Global Macro Strategy
2018 Global FX Outlook

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Global

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Where does G10 FX fit into our 2018 Outlook?

In our 2018 markets outlook we identify assets across the macro landscape that, in our view, will benefit most from a backdrop of solid growth, low but gently rising core inflation, and easy financial conditions that allows room for policymakers to normalize policy further in 2018 without accident. We expect the **USD** to weaken further against the **EUR**. What matters for the **USD** is not the timing of the next hike. It is about how far the Fed is likely to tighten over the cycle; and the market already expects a fair amount. The **EUR** remains cheap. Strong growth should catalyse appreciation. The **USD** should strengthen against currencies where central banks are likely to disappoint expectations (**CAD**) or allow policy to run loose (**JPY**). Risk-sensitive **Scandies**, **AUD**, and **NZD** look cheap, while **CHF** may weaken.

Strong growth to catalyse EUR appreciation

EUR yields remain too low given solid Eurozone growth momentum, which is likely to extend. As a result the ECB is likely to have increasing space to normalise monetary policy, boosting **EUR** yields higher. A steeper EUR curve vs persistent US curve flatness is likely to support **EUR/USD** convergence to its long-term fair value. Additionally, broader European growth and increased political stability favour further upside in **EUR/CHF** as periphery assets recover further and 'safe-haven' inflows reverse course.

Gauging the Fed 'read-across' to express targeted USD strength

We expect the **USD** to perform well vs **CAD** and **JPY** in 2018. The Canadian inflation outlook remains soft, as headwinds from recent **CAD** strength are likely to persist until H1-2018, and this should lead to further **CAD** weakness, in our view. PM Abe's super-majority bolsters the chances that the BoJ maintains its accommodative stance. This suggests higher **USD/JPY** in 2018. As inflation rises, the yield curve target will likely be adjusted upwards, stabilizing the **yen** and ultimately leading it stronger.

Some risk-sensitive currencies are more attractive than others…

In a solid growth and low but gently rising core inflation global environment, we expect risk-sensitive **AUD**, **SEK**, and **NOK** to outperform. **AUD** should continue to find support amid resilient Chinese activity, supportive global financial conditions, and positive risk sentiment for carry. We also maintain our constructive **Scandie** view, as a solid macro backdrop that benefits further from the European recovery should support gradual appreciation of **SEK** and **NOK** through 2018.

…as NZD and GBP wrestle political uncertainty

We moderate our bullish **NZD** view slightly despite kiwi screening as undervalued and its historically positive exposure to broad global growth. This is because policy uncertainty following the recent election may linger, and limit some of the **NZD** upside. Our bearish **GBP** view remains intact as a decelerating economy compounds uncertainty around Brexit negotiations. The BoE's hawkish shift does not change our **sterling** views as it is taking place against the backdrop of weaker rather than stronger macro fundamentals.

EM FX: Selective carry opportunities even as tailwinds wane

Despite an improving macro backdrop, EM currencies failed to appreciate in TWI terms in 2017. In 2018, a slower trajectory for global trade growth and commodity prices, and continued pressure from US front yields should drive more differentiation but keep EM currencies restrained on aggregate. We expect 2-2.5pc **EM NEER** depreciation and a flat **USD/EM** on aggregate even as **EUR** rises further. Volatility should remain in check with no major threats from China's slowdown or US duration.

G10 FX Outlook

UBS Research THESIS MAP

PIVOTAL QUESTIONS

Q: Will the USD enter a new bullish trend as the Fed continues to normalise policy?
We don't think so. We expect the USD to decline vs the EUR next year as the Eurozone and US cycles re-converge. We expect a more dispersed performance for the dollar against the rest of G10. This year offers evidence that Fed hikes against a backdrop of low inflation and flatter curves cannot provide a sustainable boost to the dollar. In contrast, EUR/USD remains cheap on long-term valuation metrics while ECB normalisation should provide further support. Across the rest of the G10, we remain selective, trading USD strength against the obvious policy laggards (JPY) and where markets have priced substantial tightening against weak inflation dynamics (CAD). We also like AUD, as it continues to benefit from the favourable mix of solid global growth and low rates/inflation.

Q: Which G10 currencies are most exposed to political risk?
Sterling and, more recently, NZD. Brexit negotiations remain inconclusive, with risks to sterling still skewed to the downside due to the UK's vulnerable external position. We remain bearish the pound. In New Zealand, proposed policy changes by the new Labour-led government as regards the RBNZ's mandate and immigration are likely to cap NZD upside until further clarity or other policy offsets emerge. Lastly, Italian elections (most likely) in Q1 2018 are the last significant risk event in the Eurozone during the current electoral cycle; nonetheless, the odds for substantial policy disruption remain fairly low, in our view. A relatively uneventful result should allow a quick convergence of EUR/CHF closer to fair value owing to 'safe-haven' outflows from Switzerland.

Q: Is FX still an important driver for inflation?
Yes, particularly for small open economies, such as Canada and the Scandies. In an environment of limited responsiveness of inflation to improvements in activity (flat Philips curves), currency effects have become significant drivers for inflation trends. We have developed a framework that allows us to identify key inflection points for currencies on the basis of shifting inflation (and thus policy) dynamics as a result of past currency effects. Accordingly, our bullish NOK view is predicated on the expectation that inflation has bottomed as past currency headwinds are gradually fading. Conversely, we are bearish CAD despite the BoC's hawkish shift given weak inflation dynamics and peak growth momentum. Sweden has also been dependent on SEK to boost its inflation outlook for a while. More recently, however, we are beginning to see signs of a Phillips curve revival, which underpins our bullish SEK view as policy gradually turns less defensive.

UBS VIEW

Dollar dispersion to extend; bullish EUR, Scandies, AUD, less so NZD; bearish JPY, CHF, GBP. In an environment of solid growth and low inflation, we are bullish carry currencies such as AUD and bearish the policy laggards (JPY and CHF). A strong European recovery and prospects for central bank normalisation should benefit EUR and the Scandies. We remain bearish sterling due to Brexit risks and BoP vulnerabilities, and CAD due to its weak inflation outlook.

EVIDENCE

Persistently strong growth and low inflation regime to extend; valuations reveal opportunities. An extended period of solid growth and low inflation should continue to benefit carry currencies. Our current-account based valuation framework screens GBD, CAD and CHF as expensive and EUR, SEK and the Antipodeans as cheap, thereby anchoring our directional views.

G10 FX FORECASTS

	Spot*	End-2018	End-2019
EURUSD	1.17	1.25	1.30
USDJPY	113	122 (118)	113
EURJPY	132	153 (148)	147
GBPUSD	1.32	1.32 (1.29)	1.30
EURGBP	0.89	0.95 (0.97)	1.00
EURCHF	1.17	1.22 (1.20)	1.28
USDCHF	0.99	0.98 (0.96)	0.98
EURSEK	9.95	9.20 (8.90)	8.90
EURNOK	9.73	9.10 (8.8)	8.80
AUDUSD	0.75	0.81 (0.83)	0.84
NZDUSD	0.68	0.73 (0.76)	0.74
USDCAD	1.28	1.33 (1.34)	1.36
Dollar (DXY)	94.1	91.5 (91.2)	88.2

Source: Bloomberg, UBS
**Around time of publication*

Unlocking value in G10 FX

G10 FX proved tricky in 2017, as the resumption of the Fed's hiking cycle failed to translate to broad dollar strength. That further Fed hikes would not necessarily lead to dollar strength, however, has been one of our longest-held views.

It is not about the timing of Fed hikes; the overall Fed hiking path for this cycle is well reflected in the US curve

What matters for the dollar in the medium term is not the timing of the next Fed hike, but the overall assessment of the Fed's room to tighten throughout the cycle. With the long end of the US curve in-line with the Fed's terminal rate, there is less room for the market to push overall US yields much higher and boost the dollar.

Look at the 'read-across' to other central banks and valuations as a means to unlock value in G10 FX

With the Fed well-priced, to unlock value in G10 FX we focus on: a) which currencies tend to perform well in the current global backdrop; b) which central banks may be mispriced by markets; c) tradeable feedback loops between inflation and FX, particularly in small open economies; and d) FX valuation frameworks to identify longer-term anchors of value.

What does long-term valuation tell us?

Key signals from our FEER model; the EUR looks cheap…

We employ our recently developed FEER-based model, which is based on the analysis of G10 current account dynamics, as an anchor with which to gauge longer-term directionality (Figure 1). On a current account basis, the EUR looks cheap. The dollar does not look particularly expensive, but such a broad signal hides significant regional divergences. From an external balance perspective:

…but sterling, CAD and CHF are expensive

1. We believe GBP remains expensive. Rebalancing dynamics ahead of Brexit risks skew GBP risks largely to the downside, as we will discuss in detail below.

2. Recent CAD strength reflects short-term growth dynamics that are likely to fade next year, against a background of low inflation and deteriorating competitiveness.

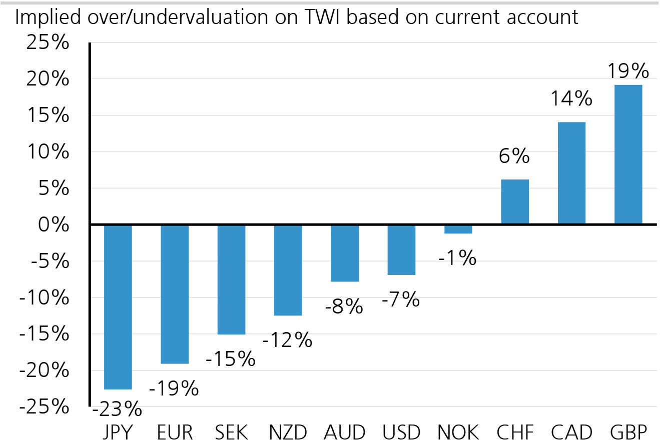
3. Against common wisdom, we think CHF is overvalued, as the true underlying external position for Switzerland is less solid than headline numbers imply.

Risk currencies are cheap (each for different reasons)…

4. Risk currencies such as SEK, NOK, AUD and NZD are cheap due to cyclical and other idiosyncrasies. The broad improvement in growth and sentiment should continue to help these currencies recover against their anchors (EUR and/or USD).

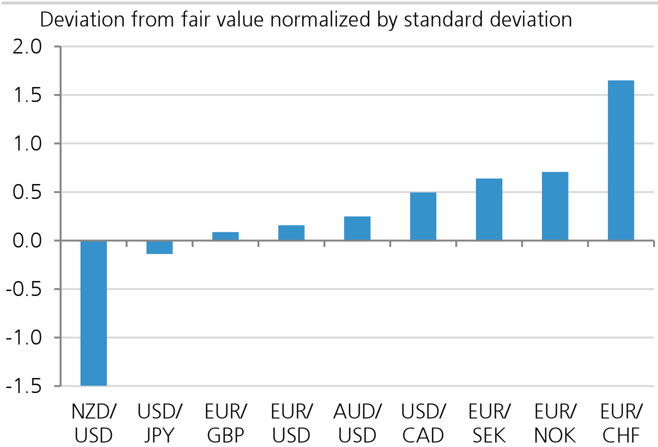
Note: This piece is an excerpt of the FX sections from our recent Global Outlook reports. See 2018 Markets Outlook: Is there room to grow and normalize? and EM Outlook 2018: Underneath the 'stable' headline.

Figure 1: UBS Long-Term FX Fair Value Framework based on current account dynamics



Source: Haver, UBS estimates

Figure 2: UBS Short-Term FX Fair Value Framework based on market variables



Source: Bloomberg, UBS estimates

5. We would disregard the signal on JPY valuation for the time being, as it is a currency driven by Japanese policy design. Until inflation firms significantly, the policy set up is unlikely to change.

...but the signal for the JPY is weak

What does short-term fair value tell us?

Empirically, we know that FX markets can diverge materially from fundamental drivers over the short-term. To help us gauge what the market truly prices and identify opportunities also on a tactical basis, we recently introduced an error correction model for G10 currencies that utilizes market variables to help explain and forecast short-term moves versus fundamental drivers (Figure 2). The model suggests that the recent correction in the EUR has brought it back to more actionable levels, following a period of brief stretch in over-optimism.

Key signals from our short-term model: EUR back to more normal levels (except vs CHF), risk currencies attractive

Ahead of the Italian elections (likely in Q1), the short-term signal suggests investors may need to wait for better levels to action EUR/CHF longs. In contrast, most risk currencies, NZD in particular, look attractive from a short-term perspective.

Further upside for EUR in 2018

Consistent with our views, the broad rebound in global growth in 2017 left the dollar weaker against much of the G10. Going forward, as the global recovery explores its "*room to grow*", the dollar should continue to depreciate and **we expect EUR/USD to reach 1.25 by end-18**.

There is more room for dollar weakness, particularly vs EUR

First, the US recovery no longer stands out compared to the recovery in the rest of the world. In fact, our forecasts envision another year of European growth closely tracking US growth and our earlier analysis identifies Europe as the place where the room to grow is more ample.

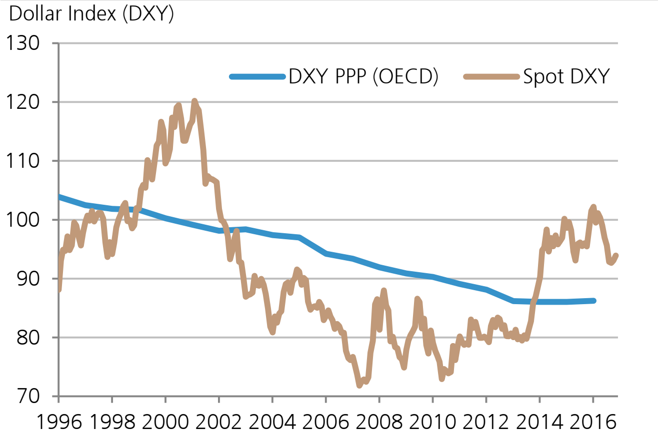
Macro convergence is set to extend...

Second, we think the hang-over from the "decoupling" years has left the dollar expensive on a number of metrics:

...the dollar is expensive on a number of metrics...

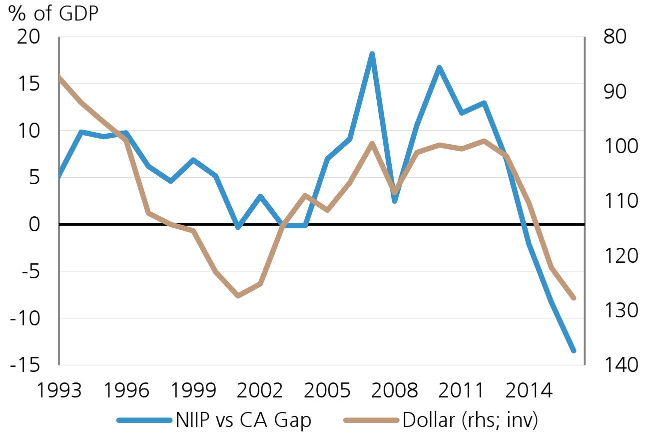
1. On a PPP basis, the dollar is still 10-15% too high (Figure 3);
2. Foreign holdings of US assets (a liability for the US) have appreciated disproportionally relative to the depreciating value in (and income from) US-held assets abroad. This has led to the biggest deterioration in the US net international asset position vis a vis where it should be based on the accumulation of current account deficits.

Figure 3: Dollar still looks expensive on a PPP basis



Source: OCED, Haver, Bloomberg, UBS

Figure 4: Dollar strength has led to a wide NIIP-C/A gap



Source: Haver , UBS

As Figure 4 shows, the past strength of the dollar is chiefly responsible for this. And vice versa, the easiest remedy to this brewing disequilibrium is a weaker USD.

...and Fed hikes have become a secondary factor

Third, upcoming hikes by the Fed, one of the last key anchors to dollar-bullish narratives, are likely to have diminishing and short-lived implications for the USD. During 2017, front-end US rates increased significantly. Yet, the curve flattened and the dollar weakened (Figure 5).

With the long end of the US curve (long-term forward rates) now in-line with the Fed's terminal rate, the market is already pricing a full cycle over the next 5+ years, even as it currently underestimates how quickly the Fed can raise rates over the next two years. Hence earlier hikes only lead to a flatter curve.

Importantly, this is not the case outside of the US and especially in Europe, where markets have space to further reflect the prospect of policy normalization. Indeed, European yields remain well below fair value (also see the rates section below), as ECB policy has prevented them from matching relative improvements in the labour market vs the US (Figure 6). Further normalisation in EUR yields as monetary policy normalises should aid the convergence of EUR/USD towards fair value.

The dollar has room to strengthen versus the CAD and JPY

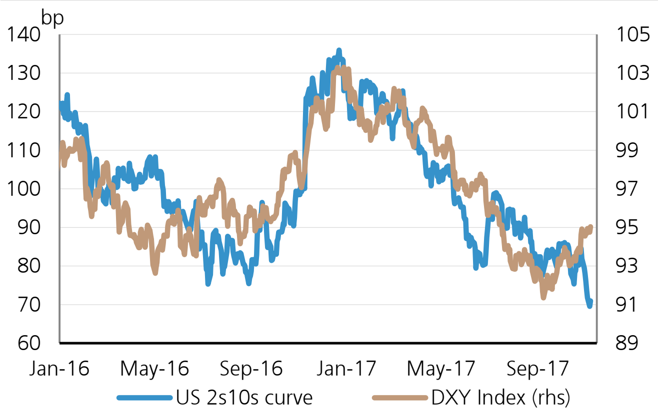
Gauging the Fed 'read-across'

The mirror argument of the above is that the dollar may have room to strengthen against currencies where the central bank is either too hawkishly priced (CAD) or is likely to stay put amid rising inflation and growth (JPY).

For **JPY**, the re-election of PM Abe with a super-majority ensures maximum policy continuity and should bolster support for the BoJ's current leadership and accommodative policies. As a result, BoJ policy is unlikely to move the needle for USD/JPY. Current Board members' stipulated pre-condition for modifying or abandoning YCC is a meaningful shift in inflation risks to the upside. While this may happen as core inflation could push back up above 1% around April next year, the Bank's overall policy stance would likely remain very accommodative given the pledge for a sustained 2% overshoot in CPI.

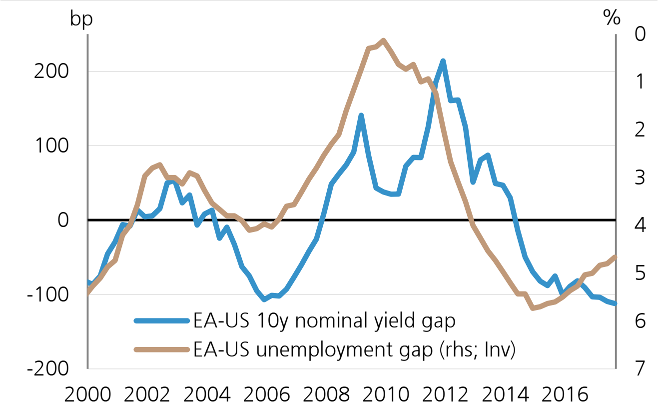
The expected pick-up in domestic inflation is predicated on the view that an increasingly tight economy and labour market will gradually feed through to domestic price pressures. Our economists expect above-trend growth to extend in 2018, taking the output gap further to positive territory (Figure 7).

Figure 5: Flatter US curves have led to dollar weakness recently



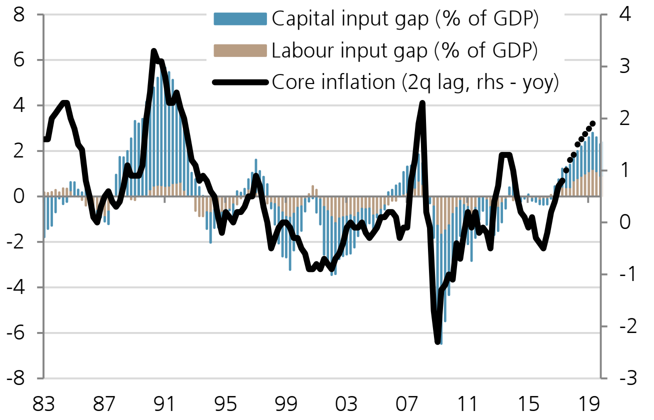
Source: Bloomberg, UBS

Figure 6: Long-term yield realignment between the US and the Eurozone is lagging relative labour-market trends



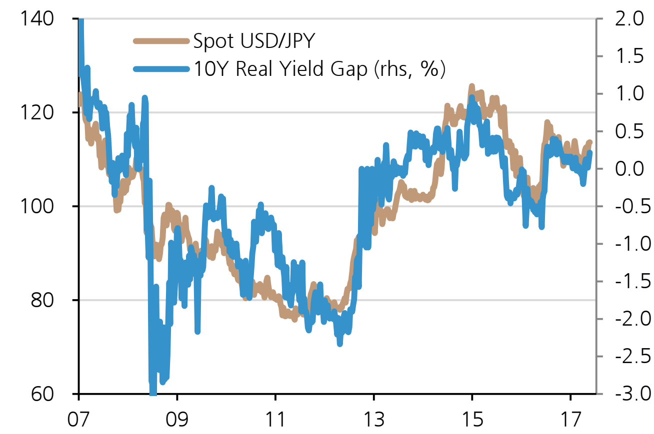
Source: Haver, UBS

Figure 7: An increasingly positive output gap in Japan should support the pick-up in inflation



Source: BoJ, Bloomberg, UBS

Figure 8: The compression of Japanese real yields should support USD/JPY



Source: Bloomberg, UBS

Easy policy against an improving macro backdrop should compress real yields and support USD/JPY

A steadily rising inflation rate against a backdrop of very easy monetary policy should help compress real Japanese yields further and weaken the yen (Figure 8). We expect **USD/JPY to reach 122 by end-18**. Further out, however, as Japanese inflation approaches the BoJ's target, this should reorient market expectations toward BoJ policy normalisation and drive **USD/JPY** back down to **113 by end-19**.

The market still views the BoC as a mini-Fed; but the macro does not support this

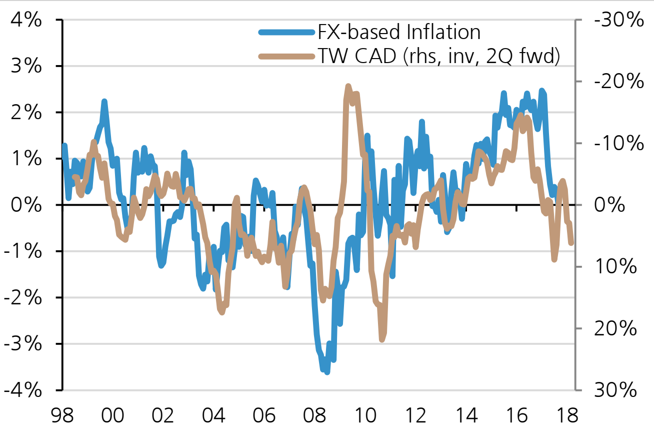
CAD faces the opposite situation: the BoC is too hawkishly priced, as the market is pricing too much 'read-across' from the Fed. As a result, we think risks to CAD remain tilted to the downside and we expect **USD/CAD to reach 1.33 by end-18**.

The outlook for inflation remains weak

The outlook for Canadian inflation remains soft. Our FX-based inflation framework indicates that recent trade-weighted CAD strength is likely to keep price pressures in FX-sensitive components of CPI subdued (Figure 9). This is occurring against a backdrop in which core inflation is already low: 1.6% average across the BoC's three measures of core inflation.

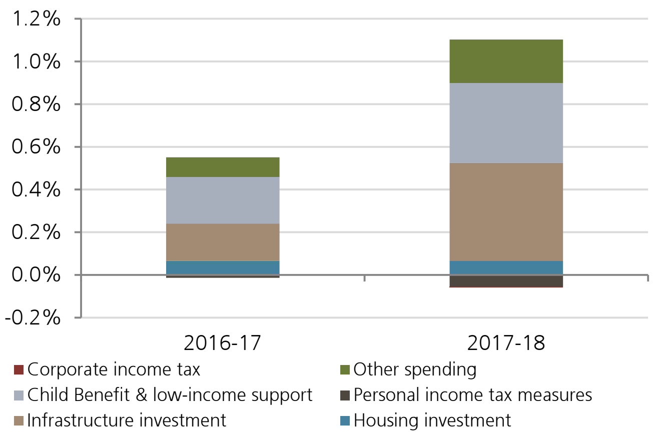
Meanwhile, the gradual eradication of slack in Canada is yet to create meaningful price pressures. Growth has been supported by fiscal stimulus, with a cumulative impact on GDP of +1.5pp over the 2016-17 and 2017-18 fiscal years (Figure 10). Looking ahead, growth is set to slow down as the impact of fiscal stimulus fades.

Figure 9: Recent CAD strength is likely to keep FX-sensitive components of inflation subdued



Source: Haver, Bloomberg, UBS Calculations

Figure 10: The impact of fiscal stimulus on activity should start fading in 2018



Source: MoF, UBS *Canada's fiscal year runs April to March

What is more, the limited responsiveness of the non-commodity trade balance to CAD depreciation since 2014 suggests that Canada's exporting capacity may have declined (Figure 11). This is not only important as a signal of residual over-valuation—CAD also remains overvalued according to our FEER model despite substantial depreciation in the last few years—but also generates added risks to the Canadian growth outlook for next year.

Canada's export competitiveness may have deteriorated

Against this backdrop, the market is still pricing a relatively optimistic rates path, albeit less so than a few weeks ago following the recent correction. We compute a Taylor Rule-implied policy rate for Canada and compare it to the 2Y1Y OIS (Figure 12). We use the 2Y1Y OIS to allow some time for the BoC to normalise policy from current levels. The results reveal that the market remains priced fairly close to a Taylor Rule-implied rate path, a relatively hawkish framework for conducting monetary policy close to the zero-lower bound.

The market continues to price an optimistic rates path for BoC

Solid growth, low inflation should support AUD

We remain of the view that **AUD** should continue to be supported by a positive global backdrop. The combination of solid global growth, low inflation and low back-end yields has been supportive thus far in 2017. We expect this to continue in 2018, forecasting **AUD/USD at 0.81 at end-2018**.

Global growth tailwinds to keep benefitting AUD

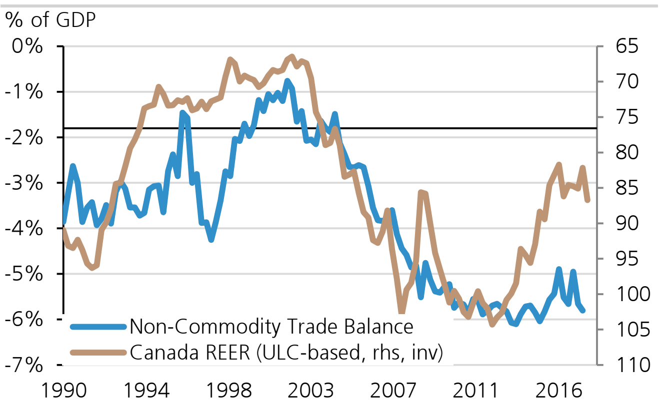
Global tailwinds are enhancing the recovery from the sharp correction in mining activity during the last few years. In addition, resilient Chinese activity in particular mitigates risks emanating from Australia's large exposure to China. To be sure, the gradual rebalancing of the Chinese economy away from investment and towards consumption could imply smaller benefits to AUD via the commodities channel. At the same time, however, the softer the landing of the Chinese economy, the more supportive global financial conditions and risk sentiment for carry currencies such as the AUD. And at any rate, the rebalancing process is not a one-off event but rather a slow process that has just begun to pick-up speed, as explained above.

A soft landing in China also helps

The AUD's leverage to global growth and trade is well represented by Australia's return to a trade surplus towards the end of last year. Notably, the trade balance has remained in healthy surplus territory despite the moderation in commodity prices since Q1-17 (Figure 13). This implies that export volumes are on the rise, part of a multi-year trend that explains why the trade surplus now is larger than in 2011 despite lower commodity prices. Overall, the AUD should still be able to find support at lower commodity prices, in our view.

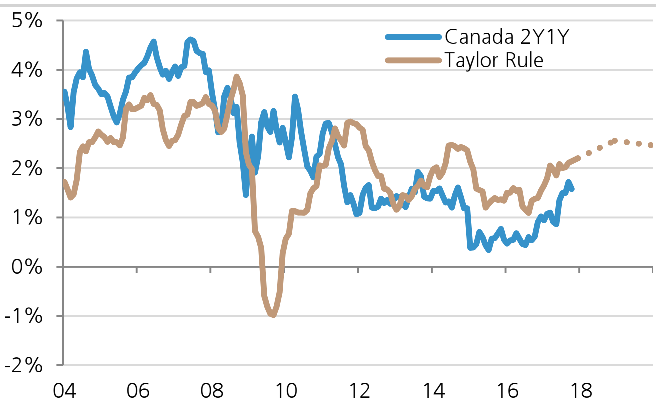
Trade balance still in surplus as a pick-up in export volumes has offset lower commodity prices

Figure 11: Canada's export capacity may have declined



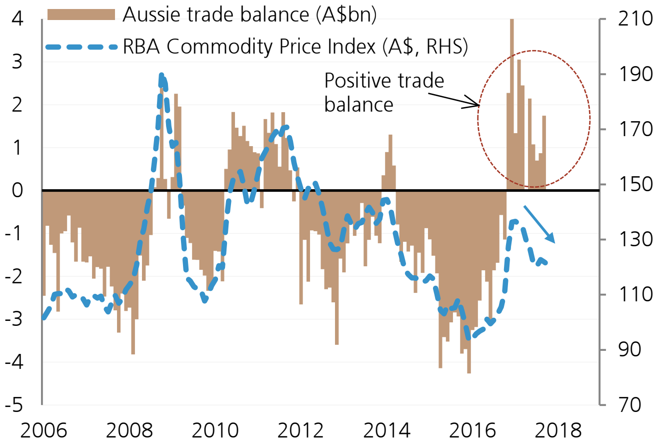
Source: Haver, Bloomberg, UBS

Figure 12: Markets are pricing in a hawkish BoC path



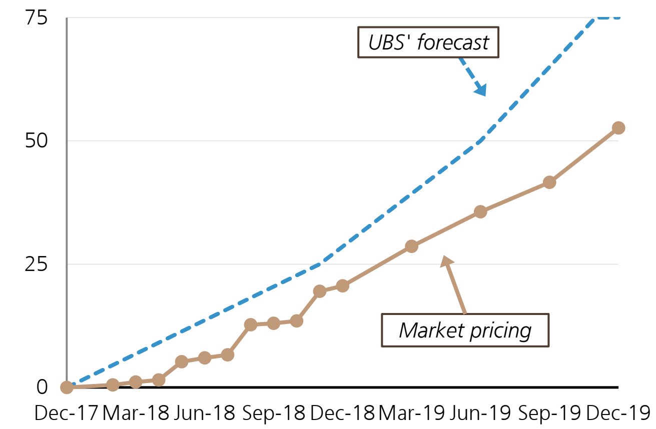
Source: Haver, Bloomberg, UBS Calculations. *Taylor rule assumes 2.5% neutral rate (0.5% ERR + 2% inflation) and uses BoC output gap estimates.

Figure 13: Australia continues to run a trade surplus, even as commodity prices have come off



Source: Bloomberg, UBS

Figure 14: Incrementally hawkish RBA rhetoric has ample room to push front-end rates higher (bp)



Source: Bloomberg, UBS

The RBA is conservatively priced, leaving room for monetary policy to support AUD

The RBA stands out for its generally upbeat narrative for the economy. Although inflation will likely remain modest for some time, our economists expect price pressures to be strong enough to trigger three rate hikes by the end of 2019 (Figure 14). This is more than the market pricing of roughly two hikes and we expect AUD to be supported by incrementally hawkish RBA rhetoric during the second half of 2018, similar to the case of other 'second mover' central bank during this year. Thus we see scope for a correction of the residual undervaluation in AUD (c. 8% according to our FEER model) as the RBA gradually moves to a tighter policy stance.

Admittedly, policy rate differentials should continue to move in favour of the US in 2018. We have already shown, however, that a full hiking cycle is broadly priced in the US. Consequently the higher US growth and rate expectations, the more likely the 'read-across' should be by markets to the RBA and AUD.

Safe-haven outflows to drive EUR/CHF closer to fair value

We expect EUR/CHF to reach 1.22 by end-18

The **CHF** should continue to depreciate in 2018, in our view, and we expect **EUR/CHF to trade up to 1.22 by end-18**.

We think the CHF remains overvalued…

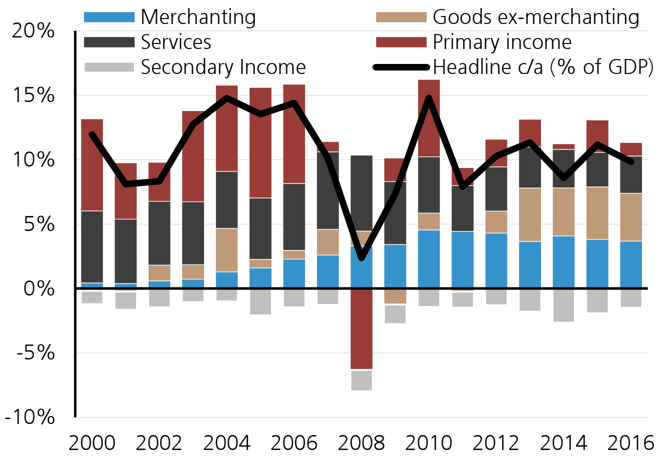
From a valuation perspective, we think the franc remains expensive. This is not only on a PPP-basis but even on a current-account basis despite a seemingly oversized current-account surplus.

This, however, should not be surprising. The Swiss current account is artificially inflated by such elements as merchanting (c. 4% of GDP since 2008) and income generated due to FX reserves and Switzerland's role as a global corporate and financial services centre (Figure 15). Adjusting for these factors yields a far more modest "underlying" current account balance that alleviates suspicions of gross undervaluation (see A bumpy path to CHF weakness for further analysis).

…due to 'safe-haven' inflows since 2008; we expect those to reverse…

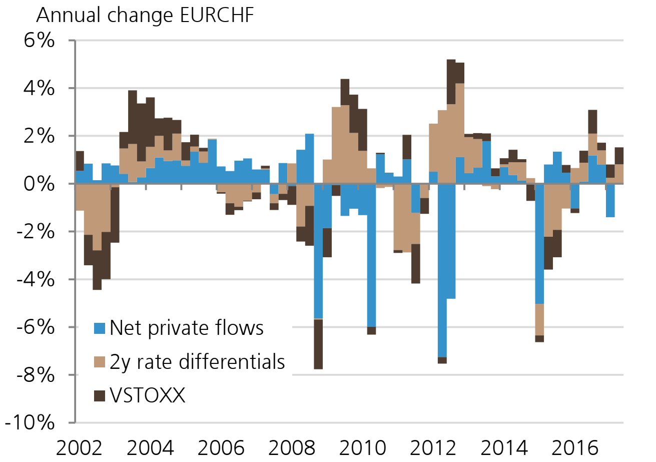
From a flow perspective we have already demonstrated that "safe-haven" flows go a long way towards explaining the CHF's strength in recent years, in particular during times of very high risk aversion and elevated political risk in the Eurozone (Figure 16). Equivalently, the crucial link missing for a sustained return of the Swiss franc to fair value is the reversal of these flows, in our view. On this count, conditions are as good as they have been since the Global Financial Crisis.

Figure 15: Merchanting accounts for a large portion of the Swiss current account surplus



Source: Haver Analytics, UBS

Figure 16: 'Safe-haven' flows explain much of the strength in CHF since the Global Financial Crisis



Source: Bloomberg, SNB, UBS calculations. We decompose year-on-year changes in EUR/CHF by estimating an OLS model with five variables: net private capital flows, 2y rate differentials, VSTOXX as a high-level measure of risk and two dummies (one for the 1.20 floor period and one to account for non-linearities).

...especially after the Italian elections early in 2018

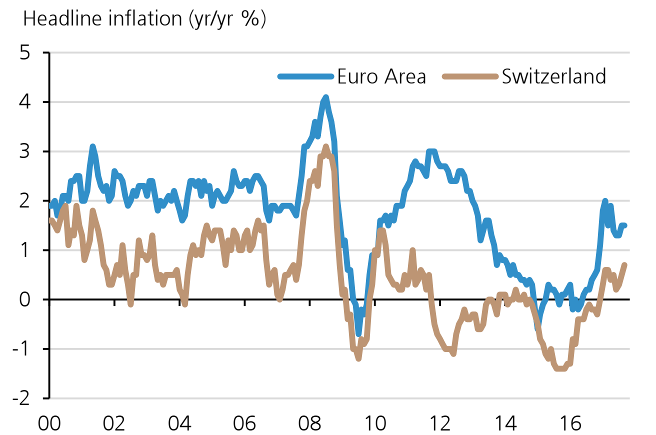
Indeed, the global economy is recovering faster and major central banks, including the ECB, have embarked on a (long) path to policy normalisation. In addition, political risk in the Eurozone – a key generator of 'safe-haven' inflows – has receded significantly since the French elections.

The last significant remaining obstacle on the political front is Italian elections, likely in Q1 (and at the latest by May). Importantly, the bar for maintaining perceived political stability in Italy may be lower than feared. Thus, Italian elections may become an important trigger for further 'safe-haven' outflows and, as such, a significant inflection point for the return of EUR/CHF closer to fair value.

The SNB is unlikely to tighten policy actively before the ECB

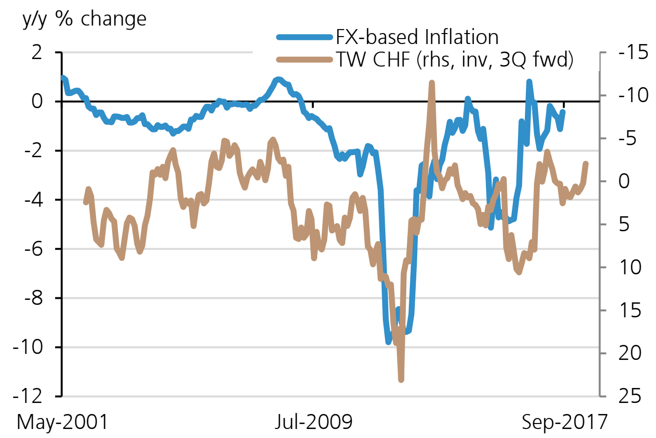
Lastly, the SNB has shown no intention to move away from its accommodative policy stance before the ECB generates some policy space first. Swiss fundamentals are supporting this stance, with Swiss inflation having lagged Eurozone inflation significantly since the GFC, in no small part due to sharp currency appreciation during this time (Figure 17 and Figure 18). All told, the outlook for 'safe-haven' flow reversal and further EUR/CHF upside into 2018 is fairly bright.

Figure 17: Swiss inflation has been lagging Eurozone inflation significantly since 2008...



Source: Bloomberg, UBS

Figure 18: ...as CHF appreciation has weighed on prices



Source: Haver, Bloomberg, UBS Calculations

GBP and NZD: De-globalisation and political risk in G10

The UK and New Zealand as instances of the de-globalisation trend

Political risk in developed economies has recently revolved around economic protectionism and immigration, as policymakers grapple with the side-effects of globalisation. On this count, most of the focus has been on Eurozone political risk, due to the systemic significance of a potential break-up of the currency union.

Remarkably, it was the UK—a non-member of the currency union—where this risk materialised more obviously via the decision to exit the EU; and more recently, the newly-formed Labour-led coalition government in New Zealand is promoting policies that bear striking similarities with Brexit.

We believe sterling remains overvalued on a current account basis…

Brexit and the UK's external imbalances have been central to our negative view on **sterling** for a while. Our FEER model screens sterling as c. 20% over-valued in TWI terms even after the substantial drop since the Brexit referendum, as the UK current account has yet to correct to more sustainable levels. In addition, substantial revisions in the income account included in the Q2 Balance of Payments release imply a larger gap to more sustainable current account levels than previously estimated (Figure 19).

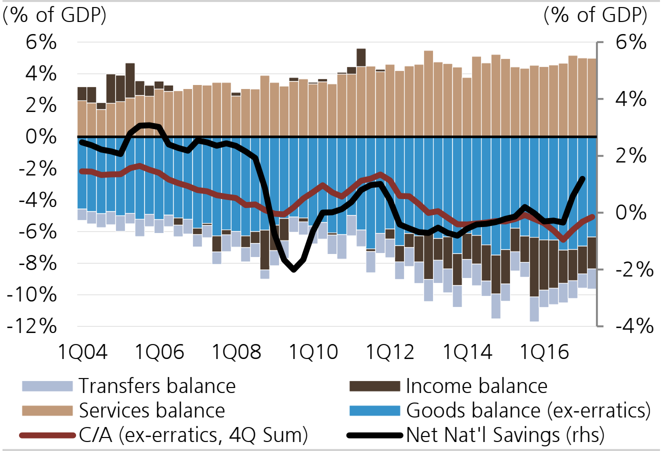
…despite tailwinds from the global recovery

At the same time sterling remains one of the most cyclical currencies in G10 due to the "risky" composition of the UK's external assets. In a benign environment for risky assets, improvements in the current account via the income account are likely to persist, thereby reducing the UK's external imbalance (Figure 20). The continuation of the Eurozone's solid recovery in particular could benefit sterling both via the income account (as Europe is the largest destination for UK's FDI) as well as the trade balance. On balance, a worse starting external imbalance should be offset to some extent by an increasingly favourable external environment. Our **EUR/GBP forecast for end-18 is only slightly changed to 0.95**.

The BoE's hawkish shift does not change our bearish views; not only is it driven by weaker fundamentals…

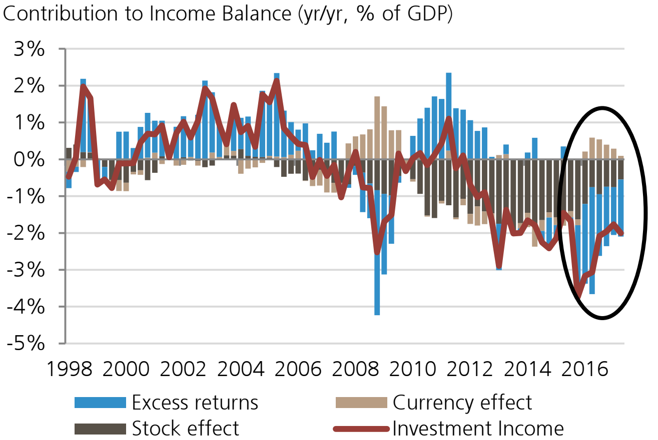
Importantly, the BoE's recent hawkish shift does not change our bearish view for sterling. This is because the reasons behind this shift are shaped by currency-induced inflation and lower potential growth rather than improving fundamentals, as highlighted in BoE Governor Mark Carney's speech at the IMF.

Figure 19: Substantial data revisions mean that the UK current account deficit remains at elevated levels…



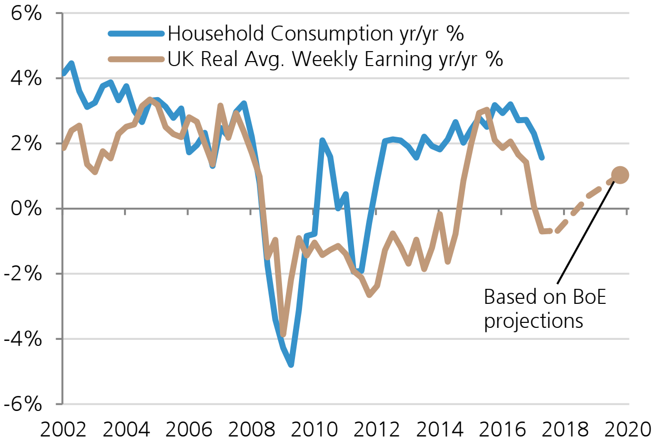
Source: Haver Analytics, UBS

Figure 20: …despite recent improvements in the income account due to global asset reflation



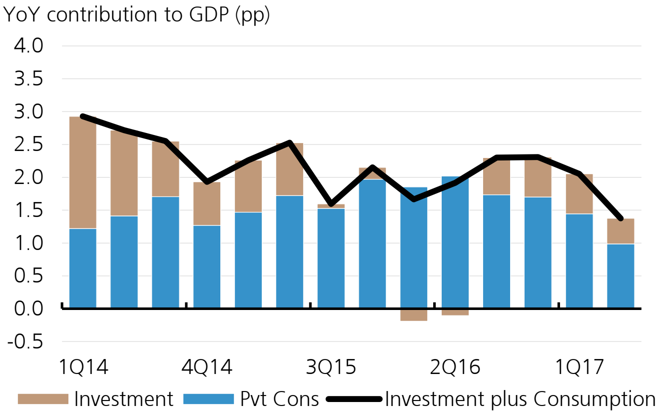
Source: Haver Analytics, UBS calculations

Figure 21: The squeeze on real wages is set to weigh on household consumption for longer…



Source: Bloomberg, UBS

Figure 22: …while an offset from investment may also not be forthcoming soon



Source: Haver, UBS

In that speech Governor Carney delved into the trade-off between high inflation and a slowing economy the BoE is currently facing from a novel perspective: that of Brexit as an instance of de-globalisation. His argument was simple: if globalisation is deflationary, de-globalisation must be inflationary. However, Brexit has deflationary side-effects too relating to prevailing uncertainty and the hit to aggregate demand.

The MPC recently judged that the pendulum had shifted towards incremental policy tightening, which culminated with the November Bank rate hike. The interplay of the inflationary and deflationary forces, however, does not guarantee a sustained direction of travel for the MPC.

As a result, the market is only pricing in a very shallow and gradual hiking cycle (roughly two more hikes by end-20). This is in line with the MPC's latest expectation in November, but is also insufficient to prop sterling up significantly on its own.

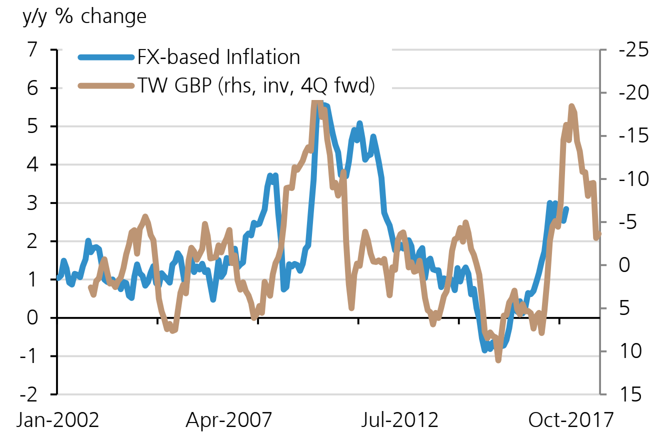
…but may also prove short-lived…

What is more, even this fairly defensive pricing for the BoE may well be already too optimistic in light of prevailing uncertainty around Brexit risks and a decelerating economy. So far negotiations with the EU have been fairly slow. As 2018 progresses and we move closer to the March-2019 deadline, however, time will inevitably become a more pressing constraint and could weigh further on sentiment and activity, especially investment.

…as demand will likely be squeezed further and inflation should peak soon

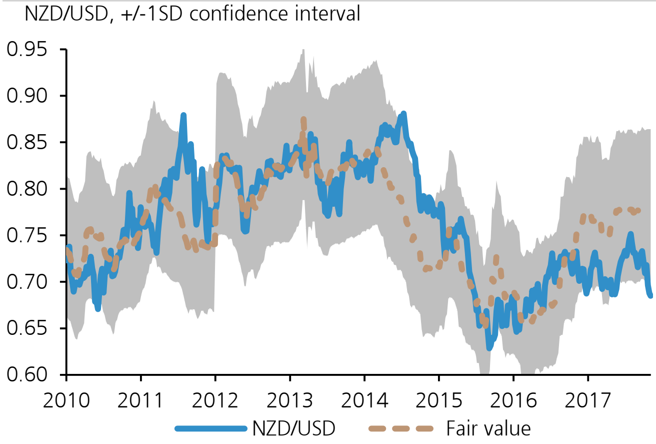
This is particularly important because a key assumption by the MPC is that the weakness in household spending, which is set to continue for a while as real earnings are squeezed further (Figure 21), will be offset by other components of demand (effectively investment). Absent such an offset—and so far there has not been one, if anything the contribution of both demand components to GDP is falling (Figure 22)—the BoE may well be forced to fall back to a more dovish stance. Similarly, post-referendum sterling stabilisation suggests that UK FX-based inflation is likely to peak soon, thereby further reducing the trade-off the MPC is trying to balance (Figure 23). Overall, the BoE is unlikely to come to sterling's rescue any time soon, in our view.

Figure 23: FX-based inflation is set to peak soon in line with sterling's post-referendum stabilization



Source: Haver, Bloomberg, UBS Calculations

Figure 24: NZD is significantly undervalued from a short-term perspective



Source: Haver Analytics, UBS

We are monitoring the EU/UK negotiations and UK politics for signs Brexit risks may ease

A more important risk to our views relates to a scenario in which Brexit-related risks ease, especially after the recent election result, which was in part a vote against a definitive break from the EU. To gauge this risk, we are monitoring Brexit negotiations and British politics more generally for any signs that we are moving towards that direction. At the moment, however, there is little evidence of an imminent reversal in the Brexit path or a smooth path to a transitional period of sufficient length and flexibility to alleviate near-term risks for sterling.

NZD is undervalued but political risk is clouding the outlook

NZD is facing a different set of circumstances from GBP, as it is undervalued both on our long-term FEER model as well as on our short-term model. Looking at short-term valuations, it may seem that the recent sell-off is offering an excellent entry level (Figure 24). In theory, the currencies of commodity exporters with solid fundamentals and higher interest rates than the rest of the world should perform well in a solid global growth environment, which is why NZD has featured in our carry baskets throughout 2017.

Market worries on RBNZ independence might take time to fade…

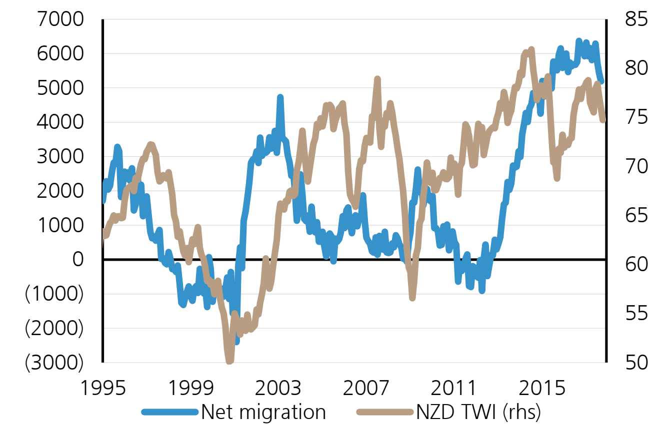
Nonetheless, NZD has been held back by rising political uncertainty following the formation of the new government after recent general elections. Markets have focused on two potential sources of risk from the new government. One relates to changes in the RBNZ's mandate via the introduction of an employment component and potentially a rate-setting committee. On their own, these changes are not novel or unprecedented and in fact they may not amount to much in terms of policy. Markets, however, may continue to worry about the preservation of the central bank's independence.

…while new immigration policies add an additional dimension of uncertainty

The other key dimension relates to immigration and bears similarities to Brexit. The new government is planning to decrease net migration by 20,000-30,000 per year, i.e. between 30-40% of the current annual flow. Following the BoE's framework, a sharp reduction in net migration would amount to a negative supply shock for the economy, reducing potential output and trend growth.

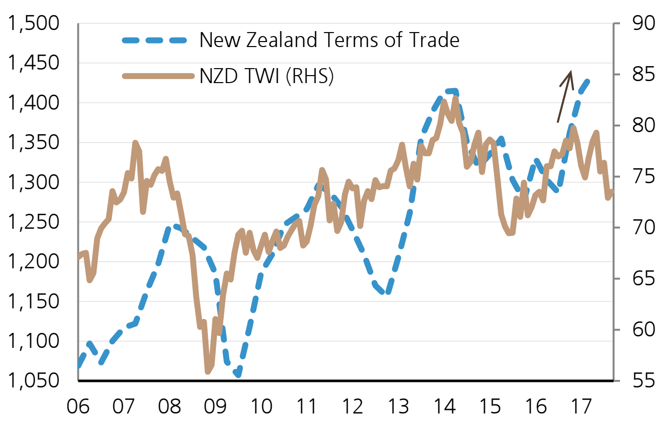
Similarly to the UK, the consequences for inflation are not straightforward, as inflationary forces (e.g. labour shortages) could be offset by the resulting demand shock from reduced migration flows. Net-net, however, New Zealand's monetary policy would have to adjust to a new equilibrium likely associated with a lower neutral rate. Ultimately this amounts to a negative shock for real rates and could reduce the positive rate gap that has supported NZD during the past decade.

Figure 25: Net migration and FX are correlated in NZ



Source: Bloomberg, Haver, UBS calculations

Figure 26: NZD should be supported by terms of trade



Source: Haver, UBS

Notably, there already seems to be a fairly tight relationship between migration and FX trends, possibly owing to the aforementioned supply-side dimension of migration (Figure 25).

A number of factors could mitigate those risks…

To be sure, a number of developments could mitigate those risks. Fiscal policy could offset some of the impact from reducing net migration; the policies ultimately adopted could be softer than currently announced and may take longer to enact; and changes at the RBNZ could be limited, preserving its independence. In addition, a lot is arguably already in the price of NZD following the post-election depreciation, as evidenced by our short-term fair value model (Figure 24).

…but we expect NZD upside to stay capped for as long as they linger

We have lowered **our end-2018 forecast for NZD/USD to 0.73**. This is still higher than spot but lower than our previous forecast. We think NZD can continue to benefit from a generally supportive global backdrop but upside may be reduced, at least as long as political uncertainties linger and cloud the outlook for growth.

Scandies to outperform in 2018

Scandies are test cases for the importance of FX for inflation

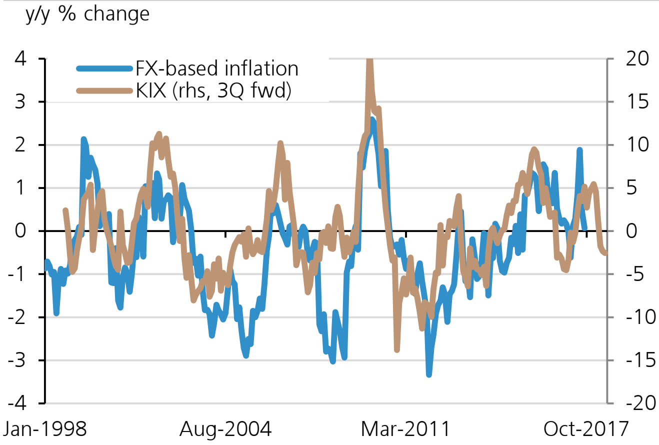
Our views on SEK and NOK have been guided by the overarching principle that a flat Philips curve amplifies the importance of currency moves for inflation in small open economies. This has helped us forecast inflation by using lagged exchange-rate movements but it has made trading both currencies tricky. Improved inflation feeds into currency strength, which then feeds into lower inflation, working against the original rationale for currency strength. This limits large directional moves in both currencies. From a micro perspective, the starting points for Sweden and Norway have some differences.

SEK is undervalued, services inflation is rising but positive currency effects for CPI are fading

SEK screens as undervalued in our FEER-metrics and Swedish inflation has benefitted from past currency weakness for most of 2017. This trend, however, may lose some support as SEK appreciation from late 2016 is set to weigh on FX-based inflation.

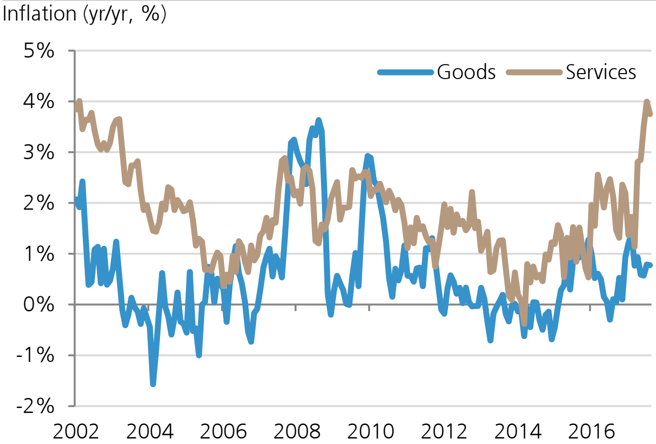
That said, the starting point for SEK is good. At 1.9% y/y, core inflation is the highest in the G10 (ex. UK) and inflation expectations have moved back above 2%. At the same time, tentative signs of a Philips curve are becoming apparent. Services inflation, in particular, has picked up significantly, a point noted by the Riksbank at the October meeting, in an environment of rapid GDP growth amid very easy financial conditions (Figure 28).

Figure 27: The tailwinds to FX-based inflation from past SEK weakness are fading…



Source: Haver, Bloomberg, UBS Calculations

Figure 28: …but services inflation has increased rapidly owing to a fast-growing economy



Source: Haver, Bloomberg, UBS Calculations

The Riksbank will want to stay dovish but solid inflation may move the needle

Extraordinarily easy policy by the Riksbank has so far been the main factor holding back substantial appreciation for SEK. From an institutional standpoint, the reappointment of Governor Stefan Ingves implies maximum policy continuity and the preservation of a dovish bias. With both realised inflation and inflation expectations already back to target, however, the Riksbank's willingness to maintain an overly accommodative stance may change, even if only marginally. As a result, the path for inflation in coming months will be crucial for Riksbank policy, especially in light of its decision to wait for more information before it makes its own decision on QE extension in December and its expectation that inflation is due to moderate temporarily.

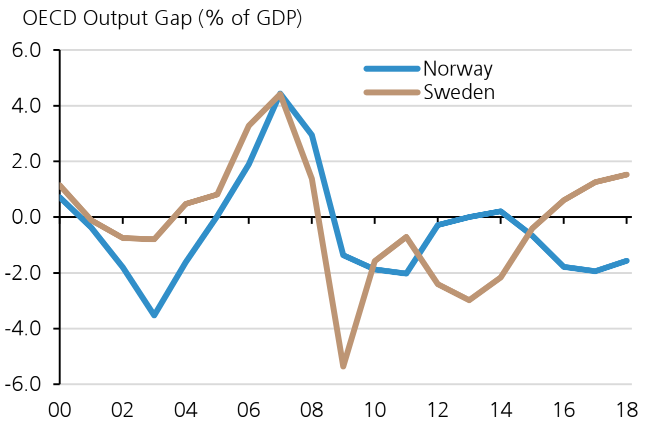
We stay bullish SEK but expect a grind

We remain constructive on SEK through 2018 and **expect EUR/SEK to grind towards 9.20** by end-18. That said, appreciation should be a very gradual process in light of the Riksbank's expressed aversion to sharp currency appreciation and the headwinds to FX-based inflation in the coming months (Figure 27).

The Norwegian economy is recovering from a lower base but inflation has likely bottomed

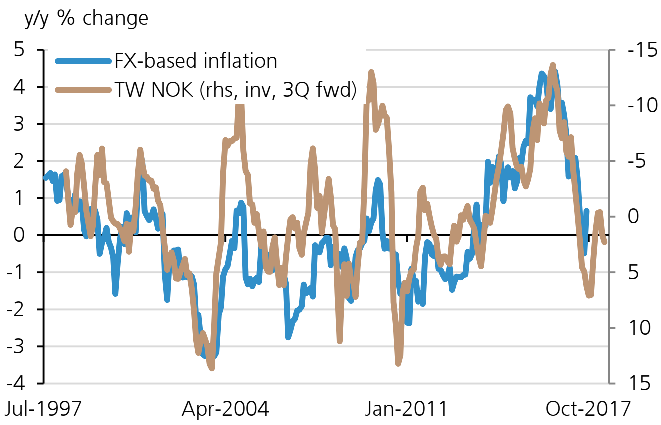
Norway is facing different macro circumstances but the implications for **NOK** are similar. While the economic recovery has also picked up speed in 2017, the country's output gap remains larger than Sweden's (Figure 29).

Figure 29: Norway's output gap is substantially larger than that of Sweden's…



Source: Haver, UBS

Figure 30: …but inflation is likely to have bottomed as past NOK-weakness is turning into a tailwind for prices



Source: Haver, Bloomberg, UBS Calculations

That said, given past NOK weakness, inflation has likely bottomed and headwinds from FX-based inflation in particular are set to fade and provide some support in the near term (Figure 30).

Norges will stay on the back foot but the market may have overpriced weak inflation

Against this backdrop, the Norges Bank has communicated an intention to remain on a low-policy regime for the foreseeable future, with the first hike pencilled in for Q3-19. Philips curves dynamics may take longer to reappear but the likely continuation of the European recovery should benefit Norway via the trade channel and resilient global growth should continue to support oil prices.

More importantly, however, the market has likely overpriced weak inflation dynamics and is now offering good entry levels for expressing a modestly constructive view on NOK. Indeed, the continuation of the domestic recovery, stable oil prices and a brighter inflation outlook arguably skew the balance of risks for Norges towards incremental policy tightening and not easing. All told, we expect **EUR/NOK to reach 9.10 at end-18**.

EM FX: A weak long-term case, but use volatility spikes to get long carry

Speed read

- *EM currencies posted respectable (4%) spot gains against the USD this year. Accelerating Chinese and global trade growth, higher metal prices, a powerful Tech cycle, and significant downside surprises in US core PCE all helped. In trade-weighted terms though, after a strong start to the year, currencies actually depreciated.*
- *Our economists see EM inflation, export volumes and growth differentials flattening in 2018, with no central banks seen hiking more than priced in. Tailwinds from US inflation and commodities will likely wane. We expect EM NEER depreciation to pick up pace modestly next year, keeping USD/EM flat on aggregate even as EUR/$ rises to 1.25.*
- *Amid modest EM external sector risk and no major China slowdown, increases in EM volatility should offer opportunities to buy carry through the year.*
- *Top trades: Long CZK and PLN vs. EUR; Long RUB vs. CAD; Long SGD vs. USD and JPY; Long ARS vs. USD. Long BRL vs. COP.*

The curious case of EM's non-appreciating trade-weighted currencies

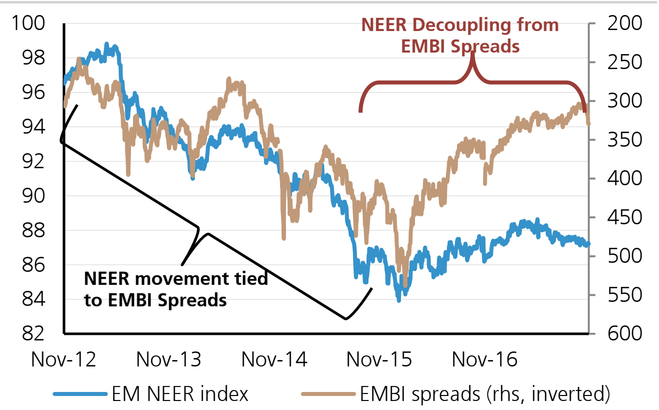
EM FX returns against the USD were more than offset by losses against the EUR this year.

On paper, all the ingredients for strong EM FX appreciation were on the table this year. The strongest global trade rebound in 5 years, benign global rates, stable EM trade balances and a gravity-defying China ought to have made for a potent cocktail. And on the surface, they have indeed done well – against the USD a simple average of the 20 most liquid EM currencies is up 4% in spot terms. However, against the EUR this group has lost nearly 6%. Thus, in trade-weighted terms, EM currencies have gone absolutely nowhere (Figure 31).

Why has EMFX failed to deliver intrinsic appreciation, and underperformed other EM asset classes since mid-2016?

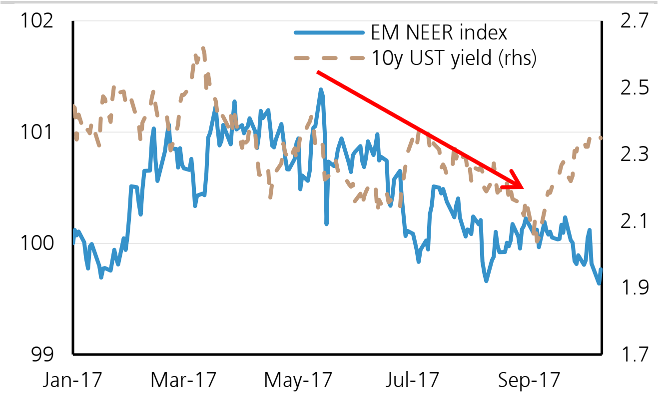
After a strong start to the year, EM NEER performance started to slip from May even as other EM asset classes continued to rise, and US back-end yields fell. This roughly coincided with the peak of the global trade cycle. Looking ahead to 2018, as tailwinds from falling US back-end yields, accelerating EM growth and commodity prices likely abate, this year's performance pattern warns us not to expect strong upside in EM FX next year (Figure 32).

Figure 31: EM NEERs vs. credit spreads: FX has decoupled/underperformed since 2016



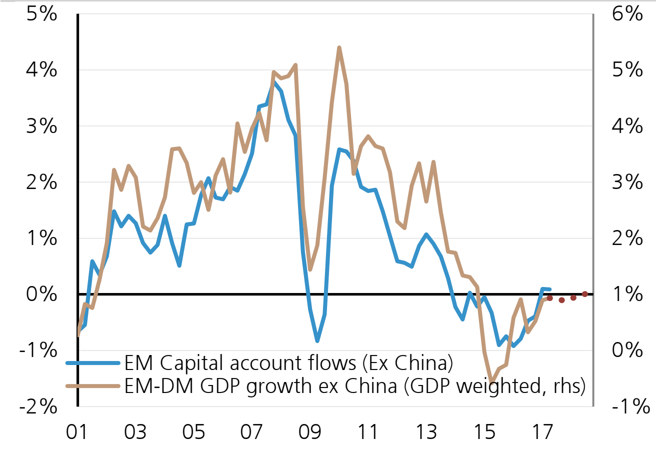
Source: Haver, Bloomberg, UBS

Figure 32: No, it's not because of higher US yields. Most of the EM NEER weakness this year came as US yields fell



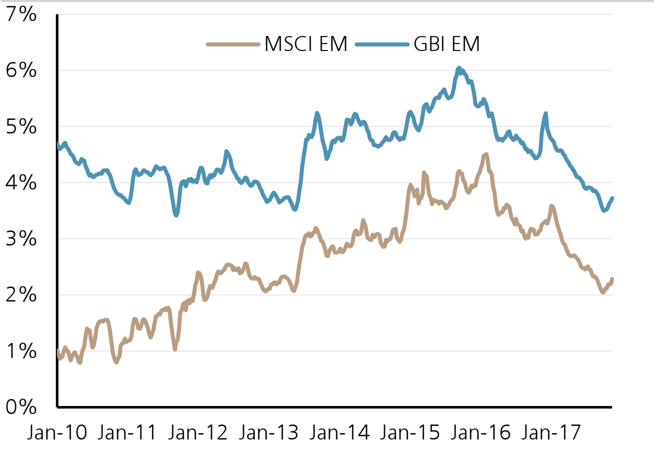
Source: Haver, Bloomberg, UBS

Figure 33: EM ex China - DM GDP growth differentials vs. EM ex China capital account flows



Source: Haver, Bloomberg, UBS

Figure 34: EM 12m FX carry vs USD: MSCI- and GBI-weighted



Source: Haver, Bloomberg, UBS

Why has EM FX delivered such moderate intrinsic returns, starkly underperforming other EM assets in the process - and what are the prospects for change in 2018?

Three factors help explain EM's modest NEER performance.

Three factors explain the underperformance of EM FX since mid-2016, in our view:

1) **FX intervention and divergent monetary policy in EM vs. DM**, amid historically low EM inflation, elevated (local currency) leverage, and limited gains in EM export competitiveness;

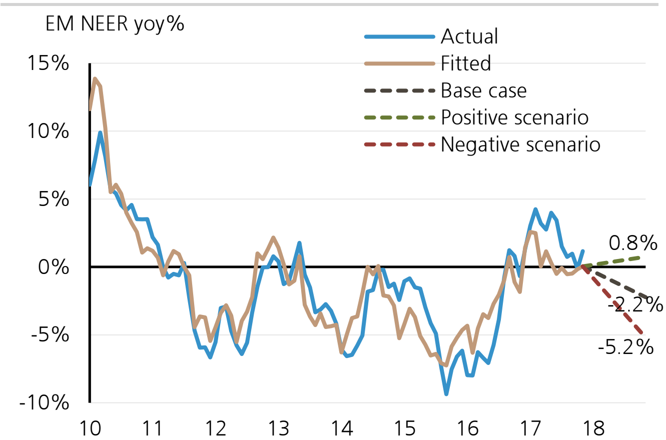
2) **Modest EM-DM growth spreads**, which typically map closely with gross capital account flows into EM (Figure 33);

3) **Declining EM FX carry**, now at the 10th and 13th percentiles of their 5y range on a GBI- and MSCI-weighted basis, respectively (Figure 34).

In 2018, a weaker outlook for commodities and flattening EM-DM growth differentials may raise the bar for FX higher still.

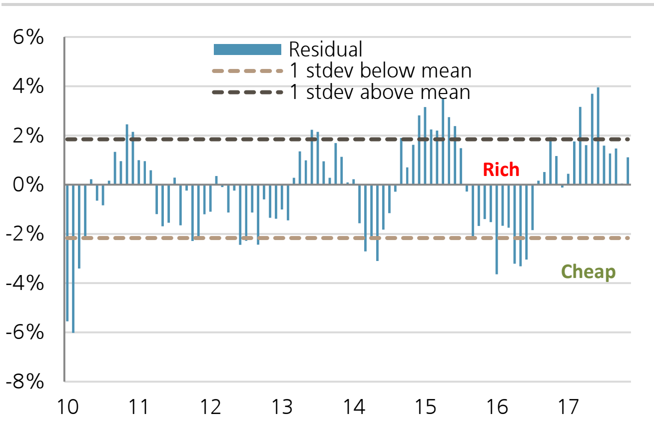
Looking into 2018, UBS expectations for weaker oil and industrial metals prices, flat EM inflation and flattening growth differentials to DM suggest little reason for a fundamental inflection point in these factors. With the Fed likely to hike rates 75 bps between now and end-18 (and 2019 looking particularly under-priced) while several EM central banks are slated to cut, the pressure on EM FX will likely rise.

Figure 35: EM NEER model: Actual and Fitted



Source: Haver, Bloomberg, UBS

Figure 36: EM NEER model: Residuals



Source: Haver, Bloomberg, UBS

Our EM NEER model, based on real EM growth, commodity prices, US rates and risk premia, projects 2-2.5% trade-weighted depreciation in 2018[1] (Figure 35 and Figure 36).

We project a slightly faster pace of EM NEER depreciation in 2018 – of around 2-2.5%.

In the context of UBS' forecasts for EURUSD at 1.25 and USDJPY at 122, this suggests modest spot appreciation vs. the USD for MSCI EM currencies, and modest depreciation vs. the USD for GBI EM currencies[2] in 2018. UBS expectations for a softer USD should continue to provide opportunities for selected USD/EMFX trades (more on this below). But as higher Bund yields (UBS sees 0.9% for the 10y by end-2018) take over from declining US inflation as the key driver of EUR upside, while other EM tailwinds wane, the impact on broad USD/EM is likely to be less supportive than was the case this year.

But no volatility break-out as EM external sector risk anchored at much lower levels.

Yet with trade balances and external sector risk more broadly holding up (Figure 37), there remain few triggers for a sustained break out in volatility. We estimate that external sector risk at a GBI EM level, for instance, is at just the 23rd percentile of its 10y range current account deficits have narrowed from 2.5%/GDP in mid-2013 to about zero as of Q2-17. This implies relatively a higher degree of resilience to external shocks compared to the past, in general, and that volatility spikes can be used as an opportunity to get long carry.

Aren't currencies cheap?

For EM FX to enjoy broader performance, external rebalancing will have to start including stronger export competitiveness.

While EM's stronger external balance sheets are important in that they reduce risks of sudden stops in EM external financing, they tells us little about the prospects for outright FX appreciation. We have shown in earlier research that EM FX has traditionally been much more closely related to export performance and GDP growth than changes in the trade balance.

As such, it's important to understand how well EM has been able to increase export competitiveness. We examine this across three simple dimensions:

1) **EM export volume growth normalised for growth in global imports** (Figure 38) – if currencies are 'cheap', one would expect local exporters to be gaining global market share;

2) **Inward FDI flows relative to GDP** (Figure 39) – a cheap currency would likely incentivise greater (gross) FDI to that economy;

3) **Dynamics in the 'core' (ex oil and gas) trade balance vs. fixed asset investment growth** (Figure 40) – a competitive currency should enable the core trade balance to improve without sacrificing investment demand. We find that while weaker currencies have helped to reduce import penetration, sharpened export competitiveness has mostly proved elusive (outside of CEE and Mexico). This likely helps to explain FX underperformance relative to other EM asset classes.

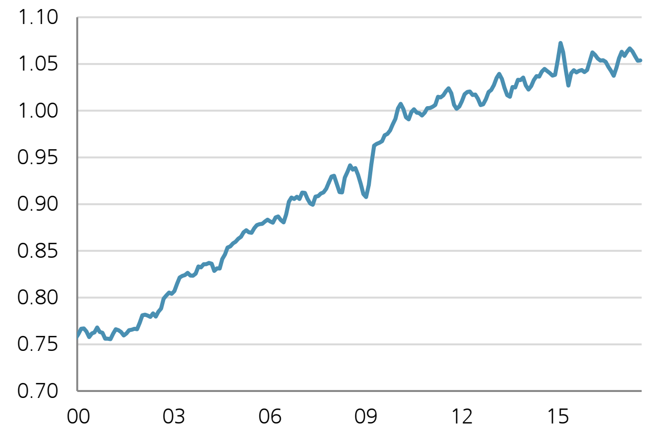
[1] While EM growth has improved this year, our estimates suggest that (all else equal), the present growth rate of EM export volumes and industrial production (around 5.5%) is still well below historical levels that have seen EM NEERs breakeven closer to 10%).

[2] This is due to the relative weights on North Asian currencies in the MSCI, which are typically correlated more closely to the USD than more vulnerable currencies in GBI EM (TRY, ZAR, COP in particular) that have relatively high weights in GBI EM.

Figure 37: Change in External Risk Score since mid-2013

Source: Haver, UBS

Figure 38: Ratio of EM export volumes to global import volumes (3mma)

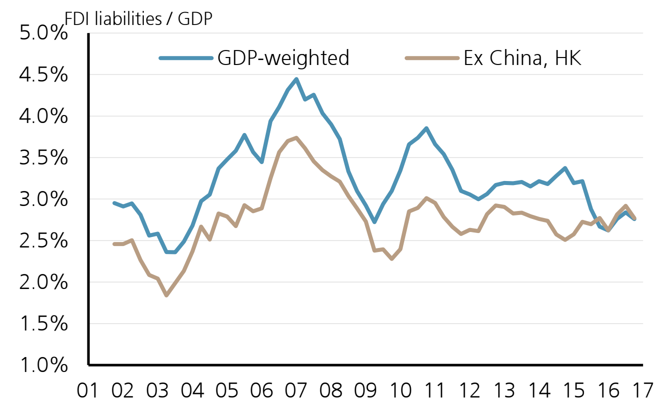


Source: Haver, UBS.

Amid muted gains in export competitiveness, it is not hard to see why EM policy makers are likely to resist strong NEER appreciation even if the USD weakens further in 2018. Policy makers are also likely to experience trade-offs between supporting domestic demand and experiencing wider external deficits. In this respect, some of the progress made in improving external sector risk may be more transitory than structural, though our stable EM growth forecasts imply only limited external deficit expansion next year.

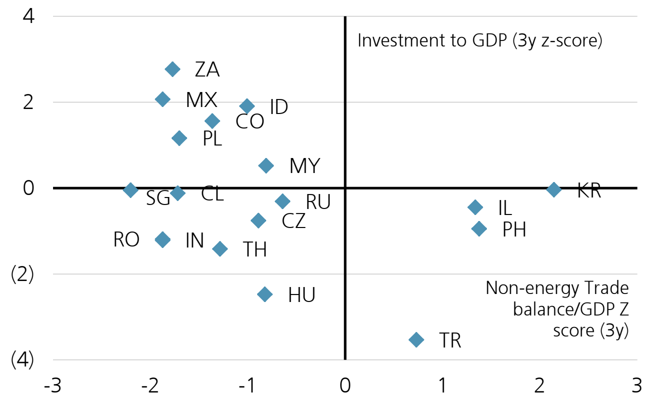
In other words, reduced EM external sector risk is helpful for the asset class, but not a sufficient condition for FX appreciation. Stronger export competitiveness is a key upside risk that we will be monitoring through 2018.

Figure 39: Foreign direct investment inflows into EM – no revival yet



Source: Haver, UBS

Figure 40: Non-energy trade balance vs. gross fixed capital formation / GDP – 3y Z-scores



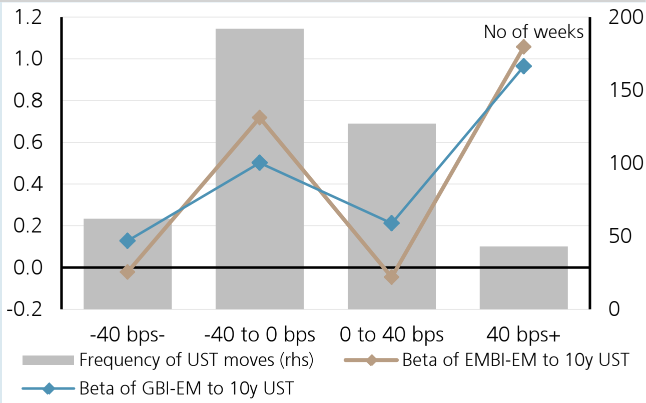
Source: Haver, UBS

Box: Friend or foe? What healthier DM growth means for EM FX

Is stronger DM capex growth in 2018 a threat or an opportunity for EM assets? How does one disentangle the negative impact of higher DM bond yields against the positive impact of stronger growth?

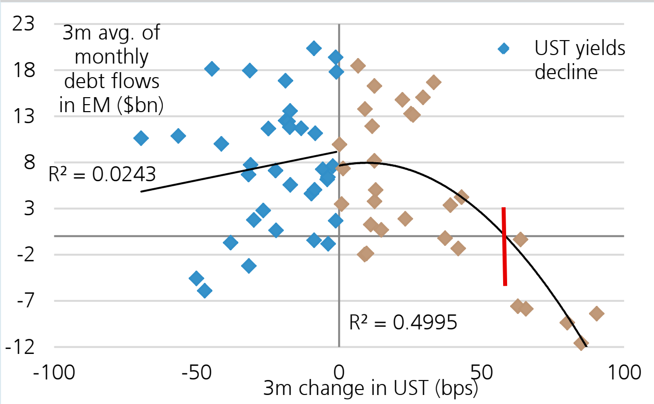
First, US long-end real rates are already close to our colleagues' estimates of fair value. As such, we think the pressure in the US bond market will remain concentrated in the front end. This should mean more for EM FX than for other asset classes, particularly in the context of declining (front end) EM carry. Second the texture of DM growth will be all important. For EM to fully reap the benefits of improving DM growth, DM capex growth needs to broaden out from the intellectual property products sector, and shale exploration in the US. A DM investment recovery focussed in these sectors alone is less likely to present a market-friendly configuration for most EM assets – in that it would create scope for higher DM yields, but with minimal boost to EM exports. Third, the pace of DM rate increases matters. We find that a 10y UST selloff of 40bps or more over 12-week intervals has tended to evoke a non-linear response from EM bonds (Figure 41 and Figure 42). EM FX typically experiences trade-weighted depreciation in these periods, and visibly underperforms other asset classes. Fourth, looking across an array of metrics – historic FX and rate sensitivities to rapidly rising UST yields, external sector strength, export sensitivity to DM capex growth, and our FX scorecard – we find that the KRW, RUB, CNY, SGD and CEE3 appear best placed to outperform if DM growth heats up (Figure 43). The COP, ZAR, MYR, IDR, and TRY screen as relatively vulnerable.

Figure 41: Beta of EMBI Global and GBI EM yields in different regimes of US 10y nominal yield movement
(based on 12-week rolling changes)



Source: Haver, Bloomberg, UBS

Figure 42: 3m change in UST (bps) vs. 3m average monthly flows into EM bond markets ($ bn)



Source: Bloomberg, Haver, UBS. Note: EM flows is an aggregate of 12 countries namely IN, ID, KR, MY, TH, HU, RU, MX, PD, BZ, TU, and ZA

Figure 43: A scorecard to rank EM FX/rates sensitivity to rising DM growth

	FX Scorecard Rank	Average FX performance when UST moves 40 bps+ over 3m	Beta of GBI yields to UST 10y yields when latter sells off by 40bps or more over 3m	Exports Volume growth beta to +ve G2 Capex growth	Latest External Risk Score (MBS)	Change in external sector risk since 2013	Rank
Weights	20%	20%	20%	20%	15%	5%	100%
Korea	9	-1.54	0.10	1.81	5.76	-0.37	5.7
Russia	6	0.22	0.24	0.66	4.85	-0.67	6.1
China	14	-0.34	0.47	2.39	5.86	0.96	6.3
Hungary	13	-1.48	0.37	2.24	8.01	0.34	7.1
Singapore	2	-1.59	0.89	1.37	2.20	0.00	7.3
Czech R	16	-0.70	0.09	1.87	8.82	-0.08	7.3
India	12	-2.92	0.26	2.36	7.73	-2.47	7.5
Brazil	1	-2.68	0.68	0.87	5.77	-1.31	8.0
Poland	7	-1.75	0.77	1.69	10.04	-1.56	8.7
Thailand	5	-2.71	0.59	0.84	5.15	-2.12	8.8
Mexico	3	-3.28	1.32	1.70	8.57	-1.13	10.0
Turkey	4	-7.25	1.91	1.95	15.74	-0.73	11.3
Philippines	15	-2.36	0.78	1.39	8.05	1.64	11.4
Indonesia	10	-2.57	1.59	1.51	11.12	-1.21	11.6
Malaysia	8	-3.59	0.55	0.75	8.06	0.37	11.6
S Africa	11	-1.99	0.85	0.85	11.39	0.30	12.2
Colombia	17	-0.95	0.94	1.09	11.17	1.01	12.5

Source: Haver, Bloomberg, UBS

Manik Narain and Bhanu Baweja

Top FX picks for 2018

We use our FX scorecard (Figure 44) to help identify key winners and losers over the next 12 months.

Figure 44: FX Scorecard

	Valuation		Flows				Carry	Macro			
	UBS FEER estimates, % undervaluation	Real effective exchange rate, percentile of 15y range	Trade balance/GDP Z score (5y)	Non-oil/gas Trade balance/GDP Z score (5y)	PI liabilities, % GDP, 12m rolling	FDI/GDP Z score (5y)	12m FX carry vs. USD	Change in G3 and Chinese import shares from 5y avg	Industrial Production Z-score (last three years)	UBS Macro Balance Sheet Risk Index	Aggregate score
Weights	**20%**	**5%**	**10%**	**5%**	**5%**	**5%**	**25%**	**10%**	**10%**	**5%**	
Brazil	6%	32%	1.8	1.7	-0.7%	0.9	4.5%	0.0%	1.6	11.7	7.0
Mexico	1%	6%	-0.5	2.1	2.9%	0.5	6.1%	0.3%	-0.9	9.6	8.6
Singapore	18%	62%	0.8	0.4	3.4%	1.6	-0.5%	0.0%	2.0	3.3	8.7
Thailand	7%	93%	0.8	0.3	0.7%	-1.6	-0.2%	0.1%	1.3	8.4	9.0
Turkey	-12%	0%	0.0	-1.8	2.0%	-0.1	11.4%	0.1%	2.1	12.2	9.5
Russia	2%	38%	-1.3	0.5	0.7%	1.8	5.4%	-0.6%	0.5	7.3	9.5
Malaysia	3%	9%	-0.2	1.0	-2.3%	0.8	1.1%	0.0%	0.9	10.3	9.6
Korea	11%	61%	1.2	-0.6	1.5%	0.1	-0.4%	-0.1%	0.5	8.3	10.1
Indonesia	-3%	24%	1.6	1.6	2.0%	1.3	5.4%	-0.1%	-1.6	8.9	10.5
Poland	0%	28%	0.5	0.7	0.4%	-2.8	-0.2%	0.1%	2.1	9.2	10.7
S Africa	-7%	13%	2.4	1.8	3.5%	-0.7	6.2%	-0.1%	-0.4	11.4	10.8
India	1%	97%	0.6	-0.3	0.8%	0.9	4.1%	0.0%	-1.1	9.9	10.8
Romania	3%	21%	-1.3	-1.5	2.1%	0.8	0.4%	0.1%	1.7	8.9	10.9
Chile	0%	43%	0.8	-0.5	2.2%	-2.4	0.8%	0.0%	2.2	8.8	11.5
Hungary	6%	30%	0.3	-2.2	-2.3%	0.0	-2.0%	0.1%	0.1	8.4	11.5
Israel	8%	98%	0.3	-1.0	2.1%	-1.0	-1.7%	0.0%	0.5	6.0	11.8
Philippines	1%	64%	-1.6	-1.4	-0.6%	1.8	3.2%	0.0%	-1.3	8.8	12.1
China	-1%	87%	-0.3	-1.2	0.5%	-0.6	2.4%	0.2%	0.0	11.2	12.2
Czech R	5%	66%	0.0	-1.1	10.3%	1.2	-1.9%	0.1%	-0.1	6.2	12.3
Colombia	-7%	18%	-0.4	1.3	2.6%	-1.5	3.4%	-0.1%	-0.3	11.5	13.5

More Attractive

Less Attractive

Source: Haver, Bloomberg, UBS

- **At the two extreme opposites of our FX scorecard, lie the BRL and COP**. We recommend going long this cross. Our balance of payments based FEER valuation model shows the BRL around 6% undervalued, the same magnitude as the overvaluation in the COP using the same model amid divergent inward FDI dynamics (at 5y lows in Colombia, near 5y highs in Brazil), while the 12m carry favours the BRL. We believe monetary policy relative to market expectations is skewed more dovish in Colombia than in Brazil.

Long BRL vs. COP

- **The SGD is one of the key picks in the scorecard – we recommend long positions here vs. USD and JPY**. Expected policy normalization by the MAS (likely October 2018), a resilient (if slightly weaker) Asian export cycle, and UBS' expectations for strong EUR appreciation/JPY depreciation are all encapsulated in this trade. We use 75:25 weightings for USD:JPY.

Long SGD vs. USD and JPY

- PLN screens as the most attractive currency in the CEE3, a region that we expect to perform well in an environment of resilient Euro area growth, closed output gaps and generally loose financial conditions. We recommend going **long an equally-weighted basket of the PLN and CZK vs. the EUR** (short EURCZK was one of our top trades for 2017).

Long PLN and CZK vs. EUR

- The RUB's relative rank in our scorecard has moderated as growth momentum has moderated after a surprisingly strong Q2 and carry has moderated, too. However, amid high real rates, (modest) de-dollarisation of local investor deposits, competitive BEER valuations, and a still-strong external balance sheet we see value here against the CAD (to reduce terms of trade risks). With policy makers likely to further resist spot RUB appreciation, however, we expect carry and duration gains to provide the bulk of returns here.

Long RUB vs. CAD

- **Finally, we roll over our exposure to Long ARS vs. USD**. A mix of acceleration in growth, declining inflation, high real rates and improvement in confidence on President Macri's reform agenda, makes the peso one of our top picks for 2018. While high inflation (expected at 28% for 2017) implies that the currency appreciated in real terms against the USD in 2017, in real effective terms the currency will end the year mostly unchanged implying that competitiveness concerns will not exacerbate imbalances. Twin deficits will continue high into 2018 (-6% and -6.7% as a percent of GDP for fiscal and current account respectively) underscoring the risks from a selloff in DM rates but the expected stability in global financial conditions should not disturb sources of financing. The expected depreciation in nominal terms (close to 8%) is more than offset by 12m carry of around 24%.

Long ARS vs. USD

- **The TRY's high rank in our scorecard doesn't compel us to get long here** on a structural basis. Downside risks to growth as the credit and fiscal impulses slows, deepening structural balance of payments headwinds amid declining bank external rollover ratios, relatively high corporate leverage and waning relations with key trade partners, and locals' limited desire to draw down their FX holding (despite expectations of a better 2018 inflation outlook) suggests high vulnerability to rising DM rates. We would be more inclined to tactically buy the lira if the central bank is forced to tighten further (as seen in January 2017).

TRY carry is eye-wateringly attractive, but structural risks remain elevated. Look to tactically get long if the CBT hikes further.

- **High carry and significant balance of payments adjustments have pushed the MXN towards the top of our scorecard**, but uncertainty related to NAFTA and the July elections are likely to weigh in the first half of the year. While we think peso valuation is competitive, we see clearer scope for gains in local rates. Inflation has sequentially already been declining in recent months but in year-over-year terms will start falling back to the target range amid multi-year high real rates. Our economists' expectations for 100bps of rate cuts next year (vs. circa 5bps priced in) may impede sizable MXN gains but should most likely support duration.

Mexico competitively valued, but more value in rates than FX as Banxico may cut much more than markets expect in H2-18.

- **CNY's stability to extend into 2018.** The CNY ranks relatively low on our scorecard, mainly on a deteriorating trade balance, still-elevated REER, and below-average MBS score. However we still expect CNY to be broadly stable on a NEER basis in 2018 (2018 forecast: 6.70). Capital outflows have stalled (and may remain so amid UBS expectations for broad USD weakness), and capital account restrictions remain in place. If export volumes remain stable, we see few reasons for the authorities to weaken the NEER. In fact, if dollar were to sustain its secular weakness (or even stay stable), we may find CNY a reasonable candidate for volatility-adjusted carry at tactical points through the year.

CNY should be stable as the USD remains on the backfoot.

Box: Will the CNY's 2017 resilience sustain?

China's financial account showed a remarkable improvement in 2017; with capital outflows slowing down to almost zero vs. $400bn/annum outflows in 2015-16 (Figure 45). Capital account restrictions, broad dollar weakening and authorities' implicit change in FX management all played a significant role. Balance of payments data shows that the largest swing came from 'Other Investments' (mostly external debt and deposits), which improved from an average -3%/GDP in 2014-16 to +1.2% in 2017 (Figure 46). Regular followers of China's financial account would recall that a large part of capital outflows in recent years was driven by strong USD/CNY appreciation expectations (Figure 47), resulting in an unwind of corporate/retail carry trades (deposits and external debt). The dynamics turned completely in 2017: the USD weakened sharply, while PBoC kept the CNY NEER broadly stable with periods of abrupt strength.

Figure 45: Outflows stalled in 2017

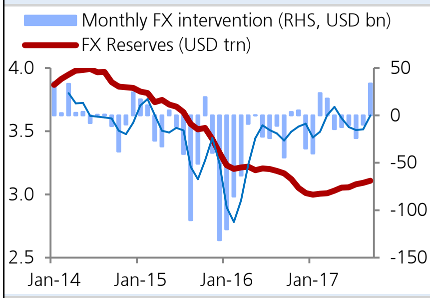


Figure 46: China's financial account

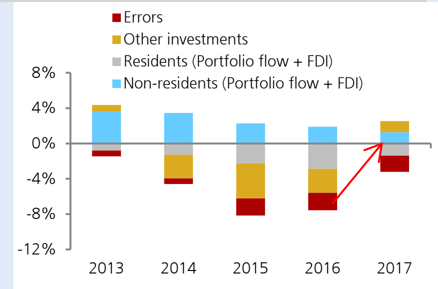
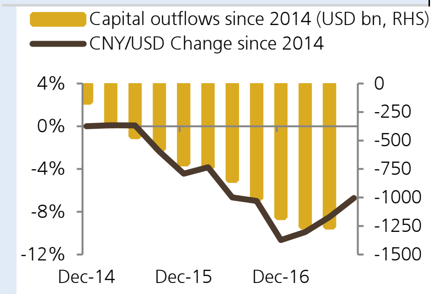


Figure 47: Outflows and FX moves



Three questions for 2018:

To assess whether the CNY will remain resilient in 2018, we address three pivotal questions: (1) Will the authorities ease capital controls? (2) Will there be a change in PBoC's FX policy? (3) If dollar strength resurfaces, could capital outflows pick up again?

- **Capital Account Restrictions**: Tighter capital outflow controls are among the most important factors underpinning recent CNY stability, so it's unlikely they will be significantly eased. Authorities remain wary of outbound flows and have recently been penalizing large firms for prior overseas investment deals. In short, the answer is not anytime soon. In fact, the capital controls easing has been the other way round so far, i.e., increased room for debt portfolio inflows.
- **FX Policy**: Up, down or flat? How do we assess? We find there is a very loose long term relationship between (lagged) growth in export volumes and the trade-weighted CNY (Figure 49). In fact, the NEER weakening in 2015 and stability/modest appreciation in 2017 do not appear completely out of sync with fundamentals. For 2018, we think barring a 2015-16-like global trade shock, NEER is likely to be range-bound. In Figure 50, we show range of outcomes for USDCNY depending on different EUR/USD and NEER outcomes. Just for the analysis, this exercise assumes historical FX sensitivities of the basket currencies to EUR and not our official forecasts. (USDCNY end-2018 forecast is 6.70)
- **What if broad dollar rally resurfaces?** While it's not our house view, but it's a fair tail risk scenario to assess. If USD/CNY completely reflects any sharp dollar strength in 2018 (risk scenario), capital outflow pressures could certainly re-surface. However, authorities' better command on capital account and corporates' better preparedness for such a shock means the amplitude of outflows would likely be much smaller (vs. 2015-16). Moreover, while it's difficult to establish a causal relationship, strength of domestic assets and capital flight from China interact with each other strongly. This implies the impact would be worst if a broad dollar strength and property market correction coincide. However, this is just a tail risk scenario, and not our base case forecast. We expect steady-to-lower USD/CNY in 2018.

Figure 48: G7 demand and CN exports

Figure 49: NEER and CN Exports

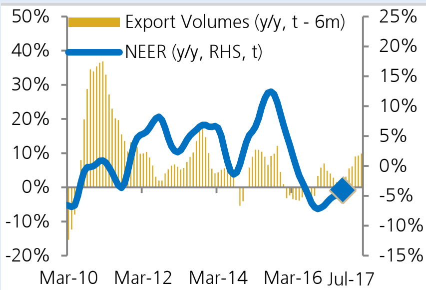


Figure 50: USD/CNY sensitivity to EUR/NEER*

NEER \ EUR	1.11	1.13	1.16	1.19	1.25
-5.0%	7.10	7.04	6.98	6.91	6.78
-2.5%	6.92	6.86	6.80	6.74	6.61
0.0%	6.75	6.69	6.63	6.57	6.44
2.5%	6.58	6.53	6.47	6.41	6.28
5.0%	6.43	6.37	6.31	6.25	6.13

Note: For this sensitivity table, we use historical regressions for other basket currencies vs. EUR (and not UBS 2018 forecasts). Source: UBS, Bloomberg, Haver

Rohit Arora and Mary Xia

Valuation Method and Risk Statement

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