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FX weekly: Why is EUR/USD not trading lower?

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As we have highlighted over the past weeks, there are good reasons to believe in a stronger USD short-term, but it is yet to materialize. Should the USD bulls be scared, now that the USD has not firmed, despite this list of USD positives?

Table 1: Our current list of convictions

Date	Direction	Trade	Rationale	Low				High*
08-Apr	Long	EUR/PLN	Poland is high beta to weaker Euro area momentum					■
18-Mar	Short	EUR/USD	Excess USD liquidity is shrinking again				■	
25-Feb	Long	USD/CAD	Trade risks and a weak housing market in Canada			■		
11-Feb	Short	AUD/USD	The reflationary long commodity positioning is too strechted				■	
14-Jan	Short	CAD/NOK	Bank of Canada pricing is strechted versus Norges Bank	■				
07-Jan	Short	AUD/CAD	Oil to outperform copper in late US cycle. Positioning in AUD + Copper is stretched			■		

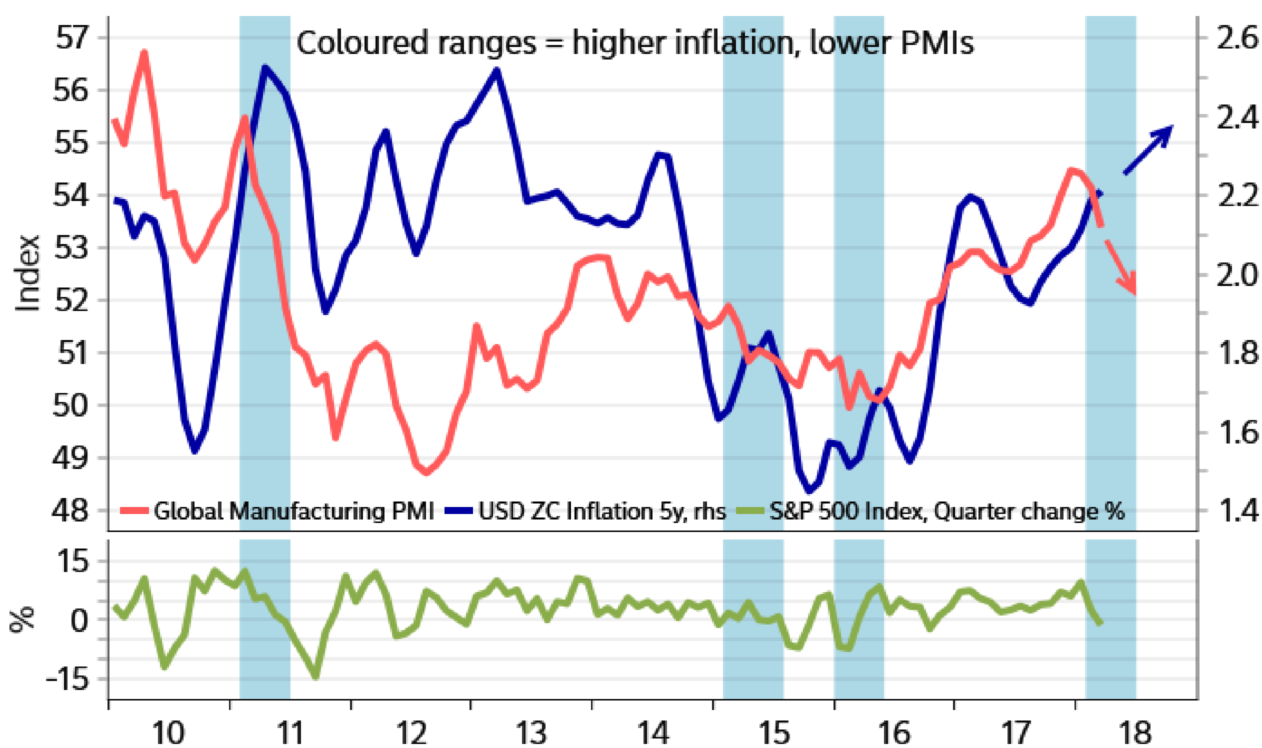
*Low to high conviction of trade

An increasingly stag-flationary environment

The conflict in Syria is hard to predict, but adds to an already long list of negatives that the markets have to cope with. On top of weaker PMI momentum globally, lessening liquidity injections by central banks and growing US inflation pressures, the markets also have to swallow a potential two-fronted geopolitical battlefield now: the risk of trade tensions with China and the risk of an outright escalation of military action against Syria (a proxy conflict with Russia).

The current environment will most likely only work to emphasise the current trends of weakening PMIs and growing inflation pressure (in particular in the US), as oil prices have increased due to tensions in Syria. A period of rising inflation and weakening PMI momentum also preceded the equity market corrections in 2011, 2015 and 2016. It will be interesting to see whether the market is able to shrug off another sentiment negative event, on the heels of the US, French and UK lead bombing mission in Syria on Saturday.

Chart 1: An increasingly stag-flationary environment? Not market friendly news

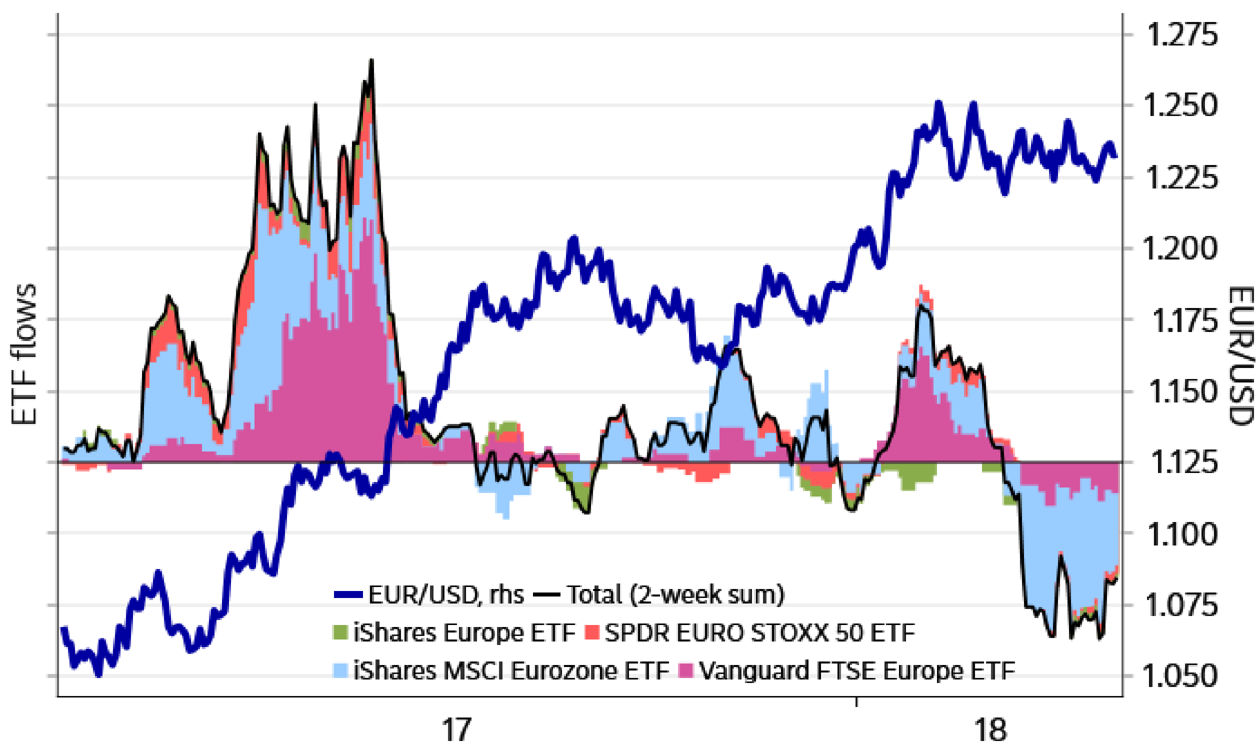


Why is the USD not getting stronger?

But this increasing list of risk sentiment negatives, have also created an environment where one should think that the USD would start to get broadly underpinned. Less USD liquidity due to QT, substantial outperformance by US vs. rest of G10 in the Economic Surprise index, wider US-EA inflation spread, potential USD buying by China in a CNY devaluation etc. The list of USD positives is long (Read FX weekly: The list of potential USD positives is getting longer), but yet EUR/USD has traded more or less sideways 2-3 months in a row now. Why isn't the USD stronger by now?

Since roughly 1st of March the flow picture into Euro area EFTs have started to turn – and while the outflow is nowhere near the size of the equivalent inflow during the EUR-phoric spring and summer of 2017, it still goes to show that the tide has turned somewhat on the positive Euro area market narrative. **But thus far the outflow has not been big enough to prompt a lower EUR/USD.** Could it be that the ETF outflow is not a good proxy of the current allocation flows in general?

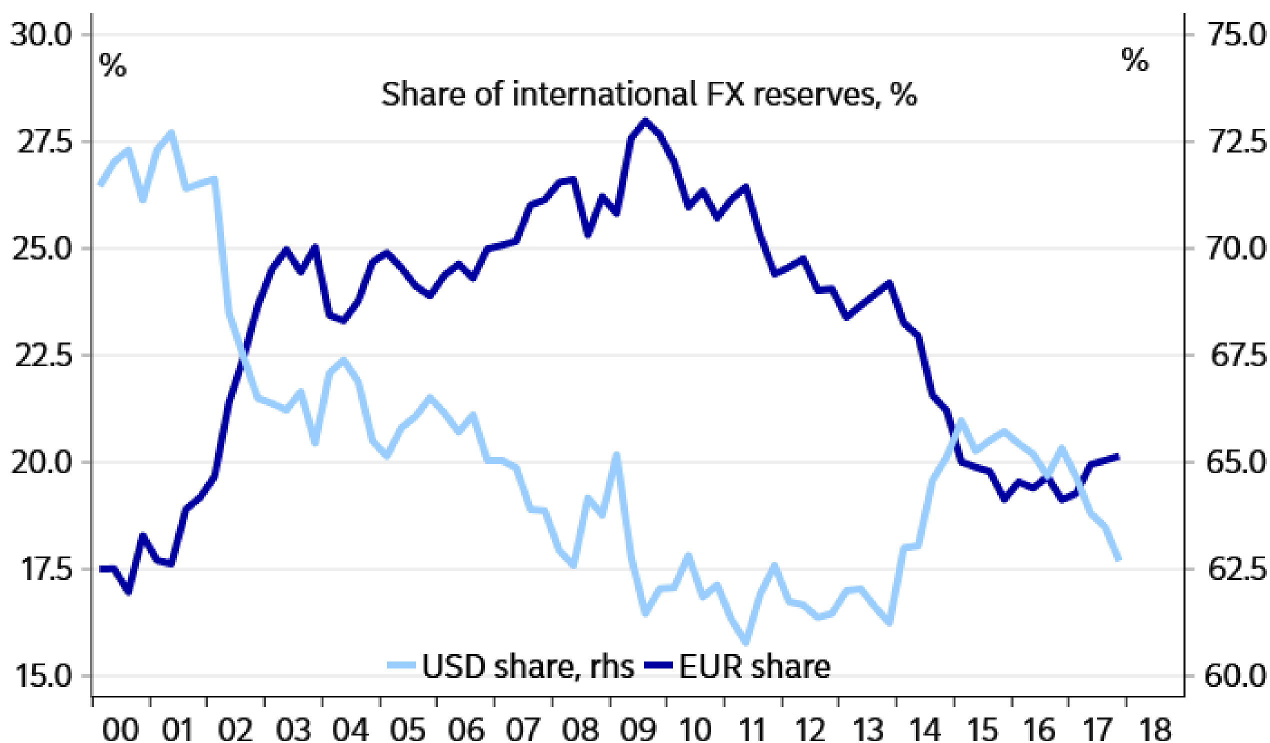
Chart 2: The outflow from Euro area ETFs continue, but EUR/USD is stuck in range



Source: Nordea Markets and Macrobond

Judged from the almost freshly updated IMF COFER data, the USD part of international central bank reserves continued to decrease in Q4-2017. And while these data offer no clues on central bank activity in Q1-Q2 (yet), **more hick-ups than what we have experienced so far is probably needed to turn the tide on the momentum in these flows.** Especially in an environment, where it has been unappealing to buy US Treasuries from an international perspective.

Chart 3: Central banks likely still diversify away from USD



And with last weeks updated 10-year budget projections from the congressional budget office, the question of "who buys the treasuries" will be back on the agenda. In total **the budget deficit is now projected to stand at 4.6% of GDP in both 2019 and 2020.** On top of that, **the Federal Reserve will allow the portfolio of treasuries to shrink by an amount corresponding to 1.5-1.7% of GDP in annualised terms,** when the quantitative tightening reaches peak speed in Q4 this year.

Judged from Fed's flow of funds data, we need to go back to 2015 to find any substantial net purchase of Treasuries by foreigners. And while there are clear limits to the positive effect on US interest rates from the lack of foreign interest in Treasuries, it **is likely one of the most important reasons why the USD has lost momentum.** And there are reasons to expect that this problem for the USD will persist over the coming 3-4 quarters.

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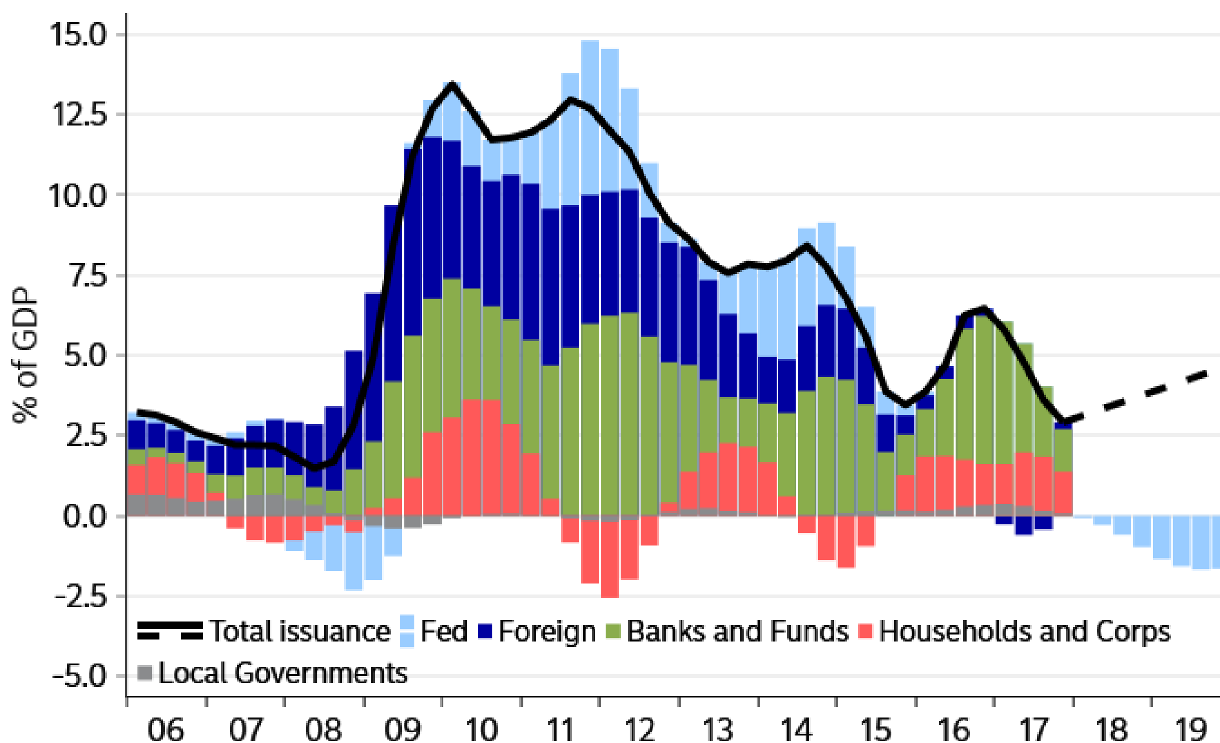
Chart 4: Who buys the treasuries? Since 2016, not foreigners! 4 quarters running, % of GDP



Source: Nordea Markets and Macrobond

The bottom-line is that we stick to our view that the USD will gain some ground in the coming months, as e.g. the inflation-spread will continue to move in favour of the USD versus the EUR. **But technically we need a breach of either 1.2150 on the downside or 1.2650 on the topside** to be really convinced that EUR/USD is out of its recent range.

And long-term the lack of foreign interest in Treasuries and central banks diversifying away from the USD could continue to cause problems for the USD.

Are we closing in on the JPY peak strength?

And while the market risk sentiment remains shaky, the JPY has actually weakened almost 3% in trade-weighted terms since late March. Whereas this shaky market environment in general should be JPY-supportive**, we are about to close in on a peak in one of the important domestic idiosyncratic JPY positives – namely the inflation pressure.**

Judged from the FX impulse, Japanese headline inflation will peak already this month – and the core inflation measures will continue to print far below the 2% mark.

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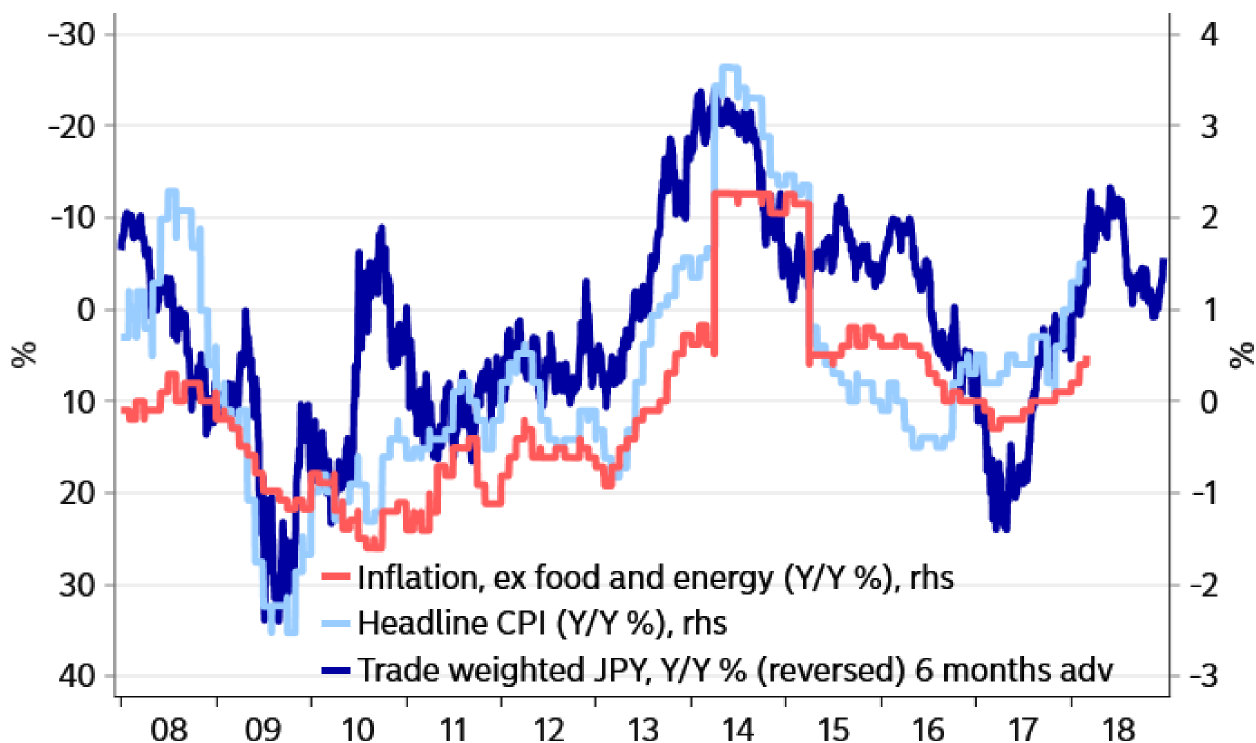
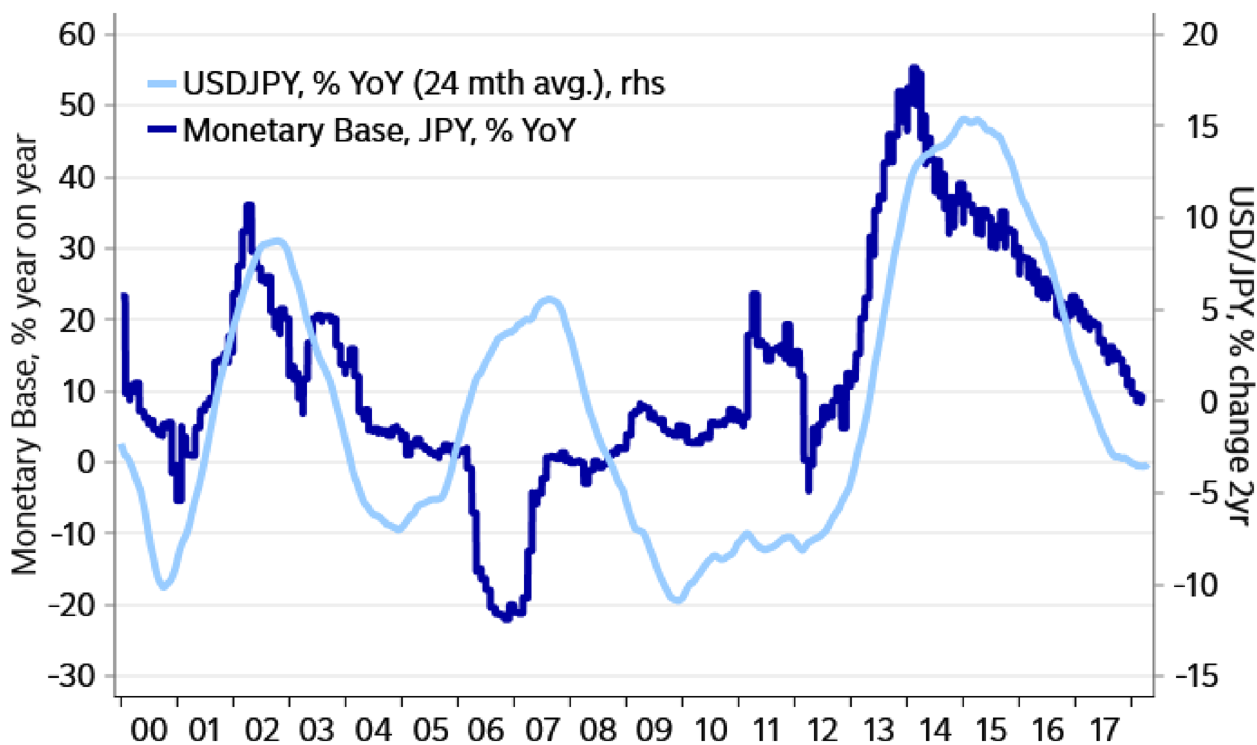
Chart 5: The inflation pressure is close to peaking in Japan



What will happen to Bank of Japans balance sheet once the inflation tide starts to turn again in Japan? Momentum-wise the increasing inflation has eased the pressure on Bank of Japans YCC-programme – and accordingly helped to ease the underlying downwards pressure on the JPY against the USD. Will BoJ have to step up the YCC efforts slightly again, if inflation has peaked? **If so, the peak JPY strength could already behind.**

Chart 6: What will happen to Bank of Japans balance sheet, if inflation has already peaked?



Scandis: A mixed bag of goodies

While the NOK has held up substantially better than the SEK in recent months, we are about to enter a season, where one has to be extraordinarily careful in the assessment of NOK.

The Norwegian dividend season is about to start and most of the big dividends will be paid out from now and until end-May. But the volumes are relatively limited, also compared to the Swedish dividend season, which is about to peak. Net NOK sales due to dividend payments amounts to roughly 5.5bn – so the negative impact on NOK should be contained.

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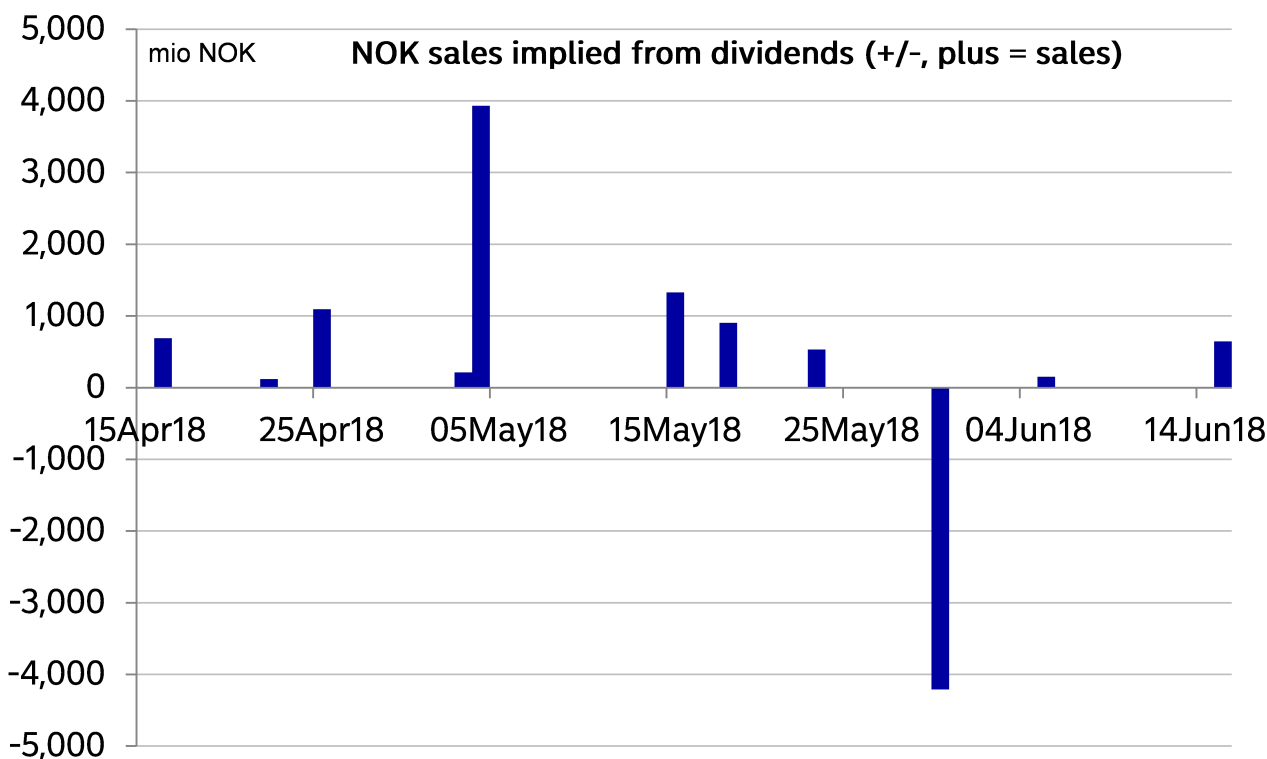
Chart 7: Net NOK sales due to dividend payments amounts to 5,4bn (NOK sales positive in chart)



And while the seasonality could work a bit against the NOK over the coming month in terms of dividends, the opposite is the case judged from the seasonal pattern in Norwegian bank liquidity. The bank liquidity usually remains very tight until mid-May (it could remain very tight all the way until mid-June this year) – and if anything this is usually positive for NOK spot.

So seasonality-wise the coming month is a mixed bag of goodies for NOK, but we maintain a slight positive bias.

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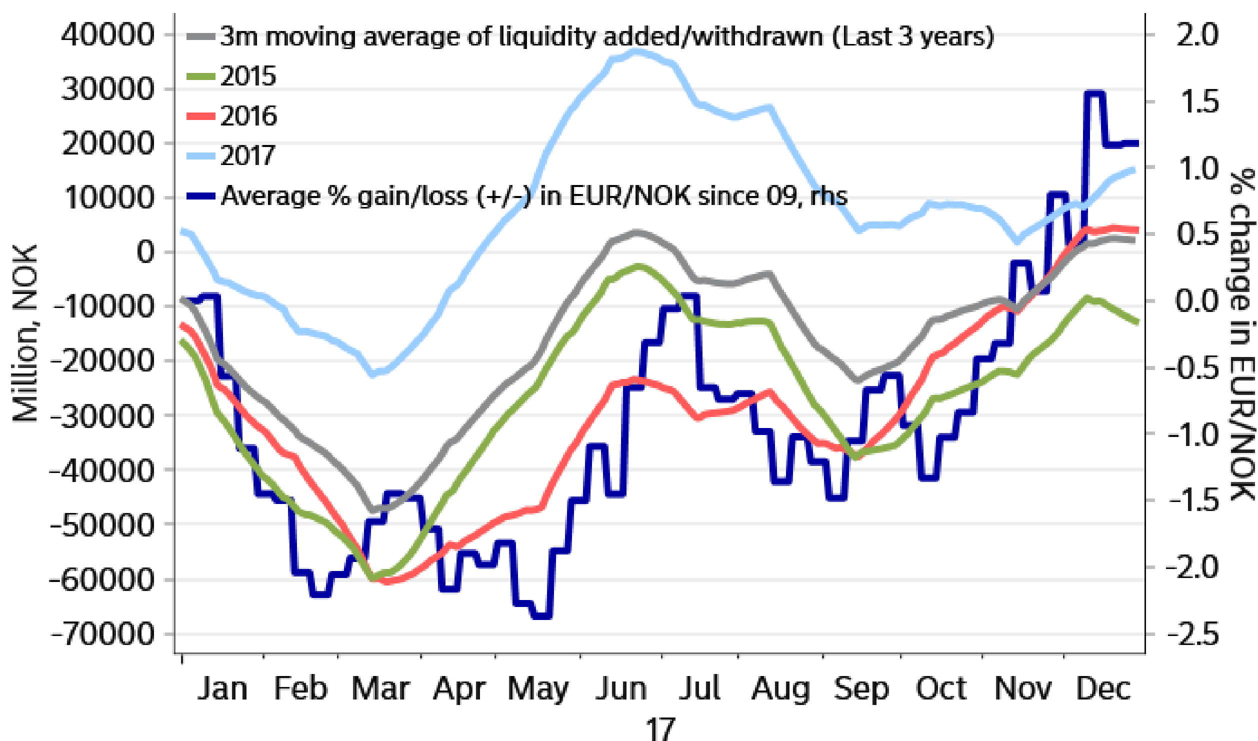
Chart 8: EUR/NOK tends to be correlated with Norwegian bank liquidity



Source: Nordea Markets and Macrobond

In terms of EUR/SEK, we were stopped out on another attempt to play the cross from the short-side. As we wrote last week, a very tight stop/loss around 10.35 was warranted in EUR/SEK, because a lot of technical damage would be done above that level**. Since EUR/SEK broke 10.35 right after a Swedish inflation disappointment last week, the pair has moved towards 10.45 – and there is still an obvious elevated risk of further moves up.** We still judge that the market positioning is LONG in the SEK, in contrast to what one should expect after a period of weak SEK performance. This of course leaves the risk of further corrections high.

But it is not all doom and gloom for SEK. The surprise index is starting to get better in Sweden (usually a weak Krona spills-over to economic momentum after a while) and the SEK is now more or less 6% weaker than the Riksbank anticipated in February. **This will substantially limit the scope for a dovish Riksbank, April 26th.**

But, after a mistimed attempt to short EUR/SEK, we are not convinced that the current market environment is attractive in terms of giving it another shot.

Chart 9: The SEK still tracks the Economic surprise momentum nicely in trade-weighted-terms

Is Chinas reflationary commodity impact behind us?

We have taken some damage to our recommendation to go long the USD versus both CAD and AUD recently. Fading NAFTA tensions and slightly better risk appetite (and decent overall commodity performance) has worked against those bets. **But judged from the Chinese reflationary impulse on e.g. industrial metals, the momentum in commodities could come under pressure during Q2.**

We hence decide to stick to our view of long USD/CAD, short AUD/USD and short AUD/CAD (AUD to be hit more by the less re-flationary environment).

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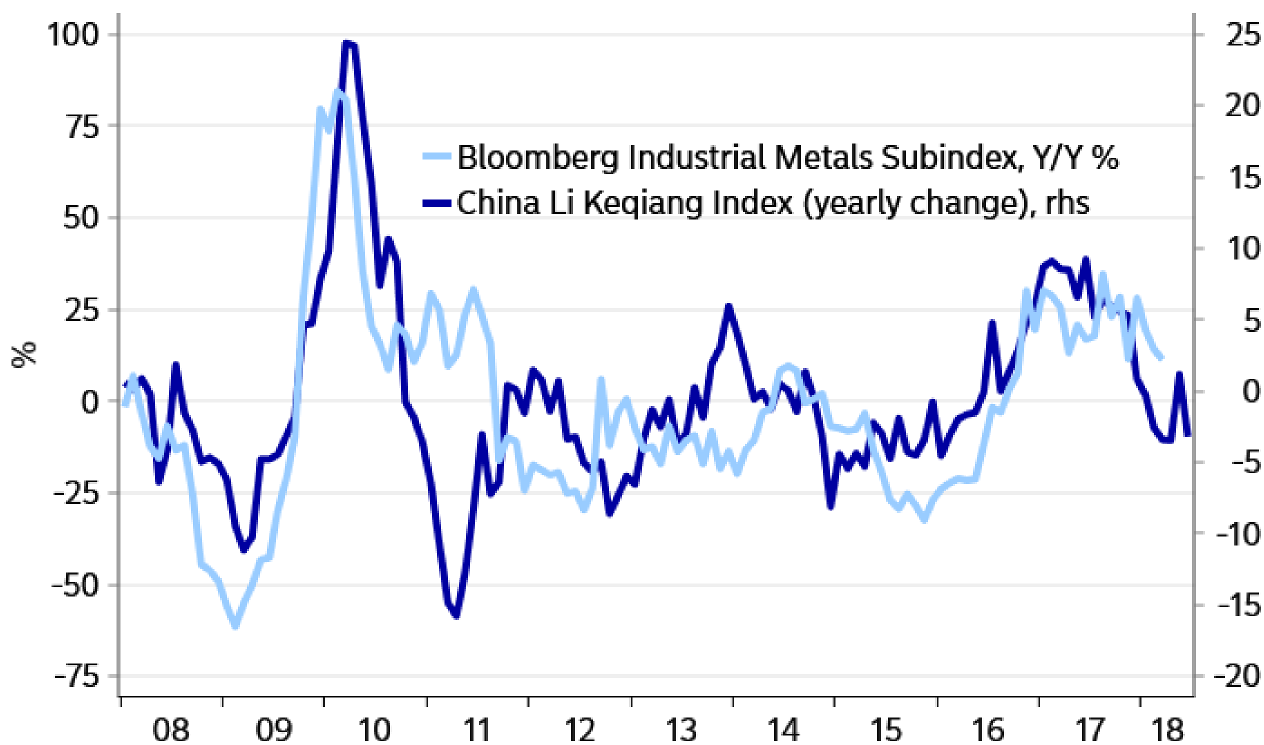
Chart 10: The re-flationary commodity environment should fade in Q2



For a complete list of our financial forecasts - see attached PDF.

Previous FX weeklies:

·FX weekly: Like watching paint dry, they said (08 Apr)

·FX weekly: The list of potential USD-positives is getting longer (01 Apr)

·FX weekly: 2 reasons why EUR/USD has decoupled from rates spreads (25 Mar)

·FX weekly: Time to buy a USD lottery ticket? (18 Mar)

·FX weekly: Taxation mirror on the wall, who is the fairest of them all? (11 Mar)

·FX weekly: Trump's game of chicken (04 Mar)

·FX weekly: Will the market neglect the clutch of canaries? (25 Feb)

·FX weekly: Is the correlation break-down driven by FX hedges? (18 Feb)

·FX weekly: The liquidity tide is ebbing (11 Feb)

·FX weekly: Hawkish spectacles (04 Feb)

·FX weekly: Who will stop EUR/USD from moving higher? (28 Jan)

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·FX weekly: Did the Democrats dent the Dollar? (21 Jan)

·FX weekly: Is 1.25 the new 1.20? (14 Jan)

·FX weekly: The euphoria rises (07 Jan)

·FX weekly: Paging Dr. Pangloss (01 Jan)

·FX weekly: The R-star of Bethlehem (24 Dec)

·FX weekly: A numbers game (17 Dec)

·FX weekly: The year-end liquidty shrink (10 Dec)

·FX weekly: Three reasons why EUR/USD isn't trading lower (03 Dec)

·FX weekly: Which currencies to sell if the housing downturn continues? (26 Nov)

·FX weekly: The global industrial cycle is set to weaken (19 Nov)

·FX weekly: Is high-yield a canary in the global coal mine? (12 Nov)

·FX weekly: Is this the end of the inflation convergence trade in EUR/USD? (5 Nov)

·FX weekly: Was that it for the EUR bulls? (29 Oct)

·FX weekly: Hawks in opposition, doves in charge (22 Oct)

· FX weekly:Continued convergence or re-divergence?(15 Oct)

·FX weekly: Thingsdon't matter until they do(08 Oct)

·FX weekly:"October seasonality is strong" (01 Oct)

·FX weekly:"Is 1.20 the new 1.15?"(24 Sep)

· FX weekly:Honey, I shrunk the balance sheet(17 Sep)

· FX weekly: "USD liquidity will turn scarcer, but when?" (10 Sep)

· FX weekly:"Strong currencies and inflation"(3 Sep)

· FX weekly:"USD in the (Jackson) hole" (27 Aug)

· FX weekly:"Q4 is the USD quarter"(20 Aug)

· FX weekly:"In the year 2525"(13 Aug)

· FX weekly:"EUR/USD ceiling or debt ceiling?"(6 Aug)

· FX weekly:"Elevator up, stairs down "(30 Jul)

· FX weekly:Trump "spices" up EUR/USD(23 Jul)

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· FX weekly:Flip-flop?(16 Jul)

· FX weekly:Consolidation time?(9 Jul)

· FX weekly:Hawks R Us(2 Jul)

· FX weekly:Another lowflation week?(25 Jun)

· FX weekly:No Fed put?(18 Jun)

· FX weekly:A bouncy dollar?(11 Jun)

· FX weekly:Heating up(4 Jun)

· FX weekly:Summertime sadness(28 May)

· FX weekly:Special counsel lessens Trumpbulence, while OPEC looms(21 May)

· FX weekly:Are China worries old hat?(14 May)

· FX weekly:Inflation week...(7 May)

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