Global Macro Strategy
Global FX Atlas: Border adjustments and the dollar

Global Macro Strategy

Global

EUR/USD has space to rise as market expectations for US reflation remain rich

Being bullish the euro has probably been our most controversial view since November. Despite a hawkish December FOMC, EUR/USD has risen substantially since the start of the year. With hopes for US reflation still in the price to a substantial extent, we may need tangible policy action for the dollar to rally further. We expect EUR/USD to rise over time as the Eurozone recovery firms up further and political risks gradually subside.

Border adjustments and other myths of dollar strength ...

In a market fixated with bullish dollar arguments, the prospect of "border adjustments" to US taxation has been widely discussed as the trigger for a possible 20% dollar rally. Yet, the notion that the introduction of a tariff and subsidy scheme (essentially) may lead to a dollar surge is largely academic. We adjust relevant models, and our results point to at most 4-5% broad dollar gain – not 20%. Given recent dollar moves vs. key US trading partners, the market may already be pricing these policy shifts.

...falter against real life cross-checks

And even this moderate dollar strength may not be granted: 1) The USD is not starting from equilibrium but may be overvalued. 2) The US is not a small open economy; instead its actions matter for global prices. 3) Even so, shifts in financial conditions matter much more than short-term CPI shifts for Fed policy, which is the most significant dollar driver. Any tightening in financial conditions and risk sentiment from US policy shifts could lead the USD weaker – not stronger. Overall, it is far from clear that border adjustments will lead to material dollar strength – especially vs. key DMs. This may be more of an issue for neighbouring US trade partners and Asian currencies.

Falling inflation and dovish policy to weigh on CAD

Since the last FX Atlas, the dovish Bank of Canada meeting and the downtrend in inflation have supported our bearish CAD view. Moreover, the near-term costs of potential US policy shifts might balance out the benefits for Canadian growth. We continue to recommend short CAD positions among our 2017 Top Macro Trades.

Take advantage of improving growth with AUD, NZD

In our Top Trades publication, we recommended pairing trades that should benefit from the acceleration in growth, along with assets that should perform well if the pickup in global core inflation remains modest. In FX, this led us to recommend currencies such as AUD, NZD, and CLP, which may have been held back by the rise in US yields. We continue to see support for these currencies from better growth and higher commodity prices, against a backdrop of still-low global yields and inflation.

Stay bearish GBP although the adjustment may take longer

The pound has depreciated much slower than our forecasts imply but we remain bearish sterling. The current account adjustment is still likely to occur while the recent spike in activity is likely to be temporary, inviting easier policy by the BoE. Overall, we think risks are skewed towards markets pricing in more unfavourable outcomes than is currently the case. Yet for sterling to move sustainably towards parity to the EUR markets may require evidence of Brexit- and Current-Account- related growth damage. This may happen by the second half of the year.

Modest NOK bears and SEK bulls as inflation inflects

We turned bearish the NOK last month amid increased downside risks for Norwegian inflation. We also shifted to neutral on SEK, tempering one of our highest conviction calls of 2016. We now expect modest SEK appreciation as inflation lifts. We revise our end-2017 EUR/SEK forecast to 9.4 from 9.8.

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Contents

Can border adjustments boost the US dollar?

Following the US election, markets as well as political commentators and economists are already trying to decipher the impact of potential policy changes. Although it is uncertain what proposals will be agreed to by the Administration and Congress, one of the most discussed possibilities among market participants involves "border adjustments" to the US tax system. Roughly speaking, these adjustments involve a shift in the way corporations are being taxed; from taxing worldwide revenues and costs to taxing revenues and costs generated in the US. Effectively, the details of this shift envisage provisions that amount to a tax on imports up to the new corporate tax rate (discussed to be around 20%), and proportional rebates/subsidies on exports.

A potential "border adjustment" tax could amount to a 20% tax on imports and a proportional rebate on exports.

Even with the probability of "border adjustments" uncertain, and the potential for details to be diluted or even dismissed due to implementation difficulties (especially with strict WTO prohibition of direct taxes that favor US-based producers), it is important to think through its potential implications, even from a theoretical perspective, as it may be a risk to our market views. Indeed, a number of academic and market economists have expressed a high degree of conviction that a broad dollar appreciation of equal or nearly equal (20%) scale would – by and large – result from the imposition of this new tax regime. The argumentation is based on "standard economics".

As we discuss, there is nothing standard about the argument that tariffs and subsidies lead to nominal trade weighted dollar appreciation in the short or long run. If you drill down into the economics of exchange rate determination, there are significant nuances that this broad-brush assessment fails to take into account.

Our analysis shows –the dollar could potentially rise in response, but only by a moderate 5% at most, and mostly against EM.

Our analysis shows the following four conclusions:

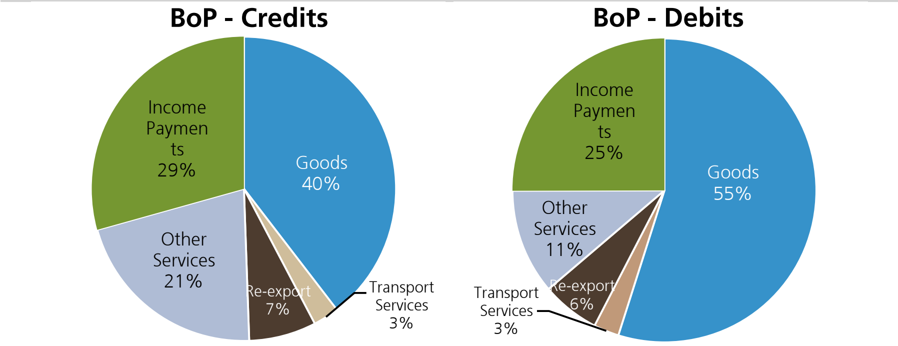
1. In model terms, the overall implied dollar appreciation may be much smaller than the headline 20% border adjustment tax implies; 4-5% seems more realistic.

2. If one takes the starting point for the dollar into account, 4-5% is the upper bound for tax-driven USD appreciation.

3. The foreign reaction to shifting US policy is very important and may tilt the balance of adjustment towards Emerging Markets (whether via exchange rate policy or via corporate surplus adjustments).

4. It is far from clear that, outside key $/EM exchange rates, border adjustments will lead to any meaningful and additional dollar strength whatsoever.

Figure 1: Goods trade accounts for a fraction of the current account only



Source: Haver, UBS

The Economics of Border Adjustment Policies

In principle, a border adjustment tax has the effect of a "fiscal devaluation" of the USD…

At its core, an effective 20% tax on imports coupled with a 20% subsidy for exports equates to a "fiscal devaluation" of the US Dollar. Via fiscal measures, the price of imports rises relative to the price of exports by as much as they would rise following a 20% dollar depreciation (assuming that the dollar depreciation is passed on to final product prices in full).

…which (again in theory), could lead to an offsetting appreciation of the nominal exchange rate.

In standard economic models, a small open economy that produces a fiscal devaluation cannot change global output and resource allocation via its policy measures. Assuming offsetting consumption tax cuts are not introduced in non-traded goods, the surplus produced via the fiscal devaluation, eventually gets reversed by a real exchange rate appreciation. Assuming a free-floating currency and an inflation-targeting central bank, the majority of the real exchange rate appreciation occurs via a stronger nominal exchange rate (rather than via spillover from higher domestic taxes into higher inflation).

In short, when a small open economy features a free floating currency and an inflation targeting central bank and – starting from equilibrium- introduces a tax on imports & subsidy to exports scheme, economics would expect the exchange rate will fully reverse the current account gain from the fiscal measures (see Feldstein and Krugman, 1990 for a discussion of the effects of taxation). One can arrive at similar results imposing the law of one price (PPP).

More advanced expositions (see Farhi, Gopinath and Itskhoki, 2012) of the problem introduce asset markets and risk sharing conditions and endogenize money supply shifts, labour market shifts and savings/portfolio choices with different assumptions of price formation mechanisms and instruments used. Conceptually, the notion that – unless you affect savings or portfolio choices – an exogenous interference with terms of trade gets offset by the exchange rate broadly holds (by model construction).

Where reality differs for the USD

In reality, a large and broad dollar appreciation is unlikely.

Intuitive as it may seem, a general 20% nominal trade weighted appreciation prediction for the USD is largely academic. For the following 7 reasons:

1) *Goods do not constitute the majority of the US current account balance.*

The US current account consists of trade in goods, trade in services and (primary and secondary) income flows. The dollar is the relative price that clears the entire external sector – not just the goods sector. In more formal terms, the paradigm of two countries two traded goods economy describes a fraction of the external balance for modern economies and the US indeed.

The sectors that could be affected by border adjustments, only account for a small share of the balance of payments.

In fact as Figure 1 shows goods and transport services only represent ca. 43% of the credit side of the current account (exports) and ca. 58% of debits (imports), accounting for re-exports. Although there is reasonable uncertainty, border taxes on cross-border services are arguably hard to implement. Our sector analyst survey indicates that the chances of a border tax on such services is low.

In that sense, and all else equal, an import tax and export subsidy of 20% would produce less than 10% of a change in the overall relative prices in the US external sector. The caveat here, is that we treat the goods and non-goods balance as indirectly linked from a first order price perspective only.

2) Part of the tax/subsidy will be absorbed by margins and not affect prices.

The dollar impact will be further reduced if firms decide to absorb the shift on their margins.

Whether firms pass the tax change on to their customers is not a foregone conclusion. A number of firms may choose to absorb the shift on their margins. Symmetrically, this is among the key reasons why the pass-through from exchange rate shifts to local prices and volumes has been limited in the past two decades. Several macro models do not distinguish between different types of income and different uses – after all, global income eventually becomes the binding constraint. But micro-trade models often acknowledge the potential for current account imbalances driven by items not related to trade (see Blanchard, 2005). Investment and borrowing decisions close to the zero bound add a level of complication. There is a question as to how long firms can absorb the shock for before becoming less competitive.

Moreover, there is a real chance that some sectors may be exempt from the new policies (e.g. our analysts argue that the energy sector may stay out of scope).

We surveyed our equity sectors analysts on the extent to which firms reflect the tax policy on prices.

This means that the relative price shift may be even less than mentioned earlier. We need to account for the degree to which tax shifts may not fully translate into relative price shifts. We run a survey among our US sector analysts. We survey the extent to which firms in the sector are likely to pass the new tax policies on to product prices (or absorb it in their margins) in an output weighted fashion.

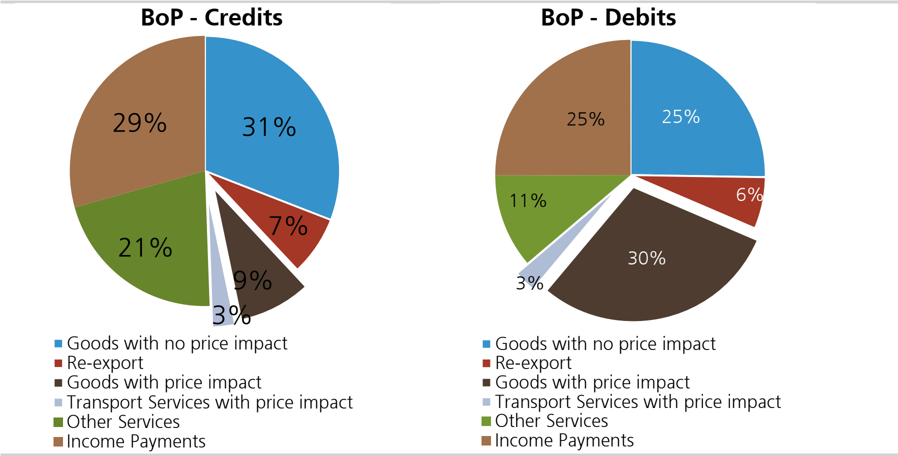
We find that only 33% of the debits side of the current account (imports) is likely to experience price increases. And as low as 12% of credits (exports) are likely to be affected by firms competing in price and volume to gain global market share (Figure 2). Taken at face value these findings could potentially even imply a net tax on exports under Lerner symmetry conditions (and certain assumptions). But we will acknowledge the margin of error in these estimates before attempting to extract firm conclusions.

Overall, taking trade into account only, the dollar impact is unlikely to be more than 4-5%.

What we do keep, however, in mind is that – on average - the relative price impact of border adjustments may be less than half of the headline tax rate. As such, the implied equilibrium dollar appreciation may be 4-5% in trade-weighted terms.

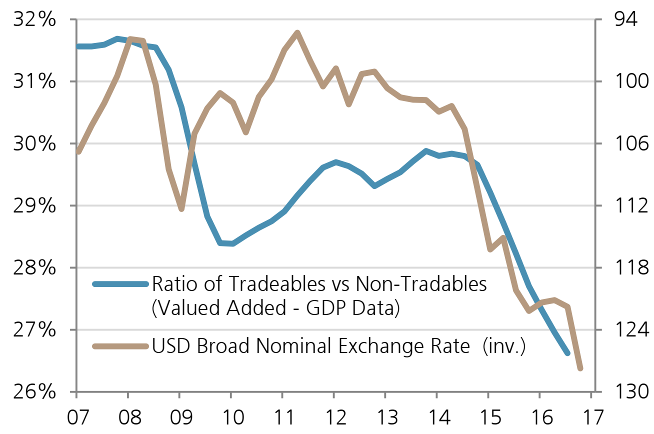
⇨ *Conclusion 1: Even in model terms, the overall implied dollar appreciation may be much smaller than a headline 20% border adjustment tax may imply; 4-5% seems more realistic.*

Figure 2: Relative prices shifts likely to affect a small fraction of BOP when firms' willingness to pass on price changes to customers is taken into account



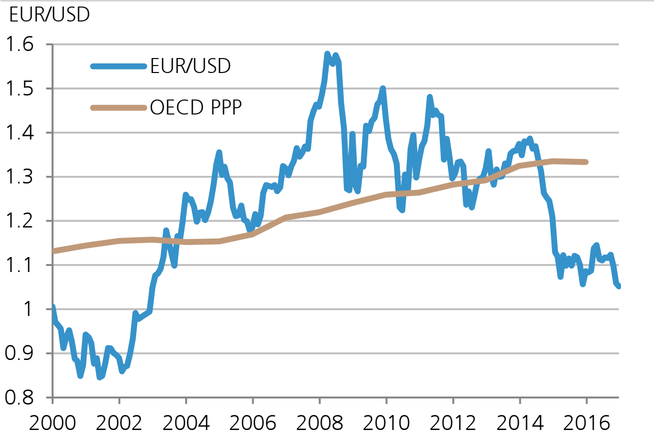
Source: UBS Research, Haver. Note: This is based on the survey results from our equity sector analysts.

Figure 3: Decade lows in value produced by tradable sector in the U.S…



Source: Haver, UBS

Figure 4: …and long-run equilibrium measure both indicate the current level of dollar is expensive



Source: OECD, Bloomberg, UBS

3) We are not starting from an equilibrium level; the dollar is already expensive.

Models of flexible, market-determined exchange rates do not allow for misalignments compared to fair value. In real life, exchange rates tend to deviate from "fair" levels whether those levels are implied by PPP, by internal/external equilibrium models, by sustainable international investment positions etc.

At the same time, dollar looks already overvalued as implied by long-run fair value estimate and a potential output imbalances…

Today, whether by relative cyclical deviations or via the impact of accumulated relative price appreciation, there is evidence of dollar overvaluation. Figure 3 shows that together with the strong dollar, the value-added produced by the US tradable sector is at decade lows compared to the value added produced by non-tradable sector, which serves as an evidence of potential imbalance in the US from a strong dollar. Figure 4 shows the value of the EUR/$ compared to estimates of PPP, again implying that the current level of EUR is too low.

In that sense, a fiscal devaluation makes the dollar less expensive compared to a theoretical "fair value". But, in no way, does it imply a spot exchange rate appreciation. One caveat is that a tax shift may have an additional impact as long as the factors driving the dollar overvaluation persist.

4) The dollar has already moved to reflect some expectation of tax adjustments.

…and current levels may already be pricing the tax adjustments, in part.

Since October, the trade-weighted dollar exchange rate is up between 3-4%. We believe a large chunk of that is driven by expectations of growth acceleration and monetary policy tightening. But arguably, some of this may well be driven by the very lively and public discussion for potential dollar strength on the back of possible border adjustments to US taxation.

⇨ *Conclusion 2: 4-5% is likely the upper bound for tax-driven USD appreciation, if one takes the starting point for the dollar into account.*

5) Distribution matters; this is more relevant for certain EMs than for EUR/USD.

In their argumentation, the future architects of US trade policy have singled out emerging economies such as China, Korea and Mexico as potential areas of focus. Indeed, as can be seen by Figure 5 and Figure 6, manufactured goods are a bigger source of income (and thus more relevant for EMs). And equally, trade with the US represents a larger share of income for smaller open economies than it does for the Euro-area.

Perhaps even more importantly, smaller open economies may be more incentivised to shift their exchange rate and monetary policy to offset some of the hit from US tax shifts. In that sense, the distribution of any kind of USD appreciation may not be symmetric and may weigh on EM vs USD exchange rates more.

Border adjustments may mostly affect certain EM exchange rates more.

6) The US is not a small open economy, but a price-setter

Oftentimes in macro models the global level of prices is not affected by policy shifts in the country under study. But the reality is that for the case of the largest economy on the planet, the assumption that it is a price-taker in global pricing decisions does not apply.

US is a price-setter economy. This means that foreign prices may adjust without an exchange rate shift.

Exporters to the US may decide to adjust their own prices to maintain market share. In that sense, the relative price adjustment may not filter through the exchange rate. Instead, they may go through foreign producer surplus reduction. What's more, the import content of the US consumer basket is modest. The SF Fed estimated that, while 11.5% of US personal consumption is not "Made in the USA", imported goods only account for 7.3%, with the remaining 4.2% attributable to transportation and services provided by US firms.

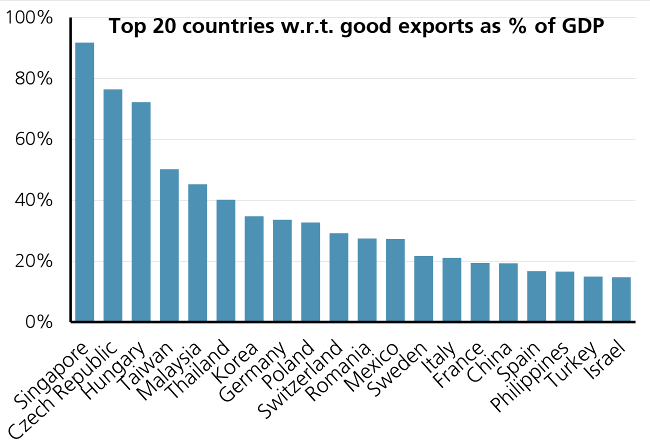
⇨ *Conclusion 3: The foreign reaction to shifting US policy is very important and may tilt the balance of adjustment towards Emerging Markets (whether via exchange rate policy or via corporate surplus adjustments).*

7) The Fed is critical for USD; it is unclear that a border tax implies hawkishness.

In all the discussion so far, we have focused on the impact of tax shifts on trade and relative prices. But the reality is that, historically, the relationship between the US current account and the dollar has been fairly loose (Figure 7). There have been periods during which sharp corrections in the current account coincided with a rising dollar (such as in the late 80s and in 2008-2009) and others during which a strong dollar moved in tandem with a rising current account deficit (such as during the 90s). Consequently, it is not straightforward at all to attribute dollar moves to developments in the US current account in the short-to-medium term.

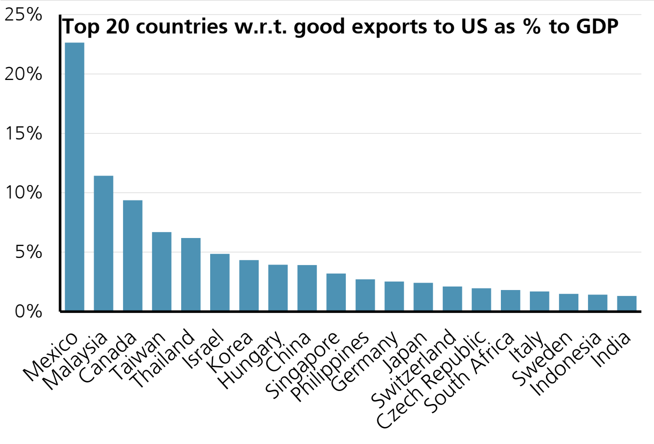
Lastly, the link between the current account balance and the US$ is quite loose...

Figure 5: Manuf. goods exports matter more for EM than DM…



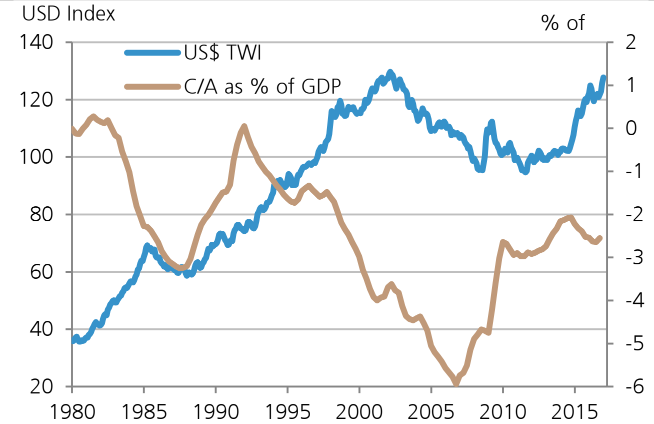
Source: UNCTAD, UBS

Figure 6: … and especially as it pertains to goods exports sold in the US



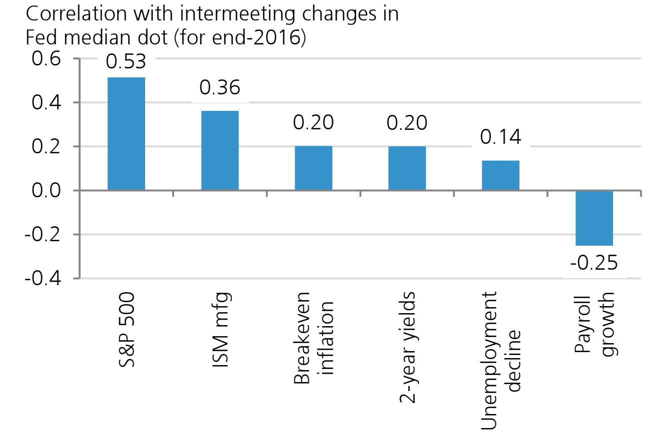
Source: UNCTAD, UBS

Figure 7: The relation between external balance and the dollar is fairly loose



Source: Haver, UBS

Figure 8: Risky assets and their impact on financial conditions seem to best drive policy shifts



Source: Federal Reserve, Bloomberg, Philly Fed, Haver, UBS. Note: Correlation with end-2016 projection, based on data know at time of FOMC meetings.

The dollar is much more than just a US trade adjustment mechanism. In many cases and over time, the dollar is a key driver for global financial conditions. And – via the dollar – the Fed's actions have a big impact on global and US capital flows.

…while the Fed's policy shifts are more critical.

How the Fed reacts to a US border adjustment policy is far from clear. Dollar strength over the past few months implies that the market expects the Fed to tighten policy in response to broader growth acceleration and fiscal easing. Within this context, policies that raise prices are already expected to add fuel to the dollar/yields fire.

The Fed's response may be more geared towards the policy effects on financial conditions – rather than the effects on short-term inflation increases.

But as we have shown before, CPI shifts are not the primary driver Fed decisions. Financial conditions shifts (in our example equity market moves) have been the best predictor of shifts in the median dot over the last few years, more so than economic indicators such as inflation and the unemployment rate (Figure 8). As we move from the zero bound, these sensitivities may change, but the broad point on the significance of broader risk sentiment remains.

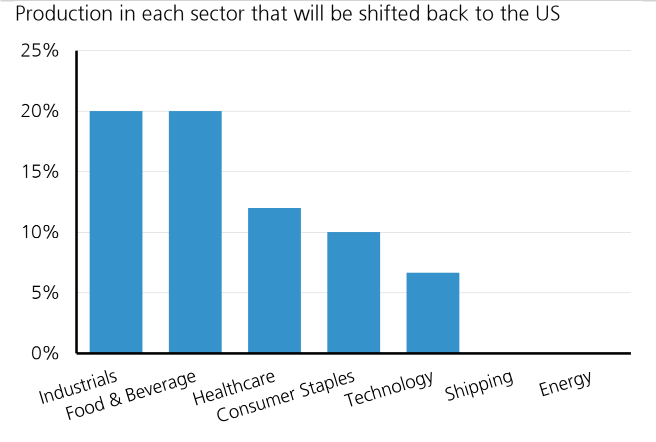
In that sense, the reaction of risky assets to policy adjustments may be a lot more important for the dollar. Arguably, the introduction of policy tools that raise the risk of a global trade conflict could have an adverse impact on financial conditions via equity/credit market weakness. In such a scenario, the Fed could be forced into a more accommodative policy stance than would otherwise be the case in order to avoid excessive tightening of financial conditions. The net result would likely be dollar weakness, not strength.

Our survey indicates that the boost to investment is likely to be limited and thus the tax proposal won't necessarily support risky assets.

The impact of the new regulation on long-term growth will be a key consideration for the Fed too, to the extent that policies may – in the long run encourage investment growth (in a good scenario) or lower productivity growth (in a bad one). Long-term growth effects would have an impact on the Fed's assessment of the (infamous by now) r*. Indicatively our survey shows that the boost to investment will likely be limited, but at the same time, demand in certain sectors may be negatively affected (Figure 9 and Figure 10).

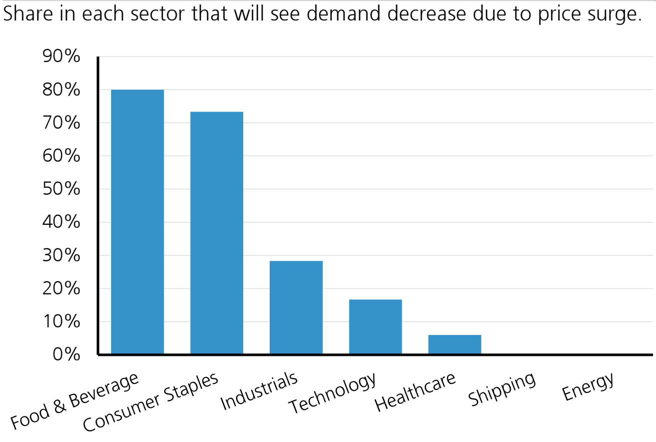
⇨ *Conclusion 4: It is far from clear that, outside key $/EM exchange rates, border adjustments will lead to any meaningful and additional dollar strength whatsoever.*

Figure 9: Investment is not likely to be markedly boosted



Source: UBS Research

Figure 10: Some sectors may see declines in demand



Source: UBS Research

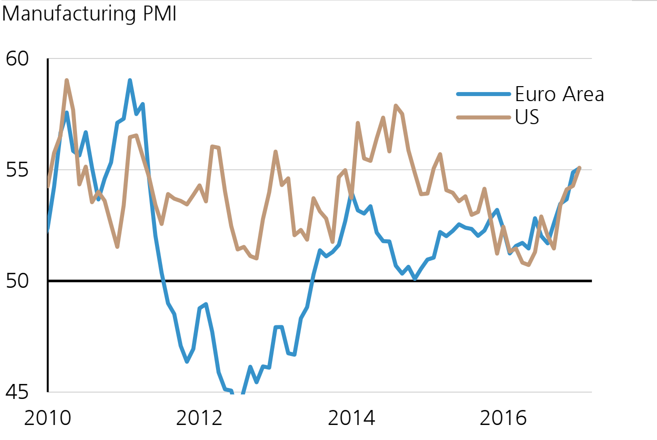
Key Views

Our key currency views remain on track. Since the last FX Atlas, dollar performance has been dispersed and generally weaker. Bullish EUR/USD has likely been our most controversial view. Despite a hawkish December FOMC, EUR/USD has risen substantially since the start of the year. Part of our argument had been that growth resynchronsation limited the downside. The US PMIs have picked up since the US election, but so have the Euro area manufacturing PMIs (Figure 11).

Within G10, the most underperformance is where we have expressed our two most bearish views, CAD and GBP. We remain bearish both. The dovish Bank of Canada meeting combined with softer December inflation reinforced our view that the weak inflation trends will keep pressure on the CAD. Short CAD is one of our Top Macro Trades for 2017 (vs. long AUD, NZD, and CLP), and we continue to favour it.

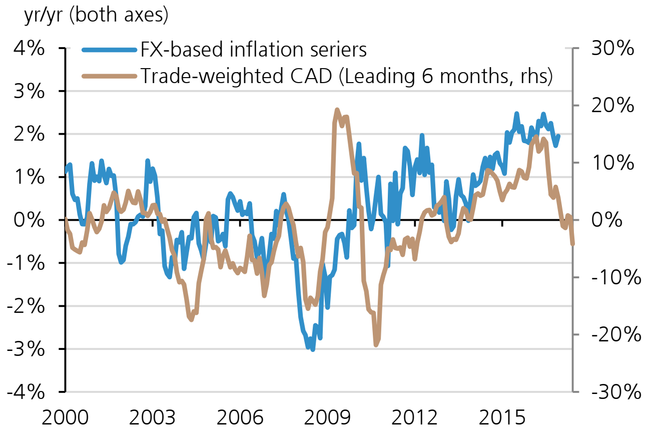
Despite the market reflecting a boost to the Canadian economy from US policy changes following the election, potential increases in US demand may be offset by protectionist policies and tax reform that hurt Canada's competitiveness. With uncertainty high, the Bank of Canada is likely to stay dovish even as the Fed turns hawkish, especially as the prior FX lift to inflation fades further (Figure 12).

Figure 11: What growth resynchronisation looks like



Source: Bloomberg, Haver, UBS calculations.

Figure 12: Past CAD strength leads to weaker inflation



Source: Haver, UBS.

Inflection points in inflation have guided us in a number of our G10 FX views. The turns in inflation prompted us to adjust our views on the Scandies. We turned bearish the NOK in the last FX Atlas on the view that the inflation impulse had become negative. Recent figures support the call, with December headline and core inflation falling short of expectations and revealing sharp m/m declines of 0.5% and 0.4%, respectively. We expect underlying inflation to decline to 2.2% by the middle of the year as the boost from past Krona depreciation gradually unwinds and a large and persistent output gap keeps domestic prices in check.

We have the opposite view on the Swedish krona. Last year, bearish SEK was one of our highest conviction views, predicated on low inflation and a dovish Riksbank. We turned neutral in recent months and are now constructive on the currency, as we expect last year's SEK weakness to soon feed into higher inflation. With activity already strong, we expect the Riksbank to moderate its overly dovish stance (Figure 12). We have now revised our end-2017 forecast to 9.4 from 9.8 previously.

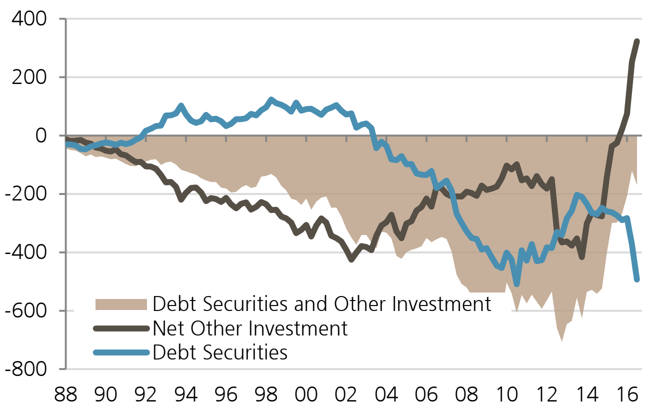
The pound has depreciated much slower than our forecasts imply. EUR/GBP has been trading around 0.86 (vs our parity forecast at end-17) since the beginning of the year, even as we approach the Article 50 trigger and the government's Brexit plans look more akin to a "hard" than to a "soft Brexit". Resilient economic activity since the referendum, a more neutral policy stance by the BoE, a fairly soft tone by the UK government ahead of the negotiations and near-term short positioning (Figure 13) have supported sterling in recent months.

Still, there are good arguments why sterling strength is likely to be temporary. The current account adjustment remains very likely, with risks skewed to the downside. Negotiations are set to begin soon against a very tight deadline and with a number of the UK's competitive advantages at risk of being at least weakened. In addition, there is little evidence that the current account deficit has begun to correct. If anything, it deteriorated during Q3 (Figure 14). Lastly, the spike in activity is likely to be temporary, inviting easier policy by the BoE in due course.

Overall, we see risks firmly skewed towards markets pricing in more unfavorable outcomes than is currently the case. That said markets may require evidence of Brexit- and Current-Account-related growth damage for sterling to move sustainably towards parity to the EUR. In our view this may happen by H2 2017.

Figure 13: Near-term short positioning, proxied by "Other Investment" in the UK's IIP, has supported GBP recently…

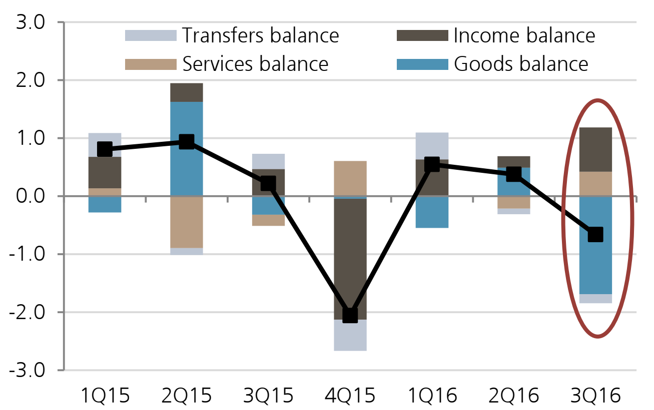
UK Int'l Investment Position (GBP, Bn)



Source: Haver, UBS.

Figure 14: …but the current account deficit correction remains ahead of us, having widened further in Q3

Percentage point change vs previous quarter



Source: Haver, UBS.

Dollar

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OUR THESIS IN PICTURES →

PIVOTAL QUESTIONS

Q: How should we expect changes to fiscal and tax policy to impact USD?
Expectations of fiscal stimulus and corporate tax reform likely benefited the dollar since the election, but further upside is limited in our view. Fiscal stimulus is transmitted to the dollar via higher US yields and growth expectations. That said, with 10-year US Treasury yields 70bp higher since the US election, the reflation theme has already run far and is bounded without further confirmation. Corporate tax reform may support profits and thus US equities, but repatriation of overseas profits and a "border tax adjustment" are not necessarily bullish USD. What's more, the current expensive valuation of the dollar is itself a barrier to policies viewed to be dollar-positive.

Q: Will a hawkish Fed lead to dollar outperformance?
Not necessarily, and if it does, we don't think it will be sustainable. Recent price action supports this view. The trade-weighted dollar remains near mid-November levels, despite a hawkish December FOMC meeting and a cacophony of hawkish comments from Fed speakers at the start of 2017, including Chair Yellen. We continue to view policy divergence insufficient to drive the dollar higher in the absence of US growth and inflation outpacing its peers. At the same time, with plenty of Fed hikes and US growth optimism in the price, the Fed has the greatest scope of G10 central banks to under-deliver tightening.

Q: Should we expect broad-based dollar trends or dollar dispersion?
Dollar dispersion seems more likely. We expect modest USD underperformance against some G10 currencies, such as the Euro, but do expect the dollar to strengthen against others, namely the GBP and the CAD. We are also broadly bullish the dollar versus EM FX. Our EM strategists view FX as the weakest link in the EM asset spectrum. We forecast EM FX depreciating around 4% vs. USD in 2017.

UBS VIEW

We expect dispersion of dollar performance in G10, but strengthening versus EM. Within G10, we have argued for USD weakness vs. the euro, against which we see dollar overvaluation. We also expect dollar weakness against AUD and NZD, which should benefit from global growth. In the opposite direction, we see USD strength vs. most of EM, as well as GBP and CAD.

EVIDENCE

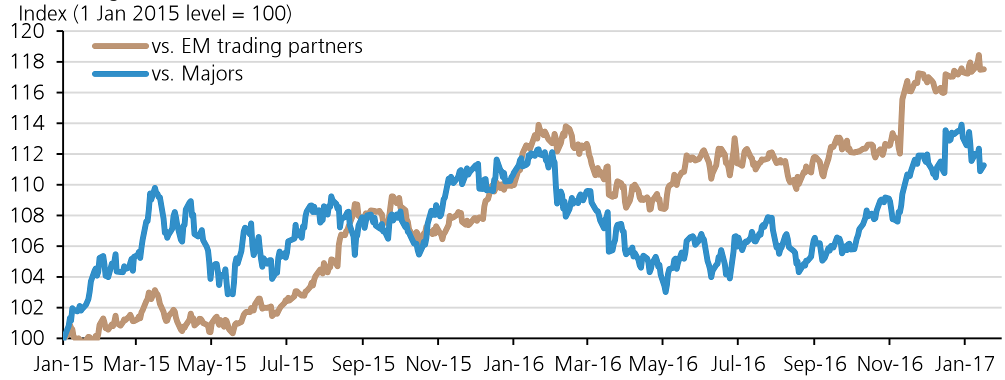
The rise in US yields reflects expectations of significant fiscal stimulus and confidence in Fed hikes. The increase in US yields since the presidential election reflects expectations of significant fiscal stimulus, and the market has renewed confidence in the Fed's tightening path. Our baseline remains that the Fed will hike twice, but this divergence is priced, and further dollar strength could tighten financial conditions and have negative feedback effects.

SIGNPOSTS

US fiscal policy, growth data and core inflation. Incoming President Trump's actions in the first 100 days in office should make it clear whether fiscal stimulus is a priority or not. Within that period, the debt ceiling limit will be reached (in March). This may direct attention towards fiscal responsibility and away from stimulus. In terms of economic data, the key question is whether optimism in survey data (ISM, NFIB, regional Fed surveys) will translate to activity. The upcoming release of durable goods orders will provide a test of whether business is investing. Finally, whether the Fed delivers the three hikes it projects this year could hinge on inflation. If core PCE edges up above 2%, it would become more likely that the market adjusts up to the Fed's median dot.

RECENT PERFORMANCE

Trade-weighted dollar (Federal Reserve)
Index (1 Jan 2015 level = 100)



Source: Bloomberg and UBS

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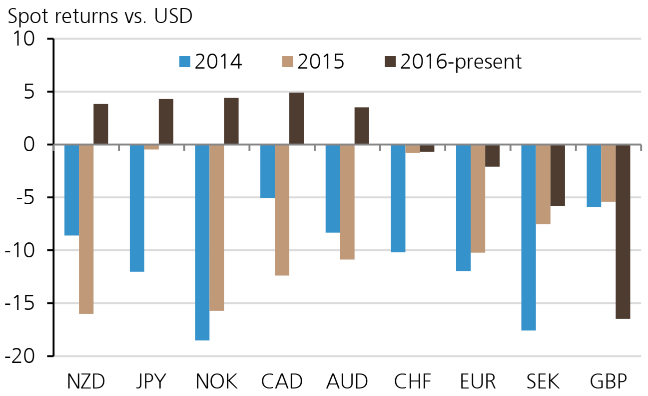
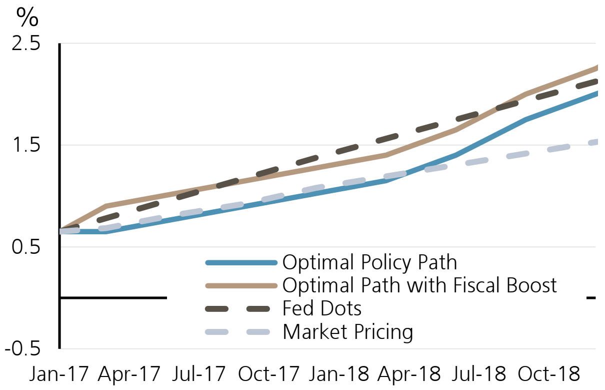
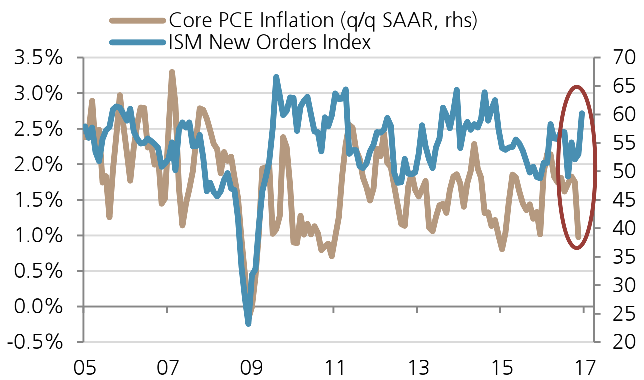


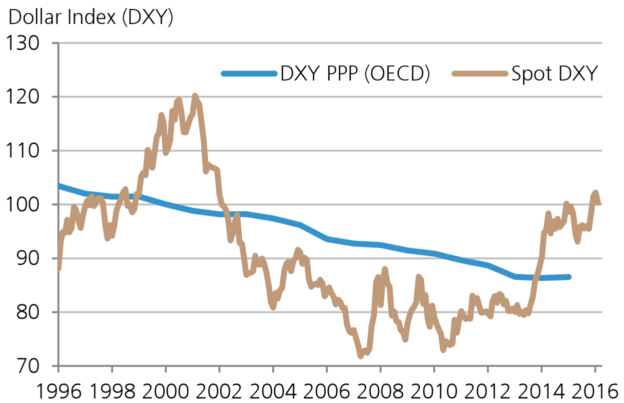
The dollar strengthened against all G10 currencies in 2014 and 2015, but that stopped in 2016 when USD returns became more dispersed. The dollar strengthened against half of G10 and weakened against half. We expect similar dispersion this year.



The Fed's December dot plot has moved away from market pricing once more, implicitly assuming that substantial growth enhancing policies will be enacted. That said, our analysis indicates that, at least as far as the Fed's next moves are concerned, it is optimal for the Fed to remain cautious, even assuming an upcoming fiscal boost. If the latest hawkish Fed shift tightens financial conditions anew, the dots could once again prove optimistic.



Despite the strong rebound in US activity surveys, inflation has lost momentum.



The dollar remains broadly overvalued. The starting point matters. The expensive valuation reduces the likelihood of a further broad dollar rally, especially since the incoming administration will hesitate in pursuing policies expected to boost the dollar

Sources for exhibits above: Haver, Bloomberg, UBS

UBS Research THESIS MAP

OUR THESIS IN PICTURES →

PIVOTAL QUESTIONS

Q: Will politics further weigh on the euro this year?
Not in our view. Aside from the French election, the political risks appear to be more benign in 2017 than in recent years. To be sure, the currency did show greater sensitivity to political uncertainty following the US elections. Nonetheless, absent tail risk events that revive existential questions around the survival of the Eurozone, we do not expect political risks to precipitate a further EUR/USD decline. The market reaction to the "No" vote in the Italian referendum offers evidence in support of this view.

Q: Will improving growth and inflation turn the ECB hawkish?
At some point, yes, but not imminently. The Euro area finished 2016 on a strong note as measures of both growth and inflation picked up. At the January ECB meeting, President Draghi communicated that recent data improvements vindicate the ECB's policies but do not alter near term policy plans. We expect the ECB to tapering its asset purchases from January 2018. Overall, however, the risks of hawkish surprises rise as inflation and growth trends continue to improve.

Q: Will divergent policy between the Euro area and the US push EUR/USD to parity?
Not in our view. EUR/USD already reflects expectations of significant monetary policy divergence, while stimulative US fiscal policy is already priced in. Compared to stretched market expectations, improving US growth, should it materialize, would be beneficial for the Euro area and positive for EUR/USD beyond what is priced in. Along the same lines, the potential for policy disappointment is higher in the US. Fiscal policy may be less stimulative in the US than priced, while the Fed may ultimately deliver less tightening. On the Euro area side, growth expectations may be too pessimistic, while the ECB's December QE extension is likely to mark the peak of its stimulus impulse.

UBS VIEW

We expect EUR/USD to trade in a narrow range, but rise gradually. We maintain the view that favourable valuation and growth re-synchronization between the US and Euro area should drive EUR/USD higher over the medium term, and we continue to forecast 1.13 at end-2017. Over a longer time horizon we expect EUR/USD to continue rising toward fair value, which we see as being around 1.25. This should be very gradual, however, and our forecast for end-2018 is only 1.17.

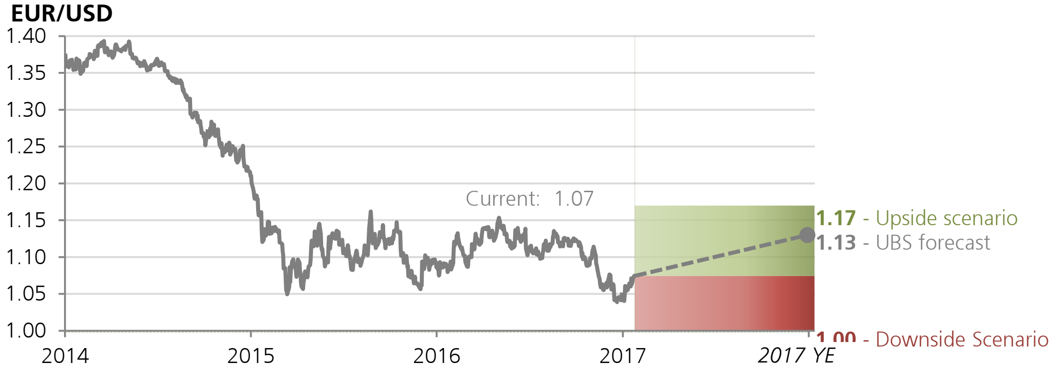
EVIDENCE

Most valuation models, including PPP and current account-based FEER, indicate that EUR/USD fair value is around 1.20-1.25. Although currencies can remain far from fair value for extended periods of time, that should require greater cyclical differentiation than we have been seeing between the US and the Euro area. After significant cyclical divergence in 2014, the Euro area and US economies spent much of 2015 converging. This continued in 2016 and we expect it to extend into 2017 as well.

SIGNPOSTS

Growth, inflation and politics. Resilient Euro area growth is central to our positive outlook for the EUR. If Euro area PMIs stay at high levels, we would expect this to translate into higher growth and support EUR/USD. In addition, we will be gauging whether recent firmer inflation persists, as well as whether it spreads from the core to the periphery. The ECB is more likely to turn hawkish if rising inflation is spread across the Euro area. This will also inform whether the ECB is on track to taper asset purchases in January 2018 (to be announced in September or December). Lastly, we are watching the political calendar. The French Presidential and legislative elections in April/May and June, respectively, stand out. If Mr. Fillion starts to slip in the polls, this could bring French politics into the spotlight.

UPSIDE / DOWNSIDE SPECTRUM



Source: Bloomberg and UBS

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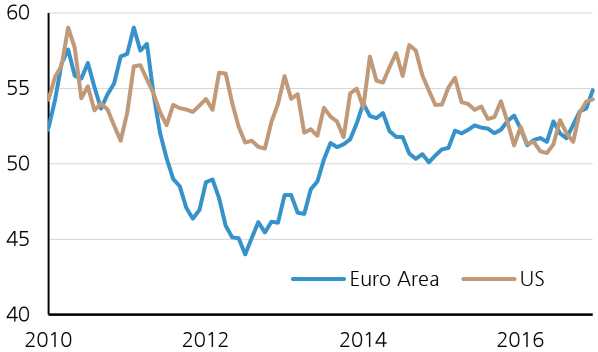
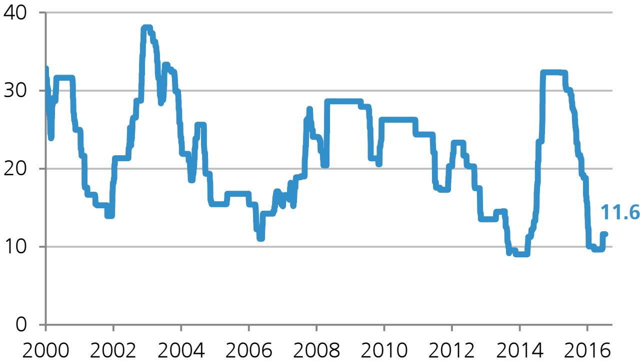
Manufacturing PMI



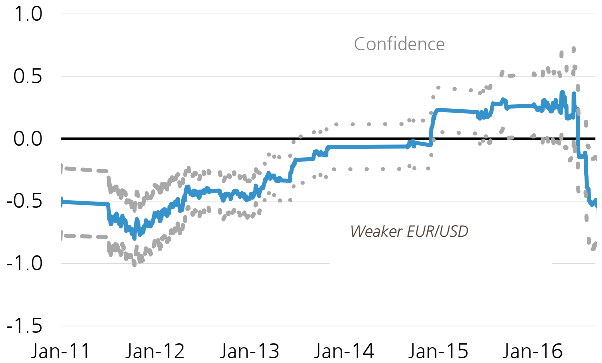
The recoupling of Euro area activity with the US no longer points to a weaker EUR/USD.

EUR/USD trailing 18-month range, % difference of high/low

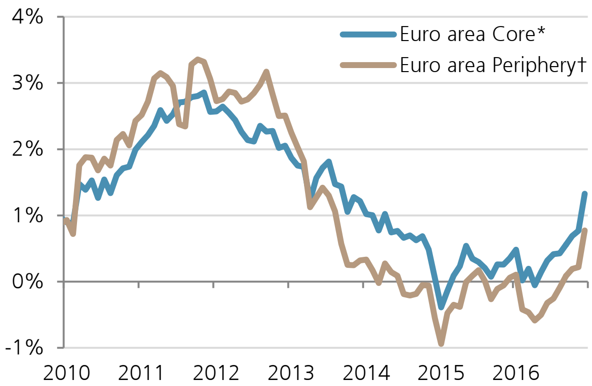


EUR/USD has traded in a range that is very narrow by historical comparison. Over the past 18 months, the difference between the high and low closes is under 10%.

EUR/USD sensitivity to European policy uncertainty*



The sensitivity of EUR/USD to political uncertainty has become statistically significant in the past several months. Our analysis suggests the current level of EUR/USD already reflects some political risk. Going forward, developments around the French elections will be key.



Euro area inflation is showing signs of revival, but this is unlikely to cause a rapid shift in ECB rhetoric. A self-sustained recovery in inflation across both core and periphery that goes beyond base effects is needed for such a change in stance.

**Germany, France, Netherlands, Austria, Belgium, Finland, Luxembourg*

† Italy, Spain, Ireland, Portugal, Greece

Sources for exhibits above: Haver, Bloomberg, UBS

UBS Research THESIS MAP

OUR THESIS IN PICTURES →

PIVOTAL QUESTIONS

Q: How is the Bank of Japan's "QQE with Yield Curve Control" affecting USD/JPY?
"QQE with Yield Curve Control" in conjunction with the sharp rise in US yields has resulted into a much higher USD/JPY. As US yields rose, the BoJ has been able to keep 10-year JGB yields close to its target by buying sufficient amounts of bonds at the right price. Thus Japanese yields have diverged from those in the US, weighing on the yen.

Q: Which factors are likely to drive the yen?
In the absence of a marked shift in BoJ policy US yields will continue to be in the driver's seat for the yen. On that front, a lot is still in the price with regards to the prospect that the new US administration enacts policies with a positive impact on growth, although less so compared to end-2016. Overall, the risks for USD/JPY are more balanced now but we still expect USD/JPY to drift a little lower from here.

Q: Is the BOJ likely to change its yield target anytime soon?
Not in the short-term. Overall, the weaker yen is playing into the BOJ's hand in light of the delays in hitting its inflation target. There is therefore little reason to expect a shift in the yield target higher before a meaningful improvement in economic fundamentals. Similarly, the BoJ is unlikely to modify the yield target lower for as long as the trajectory of US yields keeps the yen weaker. To be sure, a sharp drop in US yields and/or further delays in attaining its policy targets could force their hand into more policy accommodation. That said the threshold for additional policy action by the BoJ seems quite high.

UBS VIEW

We expect USD/JPY to hover around 110 by end-2017. By committing to the 10-year yield target, the BoJ has put US rates in the driving seat for the currency. Arguably a lot is still in the price as regards the reflation potential of the US economy, although the risks for USD/JPY are more balanced following the rally in US rates since the start of 2017.

EVIDENCE

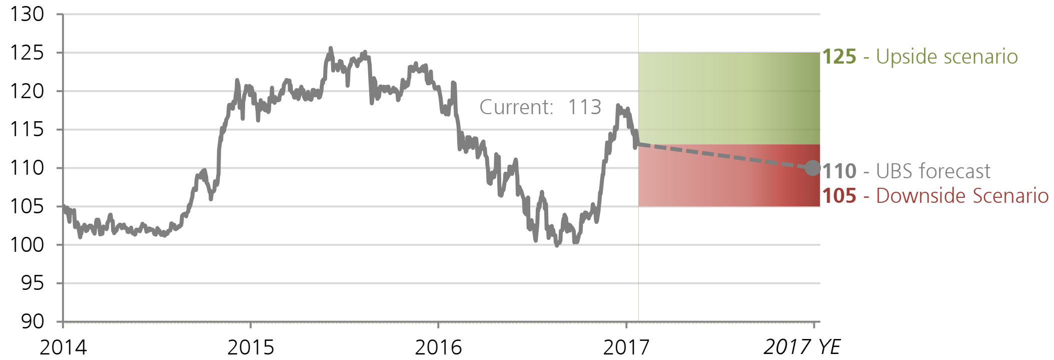
The correlation between USD/JPY and 10-year US yields has increased. The correlation of changes in USD/JPY with changes in 10-year US yields since the introduction of "QQE with yield curve control" is higher than in recent years.

SIGNPOSTS

US stimulus policy, Japanese monetary policy and macro fundamentals. The extent to which the new US administration delivers a substantial growth enhancing policy package will be crucial for the trajectory of US 10-year rates and the yen. At the same time, high frequency measures of US growth will also be important to watch, such as the PMIs and measures of inflation expectations. For Japan, we expect low inflation to keep the "yield curve control" policy in place for a prolonged period. We monitor the degree to which the BoJ adjusts its planned purchase schedule as global yields move higher or lower. We also monitor inflation and inflation expectations measures to gauge the extent to which the BOJ is moving closer to its policy targets.

UPSIDE / DOWNSIDE SPECTRUM

USD/JPY



Source: Bloomberg and UBS

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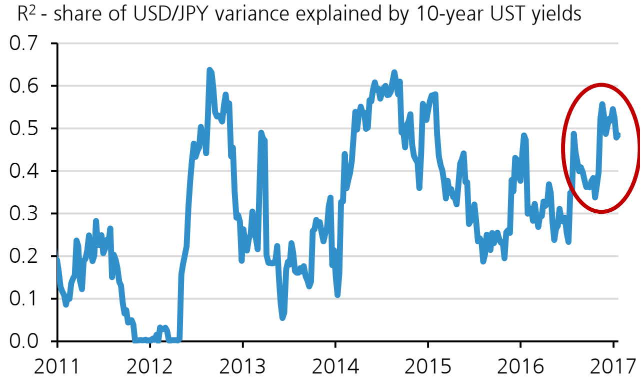
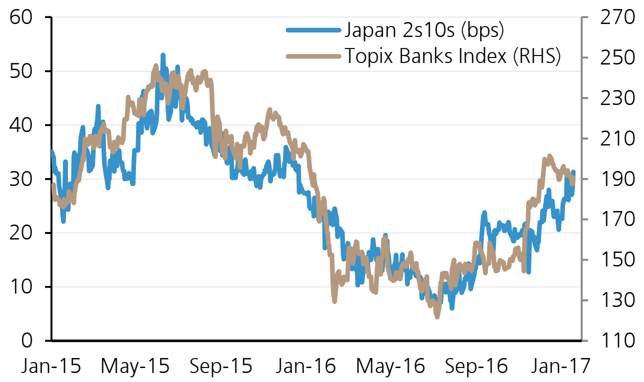
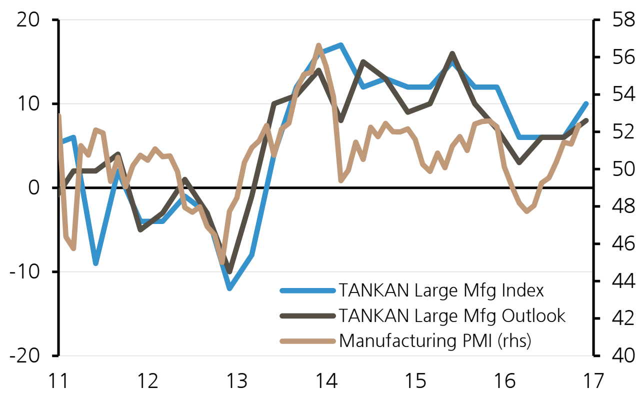


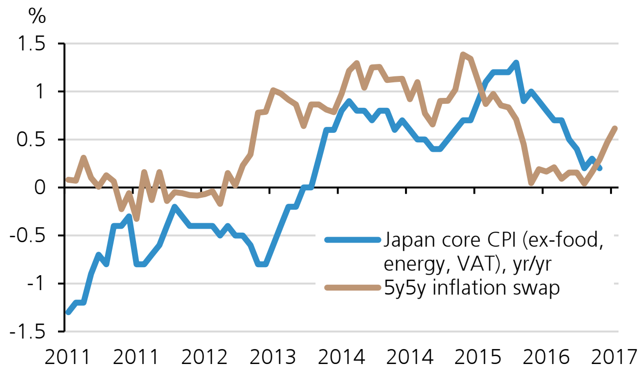
The relationship between 10-year US yields and the yen has strengthened markedly since the BoJ introduced "QQE with yield curve control".



A steeper JPY curve associated with the 10-year yield target has boosted banks shares. In fact, the shape of the yield curve and its consequences for the banking system has played a central role in the adoption of "QQE with yield curve control".



Economic activity is showing some signs of a rebound across the main survey-based indicators, although we are still some way from the Abenomics highs.



The BoJ's inflation target remains elusive. Both market-implied and survey-based measures of inflation expectations remain at very low levels while core CPI is yet to rebound. The recent yen-driven pickup has been modest.

Sources for exhibits above: Haver, Bloomberg, UBS

UBS Research THESIS MAP

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PIVOTAL QUESTIONS

Q: Has the timing for Brexit changed after the decision of the Supreme Court?
No. For all we know, the provisional timetable for Article 50 triggering by end of Q1 2017 remains in place. The Supreme Court decision requires authorisation for triggering by Parliament, which the government has already secured, without raising further complications (e.g. a potential veto from devolved assemblies or a referral to the ECJ). That said the market may be taking a fairly benign view of the probability, timing and/or implications of a "hard Brexit", which has supported sterling recently.

Q: Has sterling depreciated enough to eliminate the UK's external imbalances?
We don't think so. In previous work we argued that EUR/GBP could rise to parity by end-17 as the very large current account deficit (c. 5% of GDP) corrects to more normal levels. Although the adjustment has likely begun, there is no evidence to date that it has been substantial (in fact the current account deficit widened in Q3 driven by further deterioration in the goods balance). Should the market's benign view of Brexit and its implications prove wrong (as we think is likely) a quicker and deeper adjustment in the current account could push sterling beyond our forecasts.

Q: Will economic data continue to hold up and what would that mean for sterling?
Economic data is set to weaken in our view despite recent resilience. Forward looking indicators such as investment intentions remain weak while rising inflation is set to squeeze real earnings and hit consumption. As a result we expect the BoE to return to an easing bias in 2017, pushing sterling lower. More generically, however, the current account adjustment remains the main longer-term driver for the currency. Hence, developments around the negotiating process and type of Brexit will ultimately define the long-term trajectory for sterling, as they will determine the magnitude of the required adjustment.

UBS VIEW

We expect EUR/GBP to rise to parity by end-2017 and remain at these levels by end-2018. The reversal of the UK's current account deficit closer to historical norms will require a substantial adjustment in the currency, consistent with EUR/GBP at parity. That said the adjustment may take longer than we initially thought as markets may require evidence of Brexit- and Current-Account-related growth damage. In our view we may see this already by the second half of the year.

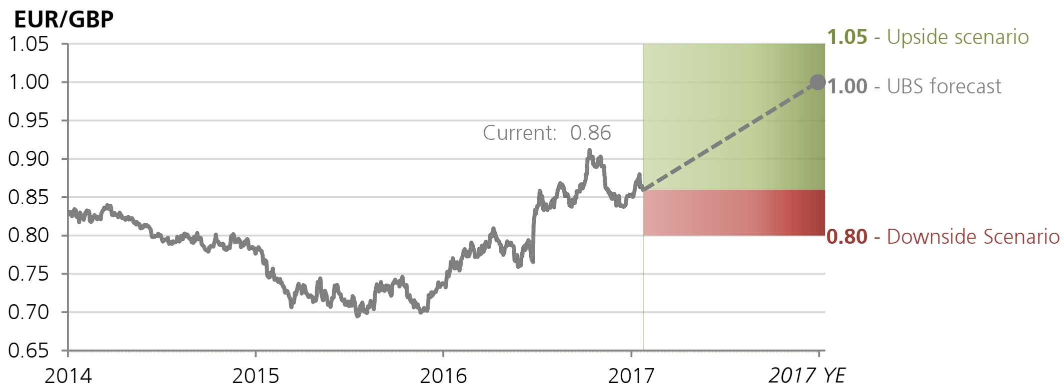
EVIDENCE

The current account deficit remains wide and growth is slowing. The current account deficit stood at 4.9% of GDP in Q3 after the latest revisions on a trailing 4-quarter average basis, 0.3pp wider than Q2 and well above historical norms. In addition, even before the referendum, growth was showing signs of slowing. We expect this trend to extend despite more resilient data releases than expected since the referendum. Overall, the current account adjustment still has significant room to run.

SIGNPOSTS

Growth, inflation, current account and politics. Gauging the extent of the short-term activity slowdown remains important. We are watching whether manufacturing, construction and services PMIs dip below 50 any time soon. We are also regularly monitoring inflation releases, as they influence the BoE's policy stance. Lastly, we monitor current account-related data releases in order to gauge the deficit adjustment. Political developments are also crucial to watch following the Supreme Court's decision on Article 50, in particular relating to the speed the government delivers on its promise.

UPSIDE / DOWNSIDE SPECTRUM



Source: Bloomberg and UBS

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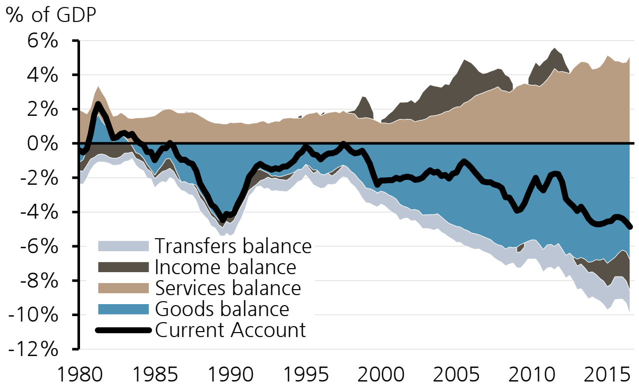
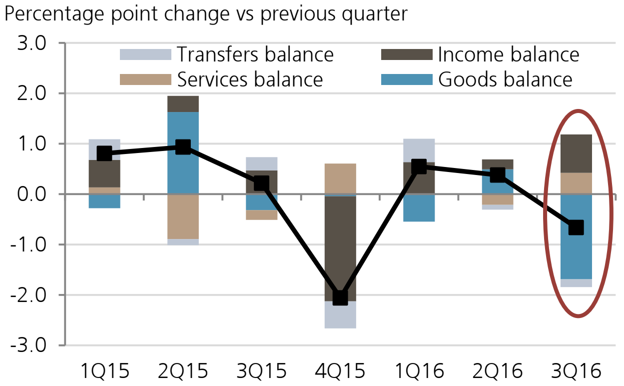
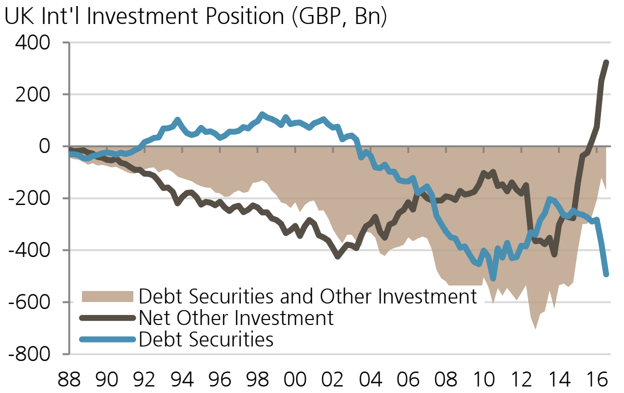


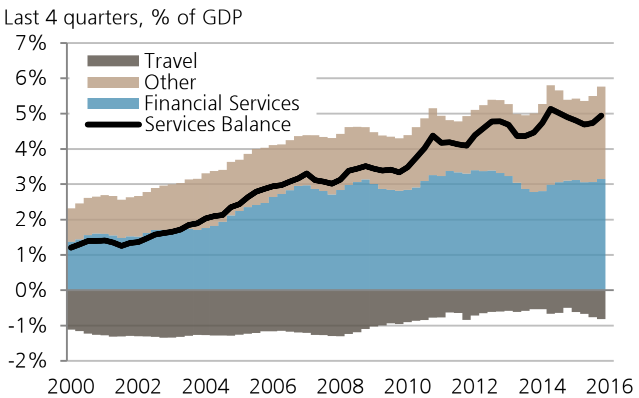
The UK's current account balance has deteriorated significantly in recent years, currently at its widest deficit levels since the 80s. This development was driven mainly by an increasingly wider deficit in the balance of goods and recent negative developments in the income balance.



Interestingly, the current account deficit deteriorated during Q3 driven by the goods balance, despite a meaningful improvement in the income balance. This could be due to the impact of the weaker sterling on import and export prices, before volumes have had time to adjust.



Positioning may have supported the sterling recently. Increased hedging activity and speculative positioning (contained in "Net Other Investments" in the IIP accounts) suggests that investors are shorter-sterling on a near-term basis. This could explain near-term strength as those hedges periodically unwind.



The reliance of the services surplus on exports of financial services is another potential pressure point for the overall current account adjustment. Currently a sizeable services surplus offsets a portion of the large deficit in the goods balance. Were that to be put into question as a result of limited single-market access, the adjustment in the goods balance would have to be deeper, thus weighing further on the currency.

Sources for exhibits above: Haver, Bloomberg, UBS

UBS Research THESIS MAP

OUR THESIS IN PICTURES →

PIVOTAL QUESTIONS

Q: Is the SNB still intervening in the FX market?
Yes but the pattern has changed. Continued intervention, in particular since the UK referendum, has not prevented EUR/CHF to drift lower. Broader dollar strength and the resulting CHF TWI weakness likely allow the SNB to be more comfortable with lower levels in EUR/CHF, especially as the reluctance to amass FX reserves has been one of the key reasons for abandoning the 1.20 floor.

Q: Will the CHF converge to fair value vs EUR soon?
We think so. The CHF is c. 35% overvalued vs the EUR on a PPP basis, while reasonable estimates of Switzerland's "true" underlying current account position (following the IMF's analysis) reveal a far more modest current account position than headline figures suggest. As the Eurozone recovery continues to firm and political risks dissipate in H2 2017 we expect EUR/CHF to gradually drift closer to fair value.

Q: What could cause the CHF to strengthen?
A number of political risk events in the Eurozone in H1 2017 could result in further downside pressure in EUR/CHF in the short-term. The Dutch elections on 15 March, the French Presidential elections (23 April/7 May) and possible early elections in Italy stand out. Brexit negotiations could also weigh on EUR/CHF if they lead to financial market instability. Lastly, persistent dollar strength resulting in CHF TWI weakness could also increase the SNB's tolerance to even lower EUR/CHF levels.

UBS VIEW

We remain modestly bullish EUR/CHF. The SNB's commitment to prevent a marked appreciation of the CHF in conjunction with our bullish view of the EUR over the medium-term points to higher EUR/CHF. We forecast EUR/CHF moving up to 1.11 by end-2017 and 1.13 by end-2018. A number of significant political events present the main downside risk to our forecast but are mostly concentrated in H1 2017.

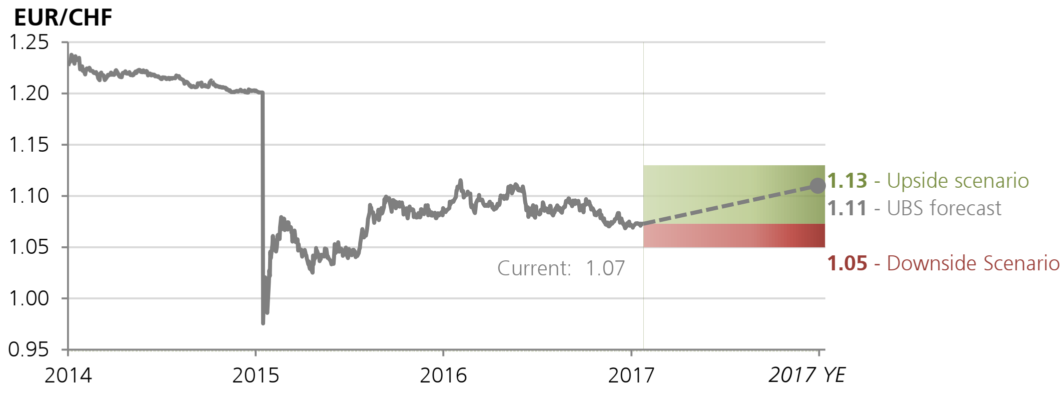
EVIDENCE

CHF looks overvalued, the SNB continues to lean against currency strength and our outlook for the EUR is positive. Currency overvaluation in conjunction with the SNB's continued presence in the markets should limit further downside pressures. With a lot of political risk priced in the EUR risks are arguably skewed towards EUR/CHF upside, especially beyond H1 2017.

SIGNPOSTS

European politics and SNB intervention. We are watching closely the various electoral contests in the Eurozone as well as developments around the upcoming Brexit negotiations. We are also focusing on Eurozone economic fundamentals (GDP growth, PMIs, CPI) to gauge the speed and depth of the recovery and the path towards a gradual removal of accommodation by the ECB. Lastly, we are also looking for signs around the path of the Swiss recovery and the extent to which inflation could return to target faster than currently forecast.

UPSIDE / DOWNSIDE SPECTRUM



Source: Bloomerg and UBS

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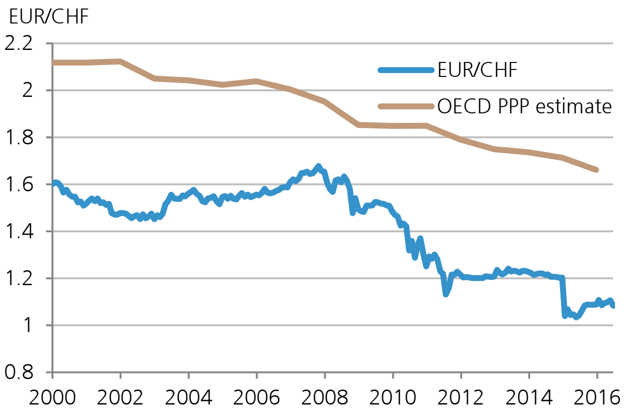
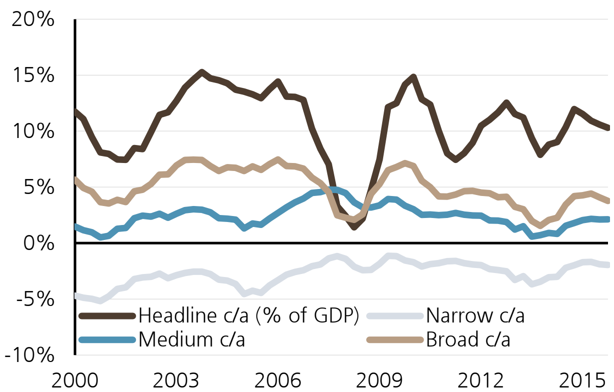
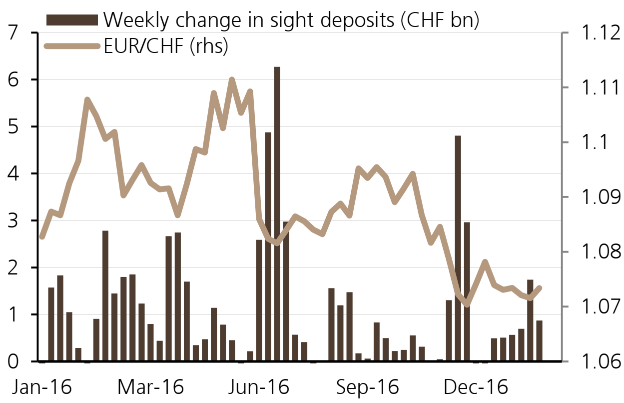


The CHF is c. 35% overvalued vs the EUR on a PPP basis…

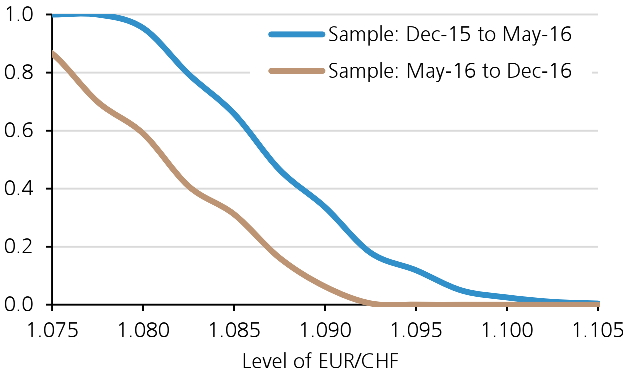


…while reasonable estimates of Switzerland's "true" underlying current account position reveal a far more modest current account position than headline figures suggest.



Despite the SNB continuing to intervene throughout 2016 around important political events such as the UK referendum and the US elections, EUR/CHF has drifted lower.

Pobability of SNB currency intervention*



We estimated a probit model linking changes in sight deposits (a proxy for FX interventions) with moves in EUR/CHF over different samples. We found that EUR/CHF levels consistent with a high probability for SNB intervention have fallen recently. The above indicate a shift in the SNB's intervention pattern and an increased tolerance for lower EUR/CHF levels.

**Probit-model: fitted probabilities of SNB intervention based on sight deposit data and deviation of EUR/CHF from calibrated threshold.*

Sources for exhibits above: Haver, Bloomberg, UBS

UBS Research THESIS MAP

OUR THESIS IN PICTURES →

PIVOTAL QUESTIONS

Q: Has sticky Canadian inflation become unstuck?
Yes, it appears so. The BoC's new preferred measures of core inflation, CPI-common, CPI-median and CPI-trim have all fallen below the 2% mid-target at 1.3%, 1.9% and 1.6%, respectively. Looking ahead, our analysis points to further declines in underlying inflation as the boost from past CAD depreciation fades. Headline inflation rose to 1.5% yr/yr in December, from 1.2% in the prior month, but we take little comfort in this reading as the move was entirely due to base effects and the m/m actually declined 0.2% m/m (vs expectations for a flat reading).

Q: Will a pick-up in activity drive CAD higher?
Unlikely. A streak of strong employment gains and an upbeat Business Outlook Survey suggest some underlying economic improvement. However, the Canadian economy still has a large output gap and needs to grow above potential for a considerable period of time before it eradicates this slack. Hence, the pass through from a near term pick-up in activity to inflation will probably be limited and is unlikely to sway the BoC into a more hawkish stance.

Q: Will CAD benefit from higher US growth?
Not necessarily. The market appears to extend higher US growth and rate expectations to Canada. However, we have argued previously that this line of thinking maybe flawed. First, the Canadian economy is at a very different point in the cycle when compared to the US, and the BoC is likely to remain on hold throughout this year even as the Fed raises rates gradually. Secondly, the pass through from higher US growth to Canada may be lower than suggested by historical relationships and also depends on the details and composition of any policy package adopted in the US. Finally, the trade policies of the new US administration could be a source of substantial downside risks for Canada.

Q: Is the market mispricing the Bank of Canada?
We think so. Market expectations are unduly hawkish in our view given the weak outlook for inflation. Despite governor Poloz stressing that further rates cuts are on the table, the market is still pricing in a 40% chance of a BoC hike by end-2017. We think this is too high and see risks for a re-pricing lower.

UBS VIEW

Downside risks to inflation point to a weaker CAD. Our analysis shows the strong rebound in CAD over the past year is set to weigh down on underlying inflation in the first half of this year. Despite the market scaling back its rate hike expectations over the past few weeks, it still prices in a 40% chance of a hike by year end – an unlikely event in our view. Lastly, we think the good news is now mostly reflected in oil prices and don't expect CAD to benefit from that end.

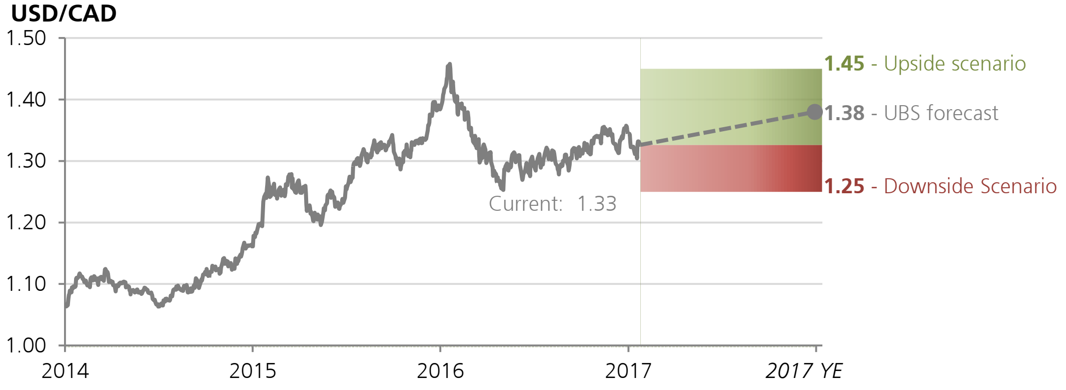
EVIDENCE

Lower inflation and higher sensitivity to rate differentials. CAD depreciation since 2014 has played a significant role in driving inflation higher. However, trade-weighted CAD appreciation in H1 2016 will soon generate additional headwinds to inflation. This should matter for BoC policy at a time of increased sensitivity of USD/CAD to rate differentials.

SIGNPOSTS

Inflation, US Policy and OPEC. We are focusing on upcoming inflation-related data in Canada, to see whether downside surprises continue. The composition of US fiscal policy measures and details on trade policy will be key. We shall also be monitoring compliance with OPEC's supply constraining deal.

UPSIDE / DOWNSIDE SPECTRUM



Source: Bloomberg and UBS

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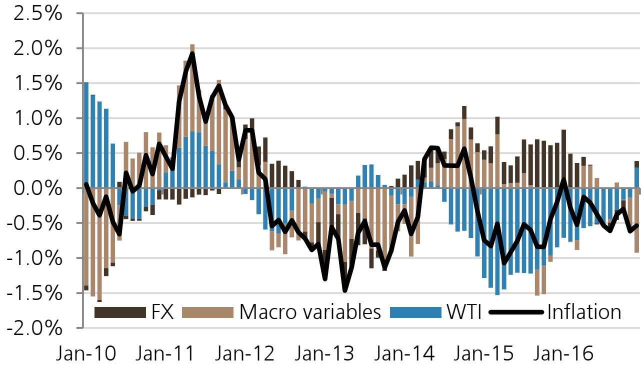
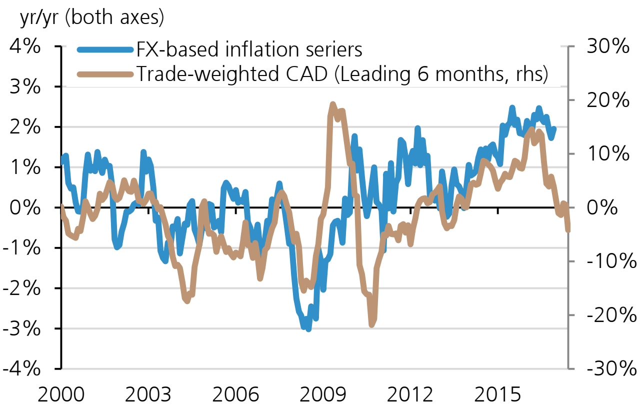
Contribution to deviation from policy target (2.0%)

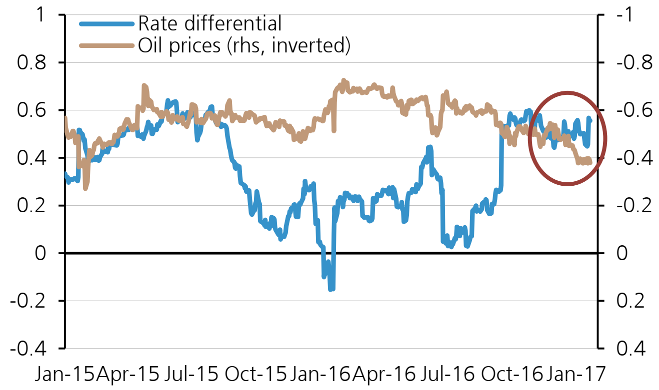


The pass-through from lower oil prices to CPI was partially offset by FX depreciation, which helped keep inflation close to target throughout last year. Recent weakness in macro fundamentals points to downside risks for inflation ahead…



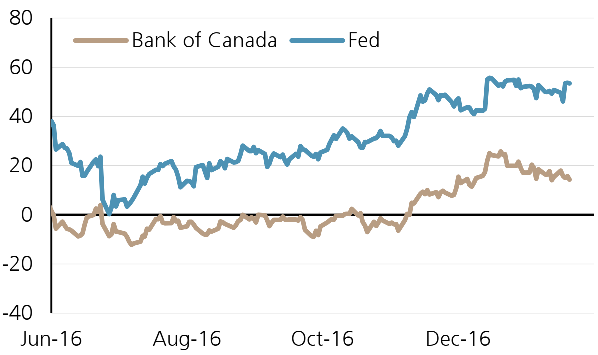
…and with the yr/yr change in trade-weighted CAD turning positive for the first time in three years, the FX-sensitive components of CPI are set to moderate sharply over the next few months.

60 Day rolling correlations



Indeed, rate differentials have become a more important driver for USD/CAD than oil prices.

Market pricing of central bank policy chang in 12 months (bps)



The market exported higher Fed rate expectations to the BoC, but this is inconsistent with Canada's vastly different macro backdrop. Some decoupling has begun and we expect this to extend, which should push USD/CAD higher, particularly as it is more sensitive to rate differentials now.

Sources for exhibits above: Haver, Bloomberg, UBS

UBS Research THESIS MAP

OUR THESIS IN PICTURES →

PIVOTAL QUESTIONS

Q: Is the commodity price rebound reflected in the AUD?

Not fully in our view. For the first time in years, AUD appears undervalued vs. the terms of trade, which have recovered significantly following the bounce in iron ore and met coal prices since Oct-16. Going forward, the better terms of trade picture should support the AUD from a flow perspective – our economists expect the trade deficit (~1.1% of GDP) to turn into a ~1.5% surplus come mid-2017. Even if, as our commodity analysts expect, some retracement in prices is likely in 2017, the currency's historically cheap valuation vs. commodities suggests this is already in the price. All in all, the risk-reward favours a constructive view on AUD given the terms of trade backdrop.

Q: Has Australia's growth outlook worsened?

Only marginally, in our view. Q3 2016 saw GDP contracting for the first time in five years (-0.5% q/q; 1.8% y/y). This, however, appears to be a temporary (in part weather related) slowing. Housing has picked up post Q3, and the rebound in commodity prices should support exports. Our economists see GDP rebounding to 2.2% y/y in Q4 before accelerating to 2.8% y/y in 2017 – slightly slower than previously expected, but still above trend. While the RBA is likely to revise down its growth forecast a bit, we believe inflation rather than growth remains the key monetary policy determinant.

Q: Is Aussie inflation near its trough?

Probably, but it will remain low. Underlying CPI printed 1.6% y/y in Q3-16 – the lowest reading ever, albeit still in line with the RBA's forecast. UBS and the RBA alike see price pressures picking up in H1-17, though the localized nature of Australian disinflation (e.g., intensifying competitive pressures in a range of sectors) spells downside risks. Still, unless those downside risks materialize and an RBA rate cut comes back into play, we would expect the terms of trade turnaround to outweigh relatively low Aussie inflation. Front-end rate differentials have only had a weak impact on the AUD over the last year, suggesting Aussie rates might have to rally materially to significantly weigh on the currency.

UBS VIEW

We are modestly bullish the AUD based on cheap valuation vs. commodities and the view that the RBA is done easing. Inflation is likely to bottom in Q4-16 and the RBA is a reluctant cutter. Nevertheless, the potential for continued below-target inflation provides some offset to an otherwise constructive view on the currency.

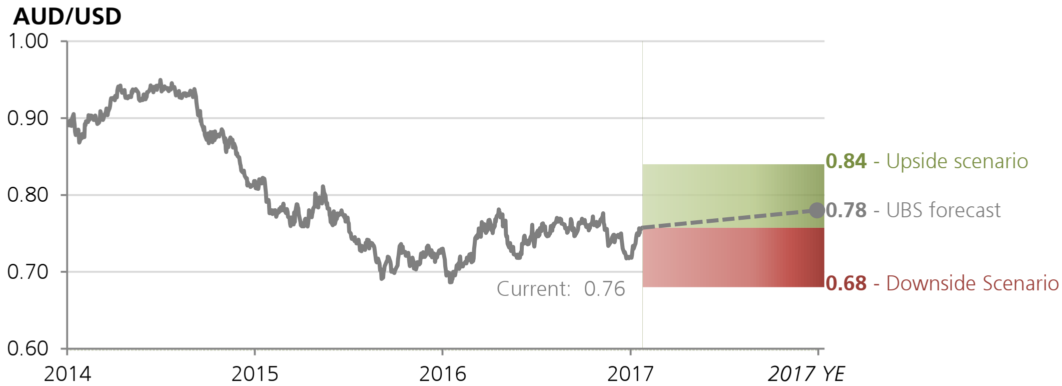
EVIDENCE

The turnaround in Aussie terms of trade looks likely to outweigh front-end rates as the key FX driver. AUD/USD has exhibited a weak relationship to front-end rate differentials in 2016.

SIGNPOSTS

Inflation, growth and commodity prices. We are closely monitoring CPI releases to see if underlying CPI bottoms out at 1.5% y/y. The next RBA meeting on 7 February will be of particular interest in the event of downside surprise to inflation. We are also monitoring employment data to gauge momentum in activity and commodity prices for the trajectory of the terms of trade.

UPSIDE / DOWNSIDE SPECTRUM



Source: Bloomberg and UBS

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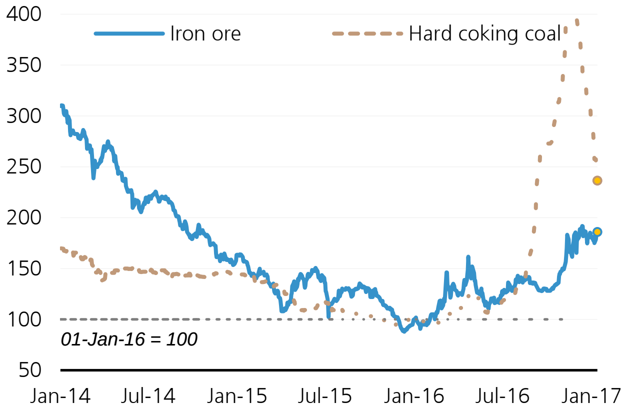
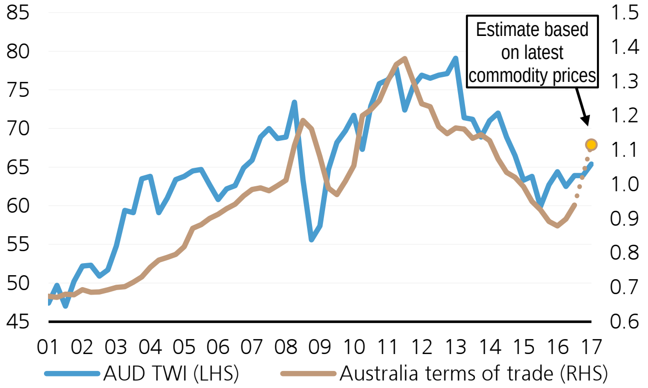
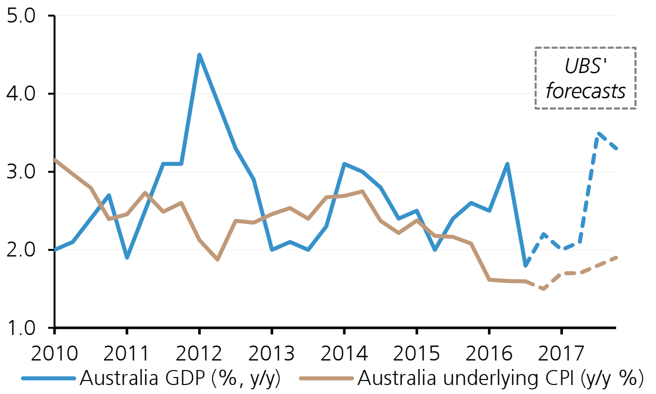


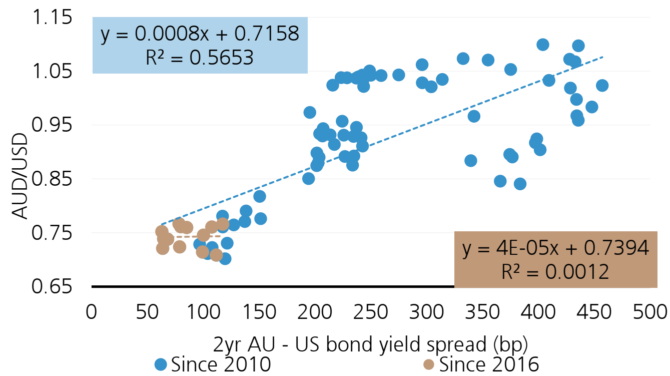
Recovering commodity prices, with iron ore and met coal up ~86% and ~136% respectively since the start of 2016, is a significant tailwind to the economy. Exports of these commodities together represent ~6.5% of GDP, with iron ore roughly 2.5 times as important.



The associated turnaround in the terms of trade represents a change in the narrative for the currency vs. the period since 2011 – for the first time in years AUD now appears somewhat undervalued. Even if commodities retrace some of their recent gains in 2017, the commodities backdrop should no longer weigh on the AUD.



The main risk to our constructive AUD view comes from subdued inflation, likely to remain historically low in 2017 despite a still healthy growth outlook…



… however, Aussie-US front-end rate differentials have over the last year exhibited a weak relationship to the currency cross. If this continues to hold, currency supportive terms of trade should outweigh dis-inflationary headwinds.

Sources for exhibits above: Bloomberg, FactSet, Datastream, RBA, UBS

UBS Research THESIS MAP

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PIVOTAL QUESTIONS

Q: Is the near-term path for kiwi inflation bullish for NZD?
Yes. New Zealand inflation has been running at a <0.5% y/y pace since 2015, a development which has seen the RBNZ cut rates by 175bp over the same period. However, the prolonged stretch of sub-target inflation is likely to end soon. Inflation should rise gradually to just short of the mid-point of the RNBZ's target at 1.8% by Q3-17, primarily driven by energy related base effects, less drag from tradables and a closing output gap. A near-term inflationary path significantly higher than in the last couple of years reinforces the case for a stronger NZD.

Q: Will the RBNZ fight currency strength?
Probably not too aggressively. Stubborn currency strength was a particularly acute dilemma for the central bank during the first half of 2016 amid falling soft commodity prices and subdued inflation. However, things today look different. While the currency remains too strong for comfort for the RBNZ given still below target inflation, soft commodities have recovered (milk is up ~60% since Jul-16). With inflation also close to turning a corner, any change in the central bank's bias from here should be in the direction of a more neutral leaning. This would be bullish for the currency.

Q: Is the NZ political landscape emerging as a more important factor for the currency?
Possibly. New Zealand's recent mid-year budget update highlighted an optimistic fiscal outlook, with annual budget surpluses expected to rise to >2% of GDP from 2019 onwards. This is relevant in the context of the next general election (due to take place no later than November 2017) and the chances of re-election for the ruling National Party and recently appointed Prime Minister English. Tight polls and upbeat finances might leave room for NZD supportive election sweeteners (e.g., tax cuts; fiscal spending). That said any perception of a weaker (potentially less growth friendly) incoming government could weigh on the currency via increased political risk premium.

UBS VIEW

A near-term pick-up in inflation should support NZD. Over the last year NZD has been supported by a carry-friendly environment and the domestic growth backdrop, but has been held back by low inflation and a dovish RBNZ. The drag from the latter two factors should fade over the coming year.

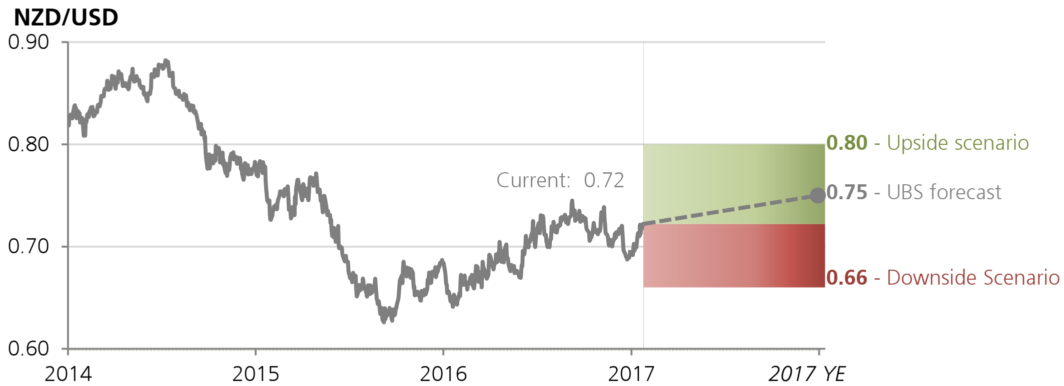
EVIDENCE

Continued strong growth (3.5% y/y in Q3-16) soon to be complemented by higher inflation. The RBNZ's preferred 'sectoral factor model' of underlying inflation has been indicative of price pressures for some time. Single component evidence suggests headline CPI is set to bounce to within the RBNZ's 1-3% target range going forward.

SIGNPOSTS

Inflation and the RBNZ. We are focusing on New Zealand CPI as outcomes in line with or better than the RBNZ's forecast should cement the view that kiwi inflation is about to turn a corner and would be supportive for the currency. We are also watching carefully the next RBNZ OCR announcement on 9 February (includes the release of a MPS).

UPSIDE / DOWNSIDE SPECTRUM



Source: Bloomberg and UBS

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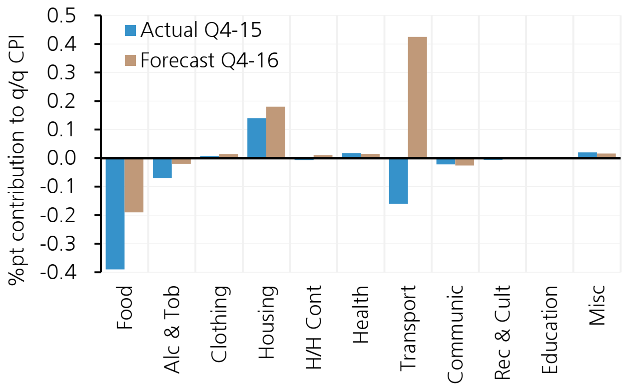
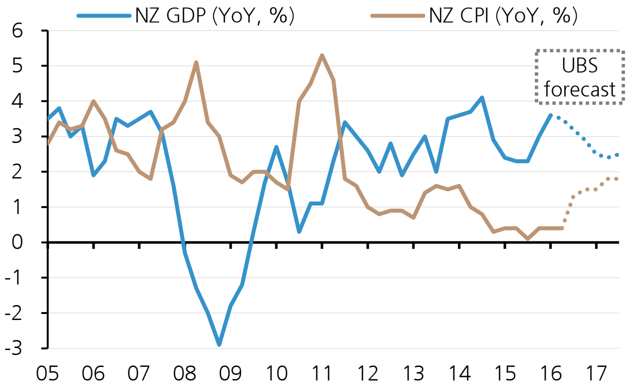
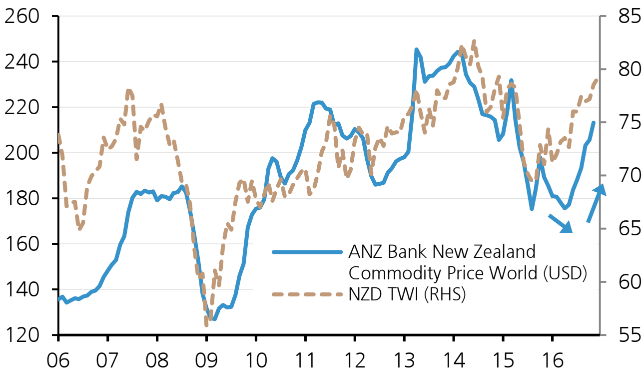


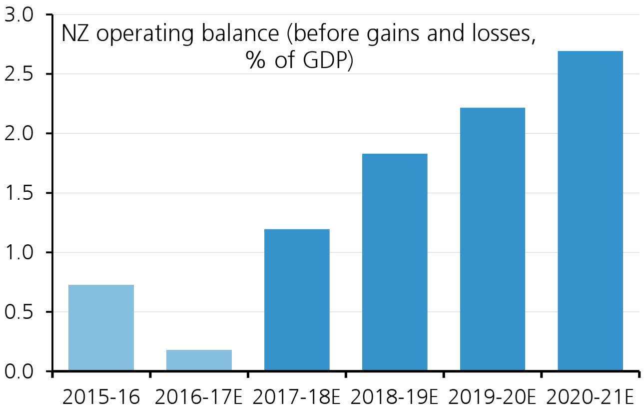
Q4-15 NZ CPI saw the largest quarterly fall since 2008, driven by weaker-than-usual prints for transport (petrol) and food. Single component analysis suggests that this year should see much less of a drag from these factors…



… which, in turn, should take y/y CPI inside the RBNZ's 1-3% target band. This could lead the RBNZ to tone down its still-dovish bias.



The strong kiwi dollar in mid-2016 coincided with a period of weak commodity performance, contrary to recent history. The recent turnaround in soft commodities reduces the extent to which the NZD appears overvalued. This, in turn, could allow the RBNZ to moderate still-dovish communication on the currency.



With one of the best fiscal outlooks in G10, tight polls ahead of the 2017 election could spell fiscal easing. While this would be supportive for NZD, it could be offset by the potential for a weaker (potentially less growth friendly) incoming government.

Sources for exhibits above: Bloomberg, RBNZ, Statistics NZ, Haver, UBS.

UBS Research THESIS MAP

OUR THESIS IN PICTURES →

PIVOTAL QUESTIONS

Q: Can the rise in oil prices drive the krona higher?

Not necessarily; EUR/NOK remains well above its October trough, despite oil prices making fresh highs in 2017. Two keys forces are driving the Krone in opposite directions. On the one hand, higher oil prices argue for a stronger NOK. On the other hand, weaker than expected growth and rapidly moderating inflation are pushing in the opposite direction. Overall, we think much of the good news in now priced into the oil market, and see room for moderate Krone depreciation as the weak domestic back-drop comes into focus.

Q: Is inflation due to moderate further?

Yes. We expect underlying inflation to decline to 2.2% by the middle of the year as the boost from past Krona depreciation gradually unwinds and a large and persistent output gap keeps domestic prices in check. Recent figures support our view, with December headline and core inflation falling short of expectations and revealing sharp m/m declines of 0.5% and 0.4%, respectively.

Q: Will the Norges ease policy again?

Unlikely, at least in the near-term. Despite rapidly moderating inflation and weaker than expected activity data, the Norges Bank has signalled its reluctance to cut rates further due to financial stability concerns around household debt and property prices. Although the bar for further cuts may be high, this is unlikely to deter the Norges Bank from dovish communication, and we see room for moderate Krona weakness in the months ahead.

UBS VIEW

We expect moderate Krone weakness ahead, targeting EUR/NOK 9.30 by end-2017. Our analysis points to a decline in core inflation below the 2.5% target by the middle of the year as recent NOK appreciation and a large and persistent output gap weigh on prices. Even as the Norges Bank resists cutting rates, the weak macro backdrop implies policy will remain on hold for longer. In addition, we think the bulk of the good news is now reflected in oil prices and don't expect another boost to the Krone from this end. If activity were to pick up sharply, this would pose an upside risk to our forecast, but this is not our base case. Despite the strong rebound in the manufacturing PMI to 51.4 in December (from 47.8), it still remains weak in absolute terms and the lowest in G10.

EVIDENCE

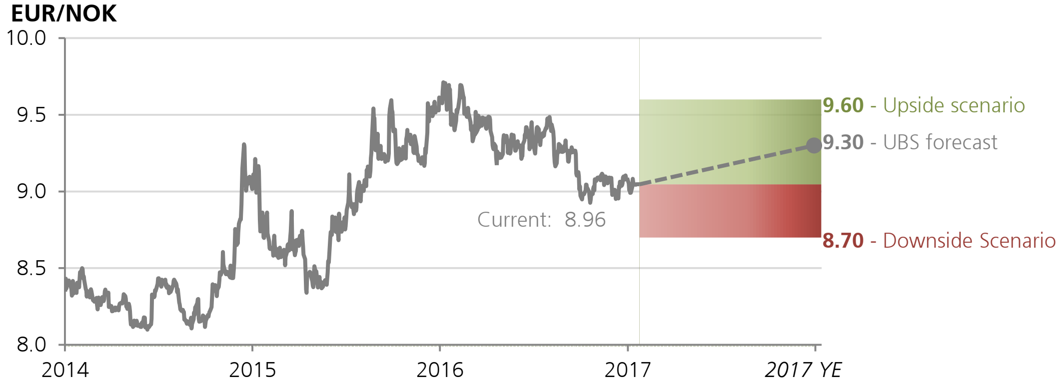
Inflation set to turn sharply lower. We separated Norwegian inflation into subcategories according to their sensitivities to trade-weighted NOK and economic slack. Based on the breakdown, we created a synthetic FX-based and slack-based inflation series, which account for 25% and 70% of the core CPI basket, respectively. The level of trade-weighted Krone and current estimates of the output gap imply a sharper decline in inflation than envisaged by the Norges Bank in its most recent (and revised) forecasts.

SIGNPOSTS

Oil, inflation, and activity data. Oil price shifts continue to be the dominant driver of EUR/NOK and monitoring developments around OPEC compliance and US shale oil will be key. Upcoming inflation prints will be crucial in assessing the speed and extent of the pass-through from Krone strength to prices (next release on 10 February). We will closely monitor the next PMI release (1 February) and the Q4 GDP print (14 February) to gauge the pace of the recovery in activity.

UPSIDE / DOWNSIDE SPECTRUM

EUR/NOK



Source: Bloomberg and UBS

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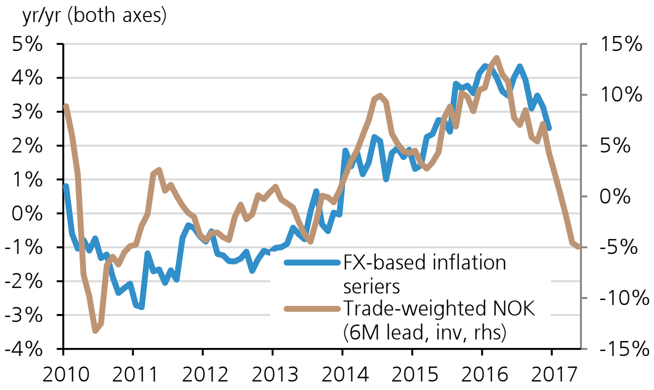
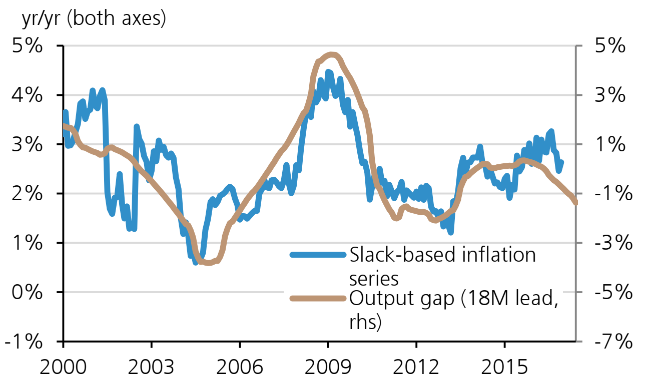
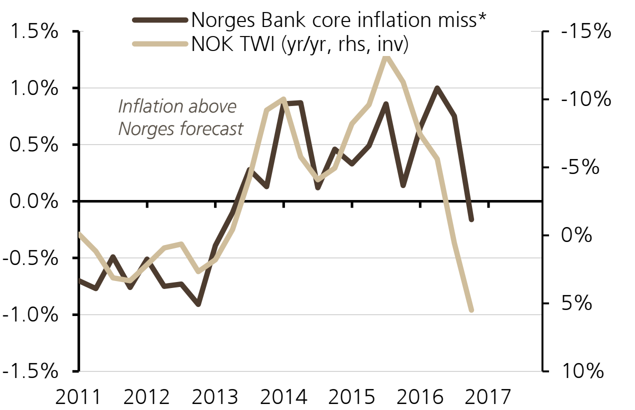


The current level of trade-weighted NOK implies a decline in the FX-based inflation series from around 3.5% currently to approximately 1.8% in 2Q17. All else equal this would shave 0.5pp off annual core inflation.

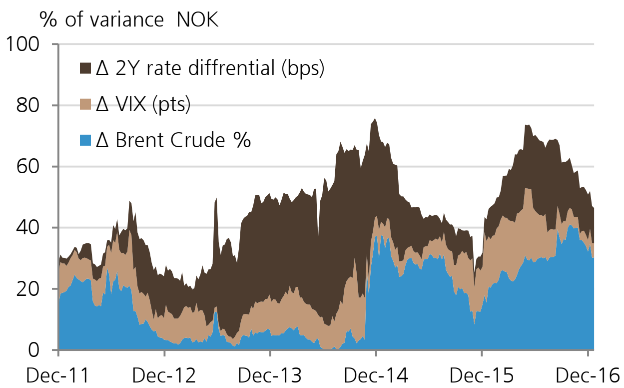


Economic slack also points to a moderation in core inflation.



There is some evidence that the Norges Bank's core inflation forecast error is correlated with changes in trade-weighted NOK. Recent Krone appreciation supports our analysis that inflation is likely to undershoot the Norges target.

**Actual core CPI less Norges forecast 1Y earlier*



Our attribution analysis reveals that oil continues to be a dominant driver for EUR/NOK. While we see the risks to crude prices as more finely balanced, they are a major source of uncertainty nonetheless.

Sources for exhibits above: Bloomberg, Haver Analytics, UBS

UBS Research THESIS MAP

OUR THESIS IN PICTURES →

PIVOTAL QUESTIONS

Q: Has the outlook for Swedish growth improved?

Yes. There is evidence that Swedish growth is accelerating again. Both the manufacturing and services PMIs have risen since the middle of last year, now standing at 60.1 and 59.9 respectively. The December business tendency survey also beat expectations and rose to the highest level in more than five years, while retail sales re-accelerated in Q4 2016.

Q: Is inflation on track to reach the Riksbank target?

Likely. Both CPI and CPIF have been steadily trending upward throughout 2016, currently standing close to the Riksbank's 2% target at 1.74% and 1.94%, respectively. SEK weakness in the latter half of 2016 is now set to provide a boost to inflation over the next several months, at a time when energy-related base effects are also set to act in the same direction. In addition, most measures of slack now point to a closed output gap, which could generate domestic price pressures in the medium term.

Q: Is the Riksbank done easing for now?

Likely yes. Despite extending its asset purchase program by SEK 30bn there were clear signs of the Riksbank's reluctance to provide further easing, as three of the executive board's six members dissented against the decision to extend QE. That said, the Riksbank appreciates the importance of the exchange rate on price developments. As a result, a sharp appreciation in the Krona could force it to revert to a more activist stance.

UBS VIEW

Krona weakness is now behind us. That said we expect the move lower in EUR/SEK to be gradual, as inflation is still below target and the Riksbank is opposed to rapid SEK appreciation. In particular, we still need to see a rebound in CPIF ex-energy, which has lagged the recovery seen in other measures of inflation. We have now revised our end-2017 forecast to 9.4 from 9.8 previously.

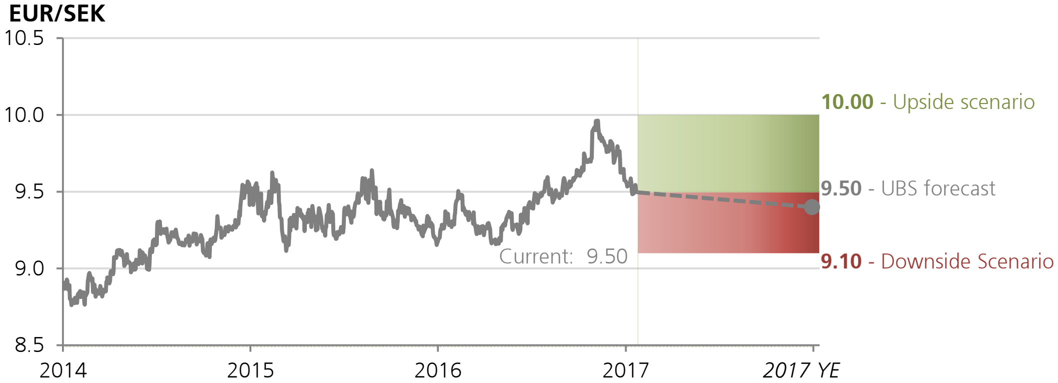
EVIDENCE

The SEK will soon turn into a tailwind for inflation, activity is robust and the Riksbank is less dovish. Our analysis shows that trade-weighted krona is an important driver of inflation in a small open economy like Sweden. Last year's currency weakness will soon be feeding into inflation, activity is picking up and the Riksbank is moderating its overly dovish stance.

SIGNPOSTS

Inflation, activity and the Riksbank. Upcoming inflation figures (Feb 17 and Mar 14) will be crucial in assessing progress toward the Riksbank's 2% target. On the activity front, the December retails sales (Jan 27), the Jan PMI (Feb 1) and the Q4 GDP release (Feb 15) will be key. Krona price action in itself is important in as much as it feed into the Riksbank's reaction function (next meeting on Feb 14).

UPSIDE / DOWNSIDE SPECTRUM



Source: Bloomberg and UBS

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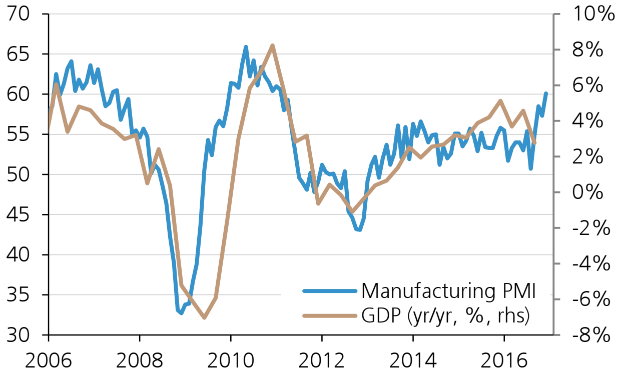
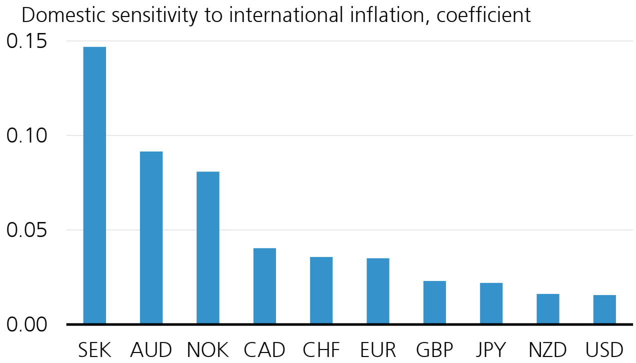
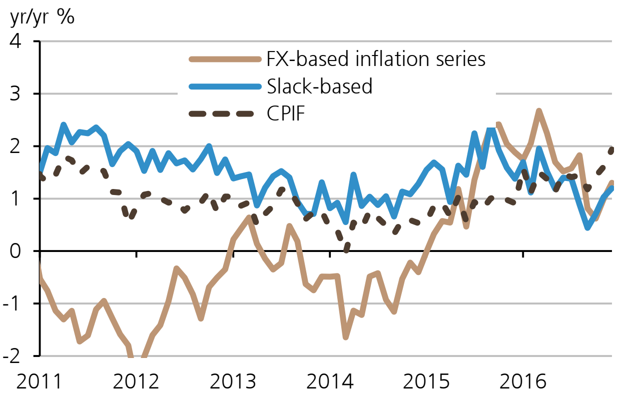


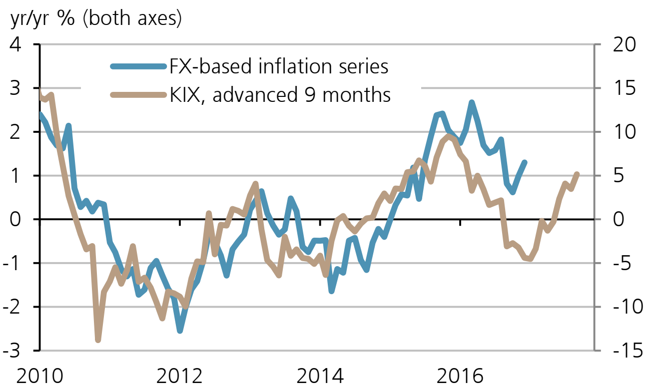
Sweden has experienced a strong economic recovery since 2013 and recent PMI releases suggest that the economy may be entering yet another phase of acceleration. For a while, however, inflation has been low and only recently has it started to pick up.



We find that within the G10, Swedish inflation is the most impacted by global inflation. We estimate this by adding a measure of average OECD inflation to Phillips curve estimations. The consequence is that global disinflationary pressure weighs down on Swedish inflation, which is why the currency is a critical policy tool for the Riksbank.



As the krona weakened throughout 2015, the FX-based inflation series (derived from the most sensitive subcategories to the lagged exchange rate) rose from flat in late-2014 to +2.7% y/y, driving much of the recent CPIF acceleration. Since then, it's started to weaken, keeping the Riksbank dovish.



Going forward recent Krona depreciation should support inflation. The question is, will it be enough to lead inflation all the way to the policy target and how will the Riksbank respond?

Sources for exhibits above: Haver, Bloomberg, Riksbank, TNS Prospera, UBS

UBS Research THESIS MAP

OUR THESIS IN PICTURES→

PIVOTAL QUESTIONS

Q: Can gold rally in a rising yield environment?
Real rates matter for gold. Inflation, inflation expectations, and the market's perception on whether the Fed is ahead or behind the curve need to be taken into account. The key risk right now is the potential for significant fiscal stimulus in the US. Modest growth impact from fiscal stimulus would be neutral to moderately positive for gold given a more limited move in real rates and expected weakness in equities. On the other hand, accelerating growth and sustainably higher real rates, marking a regime-change, would be considerably negative for gold.

Q: Are risks to the base case symmetric?
No, there is more scope for downside from our base case. Downside risks have increased following the US election as markets have shifted focus towards the potential for expansionary fiscal policy to push real yields higher. There's still much uncertainty around the details of the new administration's fiscal package and the reality is that much is required to overcome low rates and slow growth. Nevertheless, our downside scenario considers the potential for a regime change in rates and gold moves into a bear market. We expect a relatively contained move vs the previous bear market selloff, given a lower base in terms of price and positioning.

Q: What do gold fundamentals tell us?
We are concerned about weak physical demand – offtake has been weak the past year. And although there have been signs of resilience in core demand from key markets like China and India, there are also local policies and developments that could present some downside risks for physical demand up ahead.

UBS VIEW

Gold allocation within a portfolio is warranted given a benign rates and growth environment and elevated macro risks. We think further gains in gold are likely to be driven by a continuation of strategic portfolio allocation from a diverse set of investors. While we've moderated our view to reflect the move in rates, as well as greater risks up ahead, we think it's premature to call for a regime change. Gold remains under-owned and macro conditions should continue to encourage broader participation in the gold market.

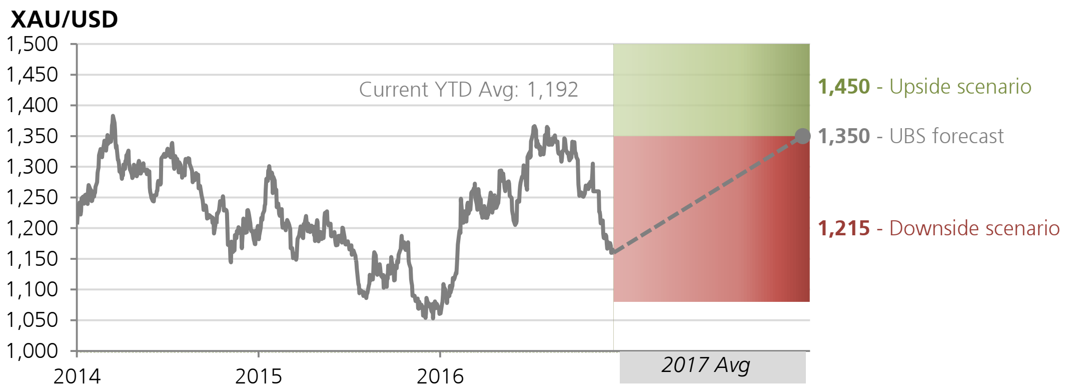
EVIDENCE

Gold has been tracking changes in real rates. Interest in gold emerged in 2016 amid expectations that global yields and growth are likely to remain low and macro uncertainty likely to remain elevated. The resilience of gold holdings (especially in ETFs) up until the post-US elections spike in rates suggests that positions were strategic and based on these views – gold's price action reflects recalibration of expectations.

SIGNPOSTS

We will be watching factors that affect real rates. A key focus right now is US fiscal policy and the impact on growth and inflation. Monetary policy at the Fed and other key central banks, nominal yields, oil and commodity prices are other factors to watch. We will also monitor cross-asset correlations, as well as trends in physical markets by looking at trade data, differentials between local and international gold prices, changes in the loco swap rate between Zurich and London, scrap flows and producer hedging activity.

UPSIDE / DOWNSIDE SPECTRUM



Source: Bloomberg and UBS

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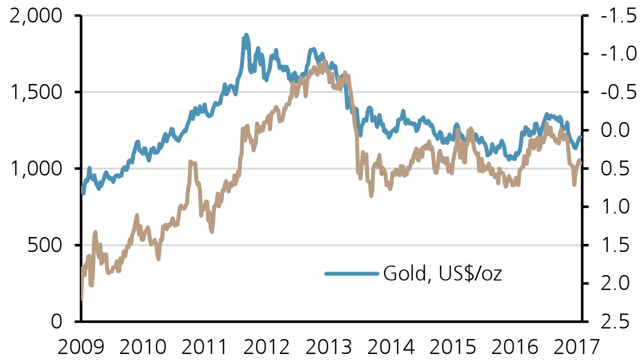
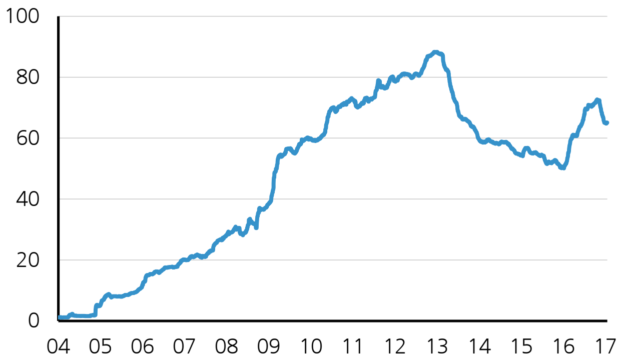
Gold and US real rates



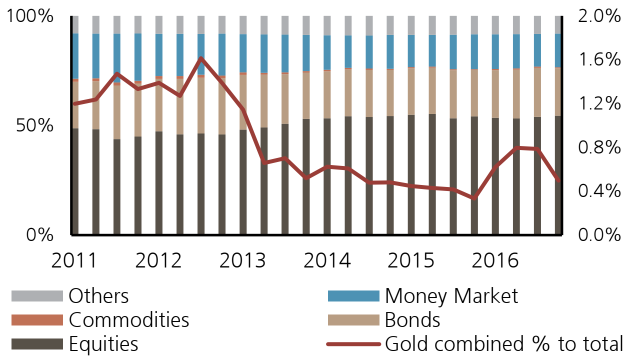
Gold has a strong negative correlation with US yields. What ultimately matters is real rates and a sustained move higher can hurt gold. The acute focus on fiscal policy and the corresponding impact on real rates create downside risks. We have moderated our positive view, but as long as there is no regime change in rates, we would consider gold price weakness as strategic buying opportunities.

Gold ETFs , moz



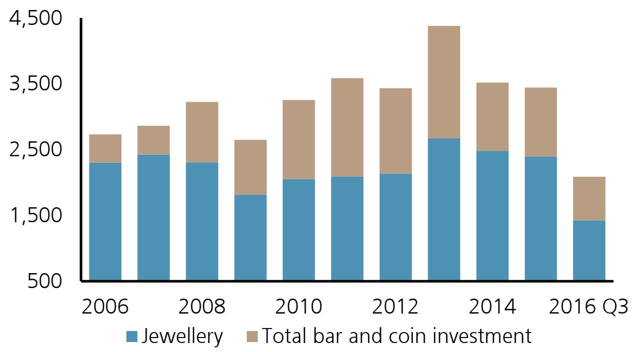
The resilience of gold positions suggest that many of the positions built over the past year are likely strategic in nature. It is therefore understandable that the risk of sustainably higher real yields triggered tapering of these positions. Large ETF outflows in Q4 2016 have slowed so far in 2017 as market participants reassess expectations on US fiscal policy, growth and rates.

US funds allocation by asset class and gold % to total (2011-2016)



We think gold is still underowned relative to other asset classes. Indicatively, gold ETFs and Comex net longs combined made up a combined 0.80% of total AUM of US funds at the peak last year. Despite the increase in gold participation in 2016, the % was still well below the high during the previous bull-run. Gold's correction in Q4 meant that the % fell to around 0.50% by the end of 2016. We think there is room for positions to grow and for the trend of strategic allocation into gold across a diverse set of investors to extend in an environment of macro uncertainty.

Gold consumer demand, tonnes



Seasonal gold demand has generally been encouraging and played a key role in supporting the market. But weak demand trends suggest that fundamentals may not be sufficient to provide the same support as in 2013, if the market was subjected to the same degree of pressure. The persistence of policy uncertainty in key markets such as India and China could additionally constrain physical offtake this year.

Sources for exhibits above: Bloomberg, Comex, Morningstar, Various ETFs, UBS

FX Forecast Table

	Spot	3-month	End-2017	End-2018
EURUSD	1.07	1.08	1.13	1.17
USDJPY	113	113	110	112
EURJPY	122	122	124	131
GBPUSD	1.25	1.19	1.13	1.17
EURGBP	0.86	0.90	1.00	1.00
EURCHF	1.07	1.08	1.11	1.13
USDCHF	1.00	1.01	0.98	0.97
EURSEK	9.49	9.50	9.4 (9.8)	9.2 (9.70)
EURNOK	8.96	9.20	9.30	9.10
AUDUSD	0.76	0.77	0.78	0.80
NZDUSD	0.72	0.73	0.75	0.76
USDCAD	1.33	1.36	1.38	1.34
XAUUSD*	1214	1300	1350	1450

Source: UBS. ‡Values in parentheses represent previous year-end forecasts.
*Year-end Gold forecast represents year average.

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