

FX Comment

The euro trap

FX

Global

Short term downside

The market consensus may expect the ECB to disappoint. This would appear to be a very reasonable position in our view, as there would seem to be little if any room for the ECB to surprise on the upside given the hyped-up expectations contrasting with institutional and operational realities. However, we would caution against underestimating the power of President Draghi's rhetoric and the credible threat of further negative steps as well as QE.

Limited longer term impact

We do not expect asset markets to sell off on the back of the ECB decision and instead would argue that they might even enjoy further support, at least marginally. For the euro, the situation might be trickier as apart from negative rates none of the possible ECB measures seem unambiguously currency bearish.

Hoping for the Fed

We stick to our 1.35 short term target, expecting a strong threat of deeper negative rates and QE to make an impression on the market. At the same time, however, we continue to believe that the ECB alone will be unable to engineer a further drop and that instead a change in Fed tone would be needed for that. If this is not forthcoming then we might well climb toward 1.40 once again.

Macro investors continue to struggle making money this year, particularly on rates and currencies. The euro has been one important reason for weak performances as many had started to finally become more positive at just the wrong moment, i.e. before the May ECB decision. Many were thus caught on the wrong foot and have now fallen back on their long held bearish views and, as a result, the market overall seems somewhat short. This might be true particularly on the slower real money side though positioning generally is thin and unconvinced as a reflection of the low volatility environment lacking any clear trends. However, on the more speculative side the prevailing consensus seems to expect the ECB to disappoint, with many traders preparing a 'buy-the-rumour-sell-the-fact' strategy. Some of this seemed to play out yesterday when a weak CPI flash estimate of just 0.5%yoy pushed the euro higher following an initial very short-lived drop. This attitude makes a lot of sense, in our view: It is hard to see the ECB surprising on the upside given the hyped-up expectations contrasting with institutional and operational realities. A symmetrical 10-15bp rate cut is arguably now fully priced in and has pushed the euro from close to 1.40 to around 1.36. In other words, 10-15bp of negative rates have bought the ECB around 5-6 big figures on EURUSD, assuming we would have gone to 1.41 or 1.42 without President Draghi telegraphing the move last month (UBS FX Comment: ECB – Taboos, packages and red lines, 27 May 2014)¹. Equally in the money market the Eonia curve has dropped substantially with the 3m swap now trading at almost 10bp from around 17bp prior to the May decision.

Short term downside

Back in early April we had argued that given the remarkably dovish turn in Draghi's communication our 1.35 target had finally come into view (UBS FX Comment: Decisive Central Bank Moments, 4 April 2014). We continue to think that a short term bearish euro position makes sense going into the ECB meeting as we do not expect the ECB to disappoint substantially. This is not because we expect any fireworks in terms of new policy action. Indeed, the move into negative rates would still not be an easy one for many members of the Governing Council. The market may have moved on but for policymakers it is hard to take such an unprecedented step and right away deliver even more complex measures at the same time - be they on targeted lending programmes or asset purchases. We thus do not expect formal announcements of any such programmes. However, we do expect President Draghi to retain an ultra-dovish tone and exhaustively stress 1) the threat of further rates action and 2) the threat of QE. If the decision was to cut 10bp, then he could very credibly claim that at least two more such steps would be possible. He could also emphasise the strong willingness to embark on a broad based asset purchase programme, i.e. QE, if inflation concerns were to escalate. Finally, he could indicate his confidence that both a credit easing programme as well as an ABS purchase programme would be launched over the next few months. All of this together may be enough to, at worst, prevent a meaningful sell off in asset markets and, at best, provide additional fuel for the recent rally.

Hoping for the Fed

The euro reaction might be trickier to predict. The problem is, as we have often pointed out, that most fundamental forces are currency positive, including still growing external surpluses, ongoing financial sector deleveraging, heavy capital

¹See also UBS Macro Keys: Lifting the lid on the ECB's toolbox, 23 May; UBS Fixed Income Strategy Comment: How to play the June ECB meeting, 2 Jun

inflows and global reserve manager demand. A further marginal widening of the interest differential will hardly change the trend. Equally, any credit easing and ABS purchase schemes might well be helpful economically, but in our view are unlikely to become balance sheet, and thus currency, relevant. And even outright QE might not be unambiguously euro negative as it might simply attract yet more capital inflows as European bond and equity markets would become even more attractive. As a result, the ECB will be under no illusion that it has the ability to sustainably weaken the euro (UBS FX Comment: Can the ECB weaken the euro? 6 May 2014). Instead, it might be satisfied to limit the appreciation until the time when the Fed would more actively push towards policy normalisation and thereby, hopefully, boost the dollar. Indeed, a frustration with the lack of policy normalisation at the Fed and the resulting dollar weakness might well be the single most important reason why the ECB has adopted a very considerably more dovish tone over recent months and is now willing to take measures that until quite recently might have been seen as questionable at best and dangerous at worst. Monetary policy in an open system is always relative, meaning that there is more than an element of competition between central banks. If the Fed remains exceptionally accommodative, then we think the ECB needs to keep up if it wants to prevent a stronger exchange rate, even if many might be of the view that the trough in inflation has now been reached, that deflation is not a real risk and that in any case monetary policy cannot fix the many structural issues in the system.

Conclusion

The market consensus may expect the ECB to disappoint. This is a very reasonable position in our view, as there would seem to be little if any room for the ECB to surprise on the upside given the hyped-up expectations contrasting with institutional and operational realities. However, we would caution against underestimating the power of President Draghi's rhetoric and the credible threat of further negative steps as well as QE.

We do not expect asset markets to sell off on the back of the ECB decision and instead would argue that they might even enjoy further support, at least marginally. For the euro, the situation might be trickier as apart from negative rates none of the possible ECB measures seem unambiguously currency bearish.

We stick to our 1.35 short term target, expecting a strong threat of deeper negative rates and QE to make an impression on the market. At the same time, however, we continue to believe that the ECB alone will be unable to engineer a further drop and that instead a change in Fed tone would be needed for that. If this is not forthcoming then we might well climb toward 1.40 once again.

Required Disclosures

This report has been prepared by UBS Limited, an affiliate of UBS AG. UBS AG, its subsidiaries, branches and affiliates are referred to herein as UBS.

For information on the ways in which UBS manages conflicts and maintains independence of its research product; historical performance information; and certain additional disclosures concerning UBS research recommendations, please visit www.ubs.com/disclosures. The figures contained in performance charts refer to the past; past performance is not a reliable indicator of future results. Additional information will be made available upon request. UBS Securities Co. Limited is licensed to conduct securities investment consultancy businesses by the China Securities Regulatory Commission.

Analyst Certification: Each research analyst primarily responsible for the content of this research report, in whole or in part, certifies that with respect to each security or issuer that the analyst covered in this report: (1) all of the views expressed accurately reflect his or her personal views about those securities or issuers and were prepared in an independent manner, including with respect to UBS, and (2) no part of his or her compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by that research analyst in the research report.

Global Disclaimer

This document has been prepared by UBS Limited, an affiliate of UBS AG. UBS AG, its subsidiaries, branches and affiliates are referred to herein as UBS.

This document is for distribution only as may be permitted by law. It is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or would subject UBS to any registration or licensing requirement within such jurisdiction. It is published solely for information purposes; it is not an advertisement nor is it a solicitation or an offer to buy or sell any financial instruments or to participate in any particular trading strategy. No representation or warranty, either express or implied, is provided in relation to the accuracy, completeness or reliability of the information contained in this document ('the Information'), except with respect to Information concerning UBS. The Information is not intended to be a complete statement or summary of the securities, markets or developments referred to in the document. UBS does not undertake to update or keep current the Information. Any opinions expressed in this document may change without notice and may differ or be contrary to opinions expressed by other business areas or groups of UBS. Any statements contained in this report attributed to a third party represent UBS's interpretation of the data, information and/or opinions provided by that third party either publicly or through a subscription service, and such use and interpretation have not been reviewed by the third party.

Nothing in this document constitutes a representation that any investment strategy or recommendation is suitable or appropriate to an investor's individual circumstances or otherwise constitutes a personal recommendation. Investments involve risks, and investors should exercise prudence and their own judgement in making their investment decisions. The financial instruments described in the document may not be eligible for sale in all jurisdictions or to certain categories of investors. Options, derivative products and futures are not suitable for all investors, and trading in these instruments is considered risky. Mortgage and asset-backed securities may involve a high degree of risk and may be highly volatile in response to fluctuations in interest rates or other market conditions. Foreign currency rates of exchange may adversely affect the value, price or income of any security or related instrument referred to in the document. For investment advice, trade execution or other enquiries, clients should contact their local sales representative.

The value of any investment or income may go down as well as up, and investors may not get back the full amount invested. Past performance is not necessarily a guide to future performance. Neither UBS nor any of its directors, employees or agents accepts any liability for any loss (including investment loss) or damage arising out of the use of all or any of the Information.

Any prices stated in this document are for information purposes only and do not represent valuations for individual securities or other financial instruments. There is no representation that any transaction can or could have been effected at those prices, and any prices do not necessarily reflect UBS's internal books and records or theoretical model-based valuations and may be based on certain assumptions. Different assumptions by UBS or any other source may yield substantially different results.

Research will initiate, update and cease coverage solely at the discretion of UBS Investment Bank Research Management. The analysis contained in this document is based on numerous assumptions. Different assumptions could result in materially different results. The analyst(s) responsible for the preparation of this document may interact with trading desk personnel, sales personnel and other parties for the purpose of gathering, applying and interpreting market information. UBS relies on information barriers to control the flow of information contained in one or more areas within UBS into other areas, units, groups or affiliates of UBS. The compensation of the analyst who prepared this document is determined exclusively by research management and senior management (not including investment banking). Analyst compensation is not based on investment banking revenues; however, compensation may relate to the revenues of UBS Investment Bank as a whole, of which investment banking, sales and trading are a part.

For financial instruments admitted to trading on an EU regulated market: UBS AG, its affiliates or subsidiaries (excluding UBS Securities LLC) acts as a market maker or liquidity provider (in accordance with the interpretation of these terms in the UK) in the financial instruments of the issuer save that where the activity of liquidity provider is carried out in accordance with the definition given to it by the laws and regulations of any other EU jurisdictions, such information is separately disclosed in this document. For financial instruments admitted to trading on a non-EU regulated market: UBS may act as a market maker save that where this activity is carried out in the US in accordance with the definition given to it by the relevant laws and regulations, such activity will be specifically disclosed in this document. UBS may have issued a warrant the value of which is based on one or more of the financial instruments referred to in the document. UBS and its affiliates and employees may have long or short positions, trade as principal and buy and sell in instruments or derivatives identified herein; such transactions or positions may be inconsistent with the opinions expressed in this document.

United Kingdom and the rest of Europe: Except as otherwise specified herein, this material is distributed by UBS Limited to persons who are eligible counterparties or professional clients. UBS Limited is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority. **France:** Prepared by UBS Limited and distributed by UBS Limited and UBS Securities France S.A. UBS Securities France S.A. is regulated by the ACP (Autorité de Contrôle Prudentiel) and the Autorité des Marchés Financiers (AMF). Where an analyst of UBS Securities France S.A. has contributed to this document, the document is also deemed to have been prepared by UBS Securities France S.A. **Germany:** Prepared by UBS Limited and distributed by UBS Limited and UBS Deutschland AG. UBS Deutschland AG is regulated by the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin). **Spain:** Prepared by UBS Limited and distributed by UBS Limited and UBS Securities España SV, SA. UBS Securities España SV, SA is regulated by the Comisión Nacional del Mercado de Valores (CNMV). **Turkey:** Distributed by UBS Limited. No information in this document is provided for the purpose of offering, marketing and sale by any means of any capital market instruments and services in the Republic of Turkey. Therefore, this document may not be considered as an offer made or to be made to residents of the Republic of Turkey. UBS AG is not licensed by the Turkish Capital Market Board under the provisions of the Capital Market Law (Law No. 6362). Accordingly, neither this document nor any other offering material related to the instruments/services may be utilized in connection with providing any capital market services to persons within the Republic of Turkey without the prior approval of the Capital Market Board. However, according to article 15 (d) (ii) of the Decree No. 32, there is no restriction on the purchase or sale of the securities abroad by residents of the Republic of Turkey. **Poland:** Distributed by UBS Limited (spółka z ograniczoną odpowiedzialnością) Oddział w Polsce. **Russia:** Prepared and distributed by UBS Securities CJSC. **Switzerland:** Distributed by UBS AG to persons who are institutional investors only. **Italy:** Prepared by UBS Limited and distributed by UBS Limited and UBS Italia Sim S.p.A. UBS Italia Sim S.p.A. is regulated by the Bank of Italy and by the Commissione Nazionale per le Società e la Borsa (CONSOB). Where an analyst of UBS Italia Sim S.p.A. has contributed to this document, the document is also deemed to have been prepared by UBS Italia Sim S.p.A. **South Africa:** Distributed by UBS South Africa (Pty) Limited, an authorised user of the JSE and an authorised Financial Services Provider. **Israel:** This material is distributed by UBS Limited. UBS Limited is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority. UBS Securities Israel Ltd is a licensed Investment Marketer that is supervised by the Israel Securities Authority (ISA). UBS Limited and its affiliates incorporated outside Israel are not licensed under the Israeli Advisory Law. This Material is being issued only to and/or is directed only at persons who are Qualified Investors within the meaning of the Israeli Advisory Law, and this material must not be relied on or acted upon by any other persons. **Saudi Arabia:** This document has been issued by UBS AG (and/or any of its subsidiaries, branches or affiliates), a public company limited by shares, incorporated in Switzerland with its registered offices at Aeschenvorstadt 1, CH-4051 Basel and Bahnhofstrasse 45, CH-8001 Zurich. This publication has been approved by UBS Saudi Arabia (a subsidiary of UBS AG), a Saudi closed joint stock company incorporated in the Kingdom of Saudi Arabia under commercial register number 1010257812 having its registered office at Tatweer Towers, P.O. Box 75724, Riyadh 11588, Kingdom of Saudi Arabia. UBS Saudi Arabia is authorized and regulated by the Capital Market Authority to conduct securities business under license number 08113-37. **United States:** Distributed to US persons by either UBS Securities LLC or by UBS Financial Services Inc., subsidiaries of UBS AG; or by a group, subsidiary or affiliate of UBS AG that is not registered as a US broker-dealer (a 'non-US affiliate') to major US institutional investors only. UBS Securities LLC or UBS Financial Services Inc. accepts responsibility for the content of a document prepared by another non-US affiliate when distributed to US persons by UBS Securities LLC or UBS Financial Services Inc. All transactions by a US person in the securities mentioned in this document must be effected through UBS Securities LLC or UBS Financial Services Inc., and not through a non-US affiliate. **Canada:** Distributed by UBS Securities Canada Inc., a registered investment dealer in Canada and a Member-Canadian Investor Protection Fund, or by another affiliate of UBS AG that is registered to conduct business in Canada or is otherwise exempt from registration. **Brazil:** Except as otherwise specified herein, this material is prepared by UBS Brasil CCTVM S.A. to persons who are eligible investors residing in Brazil, which are considered to be: (i) financial institutions, (ii) insurance firms and investment capital companies, (iii) supplementary pension entities, (iv) entities that hold financial investments higher than R\$300,000.00 and that confirm the status of qualified investors in written, (v) investment funds, (vi) securities portfolio managers and securities consultants duly authorized by Comissão de Valores Mobiliários (CVM), regarding their own investments, and (vii) social security systems created by the Federal Government, States, and Municipalities. **Hong Kong:** Distributed by UBS Securities Asia Limited. **Singapore:** Distributed by UBS Securities Pte. Ltd. [mica (p) 107/09/2013 and Co. Reg. No.: 198500648C] or UBS AG, Singapore Branch. Please contact UBS Securities Pte. Ltd., an exempt financial adviser under the Singapore Financial Advisers Act (Cap. 110); or UBS AG, Singapore Branch, an exempt financial adviser under the Singapore Financial Advisers Act (Cap. 110) and a wholesale bank licensed under the Singapore Banking Act (Cap. 19) regulated by the Monetary Authority of Singapore, in respect of any matters arising from, or in connection with, the analysis or document. The recipients of this document represent and warrant that they are accredited and institutional investors as defined in the Securities and Futures Act (Cap. 289). **Japan:** Distributed by UBS Securities Japan Co., Ltd. to institutional investors only. Where this document has been prepared by UBS Securities Japan Co., Ltd., UBS Securities Japan Co., Ltd. is the author, publisher and distributor of the document. Distributed by UBS AG, Tokyo Branch to Professional Investors (except as otherwise permitted) in relation to foreign exchange and other banking businesses when relevant. **Australia:** 1) Distributed by UBS AG (Holder of Australian Financial Services License No. 231087) and/or UBS Securities Australia Ltd (Holder of Australian Financial Services License No. 231098). The Information in this document has been prepared without taking into account any investor's objectives, financial situation or needs, and investors should, before acting on the Information, consider the appropriateness of the Information, having regard to their objectives, financial situation and needs. If the Information contained in this document relates to the acquisition, or potential acquisition of a particular financial product by a 'Retail' client as defined by section 761G of the Corporations Act 2001 where a Product Disclosure Statement would be required, the retail client should obtain and consider the Product Disclosure Statement relating to the product before making any decision about whether to acquire the product. 2) Clients of UBS Wealth Management Australia Ltd: This notice is distributed to clients of UBS Wealth Management Australia Ltd ABN 50 005 311 937 (Holder of Australian Financial Services Licence No. 231127), Chifley Tower, 2 Chifley Square, Sydney, New South Wales, NSW 2000, by UBS Wealth Management Australia Ltd. This Document contains general information and/or general advice only and does not constitute personal financial product advice. As such the content of the Document was prepared without taking into account the objectives, financial situation or needs of any specific recipient. Prior to making any investment decision, a recipient should obtain personal financial product advice from an independent adviser and consider any relevant offer documents (including any product disclosure statement) where the acquisition of financial products is being considered. UBS AG is authorised to provide financial product advice in relation to foreign exchange contracts in Australia, and as such UBS AG is responsible for all general advice on foreign exchange and currencies contained herein. **New Zealand:** Distributed by UBS New Zealand Ltd. The information and recommendations in this publication are provided for general information purposes only. To the extent that any such information or recommendations constitute financial advice, they do not take into account any person's particular financial situation or goals. We recommend that recipients seek advice specific to their circumstances from their financial advisor. **Dubai:** The research distributed by UBS AG Dubai Branch is intended for Professional Clients only and is not for further distribution within the United Arab Emirates. **Korea:** Distributed in Korea by UBS Securities Pte. Ltd., Seoul Branch. This document may have been edited or contributed to from time to time by affiliates of UBS Securities Pte. Ltd., Seoul Branch. **Malaysia:** This material is authorized to be distributed in Malaysia by UBS Securities Malaysia Sdn. Bhd (253825-x). **India:** Prepared by UBS Securities India Private Ltd. 2/F, 2 North Avenue, Maker Maxity, Bandra Kurla Complex, Bandra (East), Mumbai (India) 400051. Phone: +912261556000 SEBI Registration Numbers: NSE (Capital Market Segment): INB230951431, NSE (F&O Segment) INF230951431, BSE (Capital Market Segment) INB010951437.

The disclosures contained in research documents produced by UBS Limited shall be governed by and construed in accordance with English law.

UBS specifically prohibits the redistribution of this document in whole or in part without the written permission of UBS and UBS accepts no liability whatsoever for the actions of third parties in this respect. Images may depict objects or elements that are protected by third party copyright, trademarks and other intellectual property rights. © UBS 2014. The key symbol and UBS are among the registered and unregistered trademarks of UBS. All rights reserved.

