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**Macro**
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# Currency Special

## USD bull run: the beginning of the end

We believe the USD rally is nearing its end. This is in contrast to a market which appears determined to envisage ever greater upside for the currency. The USD has already rallied more than is typical historically, and many of the arguments currently being used to justify an extension are likely already in the price.

Having been one of the early adopters of a bullish USD view back in 2013, we now see factors that make us believe we are at the beginning of the end:

- Recent data developments
- US tolerance for USD strength has its limits
- Valuations
- Positioning / USD bullishness has become all-pervasive
- USD does not perform once Fed has actually pulled the trigger

There is obviously scope for one last spike higher, as is often the case in the later phase of big bear or bull market moves, which sucks all participants into the narrative. So convinced become the participants that any rational arguments fall on deaf ears and forecasters start coming out with ever more extreme views. But it is time to start looking the other way as this last spike is likely to be reversed swiftly. When the world seems to be revising EUR-USD expectations ever lower, we are moving the opposite way. Our forecast for year-end 2016 is now 1.10 compared to 1.05 previously, and we believe the rate will move to 1.20 during 2017.

Clearly there are events such as EUR break-up or JPY debasement which could lead to destructive dollar strength. But these are very much tail risks and we believe it would be a mistake to be drawn into the forecasting fashion of relentless dollar dominance. Markets are so caught up in the price action they are ignoring anything that suggests the move might end. The feeling in the market is that we are in the middle of a sustained USD rally whereas we would argue this is, in fact, the beginning of the end of the bull run.

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# Executive Summary

## The beginning of the end of the USD bull run

Having been one of the early adopters of a bullish USD view back in 2013, we now believe the USD rally is nearing its end. This is in contrast to a market which appears determined to envisage ever greater upside for the currency.

### The USD has already moved a long way

When the USD rally began in earnest in mid-2014, we looked to history for a guide as to what might be considered a sizeable appreciation. Excluding the mega-rallies of the early 1980s and mid-1990s, the average USD rally has been roughly 20% based on the DXY index, and has lasted just under a year. This time around, we have seen a rise of over 25% since June 2014 alone. We have already moved beyond the historical norm. Were we to take the low in 2011 as the starting point, the USD rally has been an even more dramatic 40% so far. In addition, the QE-induced declines seen in the EUR and JPY already outstrip the 20% depreciation posted by the USD during the Federal Reserve's QE1 and QE2 programmes.

### Monetary policy divergence is in the price

The arguments being promoted by the consensus for additional USD strength are getting stale. Monetary policy divergence has clearly been a key driver to the shift in exchange rates, and offers a clear rationale for the movements we have already seen. But much of it is in the price. There may be a debate over the timing of the first Fed hike, but the market generally accepts that it will happen this year, and that rates will move up only slowly thereafter. One argument is the USD will continue to rise because US interest rates will rise a lot more than the market expects. Our view on this line of thinking is: if you think you know what is going to happen in the interest rate markets why are you trading the USD? Just trade the interest rates market instead. In Europe, the ECB has laid out its plan for QE so they are effectively on auto-pilot. In Japan, the 'shock and awe' of QE has long since passed. The drama offered by policy divergence has already run its course. The USD rally will stall as the market demands "tell me something I don't know".

### Most evidence suggests the USD rally is done

The USD bull needs feeding and new factors challenge the consensus view that the USD can extend in a sustained way. The US economy may outpace others in G10, but the **disappointing data** on activity are mounting and are being ignored. US inflation remains shy of target. Policymaker tolerance for USD strength will not be limitless. At the same time, the Eurozone economy is beginning to deliver frequent upside surprises on activity, also being ignored by the FX markets. The recalibration of growth expectations could become EUR positive. In addition, **valuations** show the USD is nearly the world's most overvalued currency, outdone only by the CHF. **Positioning** has become universally bullish USD, both in terms of the market and the forecasting community, leaving it exposed to any reversal. It also begs the question why the market is happy to accept such unanimous agreement. The reversal could be prompted by the first Fed hike; as history shows the USD weakens in the months after the first tightening.

## But there is scope for a last lurch higher before reversing

We accept there is scope for one last spike higher before the rally comes to an end. An analysis of major market moves shows a tendency for the bulk of the move to happen towards the very end as doubters capitulate and join the party just before it finishes in an over-crowded mess. We suspect we are already in the last throes of the USD bull party, which will be followed by a larger reversal.

## The danger of a destructive USD rally remains

There are circumstances under which the USD rally could continue, but these largely reflect tail risks outside of the US and would point to a destructive USD surge rather than the generally benevolent one we have seen so far. In earlier research we have flagged the dangers of Japan's policymakers losing control of the JPY, or EUR break-up, or of an EM FX crisis. All would point to a much stronger USD, as would any legislation introduced in the US to effectively compel corporates to repatriate overseas earnings. If these tail risks come to fruition then we will be wrong in calling the end to the USD bull run.

## Markets will have to distinguish between the last spike and a tail risk event

Recognising USD strength propelled by a EUR crisis or Japanese policy failure should be straightforward, but it may be less easy to distinguish between an EM FX crisis and one that is simply an echo of the last lurch in the USD rally. We continue to believe a necessary component of a broader EM crisis would be higher US yields and a steeper yield curve – something we are not forecasting. So far, the EM sell-off still feels like a natural consequence of slower global cycle and the highly cyclical nature of EM.

## This is the beginning of the end for the USD rally

These tail risks are low probability events and our central case is that we are witnessing the beginning of the end of the USD rally. There will likely be one last surge for the USD, but we would warn against being drawn into this excess. In fact, we have revised our forecasts for EUR-USD higher in 2016 to 1.10 from 1.05 previously. The new forecasts are shown in the table below. We were early to join the USD bull party, but like any good party, understanding when it is time to leave is critical. That time is drawing ever closer.

**HSBC currency forecasts**

| | Q2 15 | Q3 15 | Q4 15 | Q1 16 | Q2 16 | Q3 16 | Q4 16 |
|---|---|---|---|---|---|---|---|
| EUR-USD | 1.01 | 1.05 | 1.05 | 1.07 | 1.08 | 1.10 | 1.10 |
| USD-JPY | 124 | 126 | 128 | 128 | 129 | 129 | 130 |
| GBP-USD | 1.46 | 1.46 | 1.45 | 1.45 | 1.45 | 1.45 | 1.45 |
| EUR-GBP | 0.69 | 0.72 | 0.72 | 0.74 | 0.74 | 0.76 | 0.76 |

Source: HSBC

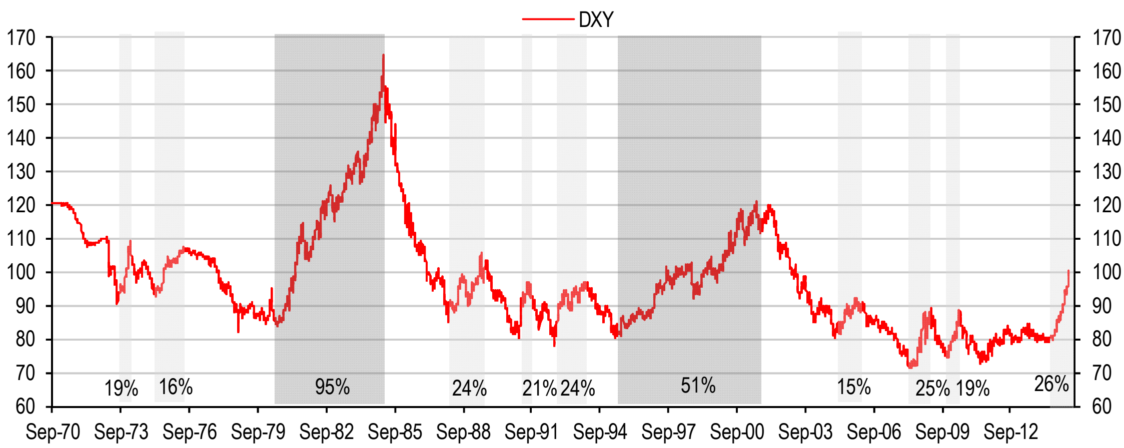
# The beginning of the end

There is a Japanese saying which encourages us to "enjoy the party, but dance close to the exit". It is advice that could be usefully applied to the USD bull run currently. Judging by the ever growing enthusiasm for the currency and the progressively more upbeat forecasts, the market appears to think the USD party is nowhere near its end. In this report we will outline why we believe this is a dangerous assumption. While there may be scope for one last thrust higher for the USD, we are likely now witnessing the beginning of the end for this USD rally. It would be prudent to challenge the consensus and start looking for signs that things are about to turn. In short we are much closer to the end than the beginning of the USD bull run.

## The USD has already moved a long way

We accept there are arguments for USD strength. After all, we were among the earliest adopters of a USD bull theme, converted from our long-running bearishness once US Fed Chairman Bernanke first mentioned the prospect of 'tapering' back on 22 May 2013 (see *'Currency War, USD to soar'*, 22 May 2013) In drafting our forecasts, we looked to history for some guide as to what might represent a sizeable USD bull run. Chart 1 shows the DXY dollar index dating back to the early 1970s, with the main periods of USD strength highlighted in the shaded grey areas. Two rallies stand out, the first in the early 80s when the USD nearly doubled in value, and the second in the mid-90s when it rose by nearly 50%. But apart from these two 'mega-rallies', the average USD rally has been around 20% and lasted just under a year.

**1. Excluding the mega rallies, the latest USD rally has been bigger than average**

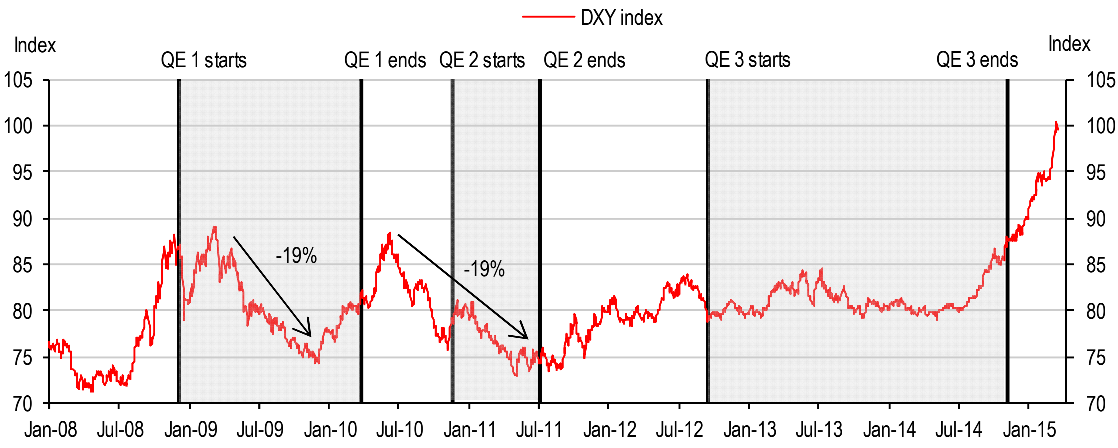



Source: Bloomberg, HSBC

The current USD bull run has already exceeded this historic average. Since June 2014, the rise has been over 25%. Arguably, one could take the starting point as the low in April 2011, in which case the gain is just shy of 40%. In either case, we have seen a USD rally which is greater than the average seen since the early 1970s. This is already a "big" USD rally.

But some may argue that this should be an outsized rally as USD strength is largely the mirror to unconventional and unprecedented monetary easing elsewhere, and so history cannot be used as a gauge. We disagree. After all, the US has been through the QE process. Chart 2 again shows the DXY index but this time the shaded areas are the three periods of QE in the US. It shows the USD fell roughly 20% during QE1, and another 20% in anticipation of and during QE2. It was largely flat during QE3. So the shifts in the JPY (-35%) and the EUR (-25%) driven by their QE strategies are already greater than witnessed in the US.

**2. US QE1 and QE2 delivered close to 20% USD adjustments. EUR and JPY declines due to their QE already exceed this.**




Source: Bloomberg, HSBC

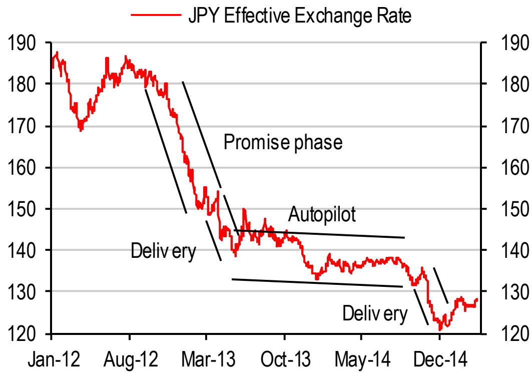
## Monetary policy divergence is in the price

There is a lot in the price, yet the appeal of divergent monetary policy still has an incredibly strong hold on the currency market. Those advocating further USD gains versus the EUR and JPY, for example, point to the likelihood that the US Federal Reserve will be raising rates at some stage this year whereas the ECB and the BoJ will continue to expand their balance sheets. We have no problem with the logic; it is identical to the argument we used at the outset for our USD bull case nearly two years ago.

The difficulty is that a bull needs feeding, and this story has already been digested. Fed funds futures are already fully priced for an interest rate hike this year by the Fed, and a further hikes during 2016. Unless one believes the Fed is going to be even more aggressive in delivering rate hikes, there are no grounds here for continuing to buy the USD. Those that think the interest rate contracts are mispriced should trade them directly.

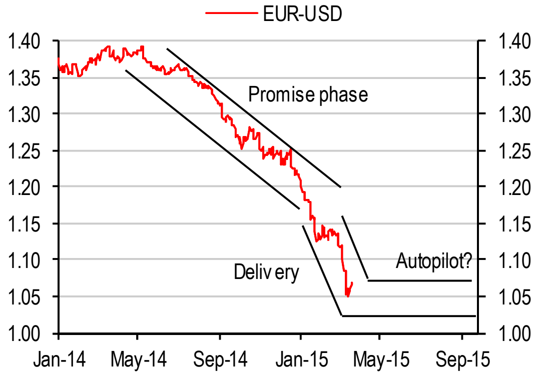
Those keen to buy the USD against the EUR and the JPY on the basis of QE, need to look back at the JPY experience for a useful historical parallel. In Chart 3 we identify the different phases of the JPY sell-off. The period from October 2012 to April 2013 was one of 'promises' when Japanese policymakers signalled their determination to do whatever it would take to get inflation higher. The JPY weakened in anticipation of policy action. Then the BoJ actually delivered with its 'shock and awe' tactic to double the monetary base in two years and push inflation to 2%. The JPY took another lurch weaker. But beyond this point the BoJ had shifted into autopilot. The market knew the plan – job done. Only when the central bank surprised with its October 2014 easing was the market jolted into fresh JPY selling.

3. The JPY sell-off around QE has had distinct phases




Source: Bloomberg, HSBC

4. The EUR is now in 'autopilot' phase




Source: Bloomberg, HSBC

Chart 4 shows that the ECB has moved through a similar promise phase when Mario Draghi and his colleagues made progressively more overt hints that unconventional easing would be a likely response to the growing deflation theat. This has been followed by the initial 'shock and awe' delivery, admittedly not on the scale of the BoJ, but the ECB's EUR60bn monthly purchase rate was larger than the market expected. And now we have moved into the autopilot phase. The ECB has laid out its plans for QE – how much and how long for. Unless you think economic conditions will force a change of tactic by the ECB, presumably to accelerate the pace of QE, then there are simply not grounds here for persistent EUR selling.

To stress the point, we have now passed the dramatic phases of Japanese QE and ECB QE. We have also priced US rate hikes in. Only those who believe actual delivery by the Fed will make a difference should be USD bulls. However, as we show later in the piece, when the Fed actually pulls the trigger the USD has traditionally already done its thing.

## Most evidence suggests the USD rally is done

If monetary policy divergence is so well known by the markets and therefore largely priced in, the hunt should be on for other factors that could determine the next stage in the USD story. We believe a number of these argue against additional USD strength.

1) The cycle is surprisingly EUR-USD bullish

2) US tolerance for USD strength has its limits

3) Valuations show the USD is 'rich'

4) USD bullishness has become all-pervasive

5) The USD weakens in the early months of a Fed-hike cycle

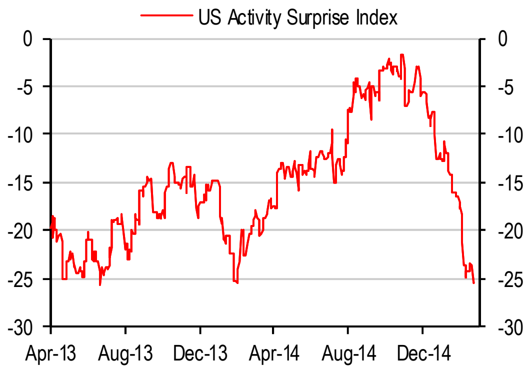
## 1) The cycle is surprisingly EUR-USD bullish

At first glance, any consideration of the economic cycle would surely point to USD dominance. After all, the consensus expectation for US GDP growth in 2015 is 3.0%, roughly three times that expected in either Japan or the Eurozone. In addition, over the last year, the consensus for the US has held steady but forecast growth rates for both Japan and the Eurozone have been trimmed back.

But here too we run into the difficulty of what is already in the price. This gap in growth prospects is echoed in the divergent expectations for monetary policy which we believe is already reflected in the USD rally. Looking forward, the issue for the FX market is whether these expectations are being challenged by the data.

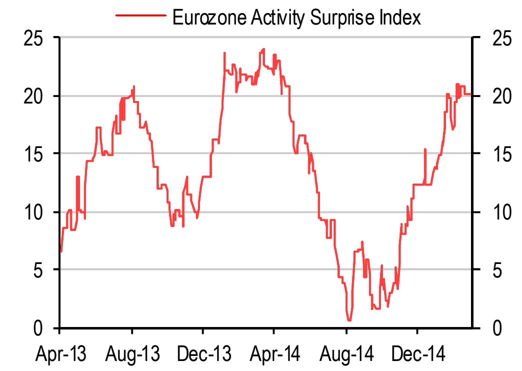
Charts 5 and 6 show our economic activity surprise index measures for the US and the Eurozone. When the lines are moving upwards, it shows that activity data is coming out better than the market expected. For much of 2014, this happy dynamic was evident in the US, encouraging forecasters to revise their expectations for growth progressively higher. However, the picture has clearly changed since late 2014, as the shortfalls in US data have begun to mount. At the same time, the Eurozone is beginning to surprise on the upside, and activity data entering 2015 has begun to signal a revival. The same pattern is shown in the HSBC Leading Indicators (see *'Momentum surges through 50'*, 18 March 2015) which shows the area of weakness being in the Americas with the European region continuing to advance.

**5. US economic data has become disappointing...**




Source: Bloomberg, HSBC

**6. ...whereas the Eurozone is surprisingly strong**




Source: Bloomberg, HSBC

The currency market is content to ignore this dynamic because the exclusive focus is on the fact that ECB has embarked on QE and the Fed is, at some not too distant point, set to pull the interest rate trigger. But the reality of the economic data is that relative to expectations, the numbers have been surprisingly EUR-USD positive. Under "normal" circumstances the market would be looking for a higher EUR-USD not a move down through parity.

## 2) US tolerance for USD strength has its limits

Part of the explanation for the market's willingness to disregard the US economic disappointments is because the data has not forced a change of rhetoric from the Fed. The tone continues to validate expectations for a rate hike at some point this year. The Fed are telling us they are going to hike, so it is best to believe them even if the data could make the case for a pause.

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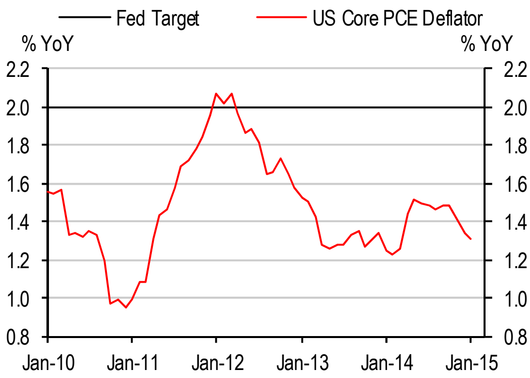
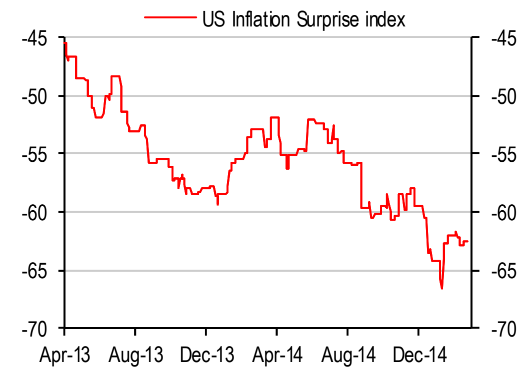
**7. US inflation is tracking well below the Fed's target**




Source: Bloomberg, HSBC

**8. US inflation measures have been softer than expected**



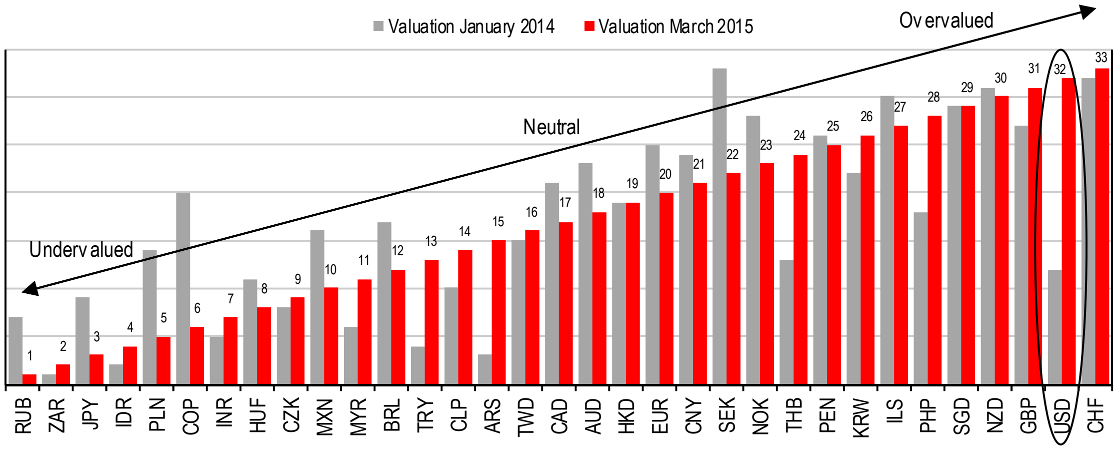

Source: Bloomberg, HSBC

But the data remains relevant in a different context. The tolerance for USD strength also has its limits. We have noted in the past that forecasts of ever greater USD gains rely on the questionable assumption that US policy will be completely passive regarding the currency. This continues to strike us as highly improbable. It relies upon an assumption that the US economy is growing sufficiently quickly to generate enough internal inflation to offset the disinflation it is importing by virtue of the strong USD. The downside surprises in activity raise a red flag as to whether this will prove true. In addition, charts 7 and 8 show that the Fed's preferred measure of inflation is below target, and inflation data in general is generally surprising on the downside.

It would not take much in terms of a further language change at the Fed to put a big hole in the consensus argument for relentless USD strength. Chair Yellen has already highlighted the economic truism that a stronger USD will make inflation lower than would otherwise be the case. This may be part of the reason for the Fed's lower projections of how high rates may have to go. After all, the USD is already doing the Fed's tightening work for it. So for an example of what impact this statement can have on a currency, one only has to look to the EUR. At the ECB's May 2014 meeting, Draghi became more explicit about the effects the EUR was having on their mandate, noting that "the exchange rate is a … serious concern for our objective of price stability and therefore this concern will have to be addressed". EUR-USD hit 1.3994 that day, but it was the high, and it marked the start of a declining EUR from which we have not looked back. The power of verbal intervention by policymakers in the currency markets is well documented. Another prime example was in January 2004 when Jean-Claude Trichet used his "brutal" comment to turn EUR-USD when he said "excessive volatility and brutal moves were not welcome and not appropriate."

The approaching US elections in 2016 could encourage members of Congress to become more vocal about the adverse impact of a strong USD on their constituents. This may not lead to a change in FX policy at the top of the administration, but it would be another sign that US policymakers are not guaranteed to stay so passive regarding USD gains. It's worth noting that if US Treasury Secretary Jack Lew – the ultimate spokesperson on the USD – were to speak out against USD strength this would be a complete game changer.

9. The USD is now nearly the world's "richest" currency




Source: Bloomberg, HSBC

## 3) Valuations show the USD is rich

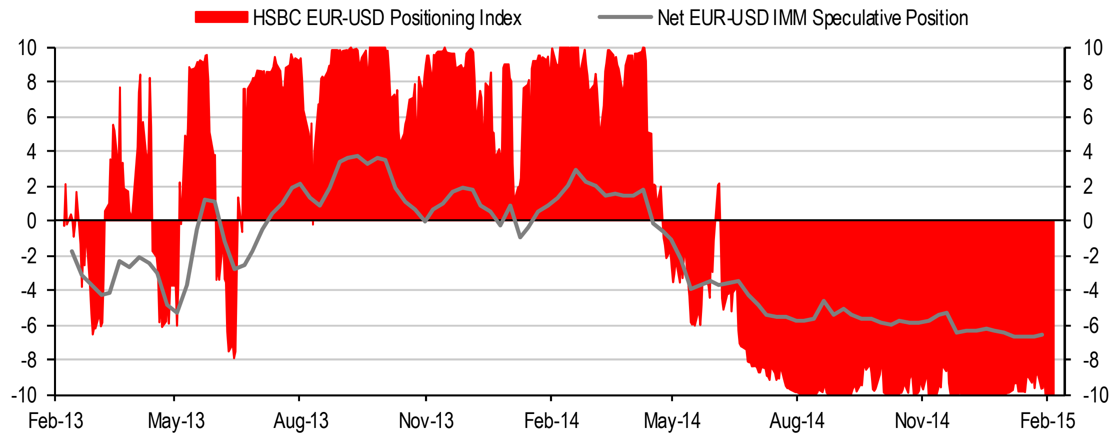
Growing policy discomfort about the scale and the pace of the USD rally is understandable when one looks at a valuation ranking of the world's currencies. We base the ranking on three measures,

The OECD measure of PPP

The Big Mac Index

The current real effective exchange rate relative to the 5-year average

10. Speculative positioning data suggests the USD longs are already at historically stretched levels



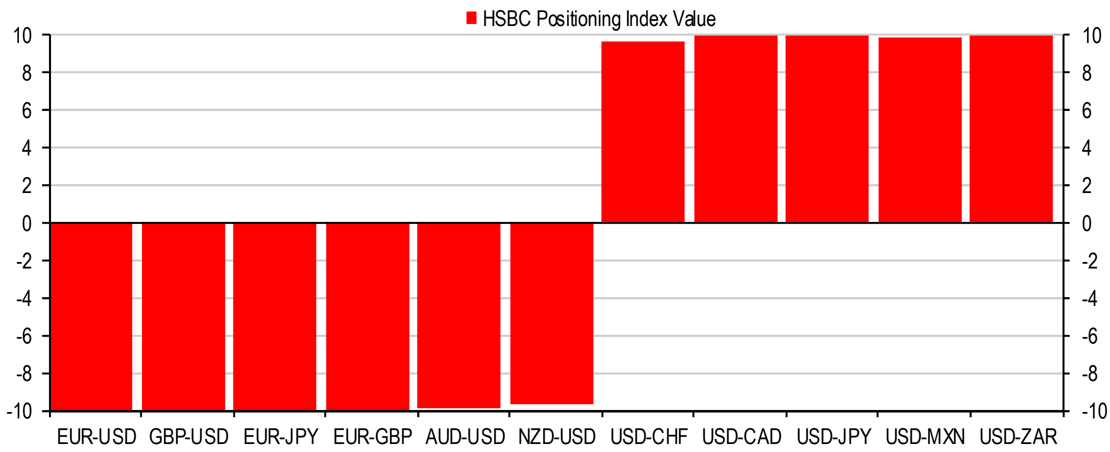

Source: Bloomberg, HSBC

Chart 9 shows in red the current rankings. The only currency more overvalued than the USD currently is the CHF. The Swiss authorities distaste for a super strong CHF is well documented. The grey columns show the rankings a year earlier in January 2014, before the USD move began in earnest. The USD was ranked a lowly 12th at that time. Skewed valuation is not of itself a cause for reversal as currencies can remain far away from fair value for prolonged periods. But it means that forecasts of additional USD strength require that valuation stretches to extend to ever more extreme levels. In addition, any signs, however unlikely, of a substantive US cyclical slowdown could provoke a powerful reversal.

## 4) USD bullishness has become all pervasive

The other constraint on extending the USD rally is that positioning is already so firmly in that direction, both in terms of the market and of the forecasting community. Chart 10 shows the IMM data for market positions, with USD longs clearly at stretched levels by historical standards.

**11. Momentum players are also most likely all long USD**




Source: Bloomberg, HSBC

There is an alternative approach to gauging market positioning. The HSBC Positioning Indicators track the degree to which momentum traders are long or short a currency pair. These indicators deduce positions by simulating hundreds of differently-parameterised momentum trading strategies and averaging across the positions held by each strategy. A value of +10 indicates that all of the trading strategies considered are currently long the currency pair and a value of -10 indicates that all the strategies are short. A positioning index value of zero implies that there are as many strategies long as are short.

The current values of the HSBC Positioning indicators are shown in chart 11. All of the USD exchange rates show extreme USD-long levels. Specifically, pairs such as USD-CAD and USD-JPY are at values near +10 and pairs such as EUR-USD and GBP-USD are at values close to -10.

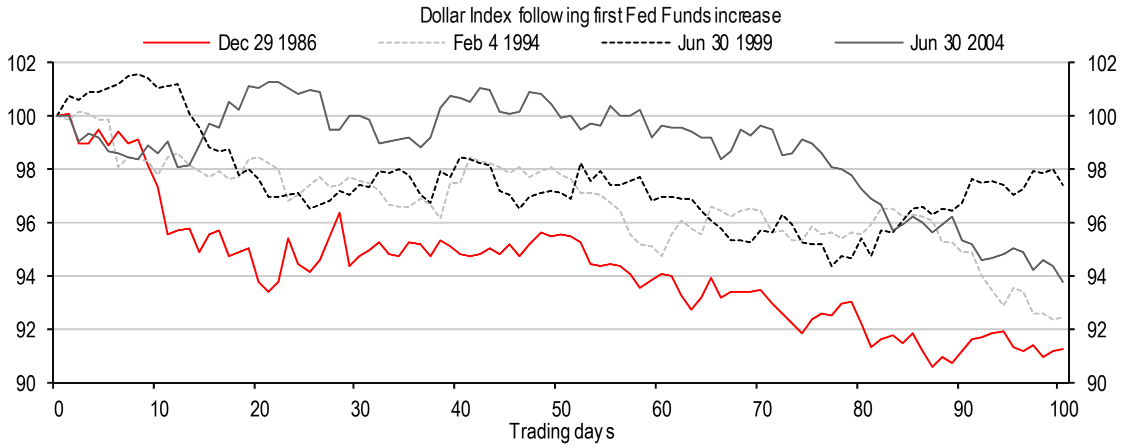
A similar skew is evident among currency forecasters. The latest survey shows that over the next year 90% of the major forecasters expect the USD to strengthen against the JPY while 80% expect the USD to out-pace the EUR. Sometimes the consensus can be correct of course. In fact, we have been comfortable with our earlier USD bullishness despite it having become a consensus view. The difficulty is that we now have a market heavily positioned for further USD strength, with most forecasters telling them they're right to be this way, but against a backdrop when the USD has already rallied 25%. There is too much greed and not enough fear at play, and it begs the question of why the market is accepting a viewpoint with such unanimous agreement. In October last year we were consistently being challenged for being in line with consensus, whereas now that the DXY is up an additional 16%, the USD bull story seems to face no resistance whatsoever. This smacks of the wholesale capitulation typical towards the end of a big move.

## 5) The USD weakens in the early months of a Fed hike cycle

The role of the Fed's tightening cycle in driving the USD rally is clear, and the shifts in US rate expectations continue to influence the currency. If the mere promise of Fed hikes can provoke USD strength, surely their actual arrival would give an additional boost to the USD?

History suggests otherwise. In fact, if we look at the previous four Fed tightening cycles which have happened over the past 30 years, **the USD has fallen in the period immediately after the first rate rise**. Chart 12 shows the path of the USD over the 100 trading days following the first rate increase. On each occasion, the USD fell even though there were additional rate increases made during the period. "Buy the rumour, sell the fact" would seem the appropriate strategy. The positive impact on the USD of Fed tightening is already in the price by the time the Fed finally delivers the first hike. Given how long the market has been talking about the upcoming hike, it seems reasonable to assume the pattern will be repeated.

**12. The USD has fallen in the period immediately after the first rate rise**




**Policy divergence is not unprecedented**

One tempting argument against history repeating itself is that this time it is different as the Fed tightening is happening while others are loosening. This unprecedented divergence in policy will over-ride the more standard USD response to Fed tightening. Our only quibble, and it's a big one, with this line of thought is that **today's policy divergence is simply not unprecedented**.

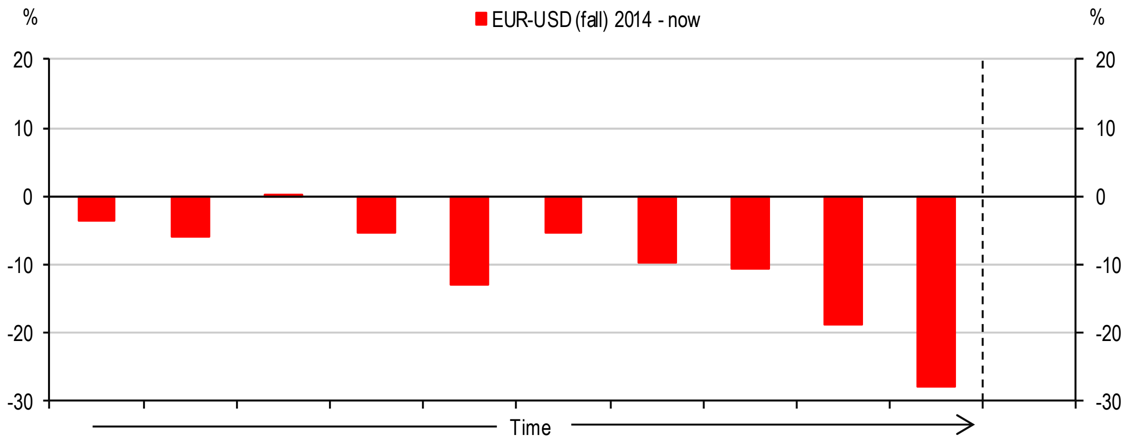
When the Fed began to raise rates in late 1986, the other major central banks were still cutting interest rates. In 1994, when the Fed began to tighten, the Bundesbank and Bank of England were easing. The 1999-2000 rate hike cycle was echoed at the BoE and ECB, but the Fed tightening in 2004-06 was not matched elsewhere. These are interesting times for monetary policy but they are not totally unprecedented in terms of policy differential.

## The USD bulls' last hurrah

We have sympathy for an argument which could point to some marked USD upside in the short term, but one which would then be swiftly reversed. This is based on the observation that the biggest market shifts often happen towards the very end of a given bull or bear market trend. Charts 14-21 on the following page provide the evidence. For example, chart 15 looks at the NASDAQ bull run during the 1990s. We divide the period over which the NASDAQ rallied into ten equal time periods, and measure the proportion of the total rally during each period[1]. The gains start off modest, but accelerate over time. We believe that exaggerated bull or bear markets are often defined by the major moves happening in the last time period, as is the case in the NASDAQ example. **More than half the move happened in the last 10%** of time. Equivalent patterns can be seen during other sustained bull or bear markets. The allure grows as more and more are drawn into the narrative, finally prompting an exaggerated surge leading to total intellectual and market capitulation – sound familiar? The charts also show the post-peak retracement in the subsequent 10% of time (shown in grey) often wipes out those late gains – as reality kicks back in and the bear or bull bubble bursts.

Chart 13 shows the pattern for EUR-USD since May 2014, the trend once again divided into 10 equal periods. The accelerating nature of the move is clear. We would not dispute this last gasp move could extend further. But any spike in the USD, or marked dip in EUR-USD, would likely prove to be violent but temporary and the pull-back could be painful. If history holds, the trigger for reversal could be the first Fed rate hike, but it might come sooner.

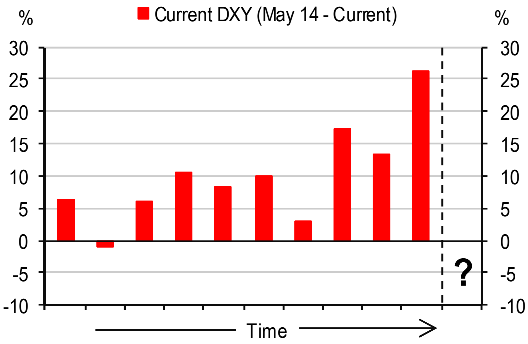
**13. The EUR-USD retreat is looking dangerously like previous "bubble" trends**




Source: Bloomberg, HSBC

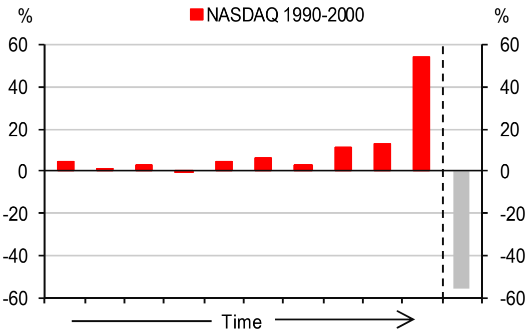
[1] Note: The length of the rally is divided into 10 time periods and the total rally (100%), split over these periods. For example, if the rise was spread evenly across all periods, all the bars would be at 10%. The 11th bar shows the subsequent fall, relative to the overall rise. If the last grey bar shows -50%, then there was a 50% retracement of the entire move.

**14. The current USD rally**



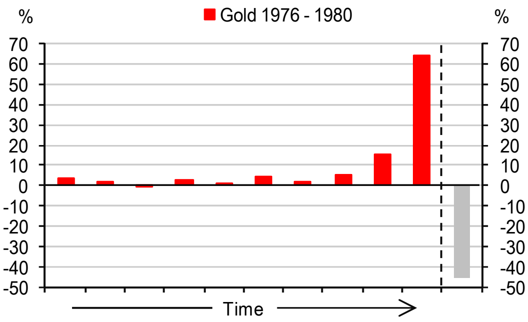

Source: Bloomberg, HSBC

**15. The rise in the NASDAQ 1990-2000**



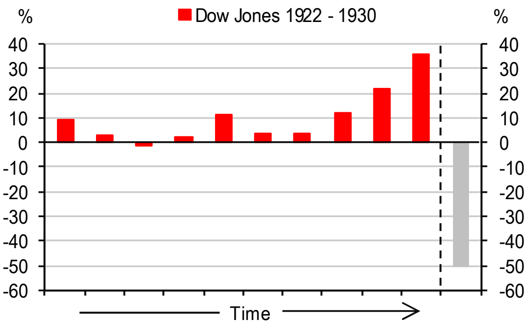

Source: Bloomberg, HSBC

**16. The rise in Gold 1976-80**



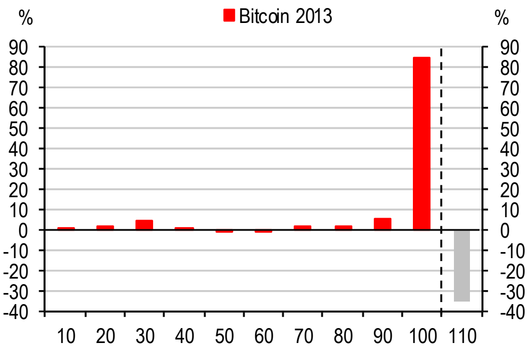

Source: Bloomberg, HSBC

**17. The rise in the Dow Jones 1922 -1930**



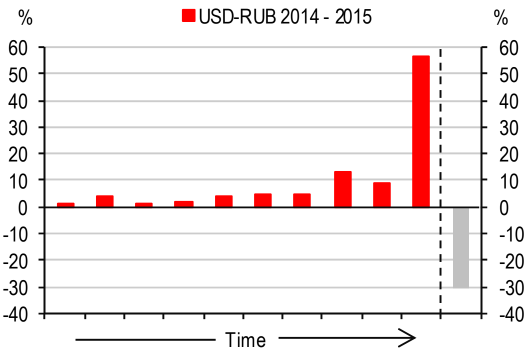

Source: Bloomberg, HSBC

**18. The rise in Bitcoin in 2013**



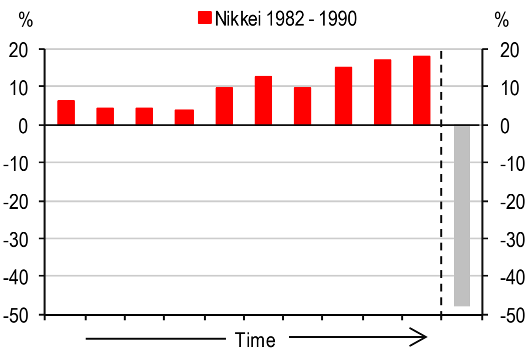

Source: Bloomberg, HSBC

**19. The rise in USD-RUB in 2014-15**



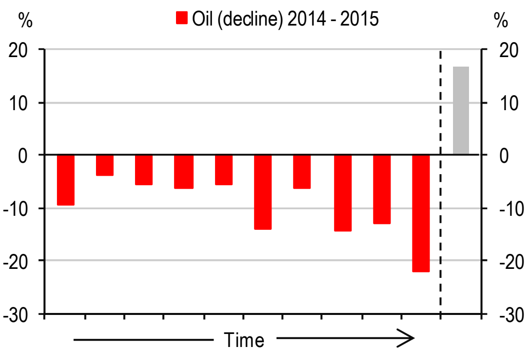

Source: Bloomberg, HSBC

**20. The rise in the Nikkei 1982-90**




Source: Bloomberg, HSBC

**21. The decline in oil in 2014-15**




Source: Bloomberg, HSBC

## The danger of a destructive USD rally remains

There are circumstances under which the USD rally could continue, but these reflect tail risks rather than central case scenarios. In earlier reports, we have identified four potential sources of a destabilising USD rally.

1) A JPY crash as Japanese policymakers lose control of their currency[2]

2) A EUR collapse on Eurozone break-up fears[1]

3) A USD surge on new legislation to force repatriation of overseas earnings to the US[3]

4) An emerging market FX crisis triggered by excessive USD strength[1]

So far, the scale of the USD rally has been large enough to help alleviate the deflation threat in the Eurozone, Japan and other countries who have seen their currencies weaken. At the same time, it has not been so large as to trip up the US recovery or challenge the Fed's willingness to tighten. We are in the goldilocks fairy-tale of not too hot, and not too cold USD rally.

The risks we have cited in our reports would create a sizeable USD rally but also a problematic one. The USD's strength would change from one which has been generally helpful to the global economy, to one which is potentially destructive. A JPY crash could be de-stabilising for the region, and in extreme circumstances could even draw China into the currency war with far-reaching consequences for Asia. Heightened EUR break-up fears could undermine efforts to reflate the Eurozone economy, and we suspect markets are too complacent about the dangers for the rest of the Eurozone were Greece ever to leave. A surging USD could see USD-EM move in such an exaggerated way as to provoke an EM crisis.

## Distinguishing between a last spike and a tail risk event

We accept that in the throes of the final stages of this USD rally, there is scope for a USD spike higher. But it will be important to distinguish between this process and one prompted by a rising probability of a tail risk materialising. In the case of a Japanese policy blowout or EUR break-up fears this should be relatively straightforward. But in the case of a sharp sell-off in EM, it may not be so easy to tell whether it is reflective of a last hurrah for the USD, or a growing disquiet with EM in general.

Chart 22 shows an equally weighted index of a selection of the world's emerging market currencies. The decline has not been as great as seen in the EUR or JPY, but the pace has picked up. For individual currencies, the depreciation has become especially dramatic lately. The Brazilian real has fallen 18% in the last three months, for example, and the Turkish Lira is down 13%. The Mexican peso has also had a troubled time. Currencies with a EUR 'postcode' have been dragged lower against the USD alongside the declining EUR. Indonesia, Malaysia and Singapore have been the notable underperformers in Asia in the last quarter.

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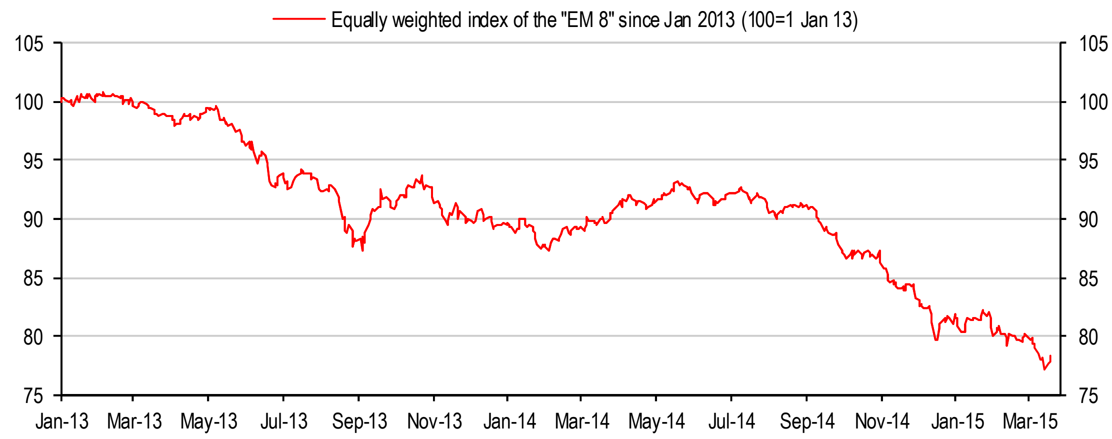
[2] See *'Currency Outlook: USD rally in 2015 – friend or foe'*, 7 January 2015
[3] See *'Currency Weekly: Another USD-positive tail risk'*, 26 February 2015

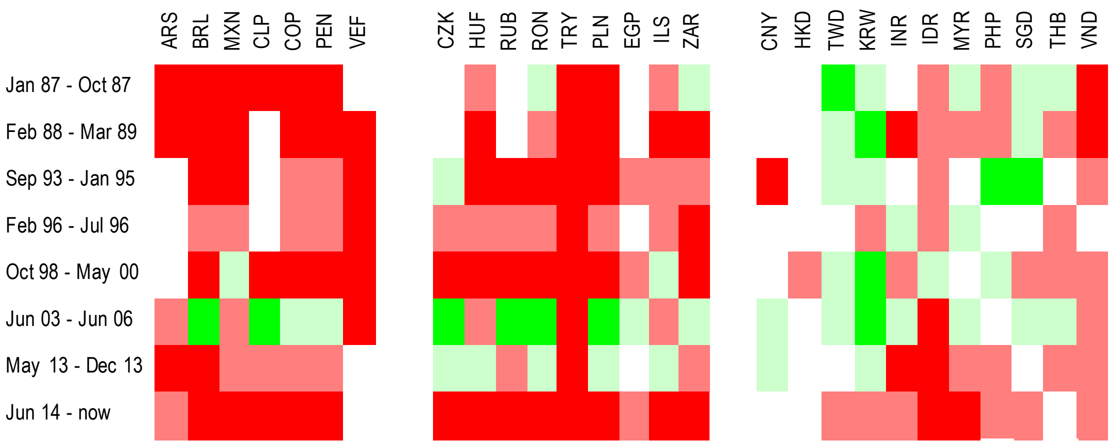
**22. EM FX has been under growing pressure**




Source: Bloomberg, HSBC. N.B: "EM 8": BRL, MXN, TRY, ZAR, KRW, IDR,INR and RUB

So far, this EM selling has largely been a natural combination of USD enthusiasm and local difficulties in various EM currencies. For this to become a full blown EM crisis it would require a swifter pace of decline. In addition, we suspect much higher US bond yields and a steeper US yield curve would also be a likely component of an EM crisis. Chart 23 shows a heat map of how various EM currencies have fared against the USD when US 10 year yields have been rising. There is a lot of red and pink, illustrating that most EM currencies decline. This type of price action was clearly visible in May 2013 when Ben Bernanke first spoke of tapering, and as US yields lurched higher the concept of the fragile five was born.

**23. Heatmap shows EM FX struggles when US yields are rising, and during the most recent sell-off**




Source: Bloomberg, HSBC

HSBC's forecasts for US 10-year yields envisage a relatively modest rise to 2.50% by the end of the year from 2.10% currently while the 2-10s spread is forecast to finish at 140bp, pretty much in line with its current level (see *'Fixed Income Asset Allocation: Taking some risk off the table'*, 12 March). On both fronts, therefore, EM FX should not be drawn into a globally-induced rapid sell-off. Local factors should continue to dominate proceedings.

# Notes

# Notes

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# Disclosure appendix

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