectations) will likely decline. This will weigh on the dollar. So, the near-term upside in the US dollar is limited in our view. What would change the overall US dollar picture is aggressive Fed rate hikes responding to a strong economy. We think this is unlikely. US data to focus on ahead of the 14-15 June FOMC meeting are: US GDP, core PCE inflation and the employment report.

Rate hike expectations and the dollar

Fed funds expectations Dec 2016, in % USD index



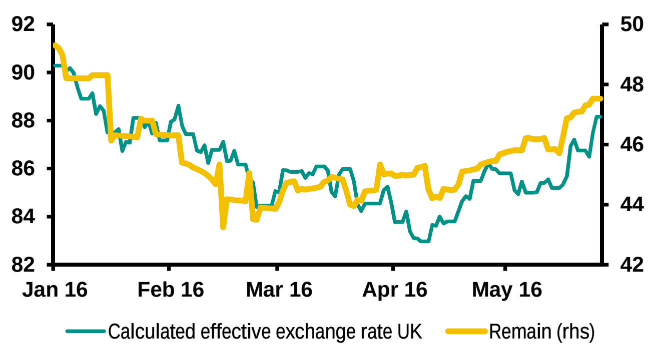
Source: Bloomberg

GBP continued to rally

Since 26 February, sterling has been on an impressive recovery path, rallying by 6% against a wide basket of currencies. This is somewhat surprising as the UK Brexit referendum (to be held on 23 June) draws closer and the media attention is fully on this topic. The main reason for sterling's impressive rise is the perceived lower probability of a Brexit. As the graph below shows, sterling tracks closely the polling average for remaining in the EU. Our base case is for no Brexit. However, financial markets could underestimate this probability of a Brexit. Ahead of the referendum, we expect uncertainty to increase and sterling to come under pressure before rallying again if the referendum outcome is for no Brexit.

Rate hike expectations and the dollar

Calculated effective exchange rate UK Polling average



Source: Bloomberg, Bank of England

Firmer oil prices support currencies of oil exporting countries

Firmer oil prices have supported currencies of oil exporting countries like the Norwegian krone, Canadian dollar (CAD) and Russian ruble. As expected, the Bank of Canada (BoC) left monetary policy rates unchanged earlier this week. We expect monetary policy to also remain unchanged this year. It is likely that rising household vulnerabilities will be addressed by more macro prudential tools. The price action in USD/CAD is showing some encouraging signs that a top just below 1.32 has formed. We expect the Canadian dollar to strengthen versus the US dollar towards 1.28 in the coming weeks.

Weaker iron ore prices weigh on the AUD; RBNZ to pause in June?

Weaker iron ore prices and capital expenditure in the first quarter of this year weighed on the Australian dollar (AUD). Nevertheless, businesses' intention to invest in the current fiscal year rose, though at lower levels than the previous year. We maintain our view that the Reserve Bank of Australia (RBA) is likely to lower the Official Cash Rate (OCR) by 25bp in August. This is almost fully priced in by financial markets. Technical indicators imply that the AUD is in near oversold territory and hence may find some support above 0.71 in the coming week. Separately, the New Zealand dollar (NZD) declined to 0.67 versus the US dollar as the dollar firmed. As the NZD trade weighted index is edging lower, the risk of a 25bp rate cut in June has receded. Indeed, the Reserve Bank of New Zealand (RBNZ) may decide to pause next month as they assess developments surrounding the timing of a rate hike by the Fed and the UK referendum before resuming its easing cycle in August.

Resilient Japanese yen and Chinese yuan

The Japanese yen traded in the range of 109.00 and 110.50 in the past week as rising Fed rate hike expectations supported the dollar. Meanwhile, there are some signs of higher hedging flows from Japanese investors supporting the yen. Ahead of the FOMC meeting next month, we think that any yen strength is likely to be capped around 109 with weakness limited towards 112.

Separately, the large deviations in the Chinese yuan fixing in the past week have re-ignited market concerns that Chinese policy makers are shifting away from a market based exchange rate regime. In our view, the long term objective to let the yuan be more market determined has remained unchanged. However, in practice the authorities take a gradual approach, turning to stability-oriented measures in volatile times. Those measures may be suited to address speculative forces, as financial markets start to anticipate that the Fed may tighten monetary policy sooner than later. Indeed, historically, a stronger USD has resulted in larger capital outflows from China. Nevertheless, market bets that China policy makers will not be able to handle volatility and depreciation pressure in the yuan has receded recently. We expect the yuan to decline only moderately to 6.70 against the USD this year.

ABN AMRO major currency forecasts

	26-May	Q2 2016	Q3 2016	Q4 2016	Q1 2017	Q2 2017	Q3 2017	Q4 2017
EUR/USD	1.1189	1.15	1.15	1.15	1.15	1.15	1.15	1.15
USD/JPY	109.96	105	110	110	110	110	108	105
EUR/JPY	123.03	121	127	127	127	127	124	121
GBP/USD	1.4708	1.40	1.42	1.48	1.50	1.52	1.54	1.56
EUR/GBP	0.7607	0.82	0.81	0.78	0.77	0.76	0.75	0.74
USD/CHF	0.9904	0.96	0.96	0.96	0.97	0.97	0.98	0.99
EUR/CHF	1.1082	1.10	1.10	1.10	1.11	1.12	1.13	1.14
AUD/USD	0.7228	0.73	0.72	0.74	0.75	0.75	0.75	0.75
NZD/USD	0.6745	0.68	0.68	0.68	0.69	0.70	0.71	0.72
USD/CAD	1.2936	1.25	1.22	1.20	1.18	1.17	1.16	1.15
EUR/CAD	1.4475	1.44	1.40	1.38	1.36	1.35	1.33	1.32
USD/SEK	8.3023	8.04	8.04	8.04	8.04	7.83	7.83	7.61
EUR/SEK	9.2893	9.25	9.25	9.25	9.25	9.00	9.00	8.75
EUR/NOK	9.2635	9.25	9.00	8.75	8.50	8.50	8.25	8.25
EUR/DKK	7.4366	7.46	7.46	7.46	7.46	7.46	7.46	7.46

Source: ABN AMRO Group Economics

ABN AMRO emerging market currency forecasts

	26-May	Q2 2016	Q3 2016	Q4 2016	Q1 2017	Q2 2017	Q3 2017	Q4 2017
USD/CNY (onshore)	6.56	6.55	6.60	6.70	6.75	6.80	6.80	6.80
USD/CNH (offshore)	6.56	6.55	6.60	6.70	6.75	6.80	6.80	6.80
USD/INR	67.2	66.5	67.0	67.0	67.0	66.0	65.5	65.0
USD/KRW	1,180	1,165	1,165	1,165	1,150	1,140	1,130	1,120
USD/SGD	1.38	1.36	1.38	1.40	1.38	1.36	1.35	1.35
USD/THB	35.61	35.00	35.00	35.00	34.80	34.60	34.40	34.00
USD/TWD	32.40	32.50	32.80	33.00	32.80	32.50	32.20	32.00
USD/IDR	13,585	13,200	13,400	13,500	13,400	13,300	13,200	13,000
USD/RUB	65	66	64	60	59	58	57	55
USD/TRY	2.93	2.85	2.80	2.75	2.75	2.75	2.75	2.75
USD/ZAR	15.53	15.00	14.75	14.50	14.25	14.00	13.75	13.50
EUR/PLN	4.40	4.40	4.40	4.35	4.30	4.25	4.20	4.20
EUR/CZK	27.02	27.00	27.00	27.00	27.00	27.00	26.50	26.00
EUR/HUF	314	310	310	305	300	300	295	290
USD/BRL	3.58	3.60	3.55	3.50	3.45	3.40	3.35	3.30
USD/MXN	18.39	17.25	17.00	16.75	16.50	15.75	15.50	15.25
USD/CLP	691	670	660	650	640	630	620	600

Source: ABN AMRO Group Economics

Find out more about Group Economics at: **https://insights.abnamro.nl/en/**

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ABN AMRO Bank
Gustav Mahlerlaan 10 (visiting address)
P.O. Box 283
1000 EA Amsterdam
The Netherlands

ABN·AMRO