UBS Investment Research

FX Morning Adviser

Talking Down the Good News

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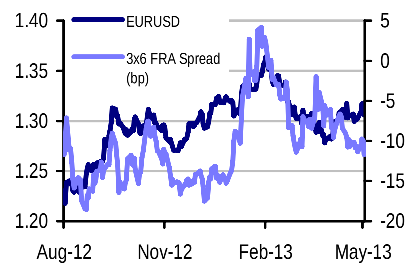
It was all plain sailing for the euro on Thursday until Draghi found an opening to express his 'openness' on negative deposit rates. Well aware that this was probably the only 'conventional' way to bring down the euro, this was a successful way in talking down the currency without even mentioning it. If we can also extrapolate now that Draghi's words meant the ECB is uncomfortable with a stronger euro, especially with the disinflationary pressures that it brings, Thursday's press conference would mark the beginning of a new phase in communications strategy which the market will have to adjust to. On a technical level, this actually can work, but we caution that 'diminishing returns' will become apparent before long.

Firstly, ECB would be well aware that they are already operating along very fine margins. Chart 1 shows the post-OMT state of play of the relationship between forward rate differentials (which policy expectations directly influence) and EURUSD. The range of the spread itself has held to a remarkably tight 25bp range – the size of one conventional policy move – yet EURUSD has managed a 15-big figure range. Before the crisis this kind of imbalance would have been unthinkable. Now, however, all G5 central banks have reached their zero bound (the ECB's refinancing rate has little influence on EONIA), but the exchange rates will still require some degree of anchoring based on technicalities and the model-driven investor segment. As a result, the impact of shifts in policy expectations on exchange rates has been amplified. The ECB and other central banks which still have some room for manoeuvre on rates are using this to their advantage for now, but they can only test the market so far. Perceived dithering over potential moves of 25-50bp to bring in 15-20 big figures worth of volatility is hardly worth the effort. At some points their bluff might even be called, putting credibility at stake.

Secondly, if we assume that diminishing returns to rate moves is in effect, how can the ECB then deal with the quantitative element? In many respects, Draghi acted out of necessity today because the ECB is a victim of its own 'success'. Out of the G5 its balance sheet is shrinking at by far the fastest pace, and even Thursday's commentary suggested that this was to their satisfaction. The problem though is that this process puts the ECB at a complete disadvantage in a market still fixated with balance sheet differentials. Chart 2 shows (unadjusted for FX) the relative growth between the Fed and the ECB's respective balance sheets, versus EURUSD. This relationship has held very well since 2010, and we could even argue that the euro is seriously undervalued given the significant shrinkage post-LTRO repayments. In the current environment, the ECB is being 'unconventional' because it will not or is unable to use active balance sheet expansion as a stimulus instrument when data is fading. This stands in sharp contrast to the FOMC's stance, which clearly warned of an increase in asset purchases should current trends continue. Even though the 'negative returns' to the dollar from more QE are also diminishing, it will still be potent in a reflationary scenario. Add the element of exigent short-EUR positioning across the board, and the 'risk' that data might start to improve somewhat in the Eurozone, the upside drivers for the currency suddenly look hard to stop and once again challenge the inflation outlook.

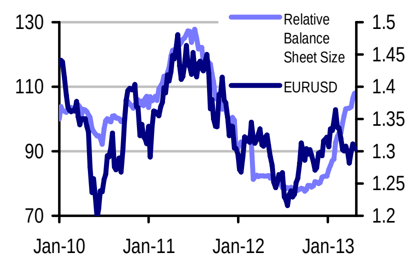
Ultimately something has to give, and avoiding deflation is a powerful incentive to keep the currency weak. External demand is not expected to pick up anytime soon, and core exporters are particularly at risk given their products' marginal buyers in emerging markets are slowing structurally. As a result, expect more of the same in future policy meetings: if the verbal firepower of threats to 'go negative' wanes, threats to 'go quantitative' might surface to offset upside risks. This just might cause enough unease amongst investors to keep the euro range-bound and investors gradually lose interest. As always, falling FX vol increases investment risk: reward, and that's the ultimate virtuous cycle that central banks will seek.

Chart 1: EURUSD vs. FRA Spread



Source: Bloomberg, UBS Calculations

Chart 2: EURUSD vs. Fed/ECB Balance Sheet Relative Size



Source: UBS Calculations

FX Technicals

EURUSD	BULLISH	The pair came under pressure after testing the critical resistance at 1.3228. Initial support is at 1.3037 ahead of 1.2955.
USDJPY	BULLISH	The latest setback does not change the broader bullish picture as long as strong support at 95.80 holds. Resistance is at 99.95.
GBPUSD	BULLISH	The pair posts new recovery high and tested the critical resistance at 1.5606, a closing break above this would open 1.5689. Support is at 1.5468.
USDCHF	NEUTRAL	There is a critical support at 0.9207 ahead of 0.9150. Near-term resistance is at 0.9373 ahead of 0.9457.
AUDUSD	BEARISH	The pair targets the support at 1.0221. A break here would be negative opening 1.0115. Resistance is at 1.0303 ahead of 1.0385.
USDCAD	BEARISH	With the MACD below its zero line any upside should be limited. Our support focus is on 1.0052 ahead of 0.9987. Resistance is at 1.0144.
EURCHF	NEUTRAL	There is a strong support at 1.2214, which is being tested currently. Next support is at 1.2177. Resistance is at 1.2264; a break here would open 1.2312.
EURGBP	BEARISH	The cross is trading just above the support is 0.8398; a break here would open 0.8287. Resistance is at 0.8498.
EURJPY	NEUTRAL	Resistance is at 129.91 ahead of 131.12. Initial support is at 127.06, a move below would signal scope for further correction to the strong support at 124.94.

***NOTE:** The trend for each currency pair as defined in the table is determined by our proprietary model and is independent of our discretionary interpretation of price action

Source: UBS FX Strategy

Key Events

Country	GMT	Release/Event	Frequency	UBS	Prev/Revised	Consensus	Actual
Australia	23:30	AiG Performance of Service Index (Apr)	index	n/a	49.6	n/a	44.1
China	01:00	Non-manufacturing PMI (Apr)	index	n/a	55.6	n/a	54.5
Australia	01:30	PPI (Q1)	q-o-q	n/a	0.20%	n/a	0.30%
Australia	01:30	PPI (Q1)	y-o-y	n/a	1.00%	n/a	1.60%
India	05:30	Cash Reserve Ratio	%	n/a	4.00%	4.00%	
India	05:30	India REPO Cutoff Yld	%	7.50%	7.50%	7.25%	
India	05:30	Reverse Repo Rate	%	6.50%	6.50%	6.25%	
Norway	*07:00*	*Norway PMI sa (Apr)*	*index*	*49.3*	*50.1*	*49.8*	
Norway	*08:00*	*Unemployment Rate (Apr)*	*%*	*2.60%*	*2.70%*	*2.60%*	
UK	*08:30*	*PMI Services (Apr)*	*index*	*52.6*	*52.4*	*52.4*	
Euro Area	09:00	Euro-Zone PPI (Mar)	m-o-m	n/a	0.20%	-0.20%	
Euro Area	09:00	Euro-Zone PPI (Mar)	y-o-y	n/a	1.30%	0.60%	
Euro Area	10:00	ECB Announces 3-Year LTRO Repayment					
United States	*12:30*	*Change in Nonfarm Payrolls (Apr)*	*lvl*	*130K*	*88K*	*140K*	
United States	*12:30*	*Change in Private Payrolls (Apr)*	*lvl*	*140K*	*95K*	*150K*	
United States	12:30	Change in Manufact. Payrolls (Apr)	lvl	n/a	-3K	5K	
United States	*12:30*	*Unemployment Rate (Apr)*	*%*	*7.60%*	*7.60%*	*7.60%*	
United States	12:30	Avg Hourly Earning All Emp (Apr)	m-o-m	0.10%	0.00%	0.20%	
United States	12:30	Avg Hourly Earning All Emp (Apr)	y-o-y	1.80%	1.80%	1.90%	
United States	13:00	Fed's Pinalto & Rosengren to Speak					
United States	14:00	Factory Orders (Mar)	m-o-m	-3.00%	3.00%	-2.90%	
United States	*14:00*	*ISM Non-Manf. Composite (Apr)*	*index*	*54.0*	*54.4*	*54.0*	
United States	16:30	Fed's Tarullo Speaks					
United States	16:45	Fed's Lacker Speaks					
Canada	*17:05*	*BoC's Carney Speaks*					

Source: UBS Global Economics, Bloomberg LP, Reuters LP, Reuters, Market News International

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