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By: HSBC FX Strategy

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Currency Outlook

Fed and the USD – a paradigm shift

The link between US monetary policy and the USD has changed. The USD is now part of the Fed's policymaking process, not a consequence of it. For this reason, buying the USD in anticipation of hikes could be self-defeating.

Cable: the price is right
GBP-USD has recently been driven by two forces: politics and the Fed. But the decreased likelihood of a Fed hike in June means that, for now, only politics matters for Cable.

EU referendum timing
We set out the likely timeline for results in the UK's EU referendum.

Summary

Fed and the USD – a paradigm shift (pg 3)

The link between US monetary policy and the USD has changed. The USD is now firmly caught in a feedback loop: Currency weakness increases the possibility of a rate hike. This in turn provokes USD buying; however, the resulting USD strength decreases the likelihood of the hike and thus the USD weakens. This means that buying the USD in anticipation of a Fed hike could be a self-defeating strategy.

US Economic Outlook (pg 9)

We expect business investment spending to shrink in 2016 for the first time since the 2008/2009 recession. However, robust consumer spending and stronger residential construction keeps our US economist's 2016 GDP growth forecast at 1.8%. He forecasts just one 25bp hike from the FOMC in 2016, and expects it to come in September.

Cable: the price is right (pg 10)

GBP-USD has recently been driven by two forces: politics and the Fed. The significant decrease in the likelihood of a Fed rate hike in June means that for now, only politics matters for Cable. Once the referendum uncertainty is fully resolved, we expect an improvement in the underlying economic data to drive GBP-USD to move higher.

EU Referendum timing (pg 14)

The UK's electoral commission estimates that the result of the UK's EU referendum on 23 June will be announced "around breakfast time" on 24 June. We discuss at what point the final outcome will be known.

Rethinking the Riksbank (pg 15)

The Riksbank is currently rethinking its mandate, after years of under-target inflation. Policy seems out of sync with growth numbers in the country, and we believe a tighter policy stance would be the logical next step. We see this following through into SEK strength, and we revise our EUR-SEK forecasts lower.

Dollar bloc (pg 17)

Whilst we think the AUD has slightly further to fall, we think the new relationship between central banking and FX means that recent AUD weakness will reduce the RBA's need to cut again. This should prevent AUD-USD from falling dramatically.

In this document HSBC may comment on the potential economic impact dependent on the outcome of the UK Referendum. HSBC is not taking a political position and this document and the information contained herein are not intended to promote or procure, or otherwise be in connection with promoting or procuring, a particular outcome in relation to the question asked in the UK Referendum.

Key events

Date	Event
15 June	Fed rate announcement
16 June	Bank of England rate announcement
16 June	SNB rate announcement
23 June	UK's EU referendum
05 July	RBA rate announcement
06 July	Riksbank rate announcement

Source: HSBC

Central Bank policy rate forecasts (%)

	Last	Q2 2016(f)	Q4 2016(f)
USD	0.25-0.50	0.25-0.50	0.50-0.75
EUR	0.00/-0.40	0.00/-0.40	0.00/-0.40
JPY	-0.10	-0.10	-0.30
GBP	0.50	0.50	0.50

Source: HSBC forecasts for Fed funds, Refi rate/ Deposit rate, Overnight Call rate and Base rate

Consensus forecasts for key currencies vs USD

	3 months	12 months
EUR	1.112	1.102
JPY	111.1	115.3
GBP	1.446	1.485
CAD	1.318	1.297
AUD	0.722	0.708
NZD	0.652	0.641

Source: Consensus Economics Foreign Exchange Forecasts May 2016

Fed and the USD – a paradigm shift

- The link between US monetary policy and the USD has changed
- The USD is now *part* of the Fed's policymaking process, not a consequence of it
- Buying the USD in anticipation of hikes could be self-defeating

Abnormal normalisation

The link between US monetary policy and the USD has changed. If you use the old framework for thinking about Fed normalisation, you are likely to make incorrect decisions.

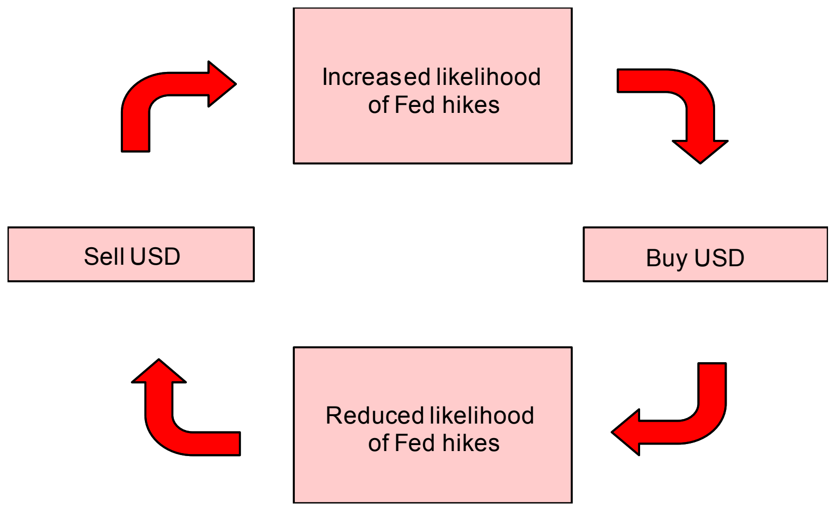
In a "*normal normalisation*" world, the initial rate hikes are indicative of several more to come. In contrast, today the economy is attempting to escape from years of unconventional policy. As a result, the Fed are embarking on an "*abnormal normalisation*" whereby a rate hike today indicates very little about the timing and degree of future hikes.

The main culprit for this *abnormalisation* is that FX is now hypersensitive to rates. This causes a feedback loop whereby not only is the FX market being dominated by expectations for future interest rates, but the plausible path for policy rates is being constrained by the strength of the currency.

The USD is now firmly caught in this feedback loop: Currency weakness increases the possibility of a rate hike. This in turn provokes USD buying; however, the resulting USD strength decreases the likelihood of the hike and thus the USD weakens.

This means that buying the USD in anticipation of a Fed hike could be a self-defeating strategy. According to Fed calculations, a mere 4% rally in the USD is equivalent to a 25bp hike. For a market which is debating whether the Fed may move once or twice this year, even a small rally in the USD will swing the abnormalisation process back towards the doves.

1. The USD is stuck in a loop

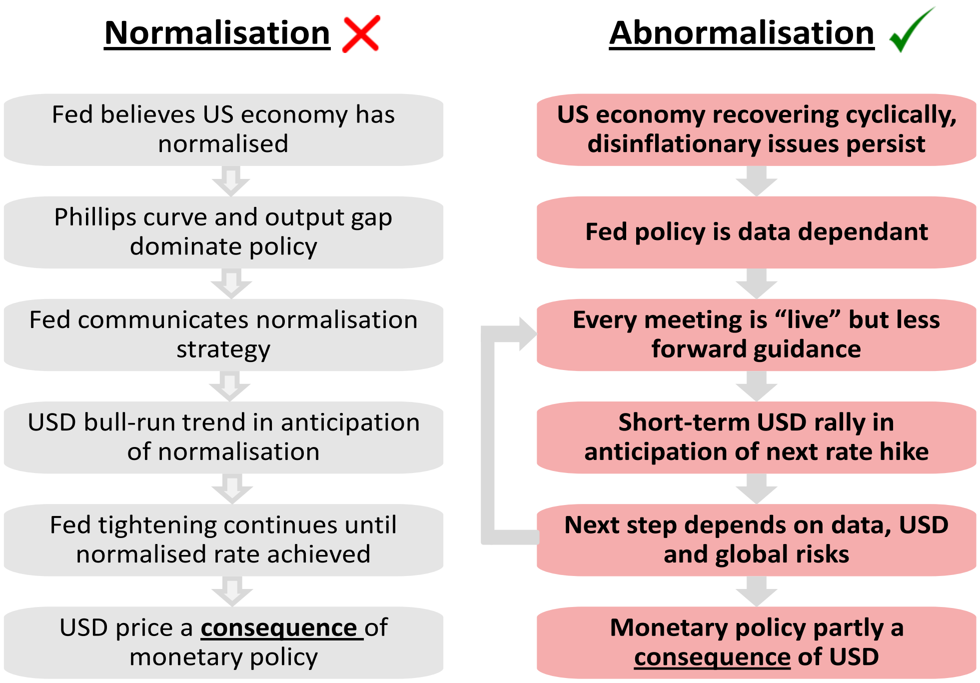


Source: HSBC

The global financial crisis has forced policymakers to throw out the rule book on many aspects of policy. In their efforts to stave off a global depression, central banks have adopted easing strategies that few would have imagined pre-2007. Set against this backdrop, it should not be surprising to realise we need to re-think how the reversal of policy might play out, with the US leading the charge for now. This is not the 'normalisation' of previous cyclical upswings, and the implications for the USD are considerably different as a result. We are at the early stages of a very different kind of normalisation – what one might call an 'abnormalisation'.

Chart 2 shows a simplified characterisation of how we believe the current abnormalisation process differs from the past process of normalisation. In the past, the Fed would make a judgement of whether the US economy had normalised based perhaps on its assessment of the output gap, the unemployment rate and its relationship to inflation via the Phillips curve. Having determined that the pieces were in place for a tightening cycle, it would communicate its intention and begin to raise rates in a sequence of steps. Forward guidance would often be a component of the strategy. The market would have a sense of the likely path, the USD would enjoy a trend strengthening in anticipation of the tightening. The currency's moves thereafter would be an echo of the consequences of the tightening which would continue until rates were normalised.

2. The Fed's tightening is different this time



Source: HSBC

This time there is no such certainty of pace or magnitude. The abnormalisation process is far more fluid, with policymakers testing the water for each and every step, judging whether the economy and the financial market can weather the next hike. This is not a pre-determined strategy based on some magic rule of a normal economy. This is a 'learn-by-doing' approach which leaves policy especially data-dependent and, by extension, particularly sensitive to the reaction of financial markets and the USD.

A strong USD is not in the Fed's interest

In a speech in December 2015, Governor Brainard observed that a 15% real appreciation of the USD is equivalent to a 100bp of tightening. This implies that a 4% rally in the USD is equivalent to a 25bp hike[1]. Fed Vice Chairman Stanley Fischer had observed very similar sensitivities in his speech in November 2015[2] suggesting the strength of the USD accounted for much of the 100bp downward adjustment in the Fed's "dots" forecasts for year-end 2016 from where they stood in mid-2014. In other words, if the USD had not rallied 17% since mid-2014, the Fed would have tightened by 100bp more.

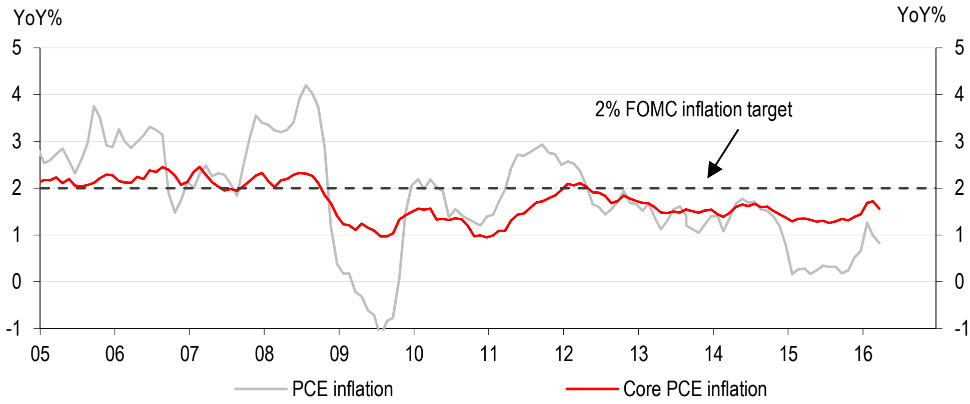
4%

The USD rally equivalent of a 25bp hike

The villainous USD

The fixation on the USD is also understandable as it is a key villain in the story of the US inflation undershoot. According to the Federal Reserve, "*The Federal Open Market Committee (FOMC) judges that inflation at the rate of 2 percent (as measured by the annual change in the price index for personal consumption expenditures, or PCE) is most consistent over the longer run with the Federal Reserve's mandate for price stability and maximum employment*." Chart 3 shows the YoY rates for both headline and core PCE deflators in recent years. It is no great surprise to see that inflation has undershot the last four years.

3. Inflation has persistently undershot the FOMC's target

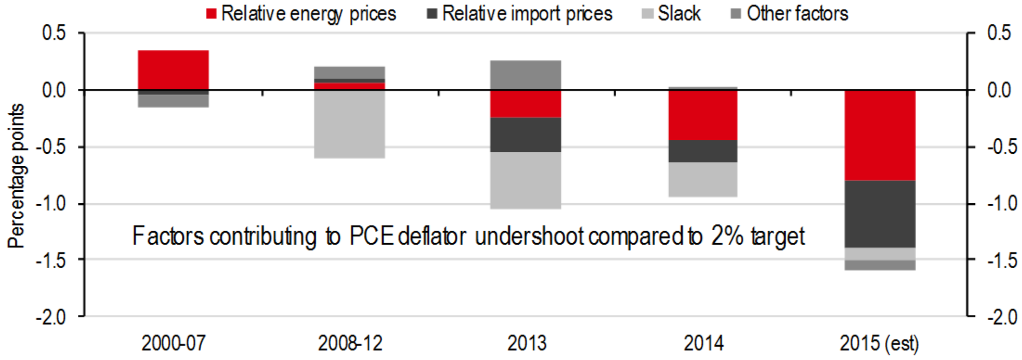


Source: Bloomberg, HSBC

The Fed conducted an analysis of why it believed inflation was coming in shy of target. Chair Janet Yellen referred to it in a speech in September 2015[3] and we reproduce one of the charts below. Chart 4 shows the Fed's assessment of the breakdown of the main drivers to the PCE deflator.

[1] *https://www.federalreserve.gov/newsevents/speech/brainard20151201a.htm*
[2] *http://www.federalreserve.gov/newsevents/speech/fischer20151112a.htm*
[3] *http://www.federalreserve.gov/newsevents/speech/yellen20150924a.htm*

4. Relative import prices and lower energy costs explain the inflation undershoot



Source: Board of Governors of the Federal Reserve System

Clearly the chief culprits for the inflation undershoot have been the decline in energy prices (in red) and the decline in import prices (in black) relative to other price movements. In her speech in September, Chair Yellen said the drop in import prices is "largely attributable to the 15% appreciation in the dollar's exchange value over the past year." So when the Fed talks about core import prices, it's code for *the dollar*.

By contrast, economic slack (measured here as the difference between the unemployment rate and the long-run natural rate) has become a progressively smaller part of the debate. The markets love to fixate on the monthly employment reports, but Chart 4 suggests we should spend more time wondering about the latest moves in energy prices and the USD.

The prominence of the USD has risen within Fed rhetoric

Given the Fed likely believes it can do little to influence movements in global energy prices, it seems to have focussed its attention on the USD. Since Yellen's speech, the prominence of the USD within Fed rhetoric has risen, its earlier strength highlighted as a constraint on inflation and a headwind to activity through a lower contribution from net exports. The USD has become a central part of the rate debate narrative, and it means that a stronger USD in anticipation of a rate hike will act as a brake on the abnormalisation process.

Policy sensitivity to USD strength is acute so close to the zero bound on rates

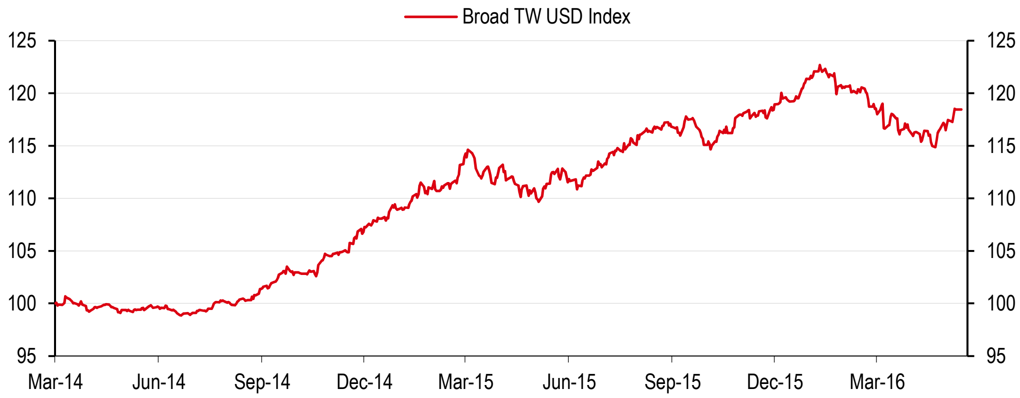
Recent comments from the Fed suggest an appetite for a further hike in the middle of this year It is characteristic of the abnormalisation process that many Fed speakers show little real conviction as to which month might be appropriate. This is a very fluid process.

Still, in this data dependent world, the economic disappointments of Q1 have passed with some estimates of Q2 GDP now pointing to annualised growth of 2-3%. The labour market remains strong and a number of inflation readings have pushed higher over the past year. Energy prices have rallied strongly from February's low and measures of global financial stress have retreated after a traumatic start to the year. Doves would likely point to the still low market-based measures of inflation expectations. Regional manufacturing surveys for May point to fresh troubles for that sector.

Many at the Fed would prefer to move away from the zero bound on rates

The complication is that this debate is happening when the policy rate is still very close to the zero bound. The Fed has noted in the past that risks are to the downside, language reflective not just of macro drivers that pose downside risks but of limited ability of policy to react to those threats. This is not to suggest the Fed wants to raise rates simply so that it can cut them again. But if conditions warrant higher policy rates, many on the Fed would welcome moving away from the zero bound in order to provide room to manoeuvre in the future when easing would be required.

5. The ebb and flow of the USD will have a bearing on Fed policy



Source: HSBC, Bloomberg

Chart 5 shows a chart of the trade-weighted USD, showing the rally from mid-2014 before a more dovish Fed in January helped prompt a move lower. The problem for the Fed is that their recent re-engineering of rate hike expectations higher is also re-energising USD bulls.

A tightening delivered via a stronger USD leaves no additional room for future conventional easing

Fed Vice-Chair Fischer has argued that a 15% rally in the USD is equivalent to 100bp of tightening by the Fed. But we would argue that "equivalent" does not mean "identical". A tightening delivered via a stronger currency provides none of the room for subsequent conventional monetary easing that a tightening via higher interest rates does. This might not matter if the policy rate were at a more normal level and that flexibility to ease already existed. Instead, we are still near-zero bound so a USD rally and a Fed hike are decidedly not the same thing.

One hike does not make a trend

For the abnormalisation process, the Fed will want to be careful not to let USD bulls hijack their efforts to massage rates higher. They can do this by promoting an understanding that one hike does not necessarily point to any certainty that more will follow. The market is already coming around to this realisation. In the wake of the December 2015 lift off from the Fed, the market was priced for 2 or 3 hikes in 2016. It was the start of the "normalisation". By the end of February 2016, the market thought the Fed might be "one and done".

In 'abnormalisation', a Fed hike does not provide the grounds for a USD bull trend

This means that while a Fed hike will be positive for the USD, it does not mean it will resurrect a bull trend for the USD. Take the more recent example of the AUD. The RBA cut rates on 3 May into a market which was not sure what to expect ahead of the meeting. The AUD has weakened since, but there is no suggestion that the rate cut has set the currency on a prolonged downward trend. If you think the Fed is going to raise rates more than the market expects, then you may be right to think the USD would go up in reaction. But this is very different from saying the ingredients are in place for a sustained uptrend simply because the Fed may hike.

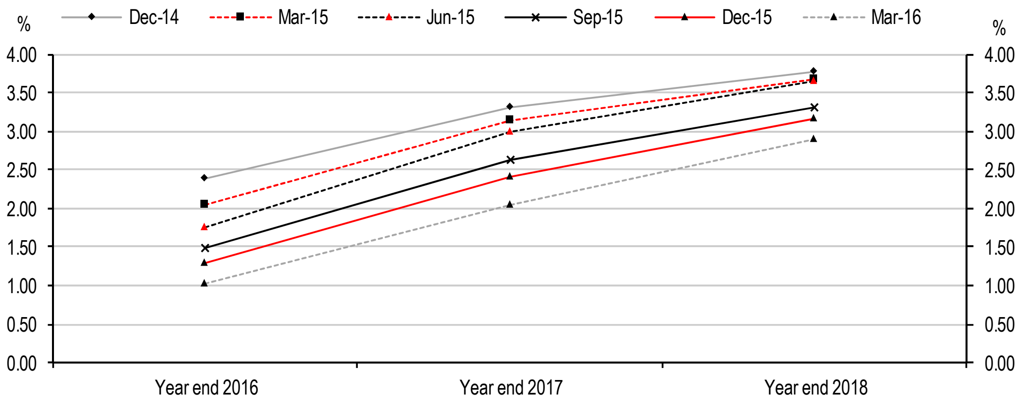
The rate debate is highly sensitive to the USD because so few hikes are expected

We believe the Fed and market are particularly attuned to the USD because the rate debate, both within the Fed and out in the market, centres on a plan for a relatively modest pace of tightening. It is only a question of exactly how modest it should be. Even the most hawkish of FOMC projections envisages a path for the Fed funds rate that is flatter than we saw in the previous cycle.

There is always going to be a range of views about the appropriate path for policy, but over the course of the last 18 months there has been a notable shift lower in the median projection for the Fed funds rate within the FOMC (Chart 6 shows the evolution of the Fed's projections since December 2014.)

The currency market has already nearly delivered one hike since the Fed began pushing the idea of a swifter tightening

6. The debate at the Fed is about ever more dovish rate hike projections



Source: HSBC, Bloomberg

The market and Fed debate for 2016 seems to be whether the Fed will move once or twice. It does not take much of a move in the USD to wipe out the rationale for one of those hikes. The USD has rallied 4% against the majors from its low on 3 May until 3 June when nonfarm payrolls was significantly weaker than expected. The USD rallied in anticipation of a hike, yet this USD move makes the hike less likely. The feedback loop of abnormalisation is in play.

Conclusion – USD gains will be limited

We need to re-think how we view the link between the Fed and the USD. We are not witnessing a traditional tightening or normalisation. This has turned out to be a different type of tightening, what we have dubbed an abnormalisation. There is no pre-determined idea of where rates may end up and hence forward guidance based on Taylor rules or output gaps has been thrown out the window. This has become a fluid, data-determined process where the USD will play a central role in determining the pace and extent of interest rate hikes. The USD in no longer a consequence of normalisation process but has become an integral part of the abnormalisation process.

The Fed has also identified that the USD has been a key reason why inflation has undershot its target for the last few years. Policymakers will not want to foster additional headwinds to the reflation effort. In addition, while a stronger USD can be compared to a rate hike in terms of its effects on the US economy, they are not identical as a rate hike that leaves room in the future for conventional easing if required. Finally, given the Fed and the market are agonising over whether they will move once, twice or three times this year, even a small move in the USD can have a material impact on the rate debate.

Abnormalisation creates a feedback loop for the USD. Currency weakness would open the door to a hike and provoke USD buying but that, in turn, would potentially rule out the hike leading to USD weakness. The circularity suggests the USD is unlikely to see a lasting trend based solely on Fed policy.

US Economic Outlook

- We expect business investment spending to shrink in 2016 for the first time since the 2008/2009 recession
- Robust consumer spending and stronger residential construction keeps our 2016 GDP growth forecast at 1.8%
- We forecast just one 25bp hike from the FOMC in 2016, and expect it to come in September

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GDP outlook clouded by weak investment spending

GDP growth averaged only 1.1% at an annual rate through the two quarters ended in March, a noticeable drop from the 3.0% rate in the preceding two quarters. The slowdown in growth can be attributed to a decline in business investment spending. Business investment is dependent on corporate profitability. Data on economy-wide corporate profits show a year-over-year decline for the past three quarters. New orders for non-defense capital equipment (excluding the volatile aircraft category) have fallen 4.5% over the past six months. This suggests that overall investment spending will remain weak in the coming months.

Declines in business investment spending are often a prelude to recession. We do not think a recession is a high probability event this year since consumer spending is still relatively robust and most of the drop in investment spending has been concentrated in the energy sector. With oil prices rebounding over the past few months, recession risks should diminish.

Consumers rebound after winter slowdown

Consumer spending rose at a modest 1.9% pace in the first quarter, but appears to be on track for a 3.6% increase in the second quarter. The rebound in the growth of consumer spending should lift overall GDP growth into the 2.5-3.0% range for the quarter. Meanwhile, inflation remains low with the core PCE price index up only 1.6% year over year in April. The latest data show overall PCE inflation at only 1.1%.

Outlook for Fed policy

The FOMC meets on 14-15 June. Fed officials have indicated that the Committee will likely hold policy steady ahead of the 23 June UK referendum on European Union membership. We believe the FOMC will hold off a move to tighten policy until there is a clearer view on the outlook for business investment. We think a turnaround in investment spending will not occur until the third quarter, leaving the Fed on hold until September (see *US Monetary Policy: Yellen points to higher rates, but is vague on timing*, 6 June 2016).

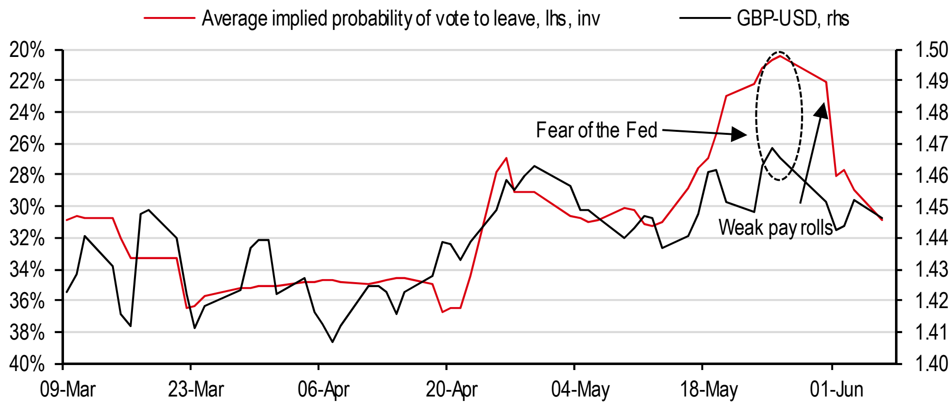
Cable: the price is right

- GBP-USD has recently been driven by two forces: politics and the Fed
- The weak US non-farm payrolls print and the latest dovish commentary from the Fed means that, for now, only politics matters
- Once EU referendum uncertainty in the UK is fully resolved, we

The GBP was the second best performing G10 currency in May. The outperformance coincided with a shift in the betting markets which, at their lowest, suggested only a 20% chance of a "Leave" vote in the EU referendum, down from around 35% in late-March. There have also been a number of polls showing an increased lead for the "Remain" campaign.

But the rally was not as aggressive as might have been expected given the large shift in implied probabilities around the referendum outcome. All else being equal we might have expected GBP-USD to have traded around 1.50 rather than 1.46.

1. Cable did not rally as hard as EU referendum probabilities would imply



Source: HSBC, Bloomberg

However, the probability of a "Leave" vote is not the only factor influencing the value of GBP-USD. There have been two main forces dominating GBP recently:

1. **Politics: GBP pulled up** by a larger probability of a "Remain" vote
2. **Economics: GBP pushed down** by lower UK-US interest rate differentials

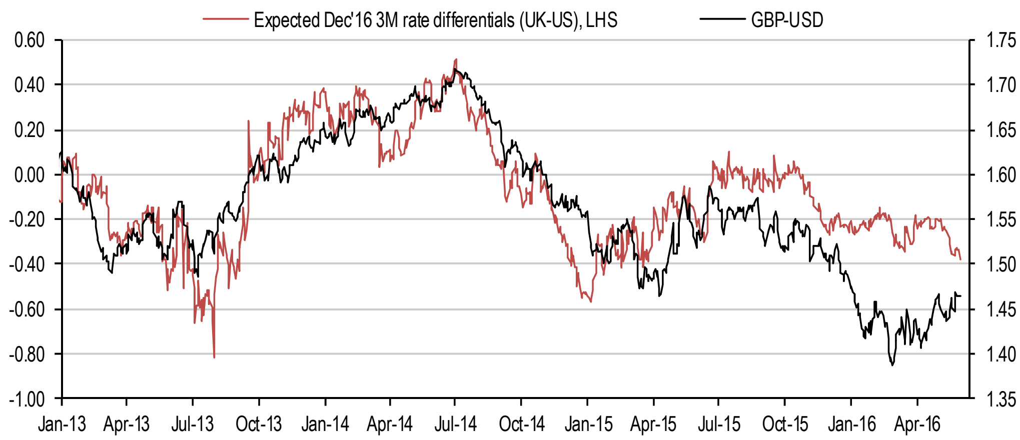
Less fear of the Fed, look at politics instead

However, in our view, **politics is now taking centre stage again**. The weak non-farm payrolls release on 3 June saw a significant re-pricing of the likelihood that the Fed would hike at its 15 June meeting. The chances of a June hike implied in the rates futures market fell from 22% to 4% after the release. This softer data was also accompanied by various comments by members of the FOMC which hinted that there was too much uncertainty to hike rates in June. With a June Fed hike now off the table, this means politics can once again take centre stage for GBP-USD.

What political risk is priced into Cable?

Before 2016, GBP-USD tracked expected interest rate differentials remarkably closely (Chart 2). However, this year the market has been focused on the EU referendum in the UK and the price of GBP-USD has remained noticeably lower than the level which would be suggested by the historical relationship with interest rate differentials. We estimate the degree of political risk priced into Cable by the gap between the current spot rate and that suggested by the relationship in Chart 2. This now suggests that if the political risk is resolved (after a vote to "Remain") that GBP-USD would rally by only around 5% from here.

2. Rate differentials have moved against the GBP in favour of the USD



Source: HSBC, Bloomberg

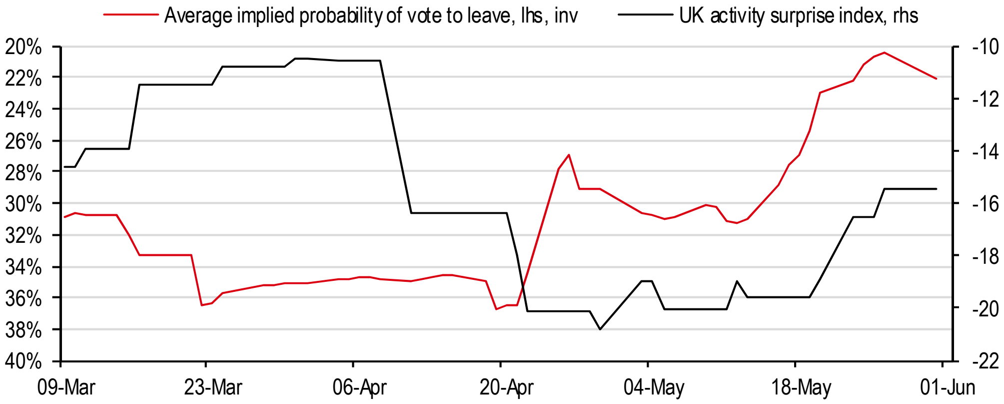
The closing of the gap in charts 1 and narrowing gap in chart 2 suggest that GBP-USD is at the right price today. However, we believe that GBP-USD will rise further after the EU referendum. This is because the uncertainty around the referendum has an impact not only on financial markets but also on the real economy.

"Remain" – increasingly in the price but not yet in the data

Why do we see GBP moving significantly higher from here? Even if the betting markets were to shift to a 100% chance of a "Remain" vote, it would only suggest a move of 5%. The currency market has largely priced in the significant change in sentiment around the referendum.

In contrast, it is likely that the soft economic data seen recently has been subdued by uncertainty around the UK's political future. If so, upcoming data will start to factor in the increasing likelihood of a vote to remain. For example, the recent release of UK GDP for Q1 2016 showed a further softening in business investment (down 0.5% q/q, following a 2.0% q/q drop in Q4 2015). The slight uptick in May's consumer confidence data could be an early sign of this realignment taking place.

3. Disappointing UK activity data may pick up as referendum sentiment shifts



Source: HSBC, Bloomberg

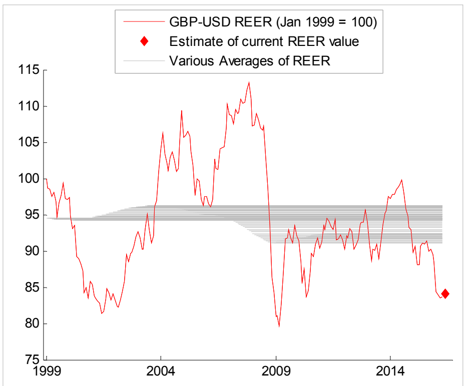
Should consumers and businesses start to believe the betting markets, they may become more inclined to take bigger consumption and investment decisions, even before the referendum vote occurs. This could see a pick-up in the economic data relative to expectations, which have been disappointing in the last few months (Chart 3). Better economic data should pull forward the market's rate hike expectations for the UK, which have been pushed back to late 2017.

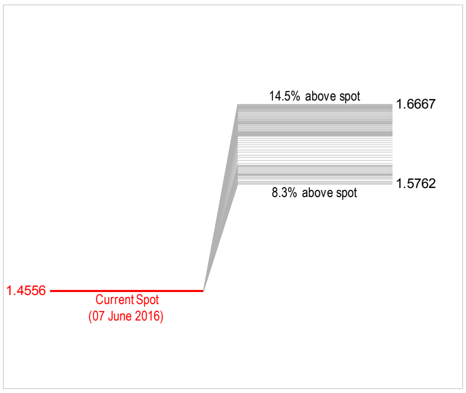
Meanwhile, our house view is that the Fed is only likely to pull the trigger once this year, in September. This would again work in GBP's favour relative to the USD. **These two scenarios working in tandem would likely propel UK rates higher relative to US rates, and would likely put 1.55 back on the table as a clear target for Cable.**

Valuation also suggests a higher GBP-USD

It is also worth considering the valuation arguments for a higher GBP-USD. The HSBC Little Mac Valuation Ranges suggest that "fair value" for Cable is between 1.57 and 1.66 (Chart 4). "Undervaluation" of around 8% is hardly a game changer, but as broader structural and political fears for the GBP decline, the natural tendency for the currency should be for it to shift higher towards a long-term equilibrium level.

4. GBP-USD around 8% below its fair value range





Source: HSBC

GBP: economics rally to follow the political rally

A lot of the juice already appears to have been squeezed out of the long GBP trade. GBP-USD has largely moved in line with the changing expectations that the UK votes to remain a part of the EU. The room for a significant rally purely on the back of a "Remain" vote is relatively small. But **we believe that if the economics starts to match the politics, then economic expectations in the market would start to shift in the GBP's favour**. In this environment, GBP-USD could generate a move higher, towards 1.55 and then 1.60 by the end of the year.

EU Referendum timings

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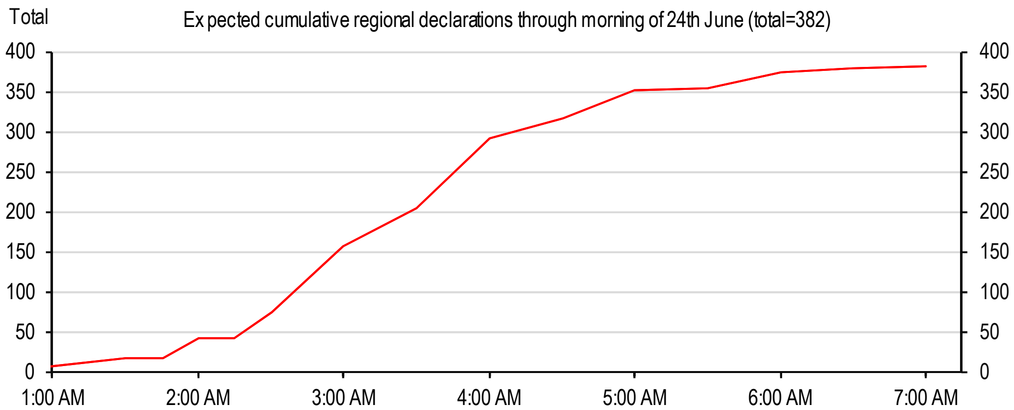
Result expected at "breakfast time"

The UK's electoral commission estimates that the result of the UK's EU referendum on 23 June will be announced "around breakfast time" on 24 June. Votes will be counted at 382 regional centres around the UK. Most of the results from the regional centres are expected to be declared between 1:00am and 6:00am UKT. The Electoral Commission estimates that around three-quarters of the regional centres will have declared by 4:00am, meaning an indication of the result could be known by then. But if the vote is close, it may be 6:00am before the UK knows if it is remaining or leaving.

- The results from each of the 382 regions are expected to be declared through the night, with the earliest declarations coming around 1:00am and the final ones at around 7:00am.
- This means we could have an indication of the result by around 4:00am, when three quarters of local counting centres are expect to have a result (see chart 1). If the vote is close it could take longer, although by 6:00am, 98% of declarations should have been made.
- The Electoral Commission's table of expected declaration times is available on their website. Note that it contains 399 counting centres (more than 382) because Northern Ireland has 18 counting centres but only one official declaration.
- To our knowledge, there will be no authoritative exit polls. Given there is no precedent, it is hard for pollsters to know at which polling stations to conduct exit polls in order to get a good proxy for the wider country. However, there have been press reports that some hedge funds and financial institutions may be funding their own exit polls.

1. By 4:00am, 75% of the regional centres are expected to have declared a result



Source: Electoral Commission, HSBC

Rethinking the Riksbank's mandate

- The Riksbank is currently rethinking its mandate…
- … a tighter policy stance would be the logical next step…
- …this should cause the SEK to strengthen

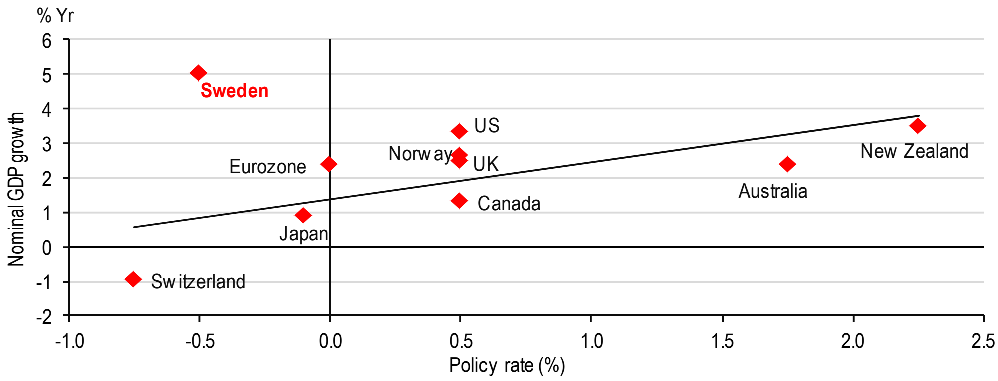
With the market's focus firmly on the Fed and the UK's EU Referendum, goings on at Sweden's Central Bank have gone largely ignored. With headline inflation stubbornly below target, Sweden's Riksbank announced in late April that it will host a conference called "*Rethinking the Central Bank's mandate*" on the 3-4 June. The rethink could lead the market to price tighter policy, supporting the SEK. **We now see EUR-SEK at 9.00 by the end of 2016**, down from 9.60 before**.**

The macro situation and the policy contradiction

The extremely accommodative monetary policy combining negative interest rates and a large-scale QE programme is at odds with the macro situation.

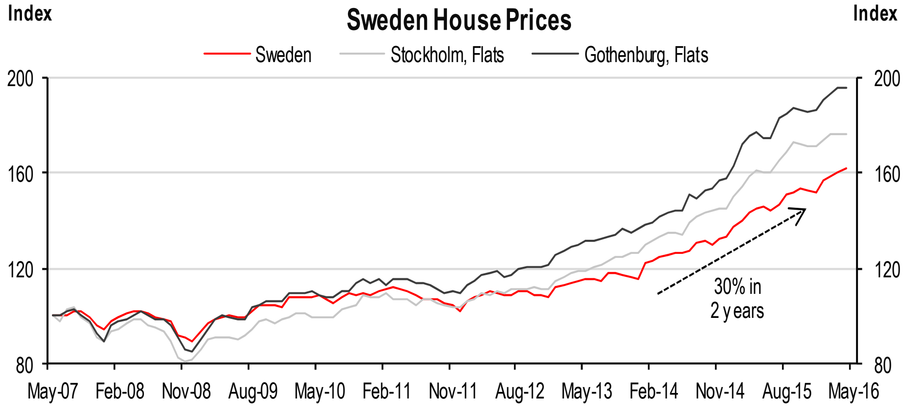
1. **Loose policy vs strong growth**
   The current pace of growth is more than double that of most other developed economies yet the Riksbank's policy rate is in negative territory.
2. **Financial stability an issue**
   House prices in Sweden are soaring. The adjustments to the mandate may hand the Riksbank greater responsibility for macroprudential policy and possibly put certain financial stability metrics at the heart of the rate-setting process.

1. Sweden's growth/policy mix really stands out among the G10



Source: HSBC

2. Loose policy in Sweden has seen house prices soar



Source: HSBC, Thomson Reuters Datastream

Market too dovish

Given the situation in Sweden all roads seem to lead to tighter policy in one way or another. The market is saying there is a 4.5% chance of a rate rise in Sweden by the end of 2016 (similar to the UK or Canada) and a 23% chance of a cut. This massively dovish view on Sweden rates held by the markets provides ample room for the SEK to strengthen should expectations change.

Conclusion: lower EUR-SEK forecasts

We believe that there is a very good chance that the Riksbank will announce a change in its mandate sometime in 2016. In other words the mood of the market could be swayed substantially towards a more hawkish policy. This should be positive for the SEK. **We therefore revise our EUR-SEK forecasts lower, looking for 9.00 by year-end rather than 9.60 before.**

EUR-SEK forecasts: new vs old

	Q1 16	Q2 16 (f)	Q3 16 (f)	Q4 16 (f)
EUR-SEK (New)	9.23	9.20	9.10	9.00
EUR-SEK (Old)	9.23	9.50	9.60	9.60

Source: HSBC

Dollar bloc

AUD: one cut does not make a trend

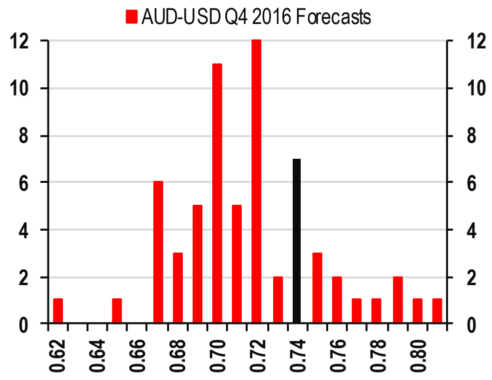
The AUD has come down some way since the start of May, from peak of above 0.77 vs the USD. Whilst RORO remains a factor, (see *AUD & NZD: global vs local*, 12 May 2016), the AUD's depreciation seems to have be driven by the RBA. From here, the actions of Australia's central bank may well push the currency down further, but not to the levels expected by some in the market (chart 1, spot on 8 June in black).

We think the AUD has slightly further to fall, but supportive factors remain. We discussed in "*Fed and the USD – a new paradigm*" (page 3) that there is a feedback loop between the USD and Fed policy. A similar process is in place for the AUD and the RBA. The AUD weakened in response to the unexpected rate cut; however, this weakening of the AUD reduces the need for the RBA to cut further (see Chart 2).

AUD fades away in May

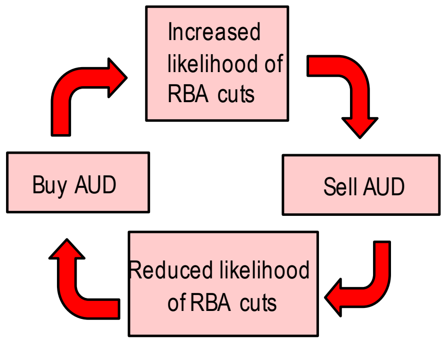
The downward pressure on the AUD began with a surprise cut from the RBA on 3 May, to a new record low of 1.75%. A contributing factor to the cut was a sharply lower than expected Q1 CPI print. The RBA then followed up the cut with a dovish monetary policy report on 6 May, whilst also revising down its outlook for inflation significantly in its official statement. The combination of the rate cut and the dovish policy report contributed to a 5% fall in AUD-USD. However, this AUD weakness has not continued. We believe that this is because the market is aware of the feedback loop we illustrate in chart 2. In other words, this rate cut does not indicate that we should expect a sequence of subsequent rate cuts so there is no need for a prolonged downward trend in the AUD. Our AUD-USD forecast therefore remains at 0.70 by year end.

1. The market sees a weaker AUD



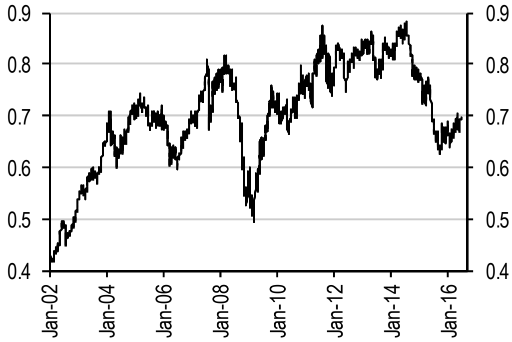
Source: HSBC, Bloomberg

2. The self-correcting FX mechanism



Source: HSBC, Bloomberg

NZD-USD



Source: HSBC, Bloomberg

New Zealand: RBNZ – 2016 rate cut likely

- In line with market expectations, the RBNZ kept the cash rate at 2.25% on 08 June. This is at odds with the RBNZ's indication that 'further monetary easing would be necessary' should inflation expectations stay below 2% - the latest two-year ahead measure of inflation expectations data read 1.64%.
- We believe a rate cut will come in August, again in line with market expectations. However, we note in "Fed and the USD – a new paradigm" (see page 3) that there is a new relationship between FX and rates. We now believe that FX is a key part of policymaking, as opposed to merely a consequence. Hence a fall in the NZD on the back of any cut in August would reduce the pressure on the RBNZ to cut rates further. This should keep the NZD supported.
- Our year end forecast of 0.68 for NZD-USD is retained.

USD-CAD

Source: HSBC, Bloomberg

Canada: fires constraining CAD

- Fires in Alberta, one of Canada's key oil-producing regions, have likely hindered the CAD in recent weeks. Output looks to have been temporarily reduced by 1 million barrels of oil per day, down from 2.5 million barrels per day in February. Likely for this reason, the CAD did not benefit from the rise in oil prices between 10 May and 18 May, from $43/bbl to almost $50/bbl.
- However, the BoC played down the economic impact of the fires, saying their effect will be temporary. Whilst the Bank estimates a reduction of 1.25ppt of Q2 GDP growth, it also expected a rebound is Q3 as oil production resumes and reconstruction begins.
- Given the Canadian government's mandate for fiscal expansion, the rebuild will not be constrained by political factors. We see large-scale government spending eventually putting upward pressure on rates which should see USD-CAD move lower. Our forecast for year-end remains 1.25.

EUR-SEK

Source: HSBC, Bloomberg

Sweden: Lower EUR-SEK forecasts

- Please see "Rethinking the Riksbank's mandate", page 15.

Asia – regional overview

Asian currencies went through a rough patch in May, as the market tempered earlier (misplaced) optimism about China's growth recovery, and factored in a greater likelihood of an impending rate hike by the Fed. Asian FX has since regained some ground in the first few trading days of June, after a particularly weak US payroll print. We will not be surprised if the trajectories of Asian currencies stay bumpy for some time, possibly into Q3 – given that HSBC economists only expect the Fed to raise interest rates in September. Notably, there is an action-packed calendar in the coming weeks – the FOMC's meeting on 15 June, the MSCI's decision on the inclusion of China's A-shares in its EM equity index on 15 June, the Bank of Japan's policy meeting on 16 June and the UK's EU referendum on 23 June, to name but a few.

But barring unexpectedly market-negative outcomes in aforementioned events, we do not expect most USD-Asia pairs to test their respective high levels reached in Q3 2015 or earlier this year. It is our belief that most Asian currencies have already passed their worst (see *EM FX Roadmap: Anxious times*, 24 May). This is especially relevant for the IDR and MYR – two of the more battered currencies in the region.

We recently reiterated our forecast for USD-IDR at 13,500 by year-end (see *The lure of the Indonesian Rupiah*, 3 June). The domestic story for the IDR remains positive relative to others in the region. Macro-economic policies have been prudent and some structural reforms (such as measures to attract more FDI inflows to plug the current account deficit) have been introduced. A successful implementation of the proposed tax amnesty programme – which could lead to USD40-50bn of inflows over a period of time, according to official estimates – will reinforce our constructive take on the currency.

As for the MYR, we are marking down our year-end forecast to 3.95 against the USD, from 4.25. As we have been saying for some time now, Malaysia's fundamentals today do not warrant comparisons to its situation during the 1997-98 Asian financial crisis. This can be seen in its improved international investment position as well as through policymakers' effective response to the MYR's weakness in H2 2015 and Q1 2016 – administrative guidance to reduce local direct investment and portfolio outflows and commitment to fiscal consolidation, for example. Yet, the currency's valuation suggests it is now as 'cheap' as it was then. With its terms-of-trade appearing to have bottomed out, we believe the MYR should start embarking on a path of recovery. That said, it could be a long and bumpy road due to thin liquidity in the onshore FX market, ongoing political uncertainty and a domestic growth slowdown.

Aside from the MYR and IDR, we have also changed our forecast for the PHP. The Philippines has overcome some lingering uncertainties with the presidential elections passing smoothly and Duterte being elected and the BSP also successfully introducing its new interest rate corridor. With suggestions the new government may be willing to lift caps on foreign ownership (Rappler, 9 May), simplify the tax system (Standard, 2 June) and hike infrastructure spending up to 7% of GDP from 2.7% currently (Inquire, 3 June) the PHP should be supported by a return in confidence and portfolio inflows. As a result we have become more constructive on the PHP and lower our year-end forecast for USD-PHP from 48.5 to 45.0.

The RMB is a notable exception to our view about USD-Asia having peaked earlier. We believe the RMB remains somewhat over-valued, although its further correction need not only be against the USD, but probably will be channelled through the other major currencies such as EUR and JPY as well. It is also important to note that we expect limited repercussions of the RMB's depreciation to the rest of Asia FX. The PBoC's recent adoption of a more transparent USD-CNY fixing mechanism has reduced the potential of an abrupt and sharp depreciation of the RMB (see *CNY fix – cracking the code*, 30 May). Its commitment to FX reforms is reinforced by the recent agreement between China and US to develop RMB trading and clearing in the US (see *The US and China push RMB internationalisation*, 7 June).

Asia at a glance

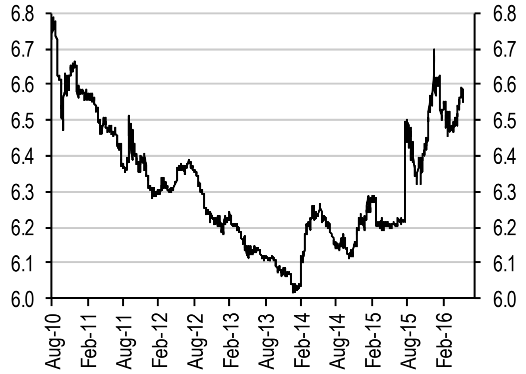
USD-CNY

Source: HSBC, Bloomberg

China (CNY): Still effectively depreciating

- The RMB remains in the midst of a difficult transition from a highly managed FX regime to more of a floating one. In our view, the 'Chinese way' shows a preference for the middle path, avoiding extremes such as a one-off devaluation and/or a re-pegging of the RMB to the USD.
- The RMB is becoming increasingly sensitive to the movements in major currencies and we believe that the PBoC has seized this current opportunity of relative calm in the global financial markets to implement the new fixing mechanism which would introduce greater two-way currency volatility over time.
- We expect further depreciation by the RMB this year and forecast USD-RMB at 6.90 by year-end. However, RMB weakness does not just have to be channelled just against the USD. Effective depreciation should also occur against the EUR and JPY as well, which would be more constructive for global sentiment.

USD-CNH



Source: HSBC, Bloomberg

China (CNH): The RMB's global reach continues to extend

- Despite RMB weakness in May and early June, both USD-CNH and the onshore-offshore basis has been more stable than in previous such episodes (i.e. Q3 2015 and January 2016).This reflects a more market-oriented fix, probably less intervention in the onshore market, and existing administrative measures (to check on capital outflows).
- As the market gets used to higher two-way volatility in the RMB, China may roll out more capital account liberalization measures. These range from a potential announcement of the Shenzhen - Shanghai Stock Connect and MSCI inclusion for A-shares.
- The US-China Strategic Economic Dialog is another focus. The market will be looking out for comments about China's FX policy and the Fed's policy rate normalisation. We also believe the meeting could lead to further progress for the RMB's internationalization in the US.

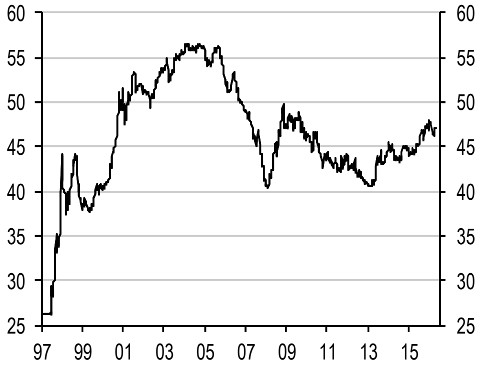
USD-IDR

Source: HSBC, Bloomberg

Indonesia: Tax amnesty – luring offshore assets home

- The IDR has gone through a difficult patch lately. Seasonal dividend outflows and FX positioning adjustments have contributed to its recent depreciation.
- Looking beyond the currency's short-term volatility, however, we believe the story for the IDR remains relatively positive. Bank Indonesia's monetary policy has been prudent and policy transmission should improve with the recent changes to the policy rate corridor. The government is delivering on some promised structural reforms, which could continue to attract more FDI inflows to plug the current account deficit.
- Additionally, the proposed tax amnesty bill has come into focus and could have important implications for the IDR. There is potential for USD-IDR to decline, owing to tax payment inflows from abroad and if repatriated assets are converted into IDR. However, the impact on the exchange rate will ultimately depend on BI's FX policy. We believe Bank Indonesia could partially absorb the inflows and slow the appreciation of the currency.

USD-PHP



Source: HSBC, Bloomberg

Philippines: BSP narrows the interest rate corridor

- The Philippines central bank, the BSP, cut its policy rate by 100bps to 3.0% as it introduced its new Interest Rate Corridor which became effective on June 3. The BSP also cut the lending rate to 3.5% and left the deposit rate unchanged at 2.5%, thereby creating a corridor width of 100bp. The changes are meant to be policy neutral.
- We don't believe the BSP's new monetary policy framework will have a significant impact on the PHP immediately. The BSP has given assurances that trusts will have access to the Overnight Deposit Facilities and therefore foreign outflows should be largely limited as a result of the changes.
- Perhaps of more importance in the near term is the BSP's suggestion that it will cut the Reserve Requirement Rate (RRR) for banks the interest corridor is fully implemented. Signs that the BSP is willing to begin easing monetary policy through this route may inhibit the PHP's performance.

USD-INR

Source: HSBC, Bloomberg

India: RBI's Rajan – will he stay or will he go?

- In India, the focus has shifted to the RBI Governor Rajan, and whether he will continue his tenure at the RBI when his first term ends in September. It is currently unknown whether he will be offered, or if he will accept, a second term at the helm of the RBI, but the focus will likely intensify over the coming months.
- Uncertainty surrounding his leadership could cause some greater FX volatility. But we believe it is too premature to conclude that a change in FX policy could occur over the coming months. The RBI's FX policy direction over the past few years has been prudent and, in our view, should stay the course.
- Despite the recent volatility in the INR we are constructive on the currency in an Asian and broader EM context. The INR still boasts a reasonable valuation, a solid carry/interest rate buffer (even after the policy rate cut) and a domestic-led growth potential. The Q1-GDP numbers which were better than expected (7.9% y-o-y vs exp of 7.5%) should also help bolster confidence in the currency.

USD- THB

Source: HSBC, Bloomberg

Thailand: An uphill task to contain THB strength

- The THB depreciated against the USD in May, but did not underperform the region as much as it used to in earlier years. The negative seasonality in the current account could have become slightly muted this year, offset by a 'recessionary' trade surplus and strong tourism inflows from China. Thailand appears to be struggling to recycle its rapidly growing current account surplus (over 10% of GDP, the largest since 1999).
- In our view, the Bank of Thailand faces an uphill task. In the latest monetary policy minutes, the MPC members maintained that the "*strengthening of the baht with respect to other currencies during some recent periods might not be as conducive to the economic recovery as it could be*". FX policy has been biased towards THB weakness all year long. Thailand's FX reserves have risen by the most – in nominal and percentage terms – in Asia year-to-date. However, despite the persistent reserve accumulation and dovish rhetoric, we foresee the THB outperforming in the near-term.

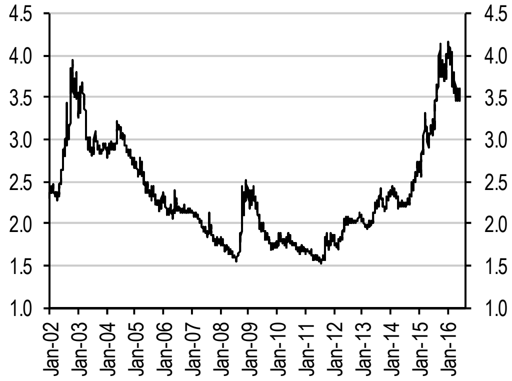
Latin America – regional overview

Fed driving LatAm FX

The market's assessment of the timing of the next Fed hike has been the main driver of risk sentiment in recent weeks, driving the USD more broadly and with it, USD-LatAm currencies. However, local factors remain in play, particularly politics. At the time of writing, Peru's election result was still too close to call, but that both candidates are seen as supporting orthodox policies has supported the PEN. Pedro Pablo Kuczynski (PPK) appears to hold a narrow lead, which if confirmed would further support local assets, we believe. In contrast, Brazil's political news flow has been less supportive. A number of members of the ruling PMDB party have been implicated in corruption probes, including Senate president, Renan Calheiros (Reuters, 7 June). High level resignations from the new post-impeachment cabinet have also rocked asset prices, including the BRL.

We believe the broader picture for currencies across the region will be dictated by swings in the risk-on/risk-off mood. Insofar as China's data readings have found some stability while the Fed looks unlikely to raise rates this month (our economists expect the next hike in September), we are cautiously optimistic on LatAm FX in the near term. Out favourite picks would be the MXN (see "*Pillars of MXN support weakened*", 01 June 2016) and PEN. However, risks associated with the UK's EU membership vote are likely to keep investors' positions light, and for currencies like the BRL and COP we see domestic weaknesses as likely to prevent any significant strength. Indeed, we would favour buying USDs on dips in USD-BRL and USD-COP. CLP remains beholden to copper prices, which continue to flirt with the psychological $2.00/lb level, while disappointing domestic activity data keep us neutral at best on the CLP. The ARS will remain well-supported by grain inflows in the near term, but we expect the currency to suffer during 2H16 as inflation pressures dictate the need for nominal ARS weakness.

USD-BRL

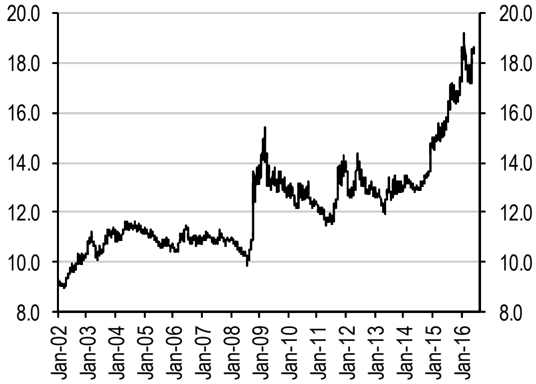


Source: HSBC, Bloomberg

Brazil: reality bites

- The BRL has lost some of its pre-impeachment gloss as the reality of the new government's challenges hits home. Several members of the new ruling PMDB party have faced accusations of impeding the corruption investigations, forcing some high profile resignations (Bloomberg, 25 May).
- Meanwhile the daunting task of trimming the country's bloated fiscal accounts without deepening the recession also appears to have dampened some enthusiasm for local assets. The BCB's ongoing unwinding of outstanding short USD forward positions (buying USDs back) may also lend the USD support, we believe.
- On balance, we prefer to buy USDs on dips below 3.50 in USD-BRL or look to sell BRL vs other regional currencies such as the PEN or MXN.

USD-MXN

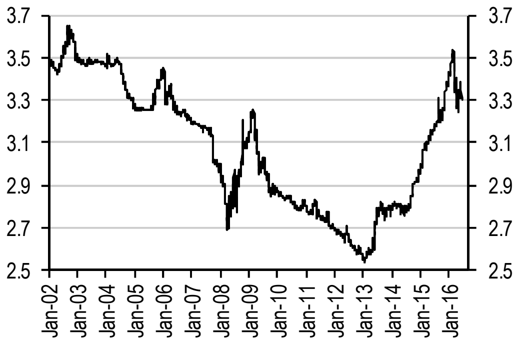


Source: HSBC, Bloomberg

Mexico: underperformer

- The MXN underperformed in May, despite the rally in oil. Given its high sensitivity to RORO, broad USD strength (as the market reassessed the Fed rate outlook) took USD-MXN higher last month. Pemex strains and a more challenging fiscal outlook have also weighed on investor sentiment. Also, Mexico's oil balance may soon slip into a deficit as waning production fails to compensate for higher refined energy imports.
- These factors have made us less optimistic over the MXN's medium term outlook, though we still see some bright spots. Cheap valuations and a central bank ready to intervene if deemed necessary should help to cap the USD's topside, while further support for Pemex appears possible, including changes to the state-owned company's pension liabilities, which we believe will support the MXN.
- We see room for the MXN to recover to 17.50/USD by year end.

USD-PEN



Source: HSBC, Bloomberg

Peru: political shift underway

- The shift away from left-wing politics in the region has continued, with Peru's election of either center-right, orthodox candidate Pedro Pablo Kuczynski (PPK) or Keiko Fujimori as president (at the time of writing the election was too close to call, though PPK held a narrow lead). Argentina shed its left-wing government last December while Brazil's political orbit has moved to the center following the impeachment of President Rousseff. Should PPK win, this may help to lift local assets given his business- and market-friendly platform of boosting growth via tax incentives to investors to reinvest profits (WSJ, 6 June). Nevertheless, negotiations with Fujimori's Fuerza Popular party will be necessary to pass any reforms.
- Meanwhile, Peru's GDP growth outlook is improving, helped by an expansion of primary activities and the current account deficit should continue to improve with the rise in export volumes. We believe the PEN has room to outperform much of the region, though it will remain somewhat beholden to broader risk-on/risk-off sentiment and commodity price swings.

CEEMEA – regional overview

The recovery in most CEEMEA currencies in the last month should serve as a reminder of the strong pull that external sentiment can and does have on FX in this region. US Fed rate hike expectations, which rose sharply in mid-May following hawkish Fed minutes from April, have reversed significantly as US data has disappointed and a wake of Fed speakers have pushed a more dovish message. This shift in external sentiment has been most notably supportive for the higher yielding currencies in this region such as the TRY and the ZAR. But there have also been some more positive developments from a local perspective for some currencies in CEEMEA.

In Turkey, the spike in political uncertainty following the resignation of the Prime Minister now appears to be fading, and the macro indicators continue to show improvement. Most notably, inflation has continued to moderate albeit from high levels. And while the CBRT has been gradually cutting rates (both in terms of the overnight lending rate and a decline in the weighted average cost of funding), real rates remain in positive territory. This has helped to support foreign bond flows into Turkey. Speculative long USD-TRY positioning has shifted back into neutral territory which should support lower volatility from here. This will further improve the TRY's carry-volatility ratio, which is already the most attractive in the region.

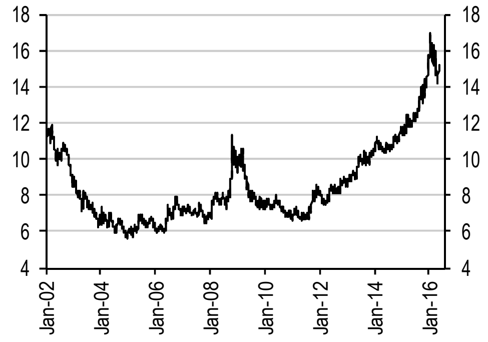
In South Africa, all the ratings reviews, by Moody's, S&P and Fitch passed without a downgrade. The lack of a downgrade has at least bought some time for the authorities to attempt to address some of the structural challenges that South Africa has long faced – an inflexible labour market, lack of investment, slow growth and high inflation. While it is hard to be structural bullish on the ZAR while these issue remain, there is room for further cyclical appreciation especially in light of an ongoing narrowing of the trade deficit and further rate hikes expected by the SARB.

There have also been **some positive near-term signals for the HUF** in terms of a shift in monetary policy bias. The NBH cut rates by 15bp on 24 May but announced the end of its rate cut cycle. Vice-Governor Marton Nagy confirmed this stance in an interview on 26 May (Reuters & Bloomberg). Interestingly, he added that the NBH had no intention, at the current juncture, to loosen monetary conditions further via unconventional instruments. This is an important development. It means the NBH will be neutral and less unconventional going forward. Tactically, this should help the HUF outperform some of its regional peers.

On the other hand, the negative outlook is intensifying in Poland. The uncertainty regarding the conversion of households' FX mortgages persists. At the time of writing, the final plan to deal with this issue was yet to be communicated. In our view, the implementation will create challenges, either for the banking sector or for the government and institutions. The NBP may need to use its FX reserves to facilitate the conversion, which could result in a decline in FX reserves. A further challenge is the ongoing standoff between the government and the Constitutional Tribunal, which has created some discomfort in the market. It has also led to negative headlines surrounding the relationship between the EU and Poland, regarding the "rule of law". Signs of weaker economic activity and softer inflation, and a central bank no longer completely excluding a rate cut are further risks to the PLN. Although we flagged the room for a sharper PLN depreciation in Q2 back in April (see PLN: History repeating, 4 April 2016), we believe weakness now has even further to run. As such we have updated our forecasts and we now look for even more PLN weakness than we previously envisaged. **We see EUR-PLN rising to 4.60 by the end of this year from 4.40 previously.**

EMEA at a glance

USD-ZAR



Source: HSBC, Bloomberg

South Africa: Respite after ratings review

- S&P recently left South Africa's rating on hold, at BBB- for the foreign currency rating and BBB+ for the local currency rating, with a negative outlook. This followed a similar decision by Moody's in May. Fitch also left its rating unchanged. In our view, the ZAR can continue to gain some ground following these decisions.
- Although South Africa still faces many longer term structural challenges, these ratings buy time for the government to attempt to contain the fiscal deficit, to boost growth, and to calm political tensions.
- With external volatility calming as fears around Fed hikes dissipate, USD-ZAR has room to fall towards the lows seen in late April and early May, given its higher beta nature.

EUR-PLN

Source: HSBC, Bloomberg

Poland: Further weakness ahead

- We believe that the PLN is likely to face further depreciation pressures in the coming months, something we initially highlighted back in April (see PLN: History repeating, 4 April 2016). The main focus for the coming month will be the potential implementation of the plan to convert FX mortgages back to PLN. It is not yet known exactly what form this will take, but in our view it is likely to weigh on sentiment for the currency.
- The NBP may need to use its FX reserves to facilitate the conversion of these mortgages. This could see reserves fall, from around 20% of GDP to around 12% of GDP if the total debt stock is converted.
- The PLN also faces an ongoing political challenge as relations between the EU and Poland remain frayed regarding the rule of law and the conflict between the government and the Constitutional Court. We have raised our EUR-PLN forecast to 4.60 at the end of 2016 from 4.40 previously.

USD-TRY

Source: HSBC, Bloomberg

Turkey: Calm after the FX positioning storm

- FX positioning in USD-TRY has been very volatile in the last few months with speculative investors appearing to shift their positions quickly and in line with broad risk sentiment. At the start of June – post the weak US non-farm payrolls – positioning in USD-TRY appeared to have shifted back to a neutral level from having previously been heavily long.
- This adjustment represents a normalisation compared to other flows in our view. For example, Turkey had continued to see foreign bond inflows, even when long USD-TRY FX positioning was building. Locals had also been selling FX holdings from previously high levels. These three different indicators of positions are now much more aligned.
- We think USD-TRY can keep moving lower for now. Less extreme positioning tends to encourage lower volatility, which is a positive development for the higher yielding TRY. The macro situation also continues to improve, and political risks appears to be less acute than in the past (see TRY FX positioning, 7 June 2016).

HSBC Volume-Weighted REERs

For full details of the construction methodology of the HSBC REERs, please see "*HSBC's New Volume-Weighted REERs*" *Currency Outlook April 2009*.

The value of a currency

Since FX prices are always given as the amount of one currency that can be bought with another, the inherent value of a currency is not defined. For example, if EUR-USD goes up, this could be because the EUR has increased in value, the USD has decreased in value, or a combination of both. One possible method for getting some insight into changes in the value of a currency is to look at movements in the value of a basket of other currencies against the currency of interest. For example, if EUR-USD increased over some time period, one could see how EUR had performed against a range of other currencies to determine whether EUR has become generally more valuable or whether this was simply a USD-based move. An effective exchange rate is an attempt to do this and to represent the moves in index form.

There are two main approaches to building an effective exchange rate: Nominal Effective Exchange Rates (NEERs) and Real Effective Exchange Rates (REERs). NEERs simply track the weighted average returns of a basket of other currencies against the currency being investigated; REERs deflate the returns in an attempt to compensate for the differing rates of inflation in different countries. The reason for doing this is that, particularly over long time frames, inflation can have a large impact on the purchasing power of a currency.

How should we weight the basket?

If we are trying to create an index for the change in value of a currency against a basket of other currencies, we now need to decide on how to weight our basket. One possible solution would be to simply have an equally-weighted basket. The rationale for this would be that there is no *a priori* reason for choosing to put more emphasis on any one exchange rate. However, this could clearly lead to the situation where a large move in a relatively small currency can strongly influence the REERs and NEERs for all other currencies. To avoid this, the indices are generally weighted so that more "important" currencies get higher weighting. This, of course, begs the question of how "importance" is defined.

Trade Weights

Weighting the basket by bilateral trade-weights is the most common weighting procedure for creating an effective exchange rate index. This is because the indices are often used to measure the likely impact of exchange rate moves on a country's international trade performance.

Volume Weights

The daily volume traded in the FX market dwarves the global volume of physical trade. From this it is possible to make a convincing argument that the weighting which would be really important would be to weight the currency basket by financial market flows, rather than bilateral trade.

To do this properly would require us to have accurate FX volumes for all currency pairs considered in the index. However, these are not available. The BIS triennial survey of FX volumes only gives data for a small number of bilateral exchange rates. However, the volumes are split by currency for over 30 currencies. From these volumes we can estimate financial weightings for each currency. We believe that this gives another plausible definition for "importance", and one which may be more relevant for financial investors than trade weights. We call this procedure volume weighting and the indices produced through this procedure we call the HSBC volume-weighted REERs.

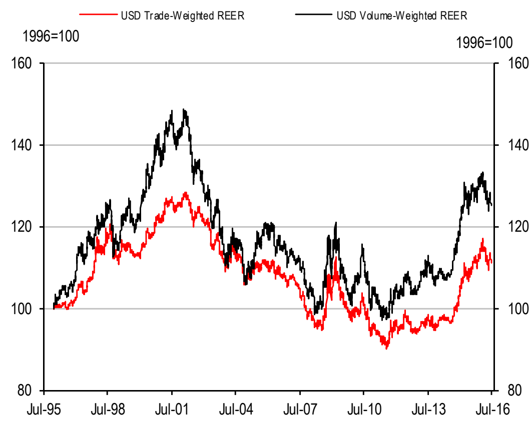
We would argue that if you are a financial market investor, the effective value of a currency you would be exposed to is more accurately represented by the HSBC volume-weighted index rather than the trade-weighted index.

Data Frequency

This is something which is rarely considered when constructing REERs – inflation data is generally released at monthly frequency at best so the usual procedure is to simply create monthly indices by default. However, some countries release their inflation data only quarterly. The usual procedure for these countries is to simply *pro-rata* the change over the period. Here there is an implicit assumption that the rate of inflation changes slowly. We take this assumption one step further and assume that it is valid to spread the inflation out equally over every day in the month.

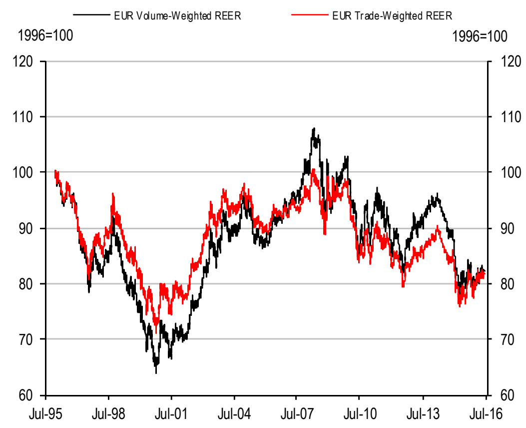
HSBC Volume – Weighted REERs

USD REER index



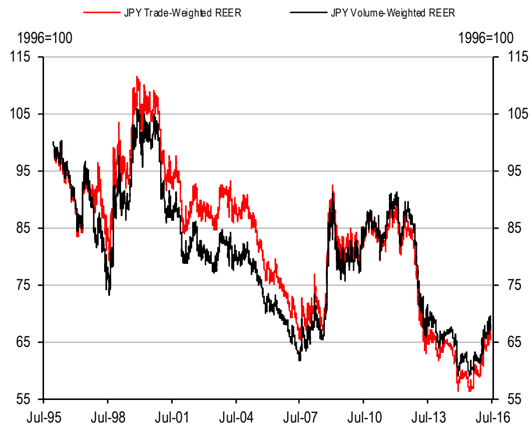
Source: HSBC

EUR REER index



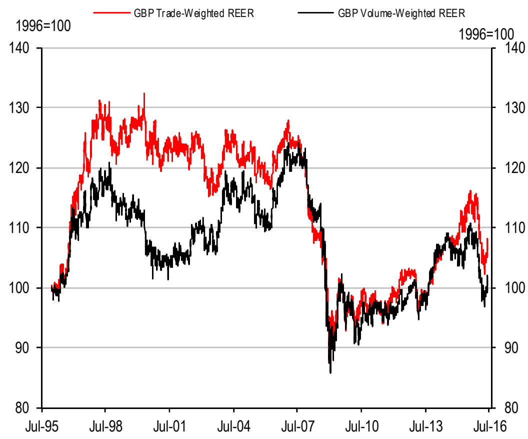
Source: HSBC

JPY REER index



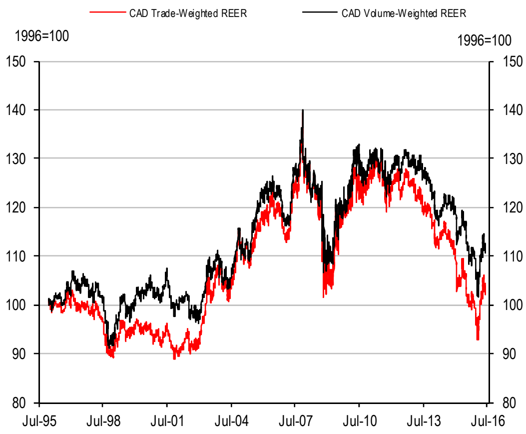
Source: HSBC

GBP REER index



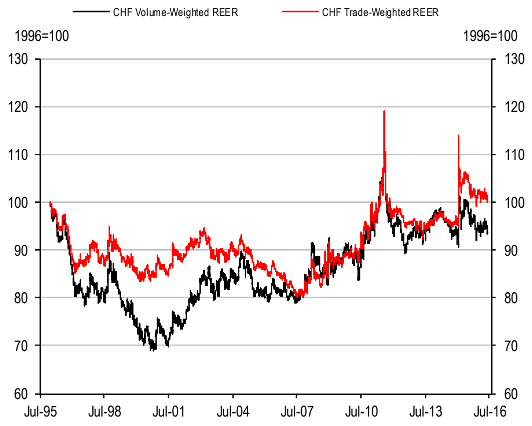
Source: HSBC

CAD REER index



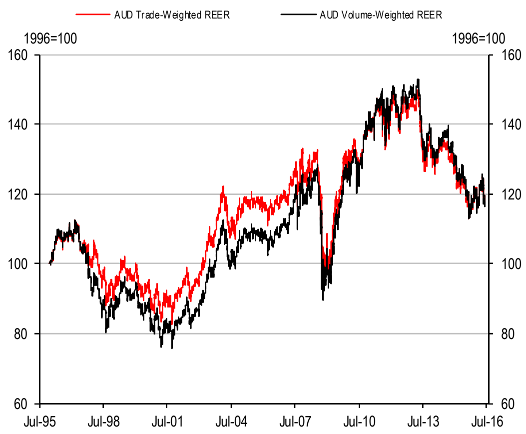
Source: HSBC

CHF REER index



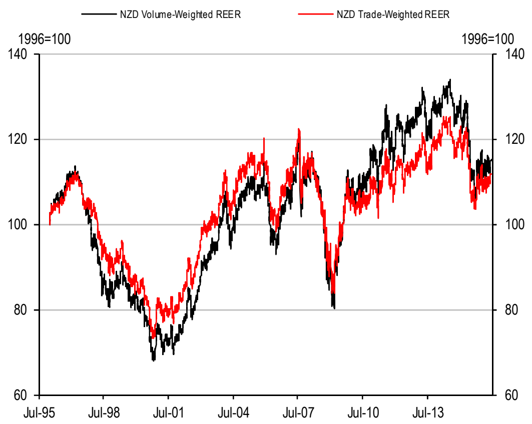
Source: HSBC

AUD REER index



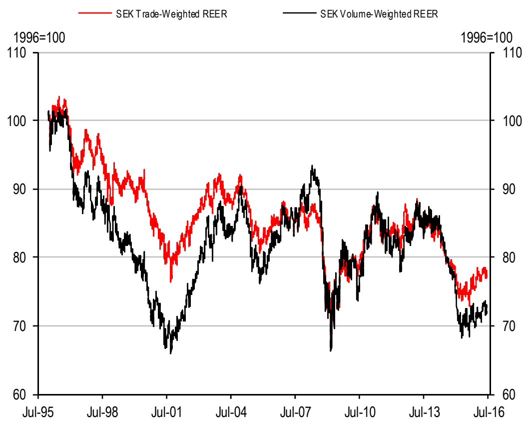
Source: HSBC

NZD REER index



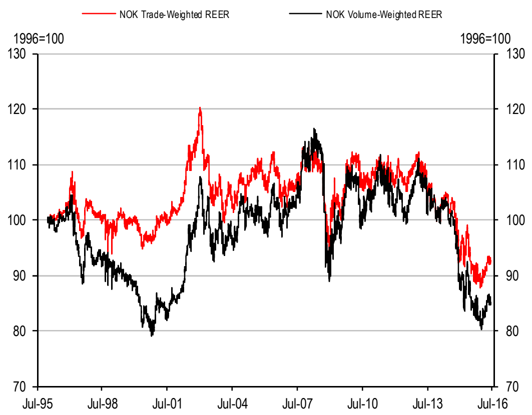
Source: HSBC

SEK REER index



Source: HSBC

NOK REER index



Source: HSBC

HSBC Little Mac Valuation Ranges

When using a REER to measure whether a currency is over/under valued, it is necessary to compare the current value of the REER to some reference value. Calculating REERs is a simple task – the difficulty in using them for FX valuation is deciding on which reference value to choose.

A common approach is to use a moving average value of the REER as the reference. However, this requires an arbitrary choice of window length to use for the moving average. One person might believe that a five-year window was an appropriate choice whereas someone else might choose 10 years. These choices will regularly give contradictory valuations and there is no principled way to choose between them.

Our methodology circumvents this problem by using all possible window lengths of five years and more. Each window choice gives a different valuation and we use the entire range of these valuations. If they **all** give a consistent valuation signal then this gives us some confidence of the direction of valuation.

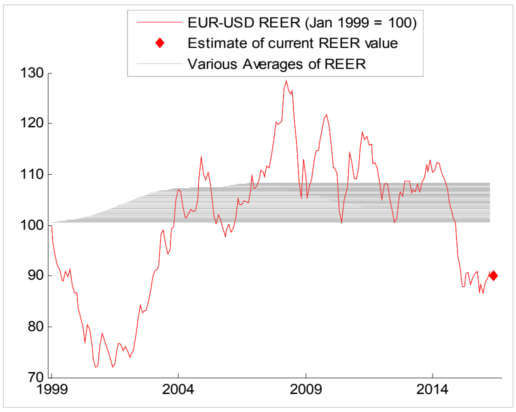
Procedure to calculate the HSBC Little Mac Valuation Ranges

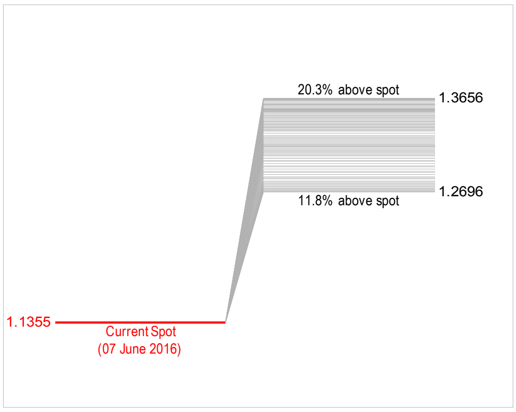
1. We create single currency pair REERs, beginning at 100 in February1999.
2. We calculate average values of the REER for all recent time windows which are at least five years in length[4].
3. We use the spot moves since the most recently available inflation data to estimate the value of the REER today[5].
4. For each average value of the REER calculated in step 2, we calculate what value of the exchange rate would move our estimated value of the REER today (step 3) to the average. We use this value as one of our estimated PPP values.
5. The range of the entire set of the estimated PPP values (step 4) constitutes our HSBC Little Mac Valuation Range for this currency pair.

For full details of the construction methodology, please see "*HSBC Little Mac Valuation Ranges*", September 2015.

[4] *The maximum window length over which we calculate an average value is from January 1999 to today.*
[5] *We make the assumption that the most recently observed YoY change in CPI will also be the YoY change observed for this month in estimating this REER value.*

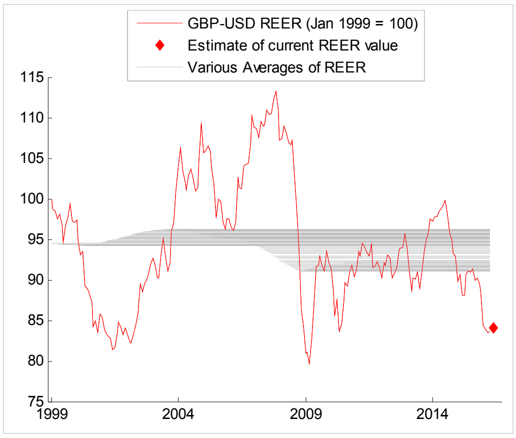
EUR-USD HSBC Little Mac Valuation Range

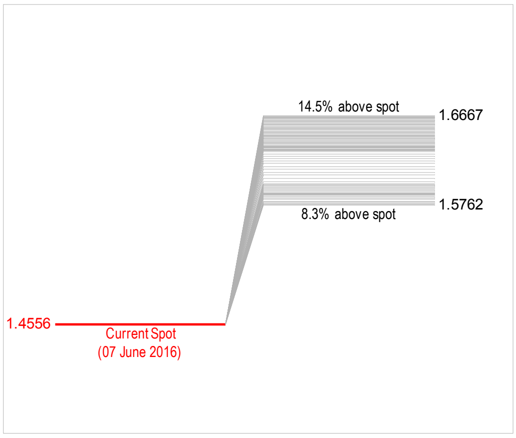




Source: HSBC, Thomson Reuters Datastream

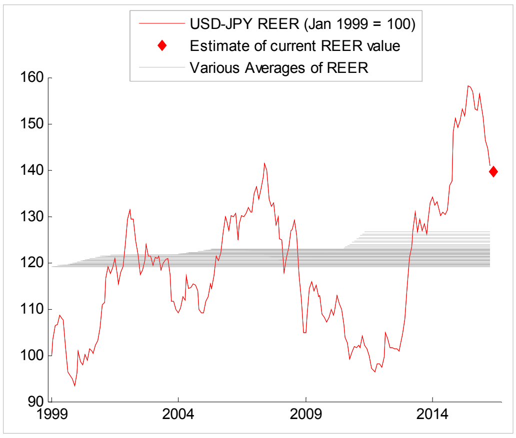
GBP-USD HSBC Little Mac Valuation Range

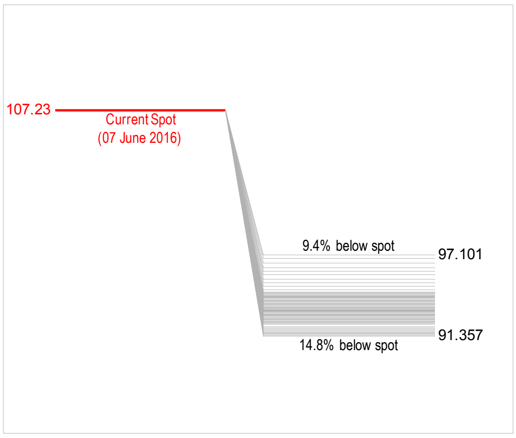




Source: HSBC, Thomson Reuters Datastream

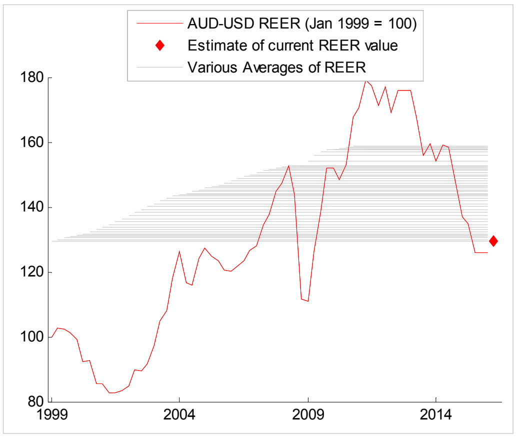
USD-JPY HSBC Little Mac Valuation Range

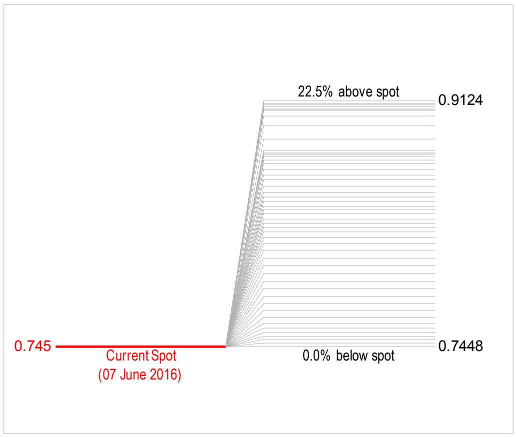




Source: HSBC, Thomson Reuters Datastream

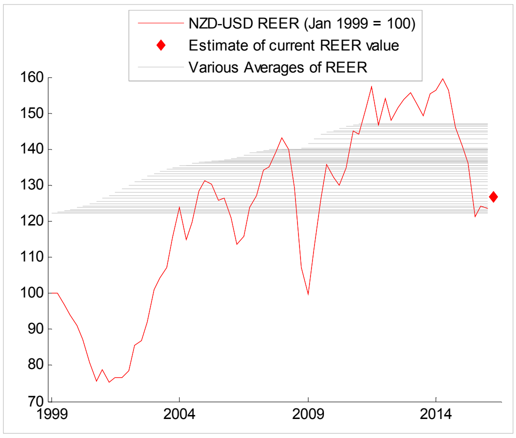
AUD-USD HSBC Little Mac Valuation Range

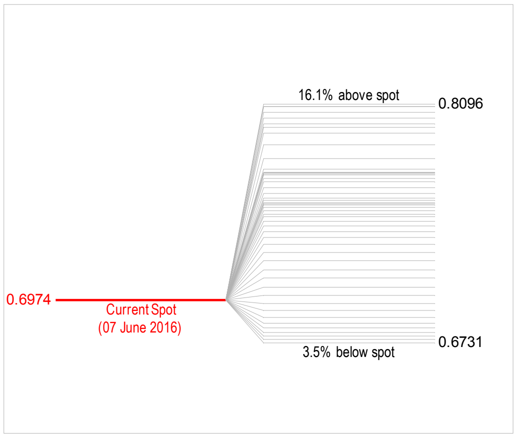




Source: HSBC, Thomson Reuters Datastream

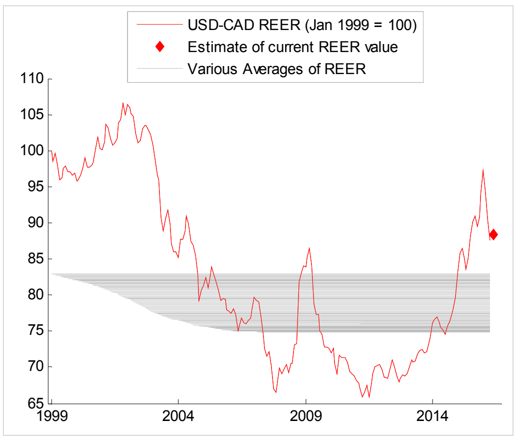
NZD-USD HSBC Little Mac Valuation Range

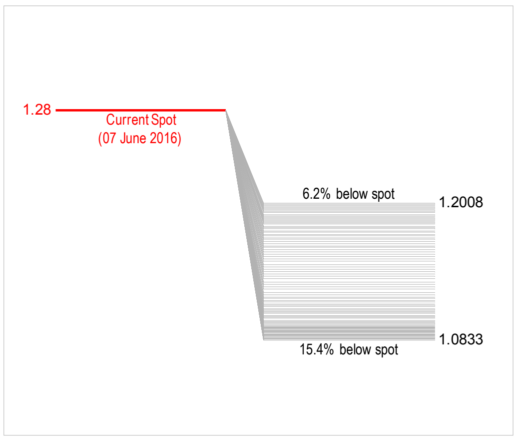




Source: HSBC, Thomson Reuters Datastream

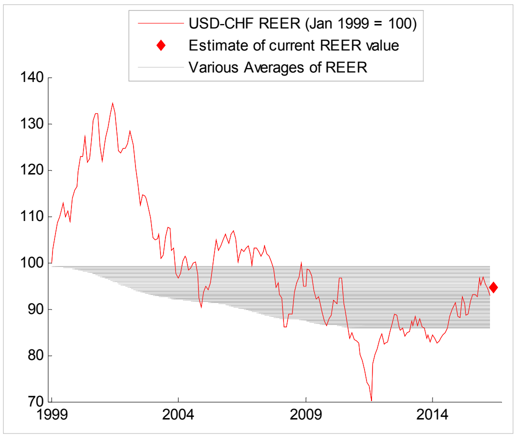
USD-CAD HSBC Little Mac Valuation Range

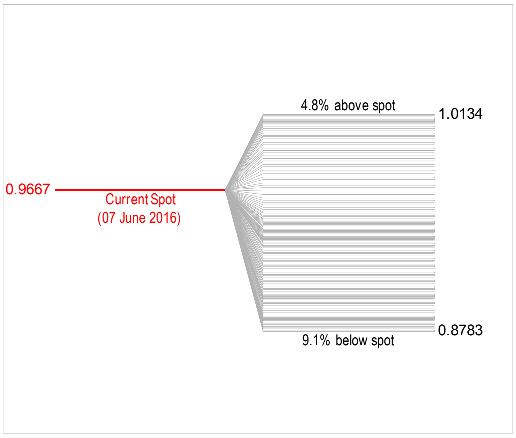




Source: HSBC, Thomson Reuters Datastream

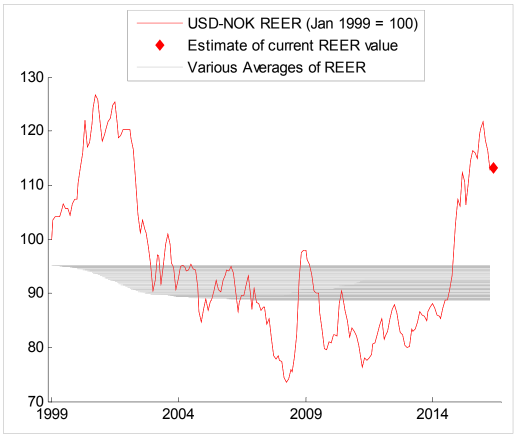
USD-CHF HSBC Little Mac Valuation Range

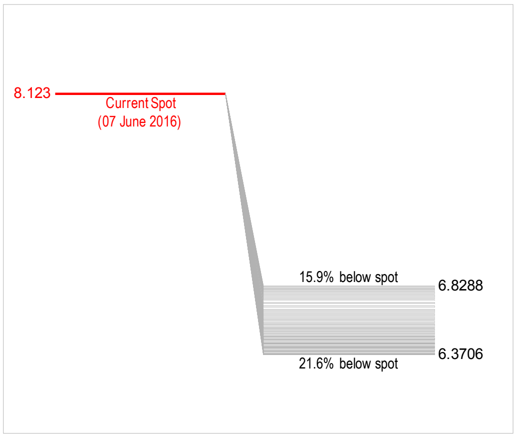




Source: HSBC, Thomson Reuters Datastream

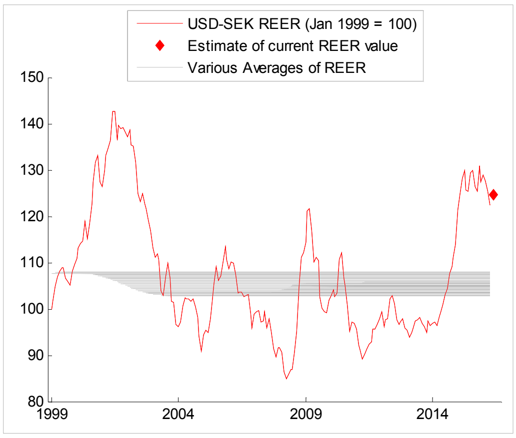
USD-NOK HSBC Little Mac Valuation Range

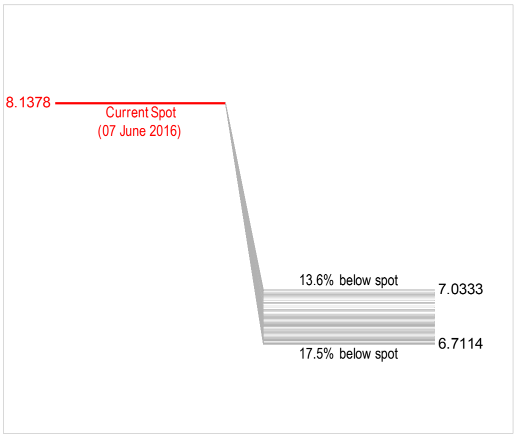




Source: HSBC, Thomson Reuters Datastream

USD-SEK HSBC Little Mac Valuation Range





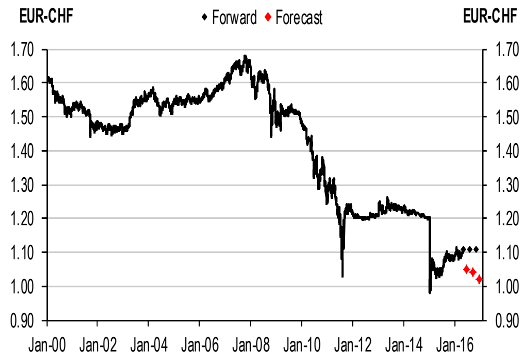
Source: HSBC, Thomson Reuters Datastream

HSBC forecasts vs forwards

EUR-USD vs forwards

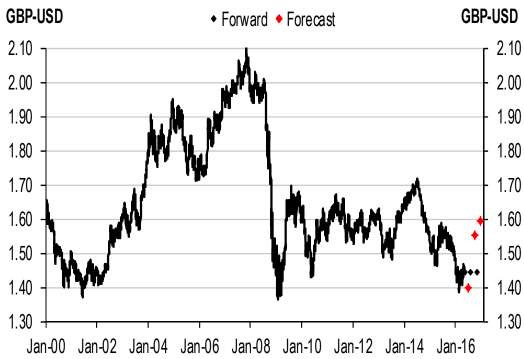
Source: Thomson Reuters Datastream, Reuters, HSBC

EUR-CHF vs forwards



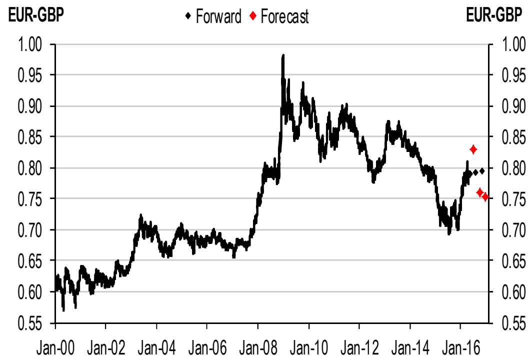
Source: Thomson Reuters Datastream, Reuters, HSBC

GBP-USD vs forwards



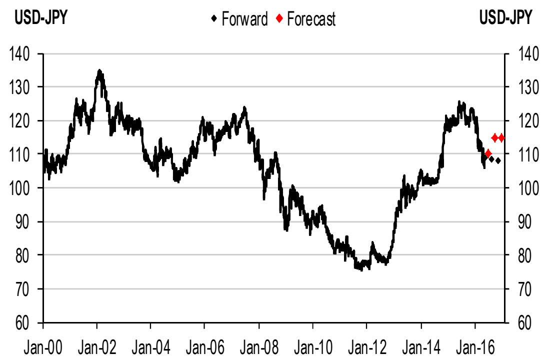
Source: Thomson Reuters Datastream, Reuters, HSBC

EUR-GBP vs forwards



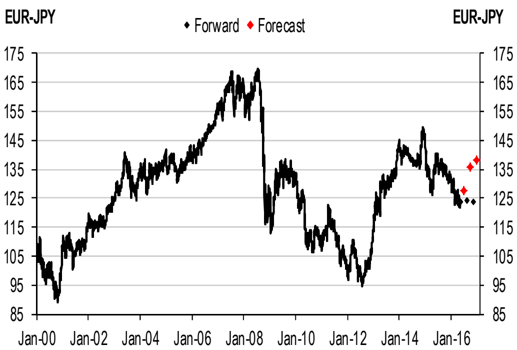
Source: Thomson Reuters Datastream, Reuters, HSBC

USD-JPY vs forwards



Source: Thomson Reuters Datastream, Reuters, HSBC

EUR-JPY vs forwards



Source: Thomson Reuters Datastream, Reuters, HSBC

Policy Rates

end period		2015		2016				2017	
	Current	Q3	Q4	Q1	Q2f	Q3f	Q4f	Q1f	Q2f
North America									
US	0.25-0.50	0.00-0.25	0.25-0.50	0.25-0.50	0.25-0.50	0.50-0.75	0.50-0.75	0.75-1.00	0.75-1.00
Canada	0.50	0.50	0.50	0.50	0.50	0.50	0.25	0.25	0.50
Asia									
China	4.35	4.60	4.35	4.35	4.10	3.85	3.85	3.85	3.60
Japan	-0.10	0.10	0.10	-0.10	-0.10	-0.10	-0.30	-0.30	-0.30
Hong Kong	0.75	0.50	0.75	0.75	0.75	1.00	1.00	1.25	1.25
India	6.50	6.75	6.75	6.75	6.50	6.25	6.25	6.25	6.25
Indonesia	6.75	7.50	7.50	6.75	6.50	6.50	6.50	6.50	6.50
South Korea	1.25	1.50	1.50	1.50	1.25	1.25	1.25	1.25	1.25
Malaysia	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25
Thailand	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50
Australia	1.75	2.00	2.00	2.00	1.75	1.50	1.50	1.50	1.50
New Zealand	2.25	2.75	2.50	2.25	2.25	2.00	2.00	2.00	2.00
Western Europe									
EMU - Refi	0.00	0.05	0.05	0.00	0.00	0.00	0.00	0.00	0.00
EMU - Deposit	-0.40	-0.20	-0.20	-0.30	-0.40	-0.40	-0.40	-0.40	-0.40
UK	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.75
Norway	0.50	0.75	0.75	0.50	0.50	0.50	0.50	0.50	0.50
Sweden	-0.50	-0.35	-0.35	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50
Switzerland	-1.25/-0.25	-1.25/-0.25	-1.25/-0.25	-1.25/-0.25	-1.25/-0.25	-1.25/-0.25	-1.25/-0.25	-1.25/-0.25	-1.25/-0.25
CEEMEA									
Poland	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50
Hungary	0.90	1.35	1.35	1.20	0.90	0.90	0.90	0.90	0.90
Turkey	7.50	7.50	7.50	7.50	7.50	7.50	7.50	7.50	7.50
Russia	11.00	11.00	11.00	11.00	11.00	10.50	9.50	9.00	8.50
Israel	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.25
South Africa	7.00	6.00	6.25	7.00	7.00	7.25	7.50	7.75	7.75
Latin America									
Brazil	14.25	14.25	14.25	14.25	14.25	14.25	14.25	13.25	12.25
Chile	3.50	3.00	3.50	3.50	3.50	3.50	3.50	3.50	3.50
Mexico	3.75	3.00	3.25	3.75	3.75	4.00	4.00	4.00	4.25

Source HSBC

Emerging markets forecast table

	9-Jun-16	2015		2016				2017	
	last	**Q3**	**Q4**	**Q1**	**Q2f**	**Q3f**	**Q4f**	**Q1f**	**Q2f**
Latin America vs USD									
Argentina (ARS)	13.90	9.42	12.94	14.59	15.00	16.25	16.75	17.50	18.25
Brazil (BRL)	3.36	3.96	3.96	3.56	3.75	3.85	4.00	4.10	4.20
Chile (CLP)	674	697	709	668	680	690	700	700	700
Mexico (MXN)	18.14	16.91	17.23	17.28	18.25	17.85	17.50	17.50	17.50
Colombia (COP)	2925	3089	3175	3009	3150	3200	3250	3250	3250
Peru (PEN)	3.30	3.23	3.28	3.33	3.43	3.46	3.50	3.53	3.55
Eastern Europe vs EUR									
Czech Republic (CZK)	27.0	27.2	27.0	27.0	27.0	27.0	27.0	27.0	27.0
Hungary (HUF)	311	314	316	314	315	315	320	320	320
Poland (PLN)	4.33	4.25	4.27	4.25	4.40	4.50	4.60	4.60	4.60
Romania (RON)	4.51	4.42	4.52	4.47	4.40	4.40	4.40	4.40	4.40
Russia vs USD (RUB)	63.5	65.5	72.9	67.2	65.0	70.0	72.0	70.0	68.0
Turkey vs USD (TRY)	2.89	3.03	2.92	2.82	2.85	3.00	3.00	3.00	3.00
Middle East vs USD									
Egypt (EGP)	8.88	7.83	7.82	8.88	9.50	10.00	10.00	10.00	10.00
Israel (ILS)	3.84	3.92	3.89	3.76	3.80	3.80	3.75	3.75	3.75
Africa vs USD									
South Africa (ZAR)	14.80	13.86	15.49	14.69	15.00	16.00	16.20	16.20	16.20

Source HSBC

HSBC

Exchange rates vs USD

end period		2015 Q1	Q2	Q3	Q4	2016 Q1	Q2f	Q3f	Q4f	2017 Q1f	Q2f
Americas											
	Canada (CAD)	1.27	1.25	1.34	1.38	1.30	1.30	1.28	1.25	1.25	1.25
	Mexico (MXN)	15.27	15.69	16.91	17.23	17.28	18.25	17.85	17.50	17.50	17.50
	Brazil (BRL)	3.20	3.11	3.96	3.96	3.56	3.75	3.85	4.00	4.10	4.20
	Argentina (ARS)	8.82	9.08	9.42	12.94	14.59	15.00	16.25	16.75	17.50	18.25
Western Europe											
	Eurozone (EUR*)	1.07	1.12	1.12	1.09	1.14	1.16	1.18	1.20	1.20	1.20
Other Western Europe											
	UK (GBP*)	1.48	1.57	1.51	1.47	1.44	1.40	1.55	1.60	1.60	1.60
	Sweden (SEK)	8.63	8.29	8.38	8.46	8.11	7.93	7.71	7.50	7.50	7.50
	Norway (NOK)	8.06	7.84	8.54	8.85	8.27	7.84	7.54	7.25	7.25	7.25
	Switzerland (CHF)	0.97	0.94	0.97	1.00	0.96	0.91	0.88	0.85	0.85	0.85
Emerging Europe											
	Russia (RUB)	58.2	55.3	65.5	72.9	67.2	65.0	70.0	72.0	70.0	68.0
	Poland (PLN)	3.80	3.76	3.80	3.93	3.73	3.79	3.81	3.83	3.83	3.83
	Hungary (HUF)	280	283	281	291	276	272	267	267	267	267
	Czech Republic (CZK)	25.7	24.5	24.3	24.9	23.8	23.3	22.9	22.5	22.5	22.5
Asia/Pacific											
	Japan (JPY)	120	122	120	120	113	110	115	115	115	115
	Australia (AUD*)	0.76	0.77	0.70	0.73	0.77	0.71	0.70	0.70	0.70	0.70
	New Zealand (NZD*)	0.75	0.68	0.64	0.68	0.69	0.68	0.68	0.68	0.68	0.68
North Asia											
	China (CNY)	6.20	6.20	6.36	6.49	6.45	6.60	6.75	6.90	6.90	6.90
	Hong Kong (HKD)	7.75	7.75	7.75	7.75	7.76	7.80	7.80	7.80	7.80	7.80
	Taiwan (TWD)	31.3	30.9	33.0	32.9	32.2	33.0	33.4	33.8	33.8	33.8
	South Korea (KRW)	1109	1118	1185	1176	1142	1180	1190	1200	1200	1200
South Asia											
	India (INR)	62.3	63.6	65.5	66.2	66.1	67.0	68.0	69.0	69.0	69.0
	Indonesia (IDR)	13074	13353	14637	13856	13118	13300	13400	13500	13500	13500
	Malaysia (MYR)	3.71	3.74	4.39	4.30	3.87	4.03	4.00	3.95	3.92	3.90
	Philippines (PHP)	44.7	45.1	46.7	46.9	46.0	46.0	45.5	45.0	44.8	44.6
	Singapore (SGD)	1.37	1.35	1.42	1.42	1.35	1.36	1.37	1.38	1.38	1.38
	Thailand (THB)	32.6	33.8	36.4	36.0	35.1	36.0	36.2	36.4	36.4	36.4
	Vietnam (VND)	21480	21725	22478	22485	22293	22300	22600	22800	23000	23000
Africa											
	South Africa (ZAR)	12.14	12.15	13.86	15.49	14.69	15.00	16.00	16.20	16.20	16.20

Source HSBC *pairs denoted XXX-USD

Exchange rates vs EUR & GBP

end period		2015				2016				2017	
		Q1	Q2	Q3	Q4	Q1	Q2f	Q3f	Q4f	Q1f	Q2f
vs euro											
Americas											
	US (USD)	1.07	1.12	1.12	1.09	1.14	1.16	1.18	1.20	1.20	1.20
	Canada (CAD)	1.36	1.39	1.50	1.50	1.48	1.51	1.51	1.50	1.50	1.50
Europe											
	UK (GBP)	0.72	0.71	0.74	0.74	0.79	0.83	0.76	0.75	0.75	0.75
	Sweden (SEK)	9.26	9.25	9.38	9.19	9.23	9.20	9.10	9.00	9.00	9.00
	Norway (NOK)	8.65	8.74	9.54	9.62	9.41	9.10	8.90	8.70	8.70	8.70
	Switzerland (CHF)	1.04	1.04	1.09	1.09	1.09	1.05	1.04	1.02	1.02	1.02
	Russia (RUB)	62.4	61.6	73.3	79.2	76.5	75.4	82.6	86.4	84.0	81.6
	Poland (PLN)	4.07	4.19	4.25	4.27	4.25	4.40	4.50	4.60	4.60	4.60
	Hungary (HUF)	300	315	314	316	314	315	315	320	320	320
	Czech Republic (CZK)	27.6	27.4	27.2	27.0	27.0	27.0	27.0	27.0	27.0	27.0
Asia/Pacific											
	Japan (JPY)	129	136	134	131	128	128	136	138	138	138
	Australia (AUD)	1.41	1.45	1.59	1.49	1.48	1.63	1.69	1.71	1.71	1.71
	New Zealand (NZD)	1.44	1.65	1.75	1.59	1.65	1.71	1.74	1.76	1.76	1.76
vs sterling											
Americas											
	US (USD)	1.48	1.57	1.51	1.47	1.44	1.40	1.55	1.60	1.60	1.60
	Canada (CAD)	1.88	1.96	2.03	2.04	1.87	1.82	1.98	1.99	1.99	1.99
Europe											
	Eurozone (EUR*)	0.72	0.71	0.74	0.74	0.79	0.83	0.76	0.75	0.75	0.75
	Sweden (SEK)	12.81	13.04	12.69	12.46	11.70	11.10	11.96	11.96	11.96	11.96
	Norway (NOK)	11.96	12.32	12.92	13.04	11.93	10.98	11.69	11.57	11.57	11.57
	Switzerland (CHF)	1.44	1.47	1.48	1.47	1.38	1.27	1.37	1.36	1.36	1.36
Asia/Pacific											
	Japan (JPY)	178	192	181	177	162	154	178	183	183	183
	Australia (AUD)	1.95	2.04	2.16	2.02	1.88	1.97	2.22	2.28	2.28	2.28
	New Zealand (NZD)	1.99	2.32	2.37	2.15	2.09	2.06	2.28	2.35	2.35	2.35

Source HSBC *denoted EUR-GBP

Disclosure appendix

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2 All market data included in this report are dated as at close 07 June 2016, unless otherwise indicated in the report.

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